A clear vision
Annual report insights 2016
The full details
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Executive summary
Executive summary

Maintaining a clear vision
The objective of making reports and accounts clear and concise is becoming harder to achieve. And despite everyone’s best efforts the size of annual reports and accounts grows inexorably year on year. Every year this survey shows that reports are getting longer, this year by an extra eight pages.

The focus should be on producing better information rather than simply more of it. This is not an easy ask against the ever growing demands for more disclosure. For example 2015 reports had to include a full list of subsidiaries and other associated companies rather than just their principal ones and for 2016 this statutory requirement is further supplemented with the disclosure of registered office addresses, no doubt resulting in yet more pages of data in the annual reports.

The tide shows no sign of turning. Investors want more transparency on tax and dividend policy for example. The FRC’s thematic review on tax and its Financial Reporting Lab’s on dividend policy are starting to focus companies’ attention on these two areas of public and investor interest. 38% of companies in our survey chose to provide information on distributable reserves in their financial statements, but thus far only 10% included detailed information on tax governance in their strategic report. As more companies are engaging in the broader debate around the social licence to operate we are seeing more examples of companies explaining the broader contribution they make to society and the broader impact they have, with 49% including a cross reference to where further corporate responsibility (CR) information could be found, compared to the 34% who did so in 2015.

Integrated reporting
<IR> by focusing on the long-term value creation is often seen as a useful framework to explain a company’s broader contribution and impact. 71% of companies in our survey are now telling their value creation story compared with 54% in the previous year; furthermore 33% discussed how they were creating value for a variety of stakeholder groups. UK companies are using the principles and ideas of <IR> to innovate rather than following the IIRC framework dogmatically. For example, the number of companies presenting information similar to <IR> capitals when discussing their business model is up from 53% to 70% in the year and 23% provided a meaningful discussion of corporate culture, an area where the FRC are currently undertaking a project.

Eight companies in our sample described their report as an integrated report, but regardless of whether they were described as such we certainly found good examples of integrated thinking shining through. Authenticity is what really puts clear blue water between one report and another.

Changing course over the past year
There was much change over the past year. On the accounting side many parent companies bade farewell to old UK GAAP, in most cases transitioning across to FRS 101, the IFRS-based reduced disclosure framework. And the 2014 Corporate Governance Code and its accompanying guidance on risk and internal controls was the main change to take effect, including the new statement on longer-term viability.
Most companies went for a three year lookout period, but only 48% of companies gave detail on qualifications to, or assumptions made in their analysis. Alongside this companies had to provide a new statement that directors had made a robust assessment of principal risks. 85% did so, but disappointingly out of these 12% did not provide a description of risk management processes that would corroborate this assertion; also, only 63% disclosed how risk appetite had been incorporated into their risk assessment process.

**Recognising the risks surrounding cyber security**
Cyber security was clearly seen as a risk on the near horizon. 79% of FTSE 100 companies surveyed discussed the board’s approach to dealing with this threat, though smaller companies took a more sanguine view, with 59% of FTSE 250 and only 12% of those outside the FTSE 350 including such a discussion.

**The effects of Brexit**
Only 16% of companies in the survey had identified a potential Brexit as a principal risk in their last annual report (being 2015 year-ends). With the referendum decision and the FRC reminders of the need to update the assessments around principal risks and uncertainties we should see a somewhat different picture in 2016. Reports will be expected to reflect the ability to navigate possibly difficult and choppy waters.

**Looking to the horizon**
Along with Brexit there are many issues for preparers to navigate both in the immediate future and in the years ahead.

Alternative Performance Measures (APMs) feature greatly in UK reports and the biggest step-change for 2016 year-ends will be the ESMA Guidelines on this. Historically the UK regulator has been perhaps more accepting than some other regulators of their presence, but with the ESMA Guidelines now fully effective the FRC has made it clear that they will consider material non-compliance with those Guidelines when assessing whether the strategic report complies with the law and thus is fair, balanced, and comprehensive. We looked at the presence of APMs in the summary sections, which is often indicative of companies’ use of APMs. Of those presenting APMs in the summary section, 72% failed to give equal or greater prominence to corresponding GAAP measures, 63% failed to provide clear reconciliations and 13% failed to provide comparative figures.

And there is also change ahead on the audit committee front as companies look to apply the 2016 Code and the revised accompanying guidance, although it is not effective until periods beginning on or after 17 June 2016. The survey shows that only 12 companies give the ratio of audit to non-audit fees. This is now a recommendation of the Guidance on Audit Committees, and only 35 companies had a relatively full description of their non-audit services policy. Where it was clear from the report that the auditor provided significant non-audit services, in only 28% of cases was there a clear description of the safeguards in place, despite the fact that this has been a recommendation for some time and is at least hinted at in the wording within the Code.

There will also be a focus on internal audit as a result of renewed attention in the new Guidance on Audit Committees. Only 41% of our sample of companies described clear reporting lines to the audit committee and so demonstrated independence from management. And only 34% described the internal audit plan being set with reference to the principal risks of the business, as is recommended by the Guidance on Risk Management, Internal Control and related Financial and Business Reporting.

With three important new IFRS standards on the way, IFRS 9 on financial instruments, IFRS 15 on revenue and IFRS 16 on leases, further disclosures about their expected impact will have to be made. Regulators and investors will be looking for quantification of the impact and, as a minimum, entity specific and detailed qualitative disclosures.

**Setting a safe course ahead**
Now is the time, ahead of the reporting season, to make sure everything is properly ship-shape and sea-worthy. This report has been designed with that objective clearly in view. Its insight and examples aim to help preparers develop a clear vision for their own annual reports and to help the annual report continue as the anchor of communication with investors, delivering a clear vision of a business to its readers.
How to use this document
How to use this document

This publication has been written with the overriding aim of providing you, the user, with insight into current best practice in annual reporting so that you can take advantage of this knowledge and make your own report as effective as possible. It has a specific focus on areas of regulatory change, as well as those that have been highlighted by regulators and investors where companies can do better – chapter 3 and the introductions to each chapter provide an overview of these. Therefore, whether you are an audit committee member, a company secretary or a finance director; work in investor relations or the finance department, there is something in here for you.

The publication is based upon an extensive survey of the annual reports of 100 UK listed companies – see appendix 1 for details. As a result it is packed with insight into historical trends that will allow you to benchmark your own report against our sample, along with plenty of examples of good practice identified from companies across the FTSE.

In our accompanying guide Planning your report we have distilled the key pitfalls to avoid, regulatory developments to watch out for, ideas for making your report stand out and ways to ensure that it is clear and concise.

What are the benefits of a good annual report?
As one of the most important opportunities for a company to communicate with its stakeholders, the quality of its annual report helps to shape a company’s reputation. And reputation is something that companies ignore at their peril – according to the 2016 UK Reputation Dividend Report¹, corporate reputations represented 38% of the FTSE 100’s market capitalisation and 25% of the FTSE 250’s. Therefore, the bottom line is simple – a good quality annual report can increase the value of a company. But there are other reasons to produce a high-quality report as well.

- As well as attracting investment, a strong annual report will provide good publicity with other stakeholders too, whether it be employees, customers, suppliers or society at large.
- The directors are responsible for preparing an annual report, including the financial statements, and are required by the UK Corporate Governance Code to state that they consider the annual report and the accounts, taken as a whole, to be “fair, balanced and understandable”. A strong report will therefore reflect well on the quality of a company’s governance.
- Prizes are awarded by a number of bodies for the best annual reports, bringing with them further prestige and good publicity.
- The Financial Reporting Council’s Conduct Committee monitors the quality of corporate reporting in the UK and investigates reports that it thinks may be defective. For obvious reasons it is desirable to avoid criticism from the regulator and the bad publicity this can bring.

Which parts of this document are most relevant to me?
The table overleaf will help you to identify those areas of the publication likely to be of most interest to you. As well as our thoughts and findings, all of the chapters listed below contain links to further guidance and examples of good practice taken from real life annual reports.

One of the focus areas of our surveying this year is the extent to which companies are applying the principles of integrated reporting. However, rather than having a separate chapter on this, our findings have been integrated into each of the chapters that make up the report.

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<td><strong>Annual report as a whole</strong></td>
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<td>Overall impressions Trends in overall report structure, from the length of the report and its various sections to the speed of reporting timetables and the cohesiveness of the report as a whole.</td>
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<td></td>
<td>5.</td>
<td>Summary material How companies set the scene with an introductory summary section, covering the presentation of both financial and narrative information and the ways of linking this effectively to the rest of the report. A particular focus area this year is the presentation of alternative performance measures in the summary material.</td>
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<td>6.</td>
<td>Strategic report Disclosures in the strategic report, including the business model, objectives, strategy, presentation of business performance. Also covers corporate responsibility information such as diversity information, anti-bribery and corruption policies and human rights issues.</td>
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<td>7.</td>
<td>Key performance indicators The types of measure identified as KPIs, how they are presented and the quality of linkage to other areas, such as directors’ remuneration.</td>
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<td>8.</td>
<td>Principal risks and uncertainties The effect of the adoption of the 2014 UK Corporate Governance Code on risk reporting. Also examines the risk areas commonly identified as principal, the level of detail given and ways of presenting the information effectively, including linking it to other parts of the annual report.</td>
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<td>9.</td>
<td>Going concern and viability statements The assessment and reporting of going concern and the way in which companies have complied with the requirements regarding the new viability statement.</td>
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<td>10.</td>
<td>Corporate governance The quality of disclosure given by companies regarding their compliance with the 2014 UK Corporate Governance Code, including explanations for areas of non-compliance.</td>
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<td>11.</td>
<td>Nomination committee reporting The work of the nomination committee, including the consideration given by companies to succession planning and consideration of corporate culture.</td>
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<td>12.</td>
<td>Audit committee reporting Insight into best practice around audit committee reporting, in particular the discussion of significant issues the committee has considered in connection with the financial statements and oversight of the external audit relationship.</td>
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<td>13.</td>
<td>Primary statements The way in which companies present information in their primary statements, in particular the use of non-GAAP measures.</td>
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<td>14.</td>
<td>Notes to the financial statements Key findings from reviewing the notes to the financial statements, including ideas for making them clearer and more concise by improving accounting policy disclosures and ensuring consistency with narrative reporting.</td>
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Regulatory overview
When preparing their annual reports, UK listed companies have to follow requirements and guidance from many different sources. These require or suggest not just what should be included in the report but also how it should be presented. Some of the most significant requirements arise from:

- the Companies Act 2006 and supporting statutory instruments (the Act);
- the Listing Rules (LR);
- the Disclosure Guidance and Transparency Rules (DTR);
- the UK Corporate Governance Code (the Code); and
- International Financial Reporting Standards (IFRSs).

Companies also need to pay attention to regulatory pronouncements from bodies such as the Financial Reporting Council (FRC), the Financial Conduct Authority (FCA) and the European Securities and Markets Authority (ESMA). While not mandatory, application of the International Integrated Reporting Council’s (IIRC) Integrated Reporting (<IR>) Framework is also becoming more prevalent.

This chapter sets out a brief overview of the key developments that management teams will need to bear in mind when preparing their annual reports for 2016 and beyond, as well as highlighting current areas of regulatory focus. More detail on these is given in the introduction to each of the chapters of this document. The information contained in this publication is not exhaustive – other publications produced by Deloitte, such as GAAP: UK reporting and GAAP: Model annual report and financial statements for UK listed groups, provide comprehensive information on all of the requirements, with the latter publication presenting a model annual report for a UK listed group. In addition, information on the latest developments, including news articles, thought pieces and supporting resources, can be found on Deloitte’s one-stop-shop for all accounting, governance and regulatory matters – www.ukaccountingplus.co.uk. Where specific developments have been discussed below we have included hyperlinks to the associated pages on UK Accounting Plus, which include Deloitte publications designed to help you understand how these changes will affect you.

The centrepiece of the Clear & Concise project is the FRC’s Guidance on the Strategic Report (the ‘FRC Guidance’), issued in 2014, which is referred to throughout this publication. This document sets out a wealth of guidance for companies on how to communicate effectively within their strategic report, as well as how to link it meaningfully to other parts of the report. In December 2015, the FRC published Clear & Concise: Developments in Narrative Reporting, which examined the impact of the FRC’s Clear & Concise initiative in general and the FRC Guidance in particular. It concluded that companies are taking on board the objectives of the FRC’s Clear & Concise initiative and the overall quality of corporate reporting has improved since the introduction of the strategic report, although opportunities for further improvement still exist.

Since we published our last annual report insights survey, the Financial Reporting Lab has issued two new publications:

- Disclosure of dividends – policy and practice (November 2015), which responds to the significant interest expressed by investors in the quality of disclosure made by companies about their planned dividend payments and the resources available for this purpose; and
- The Components of Digital Reporting (June 2016), which examines some of the key findings from the previous Lab report Digital Present (May 2015) and links these to its upcoming Digital Future project.

Areas of regulatory focus have been identified from a variety of sources, but in particular the FRC’s Corporate Reporting Review, Annual Report 2015.
At the time of writing, the Lab is also currently undertaking projects in the following areas:

- **Business model reporting** – a project exploring several characteristics of business models including how various groups define a business model, the way in which business model disclosures are prepared, how investors use business model disclosures and what good business model reporting looks like; and

- **Digital Future: Data** – a project that will look at how the use of technology to communicate corporate reporting to the investment community might evolve, by investigating the effect of technology trends and the potential transformation of reporting formats.

In June 2015 the FRC began the second phase of its Smaller listed and AIM company reporting project with the publication of its discussion paper *Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies*. This set out the FRC’s findings from the first (data gathering) stage of its project and its proposals to address the challenges faced by smaller listed and AIM-quoted companies. In June 2016 the FRC published *Update on the discussion paper: Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies*, which provides an overview of the feedback received to the Discussion Paper and summarises the FRC’s progress against the proposals that it contained. Throughout our survey we highlight areas where, from our survey data, it appears that companies outside the FTSE 350 struggle in their reporting.

As well as the work of the FRC to improve corporate reporting in the UK, the impact of Integrated Reporting (<IR>) on the UK reporting landscape continues to grow. Since the publication of the <IR> Framework in December 2013, companies have gradually began to adopt more and more of the principles set out in the Framework when putting together their annual reports, recognising the value that this gives to investors. In support of the Framework, the IIRC has published various research reports highlighting the practical outcomes of adopting <IR> in its Creating Value series. The most recent reports in this series are:

- **Integrated Reporting and investor benefits**, published in December 2015, which highlights the increasingly compelling evidence on the value of <IR> for investors

- **The value of human capital reporting**, published in June 2016, which highlights the value of reporting on human capital, sharing some of the developments and experimentation taking place in this area.
### UK corporate reporting - timeline of key changes
**Effective for periods commencing on or after***:

<table>
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<tr>
<th>1 January 2015</th>
<th>1 January 2016</th>
<th>June/July 2016</th>
<th>1 January 2017</th>
<th>1 January 2018</th>
<th>1 January 2019</th>
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<td>CMA FTSE 350 audit tendering changes</td>
<td>New Accounting Regulations and corresponding changes to UK GAAP</td>
<td>17 June – New EU Audit Regulation and 2016 UK Corporate Governance Code, including auditor rotation rules</td>
<td>EU non-financial reporting directive</td>
<td>New IFRS for financial instruments</td>
<td>New IFRS on lease accounting</td>
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<td>New UK GAAP</td>
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<td>3 July – ESMA Guidelines on Alternative Performance Measures*</td>
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<td>New IFRS on revenue recognition</td>
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*The ESMA Guidelines are effective for documents issued on or after 3 July 2016, regardless of the accounting period.

### Other significant initiatives

1. FRC's Clear & Concise initiative and Smaller listed and AIM company reporting project
2. IIRC Integrated Reporting Framework
3. IASB disclosure initiative
4. IASB conceptual framework project
5. Financial Reporting Lab projects on business models and digital reporting
6. IASB project to develop a new insurance standard
Narrative reporting
This past year, the most significant development in narrative reporting was the changes to risk reporting requirements brought about by companies adopting the 2014 UK Corporate Governance Code. While some companies made only the minimum changes necessary to their reports in order to comply with the new requirements, others took it as an opportunity to revise their risk reporting more substantially.

Existing requirements
Other than for small companies, which are exempt, the main component of the narrative section of an annual report is the strategic report, which was introduced in 2013 by section 414A of the Companies Act 2006. Companies are also required by section 415 of the Act to include a directors’ report, although since the introduction of the strategic report this contains mainly basic compliance disclosures.

The strategic report is required to include:
- a fair review of the company’s business, including (for quoted companies) elements such as a description of the company’s business model, its strategy and information about corporate social responsibility (see chapter 6 for more details);
- to the extent necessary for an understanding of the development, performance or position of the company, analysis using financial and, where appropriate, non-financial key performance indicators (KPIs) (see chapter 7 for more details); and
- a description of the principal risks and uncertainties facing the company. There have been some noteworthy developments in risk reporting this year, as a result of companies adopting the 2014 version of the UK Corporate Governance Code (see chapter 8 for more details).

Many companies have also chosen to present the new longer-term viability statement and revised going concern disclosures required by the 2014 Code as part of their strategic report (see chapter 9 for more details).

The FRC Guidance includes a lot of information for companies on how to present the content requirements of the strategic report most effectively. The <IR> Framework also gives guidance on reporting requirements that will be helpful to UK companies. However, the <IR> Framework goes further than this, introducing the concept of ‘Integrated Thinking’ – challenging and enabling companies to ‘live their story’ rather than merely tell it. <IR> is discussed in more detail throughout this report – look out for the <IR> boxes.

New requirements
The most significant new narrative reporting requirement that listed companies will have to deal with in their 2016/17 annual reports is ESMA’s Guidelines on Alternative Performance Measures. These Guidelines apply to a variety of documents but, in particular, include within their scope the narrative sections of annual reports (but not the financial statements themselves). Although they are described as ‘Guidelines’, ESMA has stated that they expect compliance with them to be enforced by national regulators. In a UK context the FRC has issued ESMA Guidelines on Alternative Performance Measures: Frequently Asked Questions, which indicate that they will be considering material inconsistencies with the ESMA Guidelines as part of the activities of their Conduct Committee i.e. reviews of company annual reports. Deloitte has produced a practical guide to the ESMA Guidelines to assist preparers in complying with the new requirements.

The Guidelines apply to documents published on or after 3 July 2016, so are already in force. They set out a framework for the presentation of Alternative Performance Measures (APMs), also known as non-GAAP measures, aimed at promoting their usefulness and transparency. In particular, they require that:
- APMs should be defined and the basis of calculation set out;
- APMs should be reconciled to the most directly reconcilable line item, subtotal or total presented in the financial statements;

5 http://www.iasplus.com/en-gb/publications/uk/need-to-know/2016/ntk-apms
• APMs should not be displayed with more prominence, emphasis or authority than the most directly comparable measure defined by the entity’s financial reporting framework;

• APMs should be accompanied by comparatives for the corresponding previous period; and

• APMs should be consistent over time, with changes in or the cessation of use of an APM explained.

Our findings on the presentation of APMs are discussed in chapters 5 (in relation to use of APMs in summary material) and 7 (in relation to the presentation of KPIs).

Areas of regulatory focus
The following areas of regulatory focus have been identified in relation to narrative reporting.

• Making the report (being both the narrative and the financial statements) clear and concise. Measures such as removing immaterial information and making effective use of cross-references to avoid duplication can help preparers meet this challenge. Companies should consider whether initiating a ‘Clear and Concise review’ would be beneficial.

• Presentation of non-GAAP measures is likely to be a significant focus area given the new requirements introduced by the ESMA Guidelines. In addition, the identification of items excluded from non-GAAP measures (often described as ‘exceptional items’) is also likely to be an area of continued focus – see the financial statements section of this chapter for more detail.

• The business review included within the strategic report should be fair, balanced and comprehensive. This includes balancing analyses that use non-GAAP measures with analyses that use unadjusted metrics, ensuring discussions of performance and position are suitably comprehensive and not omitting ‘bad news’. Companies should also ensure that they cover all relevant aspects of both financial position and performance in this review.

• Identification of principal risks and uncertainties. Companies should ensure that the risks and uncertainties disclosed are genuinely principal and make sure they discuss how risks are managed or mitigated.

• Identification of key performance indicators (KPIs). Companies should consider whether ratios that are discussed prominently in the strategic report should be identified as KPIs, and that where non-GAAP measures are identified as KPIs the information required by the ESMA Guidelines is given.

• The linkage and consistency of the information included in the ‘front half’ and ‘back half’ of the annual report. Companies should ensure that there is cohesion between the information reported and effective linkage throughout the annual report. For example, consistency would be expected between the items identified as part of capital when discussing capital management in the front and back halves of the report. Similarly, the description of reconciling items in a company’s tax note should be consistent with discussions in the strategic report.

• Compliance with the Companies Act requirements regarding employee numbers and greenhouse gas emissions. The Act is quite prescriptive regarding the content of these disclosures so companies should ensure that they are providing the correct information.

On the horizon
The only forthcoming change to narrative reporting is the UK implementation of the EU Directive on disclosure of non-financial and diversity information. Various consultations on other additional reporting requirements for companies (Closing the Gender Pay Gap and Improving Large Business Tax Compliance) have concluded that the information they are proposing should be provided in a separate document, rather than as part of a company’s annual report. However, where issues in this regard are material to the business, companies will need to consider whether disclosure should also be provided to meet the above requirements of the strategic report.

2016 is also the first year that companies will need to be publishing a slavery and human trafficking statement, as required by the Modern Slavery Act 2015. This is a statement outside of the annual report, although again companies should also consider whether this needs to be mentioned in the strategic report (34% of the companies we surveyed this year did – see chapter 6).

The EU Directive on disclosure of non-financial and diversity information has yet to be transposed into UK law, despite EU law requiring it to become effective for financial years beginning on or after 1 January 2017. It will apply to all companies that are:

- public-interest entities, as defined by EU law (which includes all companies with debt or equity listed on a regulated market, such as the LSE main market); and
- parents of a group with more than 500 employees.

For large listed companies, it will build on existing diversity disclosure requirements so that such companies will also be required to provide information on their diversity policy, covering age, gender and educational and professional background in their corporate governance report.

Also, it will introduce a specific requirement to disclose information on anti-corruption and bribery matters, including related policies. The government consulted on its implementation in the UK in February 2016 but is still deliberating on how to address the comments received.

Corporate governance
This past year the revised 2014 version of the UK Corporate Governance Code (the ‘2014 Code’) and supporting Guidance on Risk Management, Internal Control and Related Financial and Business Reporting became effective, bringing in changes to the requirements around governance reporting as well as the changes to risk reporting and the new viability statement discussed earlier in this chapter.

Existing requirements
Listed companies are required by the Listing Rules to make certain disclosures about corporate governance in their annual reports. Companies with a premium listing are required to state how they have applied the main principles set out in the UK Corporate Governance Code (the Code), in a manner that would enable shareholders to evaluate how the principles have been applied, and a statement of compliance with all relevant Code provisions, identifying provisions that have not been complied with and providing reasons for this non-compliance. During the period covered by this year’s survey companies had to report on their compliance with the 2014 Code, which is supported by the associated FRC documents Guidance on Risk Management, Internal Control and Related Financial and Business Reporting and the 2012 version of the Guidance on Audit Committees, both of which recommend various disclosures for inclusion in the annual report.

The main components of a company’s corporate governance report are:

- a report on how the company has applied the main principles of the Code, including or cross-referring to the internal control statement and the statement of compliance with the Code, often with an introduction from the chairman (see chapter 10 for more details);
- a report on the work of the audit committee, in particular its oversight of the preparation of the financial statements and the significant issues considered, as well as its oversight of the auditor relationship, including effectiveness, tendering requirements and non-audit services (see chapter 12 for more details); and
- reports from the other significant board committees, in particular the nomination committee (see chapter 11 for more details) and the remuneration committee.

Quoted companies reporting under the Act are also required to include a directors’ remuneration report. The remuneration report must contain a statement by the chair of the remuneration committee telling the story of the year in respect of remuneration. Following this the report is split into a policy report (not subject to audit) and an annual report on remuneration (some elements of which are subject to audit). The policy report is subject to a binding shareholder vote every three years, or whenever the policy is to change. The annual report on remuneration is subject to an annual advisory vote and includes a ‘single figure’ required by the Modern Slavery Act 2015. This is a statement outside of the annual report, although again companies should also consider whether this needs to be mentioned in the strategic report (34% of the companies we surveyed this year did – see chapter 6).

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The EU Directive on disclosure of non-financial and diversity information has yet to be transposed into UK law, despite EU law requiring it to become effective for financial years beginning on or after 1 January 2017. It will apply to all companies that are:

- public-interest entities, as defined by EU law (which includes all companies with debt or equity listed on a regulated market, such as the LSE main market); and
- parents of a group with more than 500 employees.

For large listed companies, it will build on existing diversity disclosure requirements so that such companies will also be required to provide information on their diversity policy, covering age, gender and educational and professional background in their corporate governance report.

Also, it will introduce a specific requirement to disclose information on anti-corruption and bribery matters, including related policies. The government consulted on its implementation in the UK in February 2016 but is still deliberating on how to address the comments received.

Corporate governance
This past year the revised 2014 version of the UK Corporate Governance Code (the ‘2014 Code’) and supporting Guidance on Risk Management, Internal Control and Related Financial and Business Reporting became effective, bringing in changes to the requirements around governance reporting as well as the changes to risk reporting and the new viability statement discussed earlier in this chapter.

Existing requirements
Listed companies are required by the Listing Rules to make certain disclosures about corporate governance in their annual reports. Companies with a premium listing are required to state how they have applied the main principles set out in the UK Corporate Governance Code (the Code), in a manner that would enable shareholders to evaluate how the principles have been applied, and a statement of compliance with all relevant Code provisions, identifying provisions that have not been complied with and providing reasons for this non-compliance. During the period covered by this year’s survey companies had to report on their compliance with the 2014 Code, which is supported by the associated FRC documents Guidance on Risk Management, Internal Control and Related Financial and Business Reporting and the 2012 version of the Guidance on Audit Committees, both of which recommend various disclosures for inclusion in the annual report.

The main components of a company’s corporate governance report are:

- a report on how the company has applied the main principles of the Code, including or cross-referring to the internal control statement and the statement of compliance with the Code, often with an introduction from the chairman (see chapter 10 for more details);
- a report on the work of the audit committee, in particular its oversight of the preparation of the financial statements and the significant issues considered, as well as its oversight of the auditor relationship, including effectiveness, tendering requirements and non-audit services (see chapter 12 for more details); and
- reports from the other significant board committees, in particular the nomination committee (see chapter 11 for more details) and the remuneration committee.

Quoted companies reporting under the Act are also required to include a directors’ remuneration report. The remuneration report must contain a statement by the chair of the remuneration committee telling the story of the year in respect of remuneration. Following this the report is split into a policy report (not subject to audit) and an annual report on remuneration (some elements of which are subject to audit). The policy report is subject to a binding shareholder vote every three years, or whenever the policy is to change. The annual report on remuneration is subject to an annual advisory vote and includes a ‘single figure’ required by the Modern Slavery Act 2015. This is a statement outside of the annual report, although again companies should also consider whether this needs to be mentioned in the strategic report (34% of the companies we surveyed this year did – see chapter 6).

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Also, it will introduce a specific requirement to disclose information on anti-corruption and bribery matters, including related policies. The government consulted on its implementation in the UK in February 2016 but is still deliberating on how to address the comments received.
Some companies have also chosen to present the new statements on the robust assessment of principal risks, longer-term viability, and the revised going concern disclosures required by the 2014 Code as part of their corporate governance report, although the majority have presented these as part of their strategic report (see chapters 8 and 9 for more details).

**New requirements**

There are no new governance reporting requirements that companies need to address until they adopt the revised 2016 Corporate Governance Code, which applies for periods commencing on or after 17 June 2016 (so not applicable to December 2016 year-ends) and is discussed below. However, companies will need to ensure that they have the necessary processes and procedures in place by the commencement of this period, for example in relation to auditor rotation and non-audit services.

**Areas of regulatory focus**

In relation to governance there are several areas of regulatory focus at the moment.

- The quality of explanations given where a company does not comply with one or more provisions of the Code. In a letter to investors sent in May 2016, ahead of the 2016 shareholder meeting season, the FRC reminded investors that companies should “set out the background to the matter, provide a clear rationale for the action being taken and describe any mitigating activities” when departing from Code provisions. It also encouraged investors to challenge companies where they believe explanations are inadequate.

- The level of detail given in the audit committee report, including in relation to significant financial reporting issues considered by the committee, how the committee has assessed the effectiveness of the external audit and safeguards on non-audit services. This year in particular, disclosure around auditor rotation is likely to be a key focus area.

- Succession planning and corporate culture, which are discussed in more detail in the next section.

**On the horizon**

2016 Corporate Governance Code

For financial years commencing on or after 17 June 2016, the 2016 Corporate Governance Code replaces the 2014 Code. However, the changes are minimal, with only a few amendments to section C.3.

- The audit committee as a whole will be required to have competence relevant to the sector in which the company operates.

- The Code provision on audit tendering for FTSE 350 companies is removed, as it is superseded by the Competition & Markets Authority Order and other regulations.

- The audit committee report will be required to provide advance notice of plans to retender the external audit.

At the same time a revised version of the FRC’s Guidance on Audit Committees also becomes effective, updated to include guidance on the committee’s new responsibilities. A new ethical standard for auditors is also introduced, which places some additional restrictions on the non-audit services that can be provided by the external auditor.
With the UK implementation of the revised EU Auditing Directive also completed by 17 June 2016, the changes that this introduces regarding auditor rotation and tendering will also come into force for periods commencing on or after that date. All listed companies are now required to tender their audit at least every 10 years, with a change of auditor required at least every 20 years.

Succession planning
The FRC is currently undertaking a project on succession planning, with a Discussion Paper12 published in October 2015 and a feedback statement13 on this in May 2016. The discussion paper explored six areas that the FRC considers to be important to succession planning:

• how effective board succession planning is important to business strategy and culture;
• the role of the nomination committee;
• board evaluation and its contribution to board succession;
• identifying the internal and external ‘pipeline’ for executive and non-executive directors;
• ensuring diversity; and
• the role of institutional investors.

The feedback statement summarises the responses received to the FRC’s proposals. In particular, there was some support for further guidance, particularly in relation to the role of the nomination committee and on reporting on succession planning. The final outcome of this project is expected to be changes to the FRC’s Guidance on Board Effectiveness, made in conjunction with the outcome of its Corporate Culture project.

Corporate Culture
The FRC has recently published the results of its study on corporate culture14. This was a joint project undertaken together with various other organisations aimed at gathering practical insight into corporate culture and the role of boards; understanding how boards can shape, embed and assess culture; and identifying and promoting best practice. No changes to the Code are planned as a result of this project, however the FRC will use the observations in this report, and any feedback received, to update its Guidance on Board Effectiveness, in conjunction with the outcome of its succession planning project.

Remuneration reporting
The Executive Remuneration Working Group, established by the Investment Association, has recently issued a report15 which provides ten recommendations “to rebuild trust in executive pay structures in the UK”. One of its recommendations includes a proposal to the FRC that the Corporate Governance Code should be amended to reflect what is already seen as ‘best practice’ in determining executive remuneration.

Financial statements
No major changes in IFRSs came into force for the reports covered by our survey this year, nor will they in the reporting season ahead. However, other than for the September year-end companies in our sample, this past year has seen the transition of company-only reporting from old UK GAAP to IFRSs or one of the new UK GAAP frameworks, principally FRS 101.

Existing requirements
Listed groups are required to prepare consolidated accounts under IFRSs as adopted by the EU and this will remain the case for the foreseeable future, despite the outcome of the referendum on the UK’s membership of the EU. Listed entities that are not parent companies, such as many investment trusts, can also choose to prepare financial statements using FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland. Financial statements consist of two main sections:

• the primary financial statements, comprising the income statement, statement of comprehensive income, statement of financial position, statement of changes in equity and statement of cash flows (see chapter 13 for more details); and
• the notes to the financial statements (see chapter 14 for more details).

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The separate financial statements of a ‘qualifying entity’ can be prepared under FRS 101 Reduced Disclosure Framework, which closely reflects IFRS accounting but with reduced disclosures. If eligible, this may be an attractive option for many parent companies’ separate financial statements and for their subsidiaries. Another option is to apply FRS 102 with reduced disclosure. At the moment, to apply FRS 101 or FRS 102 with reduced disclosures a company must notify its shareholders in writing and they must not object to its use, although the FRC is currently consulting on the removal of this requirement.

New requirements
To the right is a list of the new IFRS requirements coming into force for financial years ending between September 2016 and August 2017 (depending in some cases on whether IFRSs as endorsed by the EU or as issued by the IASB are being applied). Hyperlinks to further information are included in the table.

For periods commencing on or after 1 January 2016, changes to the Accounting Regulations come into force, which alter various disclosure requirements of the law, primarily for small companies. However, two changes that will be relevant to listed companies are:

- the requirement to disclose the registered office of all subsidiaries and other significant investments, further expanding the requirement to disclose the names of all such entities that was introduced this year; and
- where a parent prepares group accounts and takes the exemption from publication of its individual profit and loss account, its individual profit or loss for the year must be disclosed on the face of the balance sheet, rather than in the notes as was previously permitted.

<table>
<thead>
<tr>
<th>Title</th>
<th>Per IASB IFRSs, mandatory for accounting periods starting on or after:</th>
<th>Per EU-endorsed IFRSs, mandatory for accounting periods starting on or after:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Improvements to IFRSs: 2011-13 Cycle (Dec 2013)</td>
<td>1 July 2014</td>
<td>1 January 2015</td>
</tr>
<tr>
<td>Annual Improvements to IFRSs: 2010-12 Cycle (Dec 2013)</td>
<td>1 July 2014*</td>
<td>1 February 2015</td>
</tr>
<tr>
<td>Amendments to IAS 19 (Nov 2013) – Defined Benefit Plans: Employee Contributions</td>
<td>1 July 2014</td>
<td>1 February 2015</td>
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<td>Amendments to IAS 1 (Dec 2014) – Disclosure Initiative</td>
<td>1 January 2016</td>
<td>1 January 2016</td>
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<tr>
<td>Amendments to IAS 16 and IAS 41 (Jun 2014) – Agriculture: Bearer Plants</td>
<td>1 January 2016</td>
<td>1 January 2016</td>
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<tr>
<td>Amendments to IAS 16 and IAS 38 (May 2014) – Clarification of Acceptable Methods of Depreciation and Amortisation</td>
<td>1 January 2016</td>
<td>1 January 2016</td>
</tr>
<tr>
<td>Amendments to IFRS 11 (May 2014) – Accounting for Acquisitions of Interests in Joint Operations</td>
<td>1 January 2016</td>
<td>1 January 2016</td>
</tr>
<tr>
<td>Amendments to IFRS 10, IFRS 12 and IAS 28 (Dec 2014) – Investment Entities: Applying the Consolidation Exception</td>
<td>1 January 2016</td>
<td>1 January 2016</td>
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</table>

*Amendments to IFRS 2 *Share-based Payments* and IFRS 3 *Business Combinations* apply prospectively to transactions occurring on or after this date. All other amendments apply to annual periods commencing on or after 1 July 2014.
Areas of regulatory focus

In relation to financial statements, significant areas of regulatory focus at the moment include the following.

- **Identification of exceptional items.** Various issues in relation to the identification of items as exceptional have been highlighted by the FRC, including:
  - lack of or poorly designed accounting policies and inconsistent application of them;
  - recurring or immaterial items identified as exceptional;
  - failure to appropriately identify financing and tax items as exceptional;
  - lack of symmetry between good and bad news;
  - inability to reconcile measures presented; and
  - failure to present comparative information.

As discussed in the narrative reporting section, the presentation of non-GAAP measures such as ‘profit before exceptional items’ in the front half of the annual report is likely to be an area of regulatory focus with the ESMA Guidelines coming into force this year.

- **Disclosure of accounting policies.** Companies should make sure that they provide clear, company-specific policies for all material transactions and balances, bearing in mind their business model when doing this. Companies should not be afraid to remove irrelevant or immaterial accounting policy disclosures from their reports and should not give extensive detail on new IFRS requirements that will have little or no effect on future financial statements.

- **Other opportunities to make the financial statements more clear and concise.** Some issues that companies could look out for include large tables of immaterial information that could be removed or replaced with a brief piece of narrative, the possibility of aggregating small items in the primary statements, unnecessary repetition that could be replaced by a cross reference and disclosures from prior years that are no longer needed.

- **Revenue recognition.** Companies should ensure that their policies reflect their specific circumstances rather than being boilerplate. In particular, where companies have long-term contracts, sufficient explanation of how the percentage of completion of these is determined is very important. With the effective date of IFRS 15 *Revenue from Contracts with Customers* now on the horizon, the FRC and ESMA have both issued statements setting out their expectations around pre-adoPTION disclosures.

- **Clarity and completeness of critical judgements.** Companies should ensure that they state explicitly what the judgements made are, rather than just repeating the company’s accounting policy or providing a general reference to judgements being included in accounting policies. They should also ensure that a clear distinction is made between critical judgements and key sources of estimation uncertainty, even where they relate to the same item. Companies should also be aware of opportunities to match the narrative used to discuss these with the significant financial reporting issues discussed in the audit committee report.

- **Discussion of key sources of estimation uncertainty.** Companies should make sure that all of the significant uncertainties that exist are highlighted in this disclosure, in particular any that have been considered as significant by the audit committee. Companies should also remember the need to provide supporting information such as sensitivities in relation to estimation uncertainties.

• Correct accounting for business combinations. Care should be taken when doing this to determine whether the transaction is a business combination at all and, if so, which entity is the acquirer for accounting purposes. This will not always be the legal acquirer. Also, companies should ensure they exercise sufficient diligence in identifying and valuing intangible assets acquired in a business combination, rather than just assuming that any excess paid above the fair value of previously recognised assets of the acquiree represents goodwill. Care should be taken to identify any contingent payments that should be accounted for as remuneration expenses. Companies should also ensure they meet all of the disclosure requirements of IFRS 3, particularly in relation to post balance sheet business combinations.

• Calculation and disclosure related to impairment assessments. Companies should ensure that discount rates are up to date and remember that they need to be pre-tax. The identification of CGUs and allocation of goodwill to CGUs can also be subject to scrutiny. Other potential issues include use of a single pre-tax discount rate for multiple cash-generating units (CGUs) with different risk profiles (and where cash flows are not risk adjusted) and failing to give sufficient information about the assumptions made in determining value in use. Finally, companies should ensure that any required sensitivity disclosures are clear in setting out the situations in which impairments could arise.

• Accounting issues relating to pension schemes, primarily defined benefit schemes. The FRC has highlighted several issues – these are:
  – the sufficiency of disclosure regarding governance of pension plans and the applicable regulatory framework;
  – whether companies have correctly identified and described the effect of minimum funding requirements and any restrictions on recognising a surplus;
  – the sufficiency of sensitivity disclosures for actuarial assumptions; and
  – the usefulness of maturity profile information for defined benefit obligations.

• Disclosures relating to provisions, contingent liabilities and contingent assets are another area of challenge, with clear identification of the reasons for movements in provisions and disclosure about uncertainties relating to timing or amount of outflows sometimes missed. Companies should also be wary of including a significant class of ‘other’ provisions without explanation or stating that disclosure have not been made because they would be seriously prejudicial. Finally, ensuring consistency between the front and back halves in terms of contingent liabilities discussed is important.

• Financial instruments disclosures, especially the detail given in disclosures concerning items in level 3 of the fair value hierarchy. Companies should ensure that level 3 disclosures are sufficiently detailed and robust and provide sufficient quantitative information about significant unobservable inputs. Companies should also ensure that credit risk disclosures cover all financial receivables.

• Tax accounting is another current hot topic, with some potential issues being:
  – including only current tax in the effective tax rate reconciliation;
  – inappropriate aggregation of reconciling items or unclear description of them;
  – inadequate justification to support recognition of deferred tax assets that are dependent on future profitability – this is particularly relevant for loss-making businesses; and
  – lack of clarity around the treatment of tax on share-based payments.

The FRC is currently undertaking a thematic review of tax reporting by FTSE 350 companies\(^\text{17}\), which is expected to conclude in the near future.

Misclassification of items in cash-flow statements and inappropriate netting of cash flows continue to crop up in the FRC’s reviews of accounts, although they are less prevalent than in the past. Companies should also pay attention to the classification of unusual or non-recurring cash flows, as it may still be correct to classify them as operating items.

Disclosure issues relating to intangible assets, in particular the treatment of research and development expenditure, amortisation method and the distinction between internally generated and acquired intangibles. The need to separately identify individually significant intangible assets should also not be overlooked.

Capital management disclosures should include a clear identification of what is managed as capital, including quantitative data, and this should be consistent with the narrative reports. Capital management policies should also be clear and company-specific.

Judgements relating to the identification of subsidiaries and joint arrangements remain on the regulatory radar due to the relative newness of IFRS 10 and IFRS 11. Companies need to ensure that they correctly identify situations in which they have control or joint control of another entity and disclose the judgements involved. De facto control in particular is a highly judgemental area.

Other financial statements presentation issues, such as inappropriate aggregation of items like accruals and deferred income or different classes of property, plant and equipment, failure to identify whether items of other comprehensive income would subsequently be recycled to the income statement and failure to include a description of material leasing arrangements.

Complex supplier arrangements are still a hot topic following the FRC’s press release on this subject a couple of years ago. Retailers should ensure that their disclosures about such arrangements give clear and relevant information to investors.
On the horizon
Looking further ahead, the table to the right shows other new standards and amendments published by the IASB, along with their effective dates and EU endorsement status.

Note that the European Commission has decided not to endorse IFRS 14 – Regulatory Deferral Accounts for use in Europe.

In addition to these items, at the time of writing the IASB also has, inter alia, ongoing projects to develop:
- a new standard dealing with insurance contracts;
- revisions to the Conceptual Framework for Financial Reporting; and
- the disclosure initiative, a broad-based initiative to explore how IFRS disclosures can be improved.

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<thead>
<tr>
<th>Title</th>
<th>Per IASB IFRSs, mandatory for accounting periods starting on or after:</th>
<th>Per EU-endorsed IFRSs, mandatory for accounting periods starting on or after:</th>
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<tr>
<td>Amendments to IAS 7 (Jan 2016) – Disclosure Initiative</td>
<td>1 January 2017</td>
<td>TBC – endorsement expected Q4 2016</td>
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<tr>
<td>IFRS 9 – Financial Instruments</td>
<td>1 January 2018</td>
<td>TBC – endorsement expected Q4 2016</td>
</tr>
<tr>
<td>IFRS 15 – Revenue from Contracts with Customers</td>
<td>1 January 2018</td>
<td>TBC – endorsement expected Q4 2016</td>
</tr>
<tr>
<td>Clarifications to IFRS 15 Revenue from Contracts with Customers (Apr 2016)</td>
<td>1 January 2018</td>
<td>TBC – endorsement expected H1 2017</td>
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<td>Amendments to IFRS 2 (Jun 2016) – Classification and Measurement of Share-based Payment Transactions</td>
<td>1 January 2018</td>
<td>TBC – endorsement expected H2 2017</td>
</tr>
<tr>
<td>IFRS 16 – Leases</td>
<td>1 January 2019</td>
<td>TBC – endorsement expected 2017</td>
</tr>
<tr>
<td>Amendments to IFRS 10 and IAS 28 (Sep 2014) – Sale or Contribution of Assets between an Investor and its Associate or Joint Venture</td>
<td>Deferred indefinitely</td>
<td>Postponed – awaiting completion of the IASB’s project on ‘Elimination of gains or losses arising from transactions between an entity and its associate or joint venture’</td>
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04

Overall impressions

Enter the chapter
Overall impressions

Top Tips

• Demonstrating linkage helps users get a holistic understanding of the business by appreciating the relationships between the various sections of the report such as objectives, strategy, KPIs and risks. 13 companies demonstrated a comprehensive degree of linkage between the different pieces of information presented in their report.

• Consider the application of materiality to both financial and non-financial matters in order to create a clearer and more concise report. The length of the annual reports surveyed increased by an average of eight pages (2015: 12 pages) this year, the seventh consecutive year where there has been an increase in length. 34 companies (2015: 33) referred to materiality within the annual report, although the process for determining materiality was only discussed by three companies for financial matters and 11 companies for non-financial matters.

• Bear in mind the benefits that can be realised through applying the principles of integrated thinking when managing your business. More businesses appear to be doing this, judging by the increasing number that are following the integrated reporting framework in putting together their annual reports. Eight (2015: two) explicitly stated that their report follows the <IR> framework or referred to it as an ‘integrated report’.

• Consider the level of consistency between the financial reporting issues discussed in the audit committee report, the key risks covered in the audit report and the critical accounting judgements and key sources of estimation uncertainty identified by management. The FRC has indicated they will challenge unjustified inconsistencies between these reports. Complete consistency should not be seen as a goal, although ten of the companies we surveyed did show complete consistency in the issues discussed.

Keep an eye on

• Ways to create a clear and concise report. For example, 75% of companies who presented their remuneration policy in full had not had a change in remuneration policy during the year and were therefore not required to do so. Whilst some companies may be reluctant not to provide the full policy due to the current media focus on pay disclosures, a well-constructed summary can be more useful to an investor in their understanding of the remuneration policy and the related disclosures.

• The linkage between directors’ remuneration performance measures and key performance indicators (KPIs). Such linkage helps provide users with a deeper understanding of a company’s incentivisation policies and gives a clear indication as to how measures used to assess the performance of the company might impact directors’ remuneration. 76% (2015: 68%) of companies used metrics in their performance related directors’ remuneration which were also KPIs.

• The format of the annual report. This year only 18% (2015: 29%) of companies chose to present a HTML version of their report, showing that most now see that going to the cost and effort of producing a HTML version is of little benefit when the majority of investors prefer reports in a PDF format. However, few companies have responded to investors’ views on effective digital communications, as expressed in the FRC’s Financial Reporting Lab’s Digital present report18, with all 100 companies presenting their report in portrait, 91 companies using multiple columns of text and 66 companies using double page spreads to present information. All three factors are considered to inhibit the readability of a document for a digital user.

Introduction

In this chapter we examine various overall trends across the annual reports surveyed. The areas that we look at are guided by the FRC’s Communication Principles (included in the FRC’s Guidance on the Strategic Report19) and the <IR> Framework’s Guiding Principles20. Both of these sets of principles consider the content of the annual report and the presentation of information therein, including discussion around connectivity, conciseness, and balance.
FRC’s Communication Principles

• The strategic report should be comprehensive but concise.
• The strategic report should highlight and explain linkages between pieces of information presented within the strategic report and in the annual report more broadly.
• The strategic report should be fair, balanced and understandable.
• Section 5 of the FRC Guidance also includes guidance on applying the concept of materiality to the strategic report.
• Where appropriate, information in the strategic report should have a forward-looking orientation.
• The strategic report should provide information that is entity-specific.
• The structure and presentation of the strategic report should be reviewed annually to ensure that it continues to meet its objectives in an efficient and effective manner.
• The content of the strategic report should be reviewed annually to ensure that it continues to be relevant in the current period.

<IR> Framework Guiding Principles

- Conciseness
- Connectivity of information
- Stakeholder relationships
- Materiality
- Strategic focus and future orientation
- Consistency and comparability

We have considered the following specific areas.

• The length of the annual report – a crude but useful measure of whether reports are becoming clearer and more concise.
• The quality of linkage demonstrated between elements of the annual report – an area of greater importance given the ever-increasing length of reports. A good annual report tells the story of the organisation, giving a reader a holistic view of the business. One particular area that we have looked at in detail is the degree of consistency between the significant financial reporting issues discussed in the audit committee report, the key risks reported by the auditor and the critical judgements and key sources of estimation uncertainty disclosed in the financial statements.
• Discussion of the company’s relationships with stakeholder groups – something that demonstrates the growing acknowledgement that a company’s licence to operate comes not just from the financial investment of its shareholders but also from a wider perception of corporate citizenship and that its ability to create sustainable long-term value depends on broader social and environmental factors.
• The application of materiality – a linchpin in the drive to produce relevant, clear and concise reports.
• Directors’ remuneration reporting – an area of great public scrutiny at the moment, particularly in the light of research that casts doubt on the effectiveness of the 2013 changes in remuneration reporting requirements in achieving their aim of improving the link between pay and performance and curbing excessive CEO pay.

The extent to which companies have adopted the recommendations of the Financial Reporting Lab’s Digital Present report – in recognition of the fact that an ever-increasing proportion of investors use the annual report as an electronic document.

The speed with which companies report their results to the market and the way in which those results are initially reported.

The way in which reports from the chairman and CEO are included in the annual report – another area in which there are potential gains to be made in terms of making the report clearer and more concise, by reducing duplication of information.

### Length of the report

Our survey results show an average increase in the report length of eight pages from those surveyed in 2015 (see Figures 4.1 and 4.2); this is the seventh consecutive year of increases in the annual report length. This increase was driven by a five page increase in financial statements, and a three page increase in narrative. The increase in the back half was mainly due to the changes in Company Law which now require companies to include a full listing of related undertakings within the annual financial statements where previously this could have been included as an appendix to the annual return. Across our sample these lists ranged from one to 19 pages in length, with an average of three pages.

Previously, companies were only required to disclose their ‘principal’ subsidiaries and other significant holdings in the annual financial statements, which was unlikely to be more than a page in length. The increase could also be partly down to an increase in the length of disclosures concerning the impact of new accounting developments, such as IFRS 9 *Financial Instruments*, IFRS 15 *Revenue from Contracts with Customers* and IFRS 16 *Leases* where reporters have to consider the impact future standards will have on the financial statements.

The increase in the front half is likely down to the changes in the UK Corporate Governance Code, which were effective from 1 October 2014 and required companies to, amongst other things, enhance their principal risk disclosures (see chapter 8) and also include a viability statement setting out the directors’ assessment of the longer term outlook for the company (see chapter 9). Another possibility is an increase in the use of case studies by companies – while these can help to bring a company’s story to life a careful balance needs to be struck to avoid breaking up the flow of the report too much.

With annual reports being as long as they are these days, companies should make sure they make their reports easy for users to navigate. There are several ways to do this, including making sure there is a clear and logical layout, use of cross referencing, inclusion of contents pages for individual sections and creating a navigable PDF (see later).

### Average percentage of the report which consisted of narrative information (i.e. not financial statements)

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
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<tbody>
<tr>
<td>Overall</td>
<td>60%</td>
<td>59%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>61%</td>
<td>62%</td>
</tr>
<tr>
<td>Others</td>
<td>58%</td>
<td>56%</td>
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</table>

This has remained broadly consistent, though it is encouraging that smaller companies may be putting more effort into helping the user to better understand the company’s story, an area where the FRC felt some small companies were previously struggling.
Linkage and connectivity

This section focuses on the overarching concept of linkage. Linkage, or connectivity as it is referred to in the <IR> Framework, involves demonstrating relationships and interdependencies between information disclosed in the report in order to help give a user a holistic view of the company.

Linkage should not be confused with signposting/cross-referencing. Signposting consists merely of providing assistance to users in navigating around the annual report, while linkage relates to the underlying relationships and interdependencies between information presented in different sections of the report. Signposting can be used to illustrate where linkage exists between different sections of the report, but the existence of signposting does not mean that clear linkage exists, and equally good linkage can be evident in a report even if it is not clearly signposted.

The idea of <IR> connectivity is a reflection of this integrated thinking within an organisation, with all the parts of the organisation acting and moving together. For those companies that have adopted such integrated thinking we would expect this to be apparent in their annual report through a high level of connectivity. To demonstrate <IR> connectivity an organisation would therefore have to show a high level of linkage to illustrate the interdependencies and relationships existing between the information as a result of the organisation and its operations being considered as a coherent whole.

Whether the reader feels they have a holistic view of the business is subjective and assessing how connected a report is not an exact science. The FRC Guidance provides a number of examples of how linkage can be achieved. It differentiates between ‘linkage’ and ‘signposting’, with the latter being simple cross-references between sections of the annual report e.g. KPIs and strategic objectives, or to where more detail is provided.

In order to determine a measure of the linkage demonstrated by the companies surveyed, the extent to which various sections of the report were clearly linked to the other sections was considered. We considered the linkage between various sections of the report, for example, whether it shows the risks that relate to each element of the strategy or how the KPIs relate to the measures used to assess directors’ remuneration.

It was encouraging to see that 83% of the companies we surveyed displayed some degree of linkage. 13 companies displayed a comprehensive level of linkage between various sections of the report. This was an encouraging statistic and a moderate increase on the prior year where 10% of companies demonstrated a comprehensive level of linkage. Good examples of how this linkage can be demonstrated are given by G4S plc (Example 4.1) and Marks and Spencer Group plc (Example 4.2).

We have assessed various individual areas of linkage in our survey, which are discussed in the report as set out below.

<table>
<thead>
<tr>
<th>Linkage between</th>
<th>Discussed in chapter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remuneration and KPIs</td>
<td>4</td>
</tr>
<tr>
<td>Objectives, strategy, business model, KPIs, risks and CR</td>
<td>6</td>
</tr>
<tr>
<td>KPIs and strategy</td>
<td>7</td>
</tr>
<tr>
<td>Risks, strategy and KPIs</td>
<td>8</td>
</tr>
</tbody>
</table>
Along with the increase in the number of companies demonstrating a comprehensive level of linkage, there was also an increase in the number of companies mentioning integrated reporting, with 12 companies (2015: seven) specifically referring to <IR> in their annual reports. Of these:

- four (2015: two) indicated that their annual reports were prepared in line with the principles of the <IR> Framework, two of these companies being FTSE 100 (the same two preparing reports in line with the <IR> Framework in the prior year), the other two being FTSE 250;
- two (2015: two) noted that they are currently taking steps to report in an increasingly integrated way;
- four referred to an ‘Integrated approach’ in preparing the annual report, or referred to the report as an ‘Integrated report’ but did not specifically mention the <IR> Framework;
- one (2015: one) noted that the audit committee had discussed the presentation of the annual report in the context of <IR>; and
- one specifically mentioned that they had “chosen not to prepare an integrated report” although they had included a comprehensive overview of non-financial performance.

**Linkage between risks identified by the audit committee, auditor and management**

As part of our survey, we identified the most common matters noted by audit committees (as part of their analysis of significant financial reporting issues), auditors (based on the risks of material misstatements reported in their audit reports), and management (as part of their disclosure of critical accounting judgements and key sources of estimation uncertainty). Although these are all different requirements, there is a significant degree of overlap between them and so we would expect to see a degree of consistency in the issues discussed. We would expect the consistency between the audit committee report and financial statements to be the closest, since these are both written from an internal perspective whereas the audit report is based on an independent, external viewpoint. In relation to this, the FRC have indicated that, when companies’ annual reports are reviewed by their Conduct Committee, they may challenge companies where the audit committee report or audit report mentions judgements or estimates that are not identified in the financial statements. For more information on the discussion of significant financial reporting issued by audit committees see chapter 12 and for further detail on the reporting of critical judgements and key sources of estimation uncertainty see chapter 14.

For 14 of the companies in our sample there was complete consistency between the issues discussed by the audit committee and those identified by management, with ten of these also showing complete consistency with the risks identified by the auditor. On the other hand, for four of the companies we looked at there were no consistent topics identified across all three sections.
Figure 4.3 shows the risks that were most commonly identified either by audit committees, auditors or management across the companies we surveyed.

Figure 4.3 What are the most common risks identified either by audit committees, auditors or management?

<table>
<thead>
<tr>
<th>Risk</th>
<th>Number of companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill and acquisitions</td>
<td>75</td>
</tr>
<tr>
<td>Tax</td>
<td>57</td>
</tr>
<tr>
<td>Provisions</td>
<td>53</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>42</td>
</tr>
<tr>
<td>Tangible fixed assets</td>
<td>39</td>
</tr>
<tr>
<td>Financial instruments</td>
<td>42</td>
</tr>
<tr>
<td>Current assets</td>
<td>42</td>
</tr>
<tr>
<td>Revenue recognition</td>
<td>53</td>
</tr>
<tr>
<td>Identification of exceptional items</td>
<td>27</td>
</tr>
<tr>
<td>Going concern</td>
<td>27</td>
</tr>
</tbody>
</table>

In particular, in relation to these risks we noted the following.

i. The risks identified in relation to goodwill and acquisitions were usually focused on (i) acquisition accounting (including identification and measurement of assets and liabilities acquired), and (ii) impairment of goodwill and intangible assets acquired (particularly around key judgements and assumptions to estimate the recoverability of the CGUs). In some cases, audit committees also mentioned a risk regarding disclosure in these areas.

ii. The risks identified in relation to revenue recognition included a wide range of estimates and judgements regarding topics such as: cut-off; multiple arrangements; long term contracts; loyalty schemes; refunds; and gross vs net (principal vs agent) presentation.

iii. Tax is in general considered a key risk by management in companies that operate in multiple jurisdictions because they consider the assessment of uncertain tax positions to be an area of significant judgement. Other areas mentioned were the recoverability of tax losses carried forward and assessment of deferred taxes.

iv. The risks identified in relation to current assets primarily related to the assessment of provisions against accounts receivable and inventory.

v. Going concern was in general an area of focus of audit committees and auditors. The main reasons mentioned were the following (i) assessment for the appropriateness of the going concern assumption (including disclosures); (ii) the potential implications for the going concern assumption when the entity has restrictive covenants; and (iii) liquidity risks and the economic environment.

Generally the risks noted above are consistent with the areas identified by the FRC Conduct Committee in their Corporate Reporting Review Annual Report 2015 as areas of challenge, although consideration of current assets is an area not specifically identified by the FRC as a focus in their work. Other areas identified by the FRC but not by so many of the companies we surveyed include the identification of exceptional items, which was identified as a key risk more commonly by audit committees than the other groups; and the risk of cash flow misclassification which was not identified by any of the companies in our survey.

The table below shows other risks that were considered either by audit committees, auditors or management across the companies in our sample.

<table>
<thead>
<tr>
<th>Risk</th>
<th>Number of companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share-based payments</td>
<td>9</td>
</tr>
<tr>
<td>Investment property valuation</td>
<td>9</td>
</tr>
<tr>
<td>Determination of joint venture or joint operation</td>
<td>5</td>
</tr>
<tr>
<td>Basis for consolidation</td>
<td>9</td>
</tr>
<tr>
<td>Complex supplier agreements</td>
<td>13</td>
</tr>
<tr>
<td>Leases</td>
<td>7</td>
</tr>
<tr>
<td>Viability statement</td>
<td>18</td>
</tr>
<tr>
<td>Management override of controls</td>
<td>7</td>
</tr>
<tr>
<td>Internal control</td>
<td>11</td>
</tr>
<tr>
<td>Fair, balanced and understandable</td>
<td>5</td>
</tr>
</tbody>
</table>
Figure 4.4 shows the number of companies for which the risks listed were only identified as key by audit committees (but not by auditors or management).

**Figure 4.4 What are the most common risks identified primarily by audit committees as part of their annual report analysis?**

In relation to the risks noted above, it is not surprising that the viability statement and fair, balanced and understandable are discussed only by audit committees – these would not be expected to be a risk for the auditor or be a critical accounting judgement. However, (i) the risk related to management override of control and internal control was also identified as a key risk by auditors only in three cases and in five cases by both audit committees and auditors; (ii) the identification of exceptional items was also identified as a key risk by both audit committee and management in four cases and by both the audit committee and auditor in seven cases.

Figure 4.5 shows the number of companies for which the risks listed were identified by management as part of their disclosures of critical accounting judgements and key sources of estimation uncertainty but not considered as a key risk by audit committees or auditors.

**Figure 4.5 What are the risks identified only by management as part of their disclosure of critical accounting judgements and key sources of estimation uncertainty?**

This graph highlights that, where there were differences between the areas considered by the three groups, it was most common for management to consider a wider range of risks as compared to audit committees and auditors.

For example, we noted that in cases where management considered there to be estimates or judgements related to share-based payments, the basis for consolidation and joint arrangement determination and leases, these were rarely considered significant by the audit committee or auditor. This could be due to different views of materiality applied by management compared to the auditor, meaning that the areas reported by management in complying with IAS 1 would not necessarily represent key risks in the view of the auditors.

One other area in which there was a noticeable difference between the three sections of the report was in the identification of the risk of revenue recognition. For twelve of the companies surveyed this was identified as a risk area by the audit committee and auditor despite the fact that management had not identified any critical judgements or key sources of estimation uncertainty in relation to it. It is possible that this is because revenue recognition is deemed a presumed risk by Auditing Standards, in recognition of the fact that it is usually one of the most significant numbers to a user of the financial statements.
Stakeholder engagement
The FRC Guidance\textsuperscript{24} stresses the importance of engaging with stakeholders, and also goes as far as to say that the annual report should address issues relevant to stakeholders where, because of the influence of those issues on the performance, position and future prospects of the company, they are also material to shareholders. One of the most important ways in which a company can acknowledge how it interacts with its stakeholders is by discussing how it takes into account their needs and interests, and responds to them in its business model – this is discussed in chapter 6. The importance of stakeholder engagement is also a guiding principle in the <IR> Framework. Figure 4.6 shows the stakeholders referred to by the companies in our sample.

A good example of discussing stakeholder engagement is given by Paypoint Plc (Example 4.3).

\textsuperscript{24} FRC Guidance, Section 3.4

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure4_6.png}
\caption{What different stakeholders are referred to?}
\end{figure}

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|}
\hline
\textbf{Stakeholders} & \textbf{2016} & \textbf{2015} \\
\hline
Customers & 47 & 54 \\
Legislators & 23 & 17 \\
Business partners & 19 & 23 \\
Local communities & 35 & 38 \\
Employees & 45 & 52 \\
Suppliers & 34 & 38 \\
Other & 28 & 43 \\
\hline
\end{tabular}
\caption{Number of companies referring to stakeholders other than shareholders in their annual report}
\end{table}

The moderate increase suggests companies are increasingly seeing the importance of stakeholders in a company’s ability to create value. Consistent with the prior year, the most common stakeholders (other than shareholders) referred to were customers and employees (see Figure 4.7). Other stakeholders mentioned were mainly references to the environment or simply a generic reference to ‘other’ stakeholders with no definition.

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|}
\hline
\textbf{Stakeholders} & \textbf{2016} & \textbf{2015} \\
\hline
Yes & 93 & 90 \\
No & 7 & 10 \\
\hline
\end{tabular}
\caption{Number of companies that referred to stakeholders other than shareholders, but did not clearly define who these were}
\end{table}

Many companies are still not including a clear disclosure of the specific parties (other than shareholders) that they consider to be their key stakeholders. This was evidenced in some companies with a ‘Dialogue with stakeholders’ section, which referred only to how the company communicated with its shareholders, with no discussion of other stakeholders.
Number of companies describing the nature and quality of the company’s relationships with its key stakeholders (e.g. any process of communication & feedback with them)

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes, for a variety of stakeholders</td>
<td>21</td>
<td>23</td>
</tr>
<tr>
<td>Yes, but just for shareholders</td>
<td>72</td>
<td>60</td>
</tr>
<tr>
<td>No</td>
<td>7</td>
<td>17</td>
</tr>
</tbody>
</table>

It is disappointing not to see an increase in this statistic given the importance of these relationships in demonstrating how a company creates value. 72 companies did however describe the nature and quality of their relationships with shareholders, an increase of 12 on the prior year. This was usually demonstrated through a ‘Shareholder Communications’ paragraph within the Corporate Governance section. Good examples of stakeholder engagement were given by Paypoint Plc (Example 4.3), The Weir Group PLC and Morgan Sindall Group plc.

Materiality

Applying materiality involves assessing the likelihood that including or excluding an item, or changing how it is presented will affect the decisions made by the primary users of the report (the shareholders). It is a key judgment which reporters have to make, and when effectively applied, will help to produce clear, concise and relevant reporting. The FRC noted in their Corporate Reporting Review Annual Report 2015 (CRR Report) that judgements around materiality are a key area of importance to investors and will be an area of future focus for them as a result of concern about how some companies were assessing materiality. Within both the CRR Report and the FRC Guidance\textsuperscript{25} it is made clear that materiality is entity-specific and should be based on both quantitative and qualitative factors. Deloitte’s publication Thinking allowed – Materiality\textsuperscript{26} and the IASB’s draft Practice Statement Application of Materiality to Financial Statements\textsuperscript{27} both give further guidance on considerations when determining whether information is material or not. 34 companies (2015: 33) referred to materiality, whether financial or non-financial, within the annual reports that we surveyed this year. Good examples of materiality disclosures are given by Mondi Group (Example 4.4) and Premier Oil plc (Example 4.5).

The Global Reporting Initiative (GRI) has developed their own sustainability reporting guidelines, the latest version of which is referred to as G4\textsuperscript{28}. The G4 guidelines emphasise the need for companies to focus on reporting on those issues which are material to their business and key stakeholders. This materiality focus is intended to make reports more relevant, credible and user-friendly. However, it should be noted that the reporting referred to in the GRI guidelines is focused more on a company’s sustainability report, rather than the annual report itself. Therefore the GRI guidance on materiality, which was the source of the discussion for many companies in our sample, does not necessarily give appropriate guidance when determining materiality in the context of the annual report.

\textsuperscript{25} FRC’s Guidance on the Strategic Report, Section 5.3
\textsuperscript{26} http://www.iasplus.com/en-gb/publications/global/thinking-allowed/2015/materiality
\textsuperscript{27} http://www.iasplus.com/en-gb/news/2015/10/materiality
\textsuperscript{28} https://www.globalreporting.org/standards/g4/Pages/default.aspx
Number of companies that referred to financial statement materiality, or those charged with governance’s (TCWG) process to determine this

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes – process discussed</td>
<td>3</td>
</tr>
<tr>
<td>Yes – mentioned but did not discuss process</td>
<td>14</td>
</tr>
<tr>
<td>No</td>
<td>83</td>
</tr>
</tbody>
</table>

Generally discussions around financial statement materiality were located within the audit committee report in the committee’s discussion with external auditors.

Number of companies that mentioned materiality for non-financial items e.g. sustainability or TCWG’s process to determine this

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes – process discussed</td>
<td>11</td>
</tr>
<tr>
<td>Yes – mentioned but did not discuss process</td>
<td>12</td>
</tr>
<tr>
<td>No</td>
<td>77</td>
</tr>
</tbody>
</table>

11 companies discussed the process for determining their materiality threshold. This was usually in the context of risk determination, GHG carbon emissions or sustainability in general. Some reporters had also complied with the GRI’s G4 sustainability reporting guidelines, which focuses on reporting those issues which are material to the business and key stakeholders, with a concentration on sustainability matters.

Directors’ remuneration reporting

The FRC’s update to the UK Corporate Governance Code made some minor changes to the requirements in respect of directors’ remuneration to ensure boards focus on the long term success of the company and to include clawback provisions within the remuneration policy. Overall these changes have not had a significant effect on the length of directors’ remuneration reports, with report lengths staying consistent with the prior year at 17 pages – see Figure 4.7.

**Figure 4.7 How long, on average, is the directors’ remuneration report?**

11 companies discussed the process for determining their materiality threshold. This was usually in the context of risk determination, GHG carbon emissions or sustainability in general. Some reporters had also complied with the GRI’s G4 sustainability reporting guidelines, which focuses on reporting those issues which are material to the business and key stakeholders, with a concentration on sustainability matters.

There has been an increase in the number companies providing a summary of their remuneration policy with only 61 companies (as per Figure 4.8) disclosing their remuneration policy in full, compared to 73 in the prior year. This is an encouraging trend as providing a summarised remuneration policy, sufficient to understand the remuneration disclosures of the report, helps produce a more clear and concise report. Company Law requires the full remuneration policy to be included in the annual report in the financial year preceding the shareholders’ vote on the policy (every three years), or when there has been a change in policy. For companies that have not had a change of policy since they first presented one in their 2013/14 report, the 2016/17 annual report will need to contain a revised policy since the next mandatory vote will be required at the 2017 AGM. It was interesting to note that, of the 61 companies that included the policy in full, only 25% had a change in policy since the prior year. This shows that there is still plenty more scope to make reports more concise. Whilst some companies may be reluctant not to provide the full policy due to the current media focus on pay disclosures, a well-constructed summary can be more useful to an investor in their understanding of the remuneration policy and their related disclosures.

**Figure 4.8 What percentage of companies disclose their remuneration policy in full?**

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Demonstrating linkage between the measures used to determine a company’s directors’ remuneration, KPIs and business strategy helps provide users with a deeper understanding of a company’s incentivisation policies and gives a clear indication as to how measures used to assess the performance of the company might impact a director’s remuneration – see Figure 4.9. Of the companies showing at least some linkage, 31% also demonstrated linkage between the relevant KPIs and the company’s business strategy, although only 9% clearly linked all pay-related KPIs to business strategy. Marks and Spencer Group Plc (Example 4.6) demonstrated this linkage effectively in their Annual Report and Financial Statements 2016, showing clearly in their remuneration report the alignment between strategic objectives, KPIs and the relevant incentive.

As companies take a more integrated view on reporting and how a business creates value, non-financial performance measures are becoming common in determining the level of directors’ remuneration. As shown by Figure 4.10 below, of the 47 companies that used non-financial performance measures, a measure related to the strategic development was the most popular with 41 companies including one. Other popular measures were those relating to operational performance (24 companies) and people (21 companies). As companies take a more integrated approach to their business and see the importance of various stakeholders in creating value for the business, it is likely that non-financial performance measures will become increasingly more popular in determining the level of directors’ remuneration.

### Figure 4.9 Are metrics used for performance related pay included within the company’s KPIs (both financial and non-financial)?

<table>
<thead>
<tr>
<th>None</th>
<th>Some</th>
<th>All</th>
</tr>
</thead>
<tbody>
<tr>
<td>32%</td>
<td>61%</td>
<td>7%</td>
</tr>
<tr>
<td>24%</td>
<td>65%</td>
<td>10%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>None</td>
<td>32%</td>
</tr>
<tr>
<td>Some</td>
<td>61%</td>
</tr>
<tr>
<td>All</td>
<td>7%</td>
</tr>
</tbody>
</table>

### Figure 4.10 Which non-financial measures are used to determine performance related pay?

- Personal performance
- Business development
- Strategy
- People
- Governance and leadership
- Health and safety
- Operational performance
- Stakeholder relations
- Organisational structure
- Others

<table>
<thead>
<tr>
<th>Non-financial measures used in determining performance related pay</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>47</td>
<td>58</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>30</td>
<td>42</td>
</tr>
<tr>
<td>Others</td>
<td>17</td>
<td>12</td>
</tr>
</tbody>
</table>

### Auditor reporting

Since the amendments to ISA (UK & Ireland) 700 *The Independent Auditor’s Report on Financial Statements* were issued in 2013, audit reports have been increasing in length as auditors include more detailed information regarding the significant risks of material misstatement and considerations they have made in respect of determining materiality. This trend has continued in the current year with the average length of the report increasing to 4.8 pages (2015: 4.2 pages). Given the increasing length of audit reports, it was encouraging to see that the number of companies including a separate audit report (usually for company-only financial statements) had dropped to ten (2015: 18), potentially as companies have taken the opportunity to deal with the audit of the parent company’s financial statements in a combined audit report as a result of transitioning to new UK GAAP. Combining these two reports helps create a more clear and concise report with fewer pages dedicated to auditor reporting.
Larger companies had longer reports and saw the greatest increase with reports rising to 5.1 pages from 4.4 pages, compared to smaller companies where reports increased by half a page to 4.5. Larger, more complex companies potentially contain more risks of material misstatement and more detailed procedures, compared to their smaller counterparts, a potential cause of this difference in the length.

**Chairman’s and chief executive’s statements**

Neither a chairman’s statement nor a chief executive’s statement is required by law, although the Preface of the UK Corporate Governance Code does note that “Chairmen are encouraged to report personally in their annual statements”. The FRC Guidance\(^\text{29}\) notes that, whilst not required, a statement from the chairman and/or the chief executive could be included if it is considered the best way of ensuring the document is both relevant and understandable. Our survey showed that companies see both the chairman’s statement and the chief executive’s statement as key parts of the annual report, with 93 companies presenting a chairman’s statement and 77 companies providing a chief executive’s statement. 56 of the 77 companies that provided a chief executive’s statement did so as a standalone statement rather than as an introduction to the strategic report. Whilst companies clearly see these statements as an opportunity for those charged with governance to provide users with an overview of progress of the company, providing a chief executive’s statement as an introduction to the strategic report, or a combined statement with the chairman, could be a good opportunity to make the annual report more clear and concise, as it was noted that there was often duplication between the issues discussed in the two statements.

**Compass Group PLC (Example 4.7)** gives a good example of a statement from the chief executive which was presented in a question and answer format in their Annual Report 2015, an effective way of communicating the key issues to investors over the performance year in a concise manner.

<table>
<thead>
<tr>
<th>Percentage of companies that included a chairman’s statement</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>92%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>91%</td>
</tr>
<tr>
<td>Other</td>
<td>93%</td>
</tr>
</tbody>
</table>

There was little difference noted between FTSE 350 and Other companies in their decision to include these statements. It is clear companies see a chairman’s statements as a more important disclosure to users, although it should be noted that of the 17% of companies which didn’t include a statement from the chief executive, 6 companies had a single person fulfilling both the chief executive and chairman’s role.

\(^{29}\) FRC Guidance on the Strategic Report, Section 3.8
Electronic communications

This section focuses on the format used to make electronic versions of reports available to users. As noted in the Financial Reporting Lab publication Digital present\(^30\), a report on the use of digital media in corporate reporting, PDF is the preferred digital format for annual reports for the majority of users. This preference was reflected in our survey results with all companies surveyed issuing their annual report in PDF format, as shown by Figure 4.11. The Digital Present publication discusses a number of benefits of PDFs for both companies and investors (e.g. it can be downloaded, it is searchable, it is cheap to produce) and even suggests that there is no advantage in putting cost and effort into producing more complex formats such as e-books, interactive PDFs or enhanced HTMLs. Companies appear to have taken advantage of this potential saving on time and effort as only 15% of companies produced an enhanced HTML (i.e. a specifically designed website to host the content of the annual report) compared to 27% in 2015 – see Figure 4.12. The number of companies producing a basic HTML (e.g. an e-book or HTML version of the PDF) remained broadly consistent with the prior year at 3% (2015: 2%).

Whilst companies have taken on board investors’ views with respect to HTML publications, very few companies seem to have considered the other recommendations noted in the Lab’s report.

- All 100 companies presented their annual report in portrait with no alternative landscape version made available on the company’s website. A landscape format fits much better on a screen for those viewing electronically.
- 91 companies displayed text in multiple columns despite the Lab report noting that a single column approach is more suitable for digital reports and reduces a user’s frustration at having to scroll up and down the page to be able to view the report at a readable magnification on-screen.
- 66 companies presented information on double page spreads despite the difficulties in reading this information on screen.
- only 17 companies presented a report which was considered to be, or clearly marked as, printer friendly. Of these, two provided a separate printer friendly version of the annual report.

Companies should look to take more consideration of investors’ views with respect to digital communications when producing their annual report, especially given the number of investors who will be reading annual reports digitally.

Reporting timetable
The average reporting times for companies approving their annual reports this year decreased to 62 days (2015: 65 days), as shown by Figure 4.13. This decrease occurred in both larger companies and smaller companies, with FTSE 350 companies reporting times reducing to 56 days (2015: 58 days) and other companies seeing a reduction to 71 days (2015: 74 days). The fastest reporter approved their report in 32 days (2015: 36 days) – marginally faster than the prior year. The slowest reporter took 120 days to approve their report (2015: 122 days). This overall decrease suggests companies are starting to plan the annual reporting process more effectively prior to year-end, such that the work to be performed subsequent to year end is minimised and information can be released to shareholders on a timelier basis. Our accompanying publication Planning your report contains ideas for how to make this process as efficient as possible.

Preliminary announcements
Providing a preliminary announcement to the market is a method for companies to demonstrate compliance with Listing Rule 9.7A.2 (announcement of dividend and distribution decisions) and DTR 2.2 (disclosure of price sensitive information). Whilst only voluntary, we continue to see companies placing importance on making an announcement to the market prior to the publication of the annual report with 100% (2015: 99%) of companies making some form of preliminary announcement.

<table>
<thead>
<tr>
<th>Format of the first annual result announcement</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preliminary announcement that makes clear results still unaudited</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>Preliminary announcement with no mention of audit</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Preliminary announcement based on audited results</td>
<td>88</td>
<td>86</td>
</tr>
<tr>
<td>Preliminary announcement based on audited results and includes a special-purpose audit report prepared specifically for the announcement</td>
<td>3</td>
<td>0</td>
</tr>
<tr>
<td>Full results in unedited text</td>
<td>1</td>
<td>3</td>
</tr>
</tbody>
</table>

| Median number of days from year-end to preliminary announcement |
|-----------------------------|------|------|
| Overall                     | 60   | 61   |
| FTSE 350                    | 56   | 57   |
| Others                      | 69   | 71   |

Figure 4.13 How long did it take to approve the annual report?
Good practice examples

Example 4.1

G4S plc Integrated Report and Accounts 2015 (p10-11)

G4S plc clearly links strategic priorities with key risks and KPIs; there are also cross references to other relevant sections which helps a user navigate the report.
Clearly links together objectives, risks, KPIs and other factors in a single comprehensive chart.
Example 4.3  
Paypoint Plc Annual Report 31 March 2016 (p20)

Clearly demonstrates who the company considers to be its key stakeholders and the process for interacting with and supporting them.

Example 4.4  
Mondi Group Integrated report and financial statements 2015 (p1)

A brief but clear example of the considerations which went in to determining materiality for the annual report. This clearly shows the factors which were considered in determining whether financial or non-financial items were considered material.

Example 4.3

Environmental matters, employees, social, community and human rights

Paypoint is committed to dealing fairly and with a high level of integrity with all its stakeholders, including clients, retailers, merchants, consumers, local communities and shareholders. We comply with applicable laws and regulations and continuously seek to improve our performance in all aspects of our business. As part of this process, we publish results twice a year and provide two interim management statements, complying with reporting and disclosure obligations. This report sets out our approach and the way we measure our success in dealing with each group of stakeholders.

Example 4.4

Our 2015 performance

<table>
<thead>
<tr>
<th>Contents</th>
<th>€ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying operating profit</td>
<td>€957m</td>
</tr>
<tr>
<td>Underlying earnings per share</td>
<td>133.7p</td>
</tr>
<tr>
<td>Dividend per share</td>
<td>52p</td>
</tr>
<tr>
<td>Return on capital employed</td>
<td>20.5%</td>
</tr>
</tbody>
</table>

- Significant profit improvements across all business units
- Committed major projects delivering at plan, contributing incremental €50 million to underlying operating profit in 2015
- Strong capital investment pipeline: €450 million in major projects approved and in progress
- Considerable progress made against our five-year sustainable development commitments

A clear vision  | Annual report insights 2016

Mondi Group

Integrated report and financial statements 2015
Another good example of the materiality determination process with respect to sustainability was provided by Premier Oil plc. Non-financial issues have been assessed in terms of their impact on the company and stakeholders, and the materiality of each issue has been determined on that basis. This provides users with a clear understanding of how the Company has determined what issue they consider to be material.
Example 4.6

Marks and Spencer Group plc Annual Report and Financial Statements 2016 (p58)

This is a good example of linkage between strategy, KPIs and performance related pay. A cross reference has also been provided to the section on KPIs where further linkage is demonstrated to strategy and iconography has been used to illustrate which KPIs are related to performance related pay.
THROUGH DISCIPLINED GROWTH

Q WHAT WAS REVENUE GROWTH AND THE GROUP’S KEY SEGMENTS?

THROUGH DISCIPLINED GROWTH

Q WHAT ACTIONS ARE YOU TAKING TO ADDRESS THE WEAKNESS IN EMERGING MARKETS AND IN THE OFFSHORE & REMOTE BUSINESS?

Q WHAT IS THE GROUP’S STRATEGIC GOAL?

THROUGH DISCIPLINED GROWTH

Q WHAT HAPPENED TO OPERATING PROFIT AND OPERATING MARGINS?

THROUGH DISCIPLINED GROWTH

Q WHAT ARE THE GROUP’S MAIN TRENDS OF CASH AND BALANCE SHEET TRENDS?

THROUGH DISCIPLINED GROWTH

Q WHAT ARE THE GROUP’S MAIN IMPACTS ON SHAREHOLDER VALUE THROUGH DISCIPLINED GROWTH?

THROUGH DISCIPLINED GROWTH

Q WHAT IS THE GROUP’S GROWTH STRATEGY?

THROUGH DISCIPLINED GROWTH

Q WHAT IS THE GROUP’S GROWTH STRATEGY?

THROUGH DISCIPLINED GROWTH

Q SHOULD YOU SUBSCRIBE TO COMPASS GROUP PLC?

THROUGH DISCIPLINED GROWTH

Q WHAT ARE THE GROUP’S MAJOR CONCERNS?

THROUGH DISCIPLINED GROWTH

Q WHAT IS THE GROUP’S GROWTH STRATEGY?

THROUGH DISCIPLINED GROWTH

Q WHAT ARE THE GROUP’S MAJOR CONCERNS?

THROUGH DISCIPLINED GROWTH

Q WHAT IS THE GROUP’S GROWTH STRATEGY?

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Q WHAT ARE THE GROUP’S MAJOR CONCERNS?

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Q WHAT IS THE GROUP’S GROWTH STRATEGY?

THROUGH DISCIPLINED GROWTH

Q SHOULD YOU SUBSCRIBE TO COMPASS GROUP PLC?

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Q WHAT ARE THE GROUP’S MAJOR CONCERNS?

THROUGH DISCIPLINED GROWTH

Q WHAT IS THE GROUP’S GROWTH STRATEGY?

THROUGH DISCIPLINED GROWTH

Q SHOULD YOU SUBSCRIBE TO COMPASS GROUP PLC?

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Q WHAT ARE THE GROUP’S MAJOR CONCERNS?

THROUGH DISCIPLINED GROWTH

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Q SHOULD YOU SUBSCRIBE TO COMPASS GROUP PLC?

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Q WHAT ARE THE GROUP’S MAJOR CONCERNS?

THROUGH DISCIPLINED GROWTH

Q WHAT IS THE GROUP’S GROWTH STRATEGY?

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Q SHOULD YOU SUBSCRIBE TO COMPASS GROUP PLC?

THROUGH DISCIPLINED GROWTH

Q WHAT ARE THE GROUP’S MAJOR CONCERNS?

THROUGH DISCIPLINED GROWTH

Q WHAT IS THE GROUP’S GROWTH STRATEGY?

THROUGH DISCIPLINED GROWTH

Q SHOULD YOU SUBSCRIBE TO COMPASS GROUP PLC?
Top Tips

- A summary section provides an opportunity to communicate the key messages in a clear and concise way and can also be used to demonstrate how key information within the report is inter-related e.g. strategy to KPIs. This helps users get a more comprehensive understanding of how the company creates value yet, disappointingly, only 7% (2015: 7%) of companies did this. However, 14% (2015: 15%) of companies did demonstrate this linkage outside of the summary section by including a single summary of how key information in the report inter-relates elsewhere in the report.

- Providing a cross reference from the summary section to further detail contained in the annual report helps create a more concise report where information is not unnecessarily repeated. It also creates a more navigable report for users. 54% (2015: 47%) of companies provided a cross reference from material in the summary section to elsewhere in the annual report.

- Consider whether to include more discussion of non-financial measures in the summary section. This year 47 (2015: 44) companies provided some form of non-financial measure in the summary section, although only 13 (2015: 13) provided any of their non-financial KPIs in the summary section. If non-financial measures are considered key to understanding the performance of the business, and therefore identified as KPIs, companies should consider drawing these to the attention of the user earlier on in the report.

- Give appropriate context for numerical information presented in the summary section. Prior year comparatives and trend information can be helpful in this regard, as well as narrative commentary that indicates whether the actual results represent over or under-performance.

- The level of prominence given to non-GAAP measures. In order to comply with the ESMA Guidelines on Alternative Performance Measures (APMs) companies should not be giving non-GAAP measures more prominence than GAAP measures. However, in this year’s reports 72% (2015: 70%) of companies that presented non-GAAP measures in their summary section gave more prominence to them than corresponding GAAP measures.

- The transparency of reconciliations of non-GAAP measures to GAAP measures. Such reconciliations provide users with a deeper understanding of how the measures relate to one another and what adjustments management have made. In this year’s survey 37% of companies provided a clear reconciliation for all non-GAAP measures which was clearly cross referenced on the summary page. Provision of such reconciliations is another requirement of the ESMA Guidelines.

Keep an eye on

- How well the KPIs help users understand the company’s performance. Including KPIs within the financial ‘highlights’ of a company’s summary section demonstrates consistency in terms of how an entity monitors the performance of the business. 79% (2015: 73%) of companies included KPIs in their summary section although only 5% (2015: 8%) included all of their KPIs.

- Whether non-GAAP measures are consistent with other information presented in the annual report, e.g. the measures used to assess executive remuneration or the information presented as part of the IFRS 8 Operating Segments disclosure. This helps to demonstrate the purpose of the measure to users and shows it is fundamental to those charged with governance in assessing the performance of the business. 48% (2015: 37%) of companies demonstrated consistency between non-GAAP measures and IFRS 8 Operating Segments disclosures. Demonstrating the purpose of an APM is also a requirement of the ESMA Guidelines on APMs.

Introduction

There is no specific legal requirement for companies to include a summary section in their annual report. However, with annual reports getting longer (as discussed in chapter 4) and the continuing calls for clear and concise reporting, setting the scene upfront is a great way to help a user of the report understand the key messages. A well-structured and informative summary section highlights the key financial and non-financial information contained within the annual report, demonstrates how they link together and provides signposts to further detail within the annual report.
For the purposes of our survey, determining what constituted a ‘summary section’, as distinct from the strategic report more generally, required some level of judgement. Many companies did not make a clear distinction between the two, whereas others more clearly identified a discrete section before the strategic report. Nevertheless, in the former scenario summary-type information still tended to be provided very close to the start of the annual report. The information included in what we believed to represent summary sections, even if they were not labelled as such, is discussed in more detail below.

Although there is no requirement to present a summary section, having chosen to present one directors must ensure that the information contained in it does not mean that they fail to comply with the legal requirement that the strategic report is fair, balanced and comprehensive.31

One way in which this might occur is by including good news in the summary section but only discussing less positive news later in the report, thereby giving undue prominence to the good news. Another is by using non-GAAP financial measures to demonstrate the company's performance to users without giving an appropriate level of information to enable users to understand them. For 2016 annual reports, the FRC will consider whether companies are materially non-compliant with ESMA's Guidelines on Alternative Performance Measures (APMs) when deciding whether their annual report complies with the legal requirements.32 One of the most significant of the requirements of the ESMA Guidelines is that APMs should not be presented with greater prominence than the most closely corresponding GAAP financial measures. Meeting this requirement will require a change in presentation for a large number of companies.

How popular was the inclusion of a summary section in the annual report?

A summary section provides an opportunity for companies to set the scene for users by highlighting the key messages and providing an overview of the key financial and non-financial information contained within the annual report. It can also be used to demonstrate how the various aspects of the annual report are connected to give a holistic view of the business, and is a good place to provide clear signposting and cross-referencing to where users can find more detail.

Despite there being no legal or regulatory requirement to provide a summary section, it continues to be common practice. Figure 5.1 shows the trend of the number of annual reports to include a summary section over the past seven years. Despite the marginal decrease it is clear that companies continue to see the benefits of a summary section in communicating the key messages to the users of the annual report.

In its Corporate Reporting Review Annual Report 2015 the FRC commented that some smaller companies fail to “explain their story fully”. Given the importance of the summary section in setting the scene to the user, the lack of a summary in some smaller company reports could go some way in explaining the FRC’s observation.

31 Companies Act 2006 s414C(2)(3)
What kind of information is included in the summary section?

Whilst there are no legal or regulatory requirements with respect to a summary section, it is important that companies comply with the requirement of the UK Corporate Governance Code 2014 to give a “fair, balanced and understandable assessment of the company’s position and prospects” (Section C.1.). The summary section should therefore provide a balanced picture of good and bad news.

Companies presented a wide variety of information in their summary sections with a good a balance between financial and non-financial information. 95 (2015: 95) companies presented some sort of narrative information in the summary section and 89 companies (2015: 92) provided some financial information (see section on financial highlights for further discussion). Figure 5.2 shows in more detail what kind of information companies included in their summary sections.

![Figure 5.2 What kind of summary information is presented?](image)

Typically companies chose to set the scene by giving some brief information about the following.

- What the company does – though only 15 companies provided specific detail about their business model in the summary section – an example of this is given by Acacia Mining plc (Example 5.1). A concise discussion of a company’s business model provides users with an understanding of the inputs, processes and outputs and an idea of how the company creates value for its stakeholders. It was therefore surprising to see so few companies discuss this.

- Where it does it – this is often presented as a map – an example of this is given by Kaz Minerals plc (Example 5.2). As that tends to take up space, perhaps the 12% decrease this year is a result of companies feeling they could reduce the report length by cutting this out. Information is often given about the wider industry in which they operate as well.

- Their strategy – more companies are doing this year and furthermore, this year 26 companies (2015: 16) also discussed the progress that they made during the year against their strategic priorities. It is useful to do this as it gives context to any financial and non-financial KPIs presented.

The number of companies discussing customers in the summary section has increased, maybe as companies are increasingly taking a more integrated approach to the way they report, considering stakeholders and the role they play in the company’s value creation (as noted in chapter 4).
Companies also included a variety of other pieces of information in their summary section, including the items in the table and those listed below:

- financial and non-financial information on key divisions of the company (for example Sportech PLC and RM Plc);
- information on the company’s approach to sustainability and corporate social responsibility (for example Croda International Plc and Mondi Group);
- a timeline showing key milestones since the company’s incorporation (for example St. Modwen Properties PLC and Gresham Computing plc); and
- case studies illustrating various things such as the implementation of strategy, development of products, employee and customer experiences. Including one or two short, tailored case studies can be helpful to engage a reader with the report and bring it to life. However, including too many long case studies can break up the flow of the report and make it hard to follow.

<table>
<thead>
<tr>
<th>Other Information presented in the summary section</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance</td>
<td>14</td>
<td>22</td>
</tr>
<tr>
<td>Investment case</td>
<td>6</td>
<td>7</td>
</tr>
</tbody>
</table>

Most companies tend to summarise their governance information in the chairman’s statement rather than the summary section of the annual report.

The number of companies presenting an explicit ‘investment case’ remains low. Such investment cases often tend to be promotional in nature and favour good news over bad, which can create a lack of balance in the summary section.

### Linkage to the rest of the report

Providing an overview of the contents of the annual report upfront gives the company the opportunity to show how sections of the report hang together through cross-referencing and signposting e.g. how the environment the company operates in drives the strategy, the KPIs used to measure progress and the risks that might impact the performance of the business. As noted in the FRC’s Guidance on the Strategic Report, care should be taken to ensure companies clearly explain a relationship where this has been highlighted to users, this helps create a more cohesive report and clearly demonstrates linkage between sections. The use of linkage is particularly relevant for summary sections as this is the first section users will see.

It was encouraging to see a small increase in the number of companies providing these cross-references. It was less encouraging to see few companies demonstrating a link between the various elements of the annual report within the summary section. Only 7% (2015: 7%) of companies demonstrated such linkage – an example of which is provided by CLS Holdings plc (Example 5.5). Whilst few companies demonstrated this in the summary section, it is worth noting an additional 14% (2015: 15%) of companies did demonstrate this linkage outside of the summary section.

### Presentation of financial highlights and use of GAAP v non–GAAP measures

As shown by Figure 5.2 above, the majority of companies included financial information in their summary section. This was often in a section called ‘financial highlights’. Companies might want to consider whether the term ‘highlights’ is unduly positive and also ensure that the most relevant measures are included, not just those that provide the best news. Companies should also look to provide context for the

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The use of APMs in the context of KPI sections is discussed in chapter 7 and their presentation in the financial statements is examined in chapter 13.

The use of non-GAAP measures in summary sections is widespread. As they are not prescribed by GAAP, there has been a significant degree of flexibility in how companies identify and present them. This flexibility has caused concern amongst investors, with a study\(^{37}\) by the CFA Society of the UK (a body representing investment professionals) noting that only a third of respondents preferred non-IFRS measures over IFRS measures.

![Figure 5.4 What type of financial measures are presented by companies in their summary section?](image)

2016: 74% All GAAAP, 13% Mixture, 11% All non-GAAP, 2% No financial measures presented

2015: 73% All GAAAP, 8% Mixture, 12% All non-GAAP, 7% No financial measures presented

Whilst there has been concern, the use of non-GAAP measures can be a useful way for companies to present their position and performance in a way they believe to be most meaningful, provided they are presented in a clear and transparent manner. However, a note of caution was sounded recently by the Chairman of the IASB, Hans Hoogervorst, who pointed out that “securities regulators in the world of IFRS Standards are concerned that non-GAAP numbers are getting increasingly detached from reality” and that “the bottom line of the income statement will always remain the most important performance measure over time”\(^{38}\).

In order to address this concern within the market, the ESMA Guidelines have outlined the information that companies should be presenting to support these measures. Regulators have also acted on this concern, with the FRC announcing that their Conduct Committee will consider compliance with the ESMA Guidelines in their reviews of reports in the determination of whether the strategic report is fair, balanced and comprehensive, and will take enforcement action if required\(^{39}\).

The ESMA Guidelines discuss a number of principles to ensure APMs are clearly presented, four of which have been assessed as part of this survey.

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1. The **purpose** of the measure should be clearly set out. A company should explain why the non-GAAP measures give meaningful information to users of the annual report. Consistency between the non-GAAP measures used in the summary section and those used internally (for example, those reported to management and presented in the financial statements as part of IFRS 8 Operating Segments disclosures) makes this purpose easier to illustrate. Figure 5.5 shows the consistency between the non-GAAP measures presented in the summary section and other information in the annual report. Consistency of measures in the summary section with KPIs is also considered below. 48% (2015: 49%) of companies presented measures which were calculated on a consistent basis with that used in the IFRS 8 disclosures. However, 13% (2015: 10%) of companies disclosed non-GAAP measures in the summary section which were not consistent with industry guidelines or the way information was presented in the financial statements, a marginal increase on the prior year. Companies would be well advised to revisit measures used throughout the report to ensure consistency and to make sure that the purpose of the non-GAAP measures used is clear. It is an area that regulators are likely to be paying attention to. 6% (2015: 7%) of companies provided measures which were consistent with an ‘industry-standard’ measure, such as those published by the European Public Real Estate Association (EPRA) and the European Insurance CFO Forum (the forum that published the European Embedded Value ‘EEV’ measure). Companies who are in these industries, and are presenting these measures, need to ensure that the ESMA Guidelines are applied to these measures in addition to any other measures they are presenting.

2. **Non-GAAP measures should not be given more prominence** than GAAP measures. ESMA Guidelines state that the equivalent GAAP measure should be presented alongside the non-GAAP measure and this should be of equal or more prominence. 72% (2015: 70%) of companies that presented a non-GAAP measure in the summary section did so without providing the GAAP equivalent or presented the non-GAAP measure in what appeared to be a more prominent way (e.g. presenting the GAAP measure in a smaller font below the non-GAAP measure). Although it is not yet clear exactly how the FRC will interpret the requirement for ‘equal prominence’ in a UK context, many companies will have to reconsider the way they are presenting APMs in their summary sections as the majority do not appear to be compliant with this aspect of the ESMA Guidelines.

3. Provide clear **reconciliations** showing how a non-GAAP measure derives from the specific GAAP line item in the financial statements. Encouragingly, only 9% of the companies that presented non-GAAP measures failed to provide any reconciliation – see Figure 5.6. However, not all of those that did present some reconciliations necessarily gave enough information to meet the requirements of the ESMA Guidelines. Of the 91% of companies that provided reconciliations, 54% did not clearly cross reference these reconciliations from the summary page, or only provided reconciliations for some of the non-GAAP measures presented. For these reconciliations to be useful it is important that it is easy for a user to find them, something that a cross-reference makes quick and easy. Providing users with reconciliations clearly shows what adjustments have been made to the GAAP line items and, when comparatives are provided, allows users to assess consistency between non-GAAP measures between periods. Companies are therefore encouraged to revisit these disclosures and ensure clear reconciliations are provided and these are cross referenced when the relevant non-GAAP measure is referred to in the report.

### Figure 5.5 How consistent are non-GAAP measures?

![Figure 5.5](image1)

<table>
<thead>
<tr>
<th>Consistency Type</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>No non-GAAP measures</td>
<td>13%</td>
</tr>
<tr>
<td>Consistent with both Income Statement and IFRS 8</td>
<td>36%</td>
</tr>
<tr>
<td>Consistent with Income Statement only</td>
<td>24%</td>
</tr>
<tr>
<td>Consistent with IFRS 8 only</td>
<td>9%</td>
</tr>
<tr>
<td>Based on industry guidelines</td>
<td>6%</td>
</tr>
<tr>
<td>Not consistent with other information</td>
<td>12%</td>
</tr>
</tbody>
</table>

### Figure 5.6 Were reconciliations presented by those companies which presented non-GAAP measures?

![Figure 5.6](image2)

<table>
<thead>
<tr>
<th>Reconciliation Type</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes for all clear cross-reference from the summary page</td>
<td>37%</td>
</tr>
<tr>
<td>Yes for all measures, but no cross-reference</td>
<td>45%</td>
</tr>
<tr>
<td>Yes for some measures, clear cross-reference from the summary page</td>
<td>4%</td>
</tr>
<tr>
<td>Yes for some measures, but no cross-reference</td>
<td>9%</td>
</tr>
<tr>
<td>No reconciliations presented</td>
<td>5%</td>
</tr>
</tbody>
</table>
Comparatives should be given for all APMs. 87% of companies that presented non-GAAP measures provided a comparative for at least one year, the average being two years. Providing comparatives allows users to understand year-on-year performance of the company and, alongside clear reconciliations, gives an understanding of the consistency of reconciling items. It was therefore encouraging to see the majority of companies’ present comparatives. It is worth noting that those companies who failed to provide comparatives for non-GAAP measures will need to do so in their next annual report in order to be compliant with the ESMA Guidelines.

In order to assist companies in complying with the ESMA Guidelines, Deloitte has published Need to know – Alternative performance measures: A practical guide. This publication explores some of the key messages from regulators, standard setters and investors about the use of APMs, with a particular focus on assisting compliance with the ESMA Guidelines and sets out what is considered to be best practice in presenting APMs.

National Grid (Example 5.3), BT Group plc (Example 5.4) and Rolls-Royce Holdings plc appear to have taken on board aspects of the ESMA Guidelines.

Inclusion of KPIs in summary information
Companies clearly continue to see the benefit of drawing users’ attention to those measures considered key to understanding the performance of the company at the beginning of the annual report. Figure 5.7 shows that many companies presented KPIs in their summary sections. However, despite 70 (2015: 74) companies presenting a non-financial KPI later on in the annual report, only 13 (2015: 13) of them included any of these in the summary section. When comparing this to financial KPIs, 79 (2015: 74) of the 93 (2015: 90) companies that presented financial KPIs included some of these in the summary section. This demonstrates that companies still appear to see financial KPIs as more important to a user in their understanding of the business.

Given KPIs are considered key measures in understanding the performance and position of the business, you would have thought drawing these to the attention of the user early on would provide them with a useful initial snapshot of the business, and set the scene for the report. It was therefore interesting to note that few companies favour presenting all of their KPIs in the summary section (sometimes along with non-KPIs), with only eight (2015: five) companies doing so and with nine companies not including any of their KPIs in the summary section. For more discussion of how companies presented their KPIs, see chapter 7.

Figure 5.7 Are measures presented in the summary section the same as KPIs?

<table>
<thead>
<tr>
<th>Type of KPIs presented in the in the summary section (i.e. financial, non-financial or a mixture)</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>66</td>
<td>61</td>
</tr>
<tr>
<td></td>
<td>Both financial and non-financial</td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>N/A*</td>
<td>21</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>Financial</td>
<td>39</td>
</tr>
<tr>
<td></td>
<td>Both financial and non-financial</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>N/A*</td>
<td>9</td>
</tr>
<tr>
<td>Other</td>
<td>Financial</td>
<td>27</td>
</tr>
<tr>
<td></td>
<td>Both financial and non-financial</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>N/A*</td>
<td>12</td>
</tr>
</tbody>
</table>

*N/A relates to companies that either didn’t present a summary section, companies that only presented narrative information in the summary section or companies that did not present any KPIs in their summary section.
Good practice examples

Example 5.1

Acacia Mining plc Annual Report & Accounts 2015 (p6-7)

One of the companies who chose to present their business model within the summary section was Acacia Mining plc. In doing so, they have clearly demonstrated to users how they create value to stakeholders upfront. They have also incorporated their strategic pillars into their business model and signposted further information to the user.
Kaz Minerals plc provided a good example of how to present a company's locations. This was achieved through a map where locations were clearly marked and key information was provided for each location.
Example 5.3
National Grid Plc Annual Report and Accounts 2015/16 (p241)

A good example of clear disclosure with respect to non-GAAP measures was provided by National Grid Plc. Equal prominence has been given to both GAAP and non-GAAP measures with the equivalent GAAP measure being provided for each non-GAAP measure presented, comparatives for each measure have been provided and there is a clear cross reference to where reconciliations have been disclosed later on in the annual report. On that basis, this disclosure appears to be materially in line with the ESMA Guidelines.

Example 5.4
BT Group plc Annual Report 2016 (p241)

BT Group plc included an appendix which explains how they use APMs, explains the adjustments (termed ‘specific items’) made to GAAP measures and provides reconciliations, with two years of comparatives, clearly showing how the APM derives from the GAAP measure. The disclosure shown is an extract of the appendix showing a reconciliation for the ‘Adjusted EBITDA’ figure.
Example 5.5  
CLS Holdings plc Annual Report and Accounts 2015 (p4-5)

CLS Holdings plc demonstrated a link between various elements of the annual report within the summary section through the use of a table which linked the company’s business model, strategy, KPIs, risks and achievements. Cross references are also provided to where further information on these elements is given later on in the report.
Example 5.6
John Wood Group plc Annual Report and Accounts 2015 (p1)

John Wood Group plc provides a good example where context is given for the overall financial performance during the year. The chief executive indicates how the performance related to expectations. This helps set the scene for the user and provides some perspective for the remainder of the annual report.

Example 5.7
United Utilities Group Plc Annual Report and Financial Statements 2016 (p3)

A good example of a company providing context for the financial information presented in the summary section was demonstrated by United Utilities Plc. Prior year comparatives and narrative commentary that discusses trend information has been provided. This helps provide some context for the financial information presented.

“Against a backdrop of significantly reduced customer activity, the Group delivered EBITA of £470m in line with expectations and 14.5% lower than 2014. Our continued actions to reduce costs, improve efficiency and broaden our service offering through organic initiatives and strategic acquisitions, position us as a strong and balanced business in both the current environment and for when market conditions recover.”

Robin Watson, Chief Executive
The strategic report

**Top Tips**

- To help keep the annual report clear and concise, consider including CR information that is not material in a separate report or on the company website and provide a cross-reference in the annual report to where this can be accessed – 49% (2015: 34%) of companies currently do this.

- When describing the strategy of the company, think about how other parts of the strategic report can be linked into the strategy to demonstrate the holistic nature of the company’s operations.

- It is useful when presenting the company’s objectives to include information on how progress towards achieving the objectives is measured. 62% (2015: 63%) of companies did not provide any link between their objectives and how these were measured.

- The business model should explain how the company creates value – 71 companies included a business model discussing this with 33 (2015: 25) companies talking about value creation for a variety of their stakeholders.

**Keep an eye on**

- Whether the linkage given is logical when linking elements of the strategic report together. Try to ensure that there is a clearly discernible relationship between the elements being linked when doing this. Linkage of strategy and risks was frequently not particularly logical with only 28% (of the 18% of companies that linked these two elements at all) presenting linkage that, in our view, made complete sense.

- The usefulness of a visual representation of the company’s business model. 70 (2015: 57) companies used a visual representation to illustrate their business model. However, in our view only 41 (2015: 38) of these representations made it easier to understand the business model, with others failing to be clearly structured or company-specific.

**Introduction**

Section 414C of the Companies Act 2006 requires that all UK companies (other than those that meet the CA06 definition of ‘small’) prepare a strategic report, which should be approved by the directors. This approval may be combined with that of the directors’ report, as long as it is clear that each report has been approved by the board. The strategic report is required to contain:

- a fair, balanced and comprehensive review of the company’s business;

- a description of the principal risks and uncertainties facing the company; and

- to the extent necessary for an understanding of the development, performance or position of the company, analysis using financial key performance indicators (KPIs) and where appropriate, analysis using other KPIs, including information relating to environmental and employee matters.

For quoted companies, the strategic report should also contain the following (although the first two items are only required to the extent necessary for an understanding of the company’s development, performance or position):

- information on the main trends and factors likely to affect the future development, performance and position of the company’s business;

- information on environmental matters, employees and social, community and human rights issues, including any policies in these areas and their effectiveness (if any of these disclosures are omitted this should be stated);

- a description of the company's business model and its strategy (plus its objectives, as suggested by the UK Corporate Governance Code and the FRC’s Guidance on the Strategic Report – see below); and

- a gender analysis of the parent company’s directors, the group’s senior management and the group’s employees as a whole.

Although technically a requirement of the directors’ report, most companies also include the information that they are required to present about greenhouse gas emissions in the strategic report, taking advantage of the legal provision that allows them to do this.
For those companies looking to produce a strategic report that complies with the legal requirements in the most effective way possible, the FRC’s Guidance on the Strategic Report 41 (the FRC Guidance) gives helpful insight into how to do this – see also chapter 4. The FRC has also published Clear & Concise: Developments in Narrative Reporting 42, which includes further practical tips to help companies achieve clear & concise reporting. Another, even more effective method of ensuring that your reporting is as meaningful as possible is to take on board the principles of Integrated Reporting (<IR>) – throughout this chapter, and within other chapters of the publication, you will find boxes highlighting the relevant parts of the <IR> framework. <IR> is discussed in more detail in chapter 3. Ultimately though, integrated reporting is not about reporting, it is about applying integrated thinking in running a business, and from this an integrated report is a natural output. The better practice examples identified within this chapter also provide examples of how companies have put the recommendations of <IR> and the FRC Guidance into practice.

The FRC Guidance sets out three broad categories of content elements, most of which are drawn directly from the law. However, the best annual reports do not present the information as separate ‘silos’ but instead incorporate and integrate these various elements throughout their strategic report.

<table>
<thead>
<tr>
<th>Strategic management</th>
<th>Environmental context</th>
<th>Business performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>How the entity intends to generate and preserve value</td>
<td>The internal and external environment in which the entity operates</td>
<td>How the entity has developed and performed and its position at the year end</td>
</tr>
<tr>
<td>Strategy and objectives (section 2 of this chapter)</td>
<td>Trends and factors (section 2 of this chapter)</td>
<td>Analysis of performance and position (chapters 14 and 15)</td>
</tr>
<tr>
<td>Business model (section 1 of this chapter)</td>
<td>Principal risks and uncertainties (chapter 9)</td>
<td>Key performance indicators (chapter 8)</td>
</tr>
<tr>
<td></td>
<td>Environmental, employee, social, community and human rights matters (section 3 of this chapter)</td>
<td>Employee gender diversity (section 3 of this chapter)</td>
</tr>
</tbody>
</table>

This chapter is divided into sections that cover several of these content elements.

- The business model, including how well companies make use of diagrammatic representations of this and the extent to which they apply the principles of <IR> when showcasing it.
- The company’s strategy and objectives, including linkage between these and other elements of the strategic report.
- Consideration of sustainability/corporate responsibility disclosures, including the extent to which these are integrated into the rest of the report and the extent to which companies provide voluntary disclosures that go beyond the requirements of the law in relation to areas such as bribery and corruption, modern slavery, payment of suppliers and gender pay gap.

It also includes a section examining the extent of disclosures made in relation to two current hot topics where the law does not require as much disclosure as some groups believe is necessary. These are the disclosure of dividend policy and resources and disclosures about tax.

Throughout this chapter there is discussion of both ‘linkage’ and ‘cross-referencing’ in terms of how companies can tie together the relevant key parts of their strategic report. These two terms are used in the context given to them by the FRC, detailed below. It is important to note that linkage is a more comprehensive connection between two elements of an annual report, e.g. a strategic element and a KPI, than cross-referencing. However cross-referencing can be useful in ensuring that the annual report is kept clear and concise by ensuring that similar information is not duplicated throughout the narrative.

**CROSS-REFERENCING**
A means by which an item of information which has been disclosed in one component of an annual report, can be included as an integral part of another component of the annual report.

**LINKAGE**
A relationship or interdependency between, or the cause and effect of, facts and circumstances disclosed in the annual report.

Section 1. Business Model

Overall business model

A business model is a key component of the strategic report as it gives information as to what an entity does and how and why it does it. By including such information the company can then demonstrate how the entity generates and preserves value. In July 2015 the FRC’s Financial Reporting Lab (the Lab) announced a new project on effective business model reporting. The initial findings of this project revealed that the majority of companies are not convinced that business model disclosures are valued by investors. However most investors interviewed as part of the Lab’s project in fact revealed that they would like to see more detailed information provided on the business model, particularly in relation to value creation. Furthermore investors highlighted that a failure by company management to provide a clear and concise business model in their annual report was a concern, with some investors deciding not to invest as a result of this.

Both the Companies Act 2006 and the UK Corporate Governance Code require the strategic report to include a description of the company’s business model. This description should provide information on how the company generates or preserves value through its activities. However the business model should include more than just an account of what the company does.

The FRC Guidance includes a variety of areas that a company should seek to cover in the information they provide in their business model including its structure, the markets it operates in and the nature of the relationships, resources and other inputs necessary for the success of the company’s business. Where a business is complex it may be helpful to include a visual representation (such as a diagram or flow chart) to help explain the process – see the ‘Visual representation of the business model’ section later for further discussion.

In order to keep their business model clear and concise a company should focus on those parts of its business that are most significant in generating, preserving and capturing value. Business model disclosures can therefore be expected to vary considerably based on the size and complexity of the particular company in question – there is no ‘one size fits all’. BT Group plc (Example 6.1) for example included a detailed business model diagram containing a considerable amount of information whereas Howden Joinery Group Plc (Example 6.2) included equally as detailed information in the form of narrative in their Chief Executive’s statement.

LINKAGE

The FRC’s Guidance suggests the business model is a good place to demonstrate linkage existing between key elements of the strategic report e.g. strategy, risks and KPIs. This is discussed in more detail in the sections on visual representation of the business model and on interaction of the strategy and business model.

<IR> Business model

Like a strategic report, an integrated report must also describe the business model, including the key inputs, business activities, outputs and outcomes. The <IR> Framework defines a company’s business model as “its system of transforming inputs, through its business activities, into outputs and outcomes that aims to fulfil the organisation’s strategic purposes and create value over the short, medium and long term”. A good example of an ‘integrated’ business model is provided by Aggreko PLC (Example 6.3).

Other observations

<table>
<thead>
<tr>
<th>Report included a section entitled business model</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>84%</td>
<td>87%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>90%</td>
<td>88%</td>
</tr>
<tr>
<td>Others</td>
<td>76%</td>
<td>86%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Report included a section that was obviously the business model but was not described as such*</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>9%</td>
<td>9%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>7%</td>
<td>11%</td>
</tr>
<tr>
<td>Others</td>
<td>12%</td>
<td>7%</td>
</tr>
</tbody>
</table>

*Such sections were described in a variety of ways including ‘Understanding our business’ and ‘How we create value’.

44. Section 414C(8)(b)
45. Provision C.1.2
Visual representation of the business model

70 of the 93 companies that discussed their business model (2015: 57 out of 96) included a visual representation of their business model. Although this can help in presenting business model information in a reader-friendly way, particularly where the activities of the company are complex, companies should give careful thought as to whether the visual representation they provide does in fact aid understandability. Of these visual representations presented, there was a drop in the proportion that were deemed to make the business model easier to understand, with 59% (2015: 67%) achieving this. This shift was largely driven by the smaller listed companies surveyed, with only 46% (2015: 52%) of the visual representations included by smaller companies helping to make the business model easier to understand. For smaller, simpler businesses visual representations can add confusion by presenting something that is meaningful and specific to their own activities. A good diagram would usually include:

- a description of the resources/inputs used by the company;
- a description of the activities/processes that add value to these to produce the outputs and outcomes of the company; and
- a description of how key inputs relate to the capitals on which the company depends, or that provide a source of differentiation to the company, ideas which are discussed in the <IR> Framework (see section on Resources and Relationships below).

Relationships and resources

A good business model should illustrate the relationships, resources and other inputs necessary for the success of the business. The business model should then demonstrate how these various factors, which go beyond those reflected in the financial statements, are utilised in order to create value. The resources that are material to a company will clearly differ depending on the nature of that company’s operations but could include both tangible and intangible resources (such as reputation, brand, employees, research and development and natural resources).

<IR> Inputs, outputs and outcomes

As identified above, a business model should include discussion of the company’s key inputs, business activities, outputs and outcomes. <IR> also introduces the concept of ‘capitals’ to describe a company’s relationships and resources. ‘Capitals’ are the stocks of value that are used as inputs into a business model and which are increased, decreased or transformed through the business activities and outputs. The <IR> Framework determines that, broadly, there are six categories of capitals: financial, manufactured, intellectual, human, natural and social and relationship.

In an integrated report a company should demonstrate how key inputs relate to the capitals on which the company depends, or that provide a source of differentiation to the company. This is, in part, an extension of the FRC Guidance which recommends that the description of the business model should provide shareholders with a broad understanding of the nature of the relationships, resources and other inputs that are necessary for the success of the business, and also a description of what makes the entity different from its peers.

Outsputs of the business activities are considered to be items such as products, services, by-products and waste. However, an integrated report will also consider the ‘outcomes’ of the business cycle, namely the internal and external effects (both positive and negative) on the company’s capitals as a result of the business activities and outputs. There is no requirement under the <IR> Framework to identify all six capitals as being material to a company, nor to use the same terminology as that used in the <IR> Framework. The examples later in this chapter of companies applying the concepts of the <IR> Framework to their business model demonstrate the different resources and relationships, specific to the companies themselves, which have been identified as capitals.
65 companies (2015: 51) included a business model that contained reference to relationships or resources (or ‘capitals’ using <IR> terminology) that were central to their business model. This increase was driven by a noticeable rise in the FTSE 350 companies surveyed of which 78% (2015: 58%) included a business model containing some discussion of resources. It was encouraging to see that several companies had revised their business model for this year’s report, incorporating more detail about their resources and relationships. This increasing awareness of the broader resources on which a company depends, amongst the companies in our sample, is evident in Figure 6.1. As above, the <IR> Framework identifies six capitals – of those identifying resources, most referred to resources that fell broadly into four of the <IR> capitals. It is important to note that it would not be expected for most companies to refer to all six capitals given that some will not be as relevant to their business activities as others e.g. a financial services firm would be less affected by natural capital than say a mining business.

Key resources were clearly identified and discussed as part of the business model by Anglo American plc (Example 6.5) and by Tate & Lyle PLC. A minority of annual reports in our survey, having identified the resources that were key to their business model then went on to discuss how the company intended to develop and maintain such resources going forward (see detail in the <IR> Resource allocation and development’ box below). Xaar plc (Example 6.6) was one of the companies that did this clearly through the use of a colour key and column detailing their plans for the next financial year.

Figure 6.1 How many capitals were identified by each company?

Figure 6.2 Of those companies identifying <IR> capitals, which ones are referred to?

Figure 6.2 gives further detail on which resources were identified by companies. Consistent with the previous year the most common resources discussed were human (such as employees) and social and relationship (with stakeholders such as customers) which is understandable given the importance of these to the majority of industries. It is encouraging to see an increase in the number of companies referring to intellectual capital, which includes brands, reputation and other intellectual property (e.g. patents), given that the 2016 Reputation Dividend Report47 indicated that UK corporate reputations contributed £790bn of shareholder value at the start of 2016 (up from £620bn in 2015).

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<IR> Resource allocation and development
The <IR> Framework requires an integrated report to answer the question “Where does the organisation want to go and how does it intend to get there?” Ordinarily, this would include identifying the resource allocation plan the company has to implement its strategy, both as regards current resources and how it will further develop these resources in the future.

13 companies clearly identified some resource allocation or development plans i.e. specifically identified financial investment needed or a numerical target that it hoped to achieve as regards meeting future resource requirements. Another 48 companies provided this detail in part, by, for example, including the need to recruit a certain number of people to be able to support those value-creating activities identified as part of the business model.

Information on resources will be crucial in demonstrating how the company creates value for its various stakeholders. Such stakeholders will include shareholders but also others depending on the nature of the company’s operations, such as employees, suppliers, regulators and the local community. Persimmon plc (Example 6.7) clearly identified the outcomes produced by its business model for various stakeholders in its annual report. Good practice is for companies to include details of the impact of their activities on their varying stakeholders, often described as Corporate Responsibility (CR), throughout their strategic report (see the CR section later for further discussion). For further discussion of stakeholder engagement see chapter 4.

<IR> Impact on stakeholders
Through the process of identifying its capitals, a company would have identified the stakeholders upon which its business activities have a material impact. Similarly, to satisfy the <IR> Framework’s question of “What does the organisation do and what are the circumstances under which it operates?” a company should consider factors affecting the external environment which, in turn, impact the company. These impacts could be direct or indirect, such as influencing the availability, quality and affordability of a capital that the company uses or affects.

Applying integrated thinking requires an organisation to consider not only the outputs of their business, but also the outcomes i.e. the effects that outputs have on other capitals including those capitals directly related to the sustainability of the business. As such, the impact on these wider groups of stakeholders would ordinarily be considered.

<IR> Value creation
Value creation is central to the business model, which should clearly set out how a company generates or preserves value over the longer term. In simple terms this involves describing what the company actually does in its day-to-day operations. This should not just be a basic explanation of what the company’s activities are but should describe why the company carries out its operations in the way it does and how, as a result, value is generated for its stakeholders. Such a description should be specific to the company itself and thus demonstrate how the company can be differentiated from its peers in terms of its ability to create value.

A number of companies go on to use case studies in their annual report in order to demonstrate how they have created value for their stakeholders. When using case studies it is important that companies bear in mind the necessity of keeping the annual report clear and concise and therefore avoid including long case studies scattered throughout the narrative. In their Annual Report and Form 20-F 2015, BP plc included brief case studies where relevant in order to demonstrate their value creation in action whilst including cross-references to where readers could access further information outside the annual report.

<IR> Value creation
In the world of <IR>, value is not restricted to financial capital for just the company and its shareholders, but is considered more widely in terms of value generated by the impact of the business activities and outputs upon all capitals. The ability of a company to create value for itself is linked to the value that it creates for others. For example, value can be created through enhancing customer satisfaction, suppliers’ willingness to trade with the company and the terms under which they do so, and the impact of business activities on the company’s brand. An integrated report includes details of those interactions, activities and relationships which are material to the company’s ability to create value for itself. The business model in an integrated report should describe value creation over the short, medium and long term.
43% of companies included an explicit reference to value creation in their business model (i.e. specifically discussed value creation using those words). A further 28% of companies surveyed included a business model that discussed value creation generally without using the specific wording. Overall 71% (2015: 54%) discussed value creation either implicitly or explicitly. It is encouraging to see that a majority of companies are considering their business model in value creation terms rather than as a simple description of the company’s activities. Those companies surveyed that didn’t address the issue of value creation frequently presented a business model that simply described the company’s activities e.g. by setting out the different business divisions of the company.

Figure 6.3 illustrates how the business models in our sample talked about value creation (this included those companies that used terms such as ‘value creation’/‘creates value’ explicitly, in addition to those that talked about the concept without using those specific words). Johnson Matthey Plc discuss value creation for a variety of stakeholders by including a pie-chart showing how financial value had been distributed amongst the company’s stakeholders in the year (Example 6.8).

Value creation was most commonly discussed over the longer-term (see Figure 6.4) – a medium term period was assessed to be the period covered by the entity’s viability statement (see chapter 10 for further information on the viability statement). Of those companies discussing value creation over the longer-term some did so explicitly whereas others made it clear that they were considering a long term period e.g. by discussing the next ten years of company activities.

Focusing discussion of value creation on the long term is important given recent criticisms over the short-termism of many companies and the need for investors to consider their responsibilities under The UK Stewardship Code\(^4\) to influence and promote companies’ long-term performance. The FRC Guidance also encourages companies to include within their business model a description of how the company generates or preserves value over the long term. Good examples of discussion of value creation in a business model were provided by National Grid Plc (Example 6.9) and International Personal Finance plc who included detail on how value was created for various groups of different stakeholders in the pages following the business model itself.

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Few companies surveyed illustrated any clear linkage between their business model and strategy. While we would not expect all companies to be able to comprehensively incorporate their strategy into every element of their business model, especially if this could only result from ‘shoe-horning’ information together, it is surprising that many gave no linkage and did not provide a cross reference either. **St James’ Place plc** *(Example 6.10)* provided a good example of illustrating how their strategy will develop their business model by discussing strategy in terms of the key stakeholder relationships identified earlier in the business model. **G4S plc** incorporated their strategy directly into the visual representation of their business model by including detail on their strategic priorities and how they link to the activities of the business and value creation.

### Other observations

<table>
<thead>
<tr>
<th>Cross-reference between business model and discussion of strategy given</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>20%</td>
</tr>
<tr>
<td>Both sections on same page</td>
<td>17%</td>
</tr>
<tr>
<td>No</td>
<td>63%</td>
</tr>
</tbody>
</table>
Section 1. Business model – good practice examples

For each example, the aspects of good practice that it illustrates are listed next to it.

Example 6.1

• Detailed business model diagram containing considerable amount of information and cross references.

• ‘Integrated’ business model.
Detailed, concise business model in the form of narrative as opposed to using a visual representation.
‘Integrated’ business model.
Example 6.4
Fresnillo plc Annual Report 2015 (p18-20)

Linkage between business model and other key elements of the strategic report, particularly CR priorities.
Example 6.5
Anglo American plc Annual Report 2015 (p6-7)

- Good visual representation of a business model.
- Clear identification and discussion within the business model of the business’ key resources.
Example 6.6
Xaar plc Annual Report and Financial Statements 2015 (p2-3)

Provides information as to how the company is planning to nurture the resources that are key to the business model in the ‘Our plans for 2016’ column e.g. continued investment in staff.
Identification of outcomes produced by the company’s business model for various stakeholders.
Example 6.8

Johnson Matthey Plc Annual Report & Accounts 2016 (p41)

Distribution of value created to stakeholders.
Example 6.9
National Grid Plc Annual Report and Accounts 2015/16 (p14-15)

- Discussion of value creation in the business model.
- Good visual representation of the business model.
Example 6.10
St James' Place PLC Annual Report & Accounts 2015 (p7)

How the company’s strategy will develop its business model.

OUR BUSINESS MODEL

St. James's Place plc is a FTSE 100 listed Company. The business is centred in the UK
and seeks to attract clients from the mass affluent and high net worth markets.

To deliver positive outcomes to an increasing population of clients

To continue to grow and develop the Partnership

To increase funds under management

Value for Clients

Value for Shareholders

SJP is a wealth management business; the Group’s advisers, the
St. James’s Place Partnership, provide clients with a financial
planning service and face-to-face advice, and clients’ wealth
is managed through the Group’s distinctive Investment
Management Approach (IMA). Almost uniquely within the UK
wealth management market, this vertically integrated model
means that the Group is directly responsible for the whole
offering, including advice, management of investments and any
related services.

The Partnership is critical to the success of the business.
Partners are able to attract clients and, through building trust,
develop long term relationships, supporting clients with their
financial needs over time. This relationship-based approach
is greatly valued by the Group’s clients, no more so than in periods
of financial uncertainty. The Group’s experience is that there is
an increasing demand for trusted advice from experienced
advisers, backed by a strong brand and an organisation which
takes responsibility for all aspects of the service.

As a result, the Group is able to attract and retain retail
funds under management from clients with an increasing
management fee. This is the principal source of income for the
Group, and growth in both advised assets under management and the success of our approach
results in new funds under management.

Attracting new funds under management is core to the success
of the Group, and growth in both advised assets under management
and the success of our approach
results in new funds under management. As a result, the Group is able to attract and retain retail
funds under management from clients with an increasing
management fee.

Value for Clients

Value for Shareholders
Section 2. Strategy
Market overview and company strategy
By providing information on the markets in which it operates and how it engages with these markets, a company can demonstrate not only how it creates value for its stakeholders through its business model but also provide a background or context for its strategy and for its discussion of its performance in the year. This will be particularly important for companies that are intending to implement a new strategy/change in strategy in the next financial year as they will need to discuss both the previous strategy and how the new strategy will continue to develop the company. Discussion of strategy will differ based on the nature and size of the company – some companies disclose a large amount of information as regards their varying ‘strategic elements’, whereas others include briefer overviews of their strategy. Some companies include a specific strategy for each of their business divisions in addition to the overall company strategy – companies that do this should ensure that there is some link between the division-specific and the company strategy as this was not always the case.

The FRC Guidance notes that the main trends and factors likely to affect the future development, performance or position of the business should be included in the strategic report to the extent necessary for an understanding of the company’s business.40 79% (2015: 73%) of companies surveyed presented an overview of trends in the markets in which their businesses operate.

It was particularly encouraging to see an increase in the number of smaller listed companies surveyed that provided such a market overview (69% up from 53% in 2015). Treatt PLC was one of the smaller listed companies that did provide such an overview.

The best annual reports illustrate how the company is responding to the market trends identified, rather than just producing an analysis of the market/industry trends that is factual but not tailored to the company. 66% of companies surveyed provided such information as to how they are responding to market trends – Johnson Matthey Plc (Example 6.11) provided a good explanation of their strategic responses to changing market trends, as did Vectura Group plc (Example 6.12). Resilient, sustainable business models are one of the key themes of current narrative reporting and emphasise the importance of a company’s business model, including detail on their response to both positive and negative market trends.

Other observations
Report includes discussion of outlook facing the company

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>In CEO’s statement</td>
<td>29%</td>
</tr>
<tr>
<td>In chairman’s statement</td>
<td>24%</td>
</tr>
<tr>
<td>In CEO’s and chairman’s statements</td>
<td>34%</td>
</tr>
<tr>
<td>Only elsewhere in strategic report</td>
<td>8%</td>
</tr>
<tr>
<td>No discussion</td>
<td>5%</td>
</tr>
</tbody>
</table>

Including forward-looking information is a requirement of the Companies Act as well as being key for integrated reporting. Most companies give such information significant prominence by including it in the CEO’s or Chairman’s statements and in some cases it is discussed again elsewhere in the strategic report. However, 5% of companies surveyed are still not providing any information on the outlook for their business. Pearson PLC was one of the FTSE 350 companies surveyed that provided detailed disclosure of its outlook.

Report includes discussion of specific opportunities presenting themselves to the company

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>In CEO’s statement</td>
<td>33%</td>
</tr>
<tr>
<td>In chairman’s statement</td>
<td>1%</td>
</tr>
<tr>
<td>In CEO’s and chairman’s statements</td>
<td>4%</td>
</tr>
<tr>
<td>Only elsewhere in strategic report</td>
<td>40%</td>
</tr>
<tr>
<td>No discussion</td>
<td>22%</td>
</tr>
</tbody>
</table>

The fact that 22% of companies are not providing any discussion of their future opportunities suggests that their discussion of the outlook facing them could be further developed to make it a more comprehensive analysis of their circumstances and thus identify potential opportunities as part of it. Croda International Plc discussed their opportunities in the context of the industry’s global drivers of change.
**Strategy and objectives**

A quoted company is required to describe its strategy in its strategic report by the Companies Act. 97% (2015: 95%) of companies surveyed, in our view, clearly set out their strategy in their annual report. 84% presented a discussion of strategy in a clearly distinct section of their report, although this was less popular with smaller companies, with only 69% of those outside the FTSE 350 electing to do so.

Provision C.1.2 of the UK Corporate Governance Code states that the annual report should contain an explanation of “the strategy for delivering the objectives of the company”. Objectives (frequently described as ‘strategic priorities’) are commonly understood to be the goals, aims or missions of the company whereas the strategy denotes the intended plan as to how these objectives should be achieved. These two terms are frequently used interchangeably by companies and this can, at times, lead to some confusion in the articulation of both. Of the companies surveyed 81% clearly set out the objectives of their business, objectives reported ranged from detailed descriptions to more basic ‘mission statements’ e.g. “the company’s objective is to increase total shareholder value”. The latter was more common amongst the smaller listed companies, a number of which then failed to go on to explain a coherent strategy for achieving such an objective.

**British Polythene Industries PLC** was an example of a smaller listed company that did clearly identify its objectives.

The majority of companies included a mix of financial and non-financial objectives (see Figure 6.5) indicating that they consider their goals to be of a more holistic nature than merely meeting financial targets. Inclusion of non-financial objectives also demonstrates the integration of CR priorities into the wider strategic report discussion. Non-financial objectives included by companies in our survey ranged from “to become the bank of choice for our stakeholders” to “to work with our customers to find innovative solutions”.

**Figure 6.5 What type of objectives are identified by companies?**

![Chart showing the distribution of objectives identified by companies.](image)

**LINKAGE**

Given the interrelationship between strategy and objectives it is beneficial to present these in a linked way. Popular ways of doing this included a table setting out what the company wanted to achieve (its objective) and alongside how they were going to go about achieving this (its strategy). By showing linkage in these areas it demonstrates why the company has adopted the strategy it has, by setting out what the business wants to achieve.

Other observations

<table>
<thead>
<tr>
<th>Report clearly illustrates linkage between objectives and the financial/operational metric measuring them*</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>All objectives linked</td>
<td>19%</td>
<td>23%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>22%</td>
<td>28%</td>
</tr>
<tr>
<td>Others</td>
<td>14%</td>
<td>16%</td>
</tr>
</tbody>
</table>

*Financial and operating metrics were not only measures specifically designated as KPIs (linkage between objectives/overall strategy and KPIs specifically is examined in the next section).
Strategy linkage

Linkage between separate parts of the annual report helps a company show how its strategy underpins the business and management consider the business in a holistic way. Good linkage goes beyond a simple cross-reference by providing some context or explanation as to how the different areas of the reports link. For further discussion of linkage and cross-referencing see the start of this chapter.

The table below contains statistics on linkage and cross-references as included in the discussion of objectives/strategy and not elsewhere in the annual report. Statistics have also been collected on linkage and cross-referencing between strategy and KPIs (see chapter 7) and between strategy and the discussion of principal risks (see chapter 8), regardless of where that linkage is presented. There are also some overall considerations in relation to linkage in the annual reports of the companies surveyed in chapter 4.

<table>
<thead>
<tr>
<th>Report includes a basic cross reference from:</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Objectives/strategy to KPIs</td>
<td></td>
</tr>
<tr>
<td>Overall</td>
<td>27%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>36%</td>
</tr>
<tr>
<td>Others</td>
<td>14%</td>
</tr>
</tbody>
</table>

A company should make sure that, when using a cross-reference it specifically identifies the nature and location of the information to which it relates. KPIs were the most common element that was cross-referenced to strategy, perhaps not surprising given that they should demonstrate how the strategy is measured.

<table>
<thead>
<tr>
<th>Objectives/strategy to principal risks</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>20%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>29%</td>
</tr>
<tr>
<td>Others</td>
<td>7%</td>
</tr>
</tbody>
</table>

The fact that only a minority of companies provided a cross-reference between their strategy discussion and their principal risks implies that there may be a failure to consider these two elements as interrelated, i.e. that your principal risks should be identified bearing in mind what your strategy actually is.

**Linkage from Strategy to KPIs (i.e. information is provided for each strategy element about which KPIs are related to it)**

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Complete linkage</td>
<td>15%</td>
</tr>
<tr>
<td>Partial linkage</td>
<td>11%</td>
</tr>
<tr>
<td>No linkage</td>
<td>74%</td>
</tr>
</tbody>
</table>

It is surprising that the majority of companies do not directly link their strategy to any of their KPIs (although a slightly higher number do provide linkage between their objectives and the means by which these are measured as detailed in the section above). Thought should be given as to whether KPI measures are those ‘key’ to the company if they cannot be linked in any way to the company’s strategy. Where any non-GAAP measures have been chosen as KPIs, providing a link between these and the company’s strategy can be an easy way of showing their purpose – something that will be required in future by the ESMA Guidelines on Alternative Performance Measures.

**Is linkage from strategy to KPIs logical? (as % of the 26 companies including linkage)**

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Completely</td>
<td>50%</td>
</tr>
<tr>
<td>In part</td>
<td>50%</td>
</tr>
</tbody>
</table>

To determine whether the linkage presented was logical, the KPIs were examined in light of the strategic element they had been linked to in order to see if it was clear that there was a genuine relationship between the two. The fact that only half of those companies presenting some linkage gave linkage that always appeared logical suggests that some companies need to consider whether there is in fact a relationship present in the manner suggested or to explain it more clearly. Acacia Mining PLC (Example 6.14) was an example of one of the few companies surveyed that presented logical linkage between all strategic elements and KPIs.
Report includes linkage from strategy to risks (i.e. information is provided for each strategy element about which risks are related to it) 2016

Complete linkage 17%
Partial linkage 1%
No linkage 82%

It is interesting to note that for those companies that did present linkage between their strategy and risks the vast majority provided linkage between all areas. This suggests that perhaps when companies do think about this linkage they find it easier to connect a risk to every element of strategy rather than to identify only some potential relationships.

<table>
<thead>
<tr>
<th>Is linkage from strategy to risks logical?</th>
<th>2016</th>
<th>(as % of the 18 companies including linkage)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Completely</td>
<td>28%</td>
<td></td>
</tr>
<tr>
<td>In part</td>
<td>72%</td>
<td></td>
</tr>
</tbody>
</table>

As noted directly above most companies that provided linkage associated a risk with all the components of their strategies. However only a minority of companies that provided any linkage in this area presented linkage where the logic was deemed self-evident. For example, some companies provided very generic linkage by linking overarching risks e.g. ‘business risk’ to a specific part of their strategy without properly explaining how that element of their strategy was linked to the wider risk. Such information is useful in the strategy section, rather than solely relying on descriptions in the principal risks section, as a failure to do so can result in linkage in the strategy section being unclear or seeming superficial. Other companies provided linkage that did not seem logical, i.e. there was no apparent relationship discernible between the risk and strategy - this was perhaps a result of trying to ‘shoehorn’ elements of the report together. G4S plc and St Modwen Properties PLC (Example 6.15) both provided a good example of how to logically link risks and strategy.

Report includes linkage between strategy and corporate responsibility (i.e. information is provided for each strategy element about which CR priorities are related to it) 2016

| Complete linkage | 1% |
| Partial linkage  | 9% |
| No linkage       | 90% |

Generally, CR content in the strategic report is presented in the form of a separate report most commonly towards the end. Better companies demonstrate how CR considerations are embedded in their strategy. Companies should give consideration as to how content that may currently be included in the annual report does actually relate to the company’s overall strategy as, if it does not, it could instead be included in a standalone CR report thereby keeping the annual report clear and concise. Rexam plc (Example 6.16) and Fresnillo plc (Example 6.4) incorporated CR priorities well into their strategy/business models. It should be noted that it may not be the case that every strategy element would have CR linkage and companies should consider this in light of their own specific facts and circumstances.

<table>
<thead>
<tr>
<th>Is linkage between strategy and corporate responsibility logical?</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>(as % of 10 companies including any linkage)</td>
<td></td>
</tr>
<tr>
<td>Completely</td>
<td>60%</td>
</tr>
<tr>
<td>In part</td>
<td>40%</td>
</tr>
</tbody>
</table>

Again, companies need to consider whether the linkage they are illustrating is logical rather than trying to create linkage where none exists.
Section 2. Strategy disclosures – good practice examples
For each example, the aspects of good practice that it illustrates are listed next to it.

Example 6.11
Johnson Matthey Plc 2016 Annual Report & Accounts (p17)

Good explanation of a company’s strategic responses to changing market trends.
Good explanation of a company's strategic responses to changing market trends.
Linkage of all strategic priorities to how progress against them is measured.

Linkage between strategy/objectives and risks.

Discussion of company outlook.
Throughout 2015, we continued to make progress against our refreshed strategic approach and our ambition to become a leading company in Africa.

To be the leading gold producer in Africa.

We will do this through:

- To be the leading gold producer in Africa.

Throughout 2015, we continued to make progress against our refreshed strategic approach and our ambition to become a leading company in Africa.

Our business

We have built on our refreshed strategic approach and are now focused on executing against our refreshed strategy and our ambition to become a leading company in Africa. We have made progress against our refreshed strategic approach and our ambition to become a leading company in Africa.

Our people

Our people are our most important asset and are focused on driving our business results. They are the key to our success and we are committed to supporting them to achieve their full potential.

Our relationships

We are committed to building strong relationships with our local communities, our employees, and our shareholders. We are focused on developing these relationships to support our business and achieve our strategic objectives.

Our future

We believe that our refreshed strategic approach and our ambition to become a leading company in Africa are achievable. We are confident in our ability to execute against our refreshed strategic approach and our ambition to become a leading company in Africa.

The Company's refreshed strategic approach and our ambition to become a leading company in Africa are supported by the Company's key performance indicators (KPIs), which are aligned with its refreshed strategic approach and our ambition to become a leading company in Africa. The Company's key performance indicators (KPIs) are aligned with its refreshed strategic approach and our ambition to become a leading company in Africa.
Logical linkage of risks and strategy.
Company’s corporate responsibility priorities embedded in the strategy.
Section 3. Corporate Responsibility

Information on environmental, employee, social, community and human rights matters is required to be included in the strategic report to the extent necessary for an understanding of the development, performance or position of the company’s business.50

<IR> CR considerations

Embedding integrated thinking into an organisation’s activities requires better connection of external reporting and the information used for management reporting, analysis and decision-making. For entities operating in silos, the preparation and presentation of separate sustainability or corporate responsibility reports can often be seen as bolt-on processes to other reporting. In this way, integrated reporting often initiates processes to integrate sustainability or corporate responsibility information into business management and reporting systems, and, where necessary, to identify and develop smarter non-financial information and KPIs. An integrated report would therefore naturally weave into its discussion of strategy, business model and performance the impact upon all relevant stakeholders, therefore eliminating the common standalone CR sections.

The best annual reports incorporated CR considerations throughout their strategic report as opposed to having a ‘bolt-on’ CR section at the end of the strategic report. This reflects the idea that broader environmental and social issues should be embedded into the strategy and business model of an organisation. How a company interacts with its various stakeholders should be a key theme of the strategic report, which is linked to the premise of <IR> that a company should be managing all of its various capitals (e.g. human, social and relationship, natural) in an integrated fashion. A good example of this was Fresnillo plc (Example 6.4) which incorporated sustainability directly into its business model (see example in business model section above). Mitie Group plc and Rotork plc (Example 6.17) also provided good examples of integrated CR content by incorporating these directly into their strategic priorities. A minority of companies also provided some linkage by including a CR KPI as part of their main KPIs, the most popular choice being an employee measure as shown in Figure 6.6. Companies should however aim to avoid having specifically designated ‘sustainability/CR’ KPIs in addition to their ‘main’ company KPIs as this suggests that such sustainability KPIs are not integral to the business as a whole. The KPIs presented should be those measures used to manage the business and demonstrate how the company is creating value for shareholders and their wider stakeholders.

If a company does have sustainability KPIs they should ensure that the measurement and description of the KPI indicates how that measure demonstrates the value creation processes in place within the company. For example a KPI of ‘number of workplace injuries’ does not in itself demonstrate how the company creates value, whereas providing an assessment of the value lost to the company per each workplace injury and a decrease in the KPI year-on-year does indicate how value is being created/preserved.

Figure 6.6 To what extent is CSR information included within the annual report?

![Figure 6.6](image-url)
As disclosed in Figure 6.7, with the exception of the required gender disclosures, very few companies currently disclose wider diversity figures. CR disclosure, in particular diversity, is expected to gain increasing prominence given the EU Non-Financial Reporting Directive which will extend the level of diversity disclosures for periods beginning on or after 1 January 201751 (see chapter 3 Regulatory overview for further discussion).

Figure 6.7 What diversity information was disclosed by companies?

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gender</td>
<td>96%</td>
</tr>
<tr>
<td>Race</td>
<td>6%</td>
</tr>
<tr>
<td>Age</td>
<td>2%</td>
</tr>
<tr>
<td>Experience/Length of service</td>
<td>5%</td>
</tr>
<tr>
<td>Disabled</td>
<td>2%</td>
</tr>
<tr>
<td>Sexual Orientation</td>
<td>1%</td>
</tr>
</tbody>
</table>

Companies need to strike a balance in determining the amount of CR information included in their annual report in order to meet this requirement whilst ensuring that the report is kept clear and concise. For example it may not be necessary to include information in the annual report to solely illustrate that the company is ‘doing the right thing’ when this is not material to the company. A recommended means of ensuring information is kept clear and concise is to only include the CR information that is assessed to be material to shareholders in the annual report in order to support the company’s value creation story and to include a reference to where further detail can be accessed e.g. on the company’s website or in a separate sustainability publication. This may be particularly relevant to those companies where detailed sustainability information may be relevant to other interest groups, e.g. NGOs, but where a large quantity of this would not be considered material for the purposes of the annual report. 49% (2015: 34%) of companies surveyed provided references to where further CR information could be accessed outside the annual report, suggesting that increasing consideration is being given by companies to making their annual reports more clear and concise by not including immaterial CR disclosures.

A number of companies struggle with the concept of materiality as it relates to CR and are more comfortable in making materiality determinations when looking at their financial information. For further discussion of materiality in relation to both financial and non-financial content in annual reports see chapter 4.

In relation to materiality considerations for company’s sustainability reports, there are a number of specific sustainability reporting guidelines, such as the Global Reporting Initiative (GRI) guidelines (G4)52, that provide useful guidance for companies, though it may be the case that not everything which is material from a sustainability report perspective will be material for the purposes of the annual report. A good example of a materiality determination process with respect to sustainability was provided by Premier Oil plc (Example 4.5) who provided a ‘materiality matrix’ addressing their corporate responsibility issues. Although sustainability information is not subject to any mandatory external assurance requirements a minority of companies did gain such assurance over the figures they presented (see Figure 6.8).

Figure 6.8 Has sustainability information been assured?

- Yes – GHG information: 67%
- Yes – other information: 13%
- Yes – both GHG and other information: 5%
- Yes – ESOS*: 14%
- No: 1%

*The Energy Savings Opportunity Scheme (ESOS) is a mandatory energy assessment and energy savings scheme that applies to large undertakings and groups containing large undertakings in the UK. For further guidance see the UK government’s publication on the ESOS scheme.53
## Other observations

### Report mentions the company’s approach to dealing with bribery and corruption

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>In strategic report</td>
<td>56%</td>
<td>40%</td>
</tr>
<tr>
<td>Elsewhere in annual report</td>
<td>24%</td>
<td>27%</td>
</tr>
<tr>
<td>Not mentioned</td>
<td>20%</td>
<td>33%</td>
</tr>
</tbody>
</table>

The EU Non-financial Reporting Directive will specifically require reporting on bribery and corruption so it is encouraging to see an increase in the number of companies disclosing this overall. One company in our survey that included discussion of their approach to bribery and corruption in their strategic report was BTG plc.

### Report mentions modern slavery

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>In strategic report</td>
<td>30%</td>
</tr>
<tr>
<td>Elsewhere in annual report</td>
<td>4%</td>
</tr>
<tr>
<td>Not mentioned</td>
<td>66%</td>
</tr>
</tbody>
</table>

The Modern Slavery Act54 introduces a requirement for all entities with UK operations and turnover > £36m (with a year end on or after 31 March 2016) to publish a slavery and human trafficking statement on their website as soon as reasonably practicable after year end. Although there is no requirement for companies to include information on this in their strategic report (reflected by only a minority of companies disclosing such information), thought should be given as to whether such disclosure is likely to be seen as material information on human rights given the nature of the entity’s operations. The level of disclosure seen in the annual reports surveyed varied and in many cases was limited to a very brief mention.

### Report mentions the company’s approach to prompt payment of suppliers

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>In strategic report</td>
<td>9%</td>
<td></td>
</tr>
<tr>
<td>Elsewhere in annual report</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td>Not mentioned</td>
<td>87%</td>
<td></td>
</tr>
</tbody>
</table>

There is no requirement for companies to publish information on their supplier payment policy in their annual report, although some may see it as important information as regards their stakeholder relationships. Of those companies that did mention this the majority just made a brief reference to their overall policy – a more detailed disclosure that made specific reference to the Prompt Payment Code (a voluntary UK government initiative) was provided by ELS Holdings plc.

### Report discloses ‘Scope 3’ GHG emissions

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>36%</td>
<td>22%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>36%</td>
<td>28%</td>
</tr>
<tr>
<td>Others</td>
<td>36%</td>
<td>14%</td>
</tr>
</tbody>
</table>

There is no requirement under the Companies Act to disclose Scope 3 emissions (which relate to indirect emissions which are a consequence of the company’s actions but occur at sources that are not owned or controlled by the company e.g., purchased materials). The rise in the number of companies disclosing this data suggests that an increasing number see it as providing important sustainability information as regards the company’s activities. BT Group plc was one of the companies that did make such disclosure.

### Report includes information on gender pay gap

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall (2% both FTSE 350)</td>
<td>N/A</td>
<td></td>
</tr>
</tbody>
</table>

The UK government has published draft regulations calling for pay and bonus information across genders to be reported publicly by all employers with 250 or more employees. The first disclosures under the regulations will be required by April 2018. It will be interesting to see if this number grows in future as companies move toward applying the new regulations. National Grid Plc made a brief reference to their previous publication of gender pay gap data in their 2015/16 Annual Report.

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Section 3. CR/Sustainability reporting – good practice examples
For each example, the aspects of good practice that it illustrates are listed next to it.

Example 6.17
Rotork plc Annual Report 2015 (p28)
CR content integrated directly into company’s strategic priorities.

See also Example 4.4 in chapter 4, an extract from the Premier Oil plc 2015 Annual Report and Financial Statements (p58-59), which demonstrated disclosure of the assessment of which CR considerations are material in a sustainability context.
Section 4. Other reporting trends

Dividend disclosures

In November 2015, the Financial Reporting Council’s Financial Reporting Lab published a Lab project report on Disclosure of dividends – policy and practice. The report found that both companies and investors agree that dividend policy and practice disclosures provide useful information that affect both investment decisions and assessment of company stewardship. However there was consensus that dividend disclosures are currently not clearly articulated and that frequently there is a disconnect between any description of the dividend policy and how that policy has been implemented in practice.

Disclosures in the annual report are frequently spread throughout the strategic report, financial statements and shareholder information sections with no inter-linkage provided. The majority of survey companies (59%) did include some detail on their dividend policy in their strategic report, generally in the chairman or CEO’s statement. Such detail ranged from descriptions of how the dividend policy functioned to factors that had affected the dividend payment in the year and in the immediate future. This was far more common amongst the FTSE 350 companies surveyed with 72% providing such information compared with 40% of the smaller listed companies surveyed.

Disclosure of dividend policy in the annual report should be done in a way that makes it clear to the reader how the policy actually operates in practice e.g. ‘for 2016 and 2017 we will increase the annual dividend by a minimum of 4%’. Only 56% of the companies surveyed that included disclosure of their dividend policy were assessed as doing this, with the FTSE 350 companies surveyed providing clearer disclosure (64% of disclosures judged to be clear) compared to the smaller listed companies (35%). Persimmon PLC (Example 6.18) provided a clear discussion of the future dividend payments they intended to make under their Capital Return Plan.

The topic of dividend disclosures is still the subject of much public comment. It will be interesting to follow how practice in this area develops in future.

Other observations

<table>
<thead>
<tr>
<th>Strategic report includes some disclosure of dividend resources (either cash or distributable reserves)</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>13%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>17%</td>
</tr>
<tr>
<td>Others</td>
<td>7%</td>
</tr>
</tbody>
</table>

Disclosure of dividend resources was only given by a small minority of companies in their strategic report (this statistic also includes consideration of any cross-references to the back half of the report). See chapter 14 for an analysis of disclosure in this area in the financial statements.

<table>
<thead>
<tr>
<th>Strategic report includes disclosure regarding cash available to pay dividends</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>9%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>14%</td>
</tr>
<tr>
<td>Others</td>
<td>2%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Strategic report includes disclosure regarding level of distributable reserves</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>4%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>3%</td>
</tr>
<tr>
<td>Others</td>
<td>5%</td>
</tr>
</tbody>
</table>

Tax disclosures

The 2016 Finance Act includes revised legislation on tax transparency which will require certain large businesses to publish their tax strategy in relation to UK taxation on their website before their financial year-end. Companies required to do this are those multinational businesses with UK operations and consolidated turnover > €750 million, in addition to UK registered companies, partnerships and permanent establishments with turnover > £200 million or gross assets > £2 billion. For December year ends this will mean publication of the UK tax strategy before the end of December 2017 for such entities. This legislation highlights the growing impetus on UK companies to be transparent in how they approach paying taxes following intense media scrutiny of certain large companies. Another example of this is the new statutory requirements for those UK headed multinational enterprises where consolidated group turnover is £750 million or more in a twelve month accounting period, or UK subgroups of these, to make an annual country-by-country report to HMRC. There are also EU proposals to require similar information to be reported publicly.

From an assessment of companies in our survey it is clear that the majority currently do not include detail of their tax governance policies or, indeed, a statement as to where such information can be accessed on their company website (as will be required for larger companies post-December 2017). 23% (2015: 9%) of the companies surveyed did provide some disclosure of their tax governance policy in their strategic report. However, of these only 10% gave detailed disclosure, with the remaining 13% of disclosures in this area being boilerplate. Mondi Group (Example 6.19) provided a good example of a tax governance disclosure in the front half of their annual report.

The majority of companies surveyed (59%) did include some explanation of the tax charges or payments that they had made to tax authorities in the year in their strategic report. However the majority of these were boilerplate statements as to the company’s effective tax rate for the year with a minority giving more detailed information as to specific issues affecting their tax charge in the year. Companies might want to include disclosure on this in order to demonstrate to their shareholders that they are not undertaking any aggressive tax planning that may later be open to challenge.

Although not a statutory requirement, companies may want to include some disclosure of the quantification of their tax payments made in the year in their strategic report to demonstrate that they are fulfilling their role as good corporate citizens. A minority of companies did make some sort of disclosure in the front half of their annual report as to the quantification of their tax charge in the year. However the vast majority of such disclosures were boilerplate statements as to the company’s effective tax rate for the year with only a minority giving more detailed information as to specific issues affecting their tax charge in the year.

Section 4. Other emerging issues – good practice examples
For each example, the aspects of good practice that it illustrates are listed next to it.

Example 6.18
Persimmon PLC Annual Report 2015 (p22)

Clear disclosure of future dividend policy.
Gearing at 31 December 2015 was 32.0% and our net debt to 12-month trailing EBITDA ratio was 1.7 times, well within our key financial covenant requirement of 3.5 times. Net leverage costs of €1,650 million were materially higher than the previous year. Average net debt of €1,010 million was similar to the prior year and an effective interest rate increased from 2.9% to 3.1%.

Currency

Our multilateral intercompany transfers impact foreign exchange risk in the ordinary course of business. Currency movements can also influence the level of reported profit as the currency value of denominated income and expenses changes at the time of reporting. Accordingly, we believe it is important to provide transparent analysis of currency movements on net income as well as foreign currency operations.

We use foreign exchange derivatives to hedge material net balance sheet exposures and forecasted future capital expenditure. We do not hedge our exposure to potential future sales or purchases. We do not take hedge accounting. We use derivatives contracts only to hedge the cash flows of forecasted transactions, which are in a foreign currency and for which the timing and amount is reasonably predictable. These hedges are designated as cash flow hedges.

Volatility in foreign exchange rates has a significant impact on the profitability of the operations. A 1% fluctuation in the spot rate has a similar impact on the results of our business as a 1% fluctuation in sales volume or margins. The 1% fluctuating rates of the spot rate at the end of the next financial year are more likely to be higher than the change in the real terms of the spot rate in the previous financial year.

We account for foreign exchange movements, either as a result of remeasuring the foreign currency balance sheet or as a result of remeasuring the income statement, in our consolidated financial statements. The change in our currency exchange gains or losses is recorded in our consolidated income statement. We incorporate projections of future foreign currency rates into net balance sheet translation gains or losses. The reported gains or losses on foreign currency transactions are included in our consolidated statements of profit or loss.

Tax

We aim to manage our tax affairs conservatively, consistent with our approach to all aspects of our business. We have a dedicated team of tax professionals to monitor the tax implications of our activities. We maintain a detailed set of operational guidelines aimed at ensuring a sound tax control environment.

Mondi operates in a number of countries, each with a different tax system. In addition, we are impacted by tax incentives and exemptions available under EU directives. We endeavour to manage our tax affairs conservatively, consistent with our approach to all aspects of our business. We have a dedicated team of tax professionals to monitor the tax implications of our activities. We maintain a detailed set of operational guidelines aimed at ensuring a sound tax control environment.

We maintain a detailed set of operational guidelines aimed at ensuring a sound tax control environment. These guidelines are regularly reviewed and updated to ensure they are in line with tax legislation. We are well positioned as a leading international packaging and paper group with a strong and stable financial position.
Key performance indicators
Key performance indicators

**Top Tips**

- Explain why a KPI has been chosen – 59% (2015: 58%) did. Demonstrating how the KPIs link to the company's strategy and objectives is a good way of doing this, though only 41% of companies provided this linkage in some way. A cross reference from the KPIs to the section that sets out the company's strategy is a helpful first step, but even better is to provide a mapping of KPIs against strategy using the various methods discussed later in this chapter.

- Give future targets for KPIs – only 25% (2015: 26%) did. Targets for KPIs help investors assess future prospects of the company and the success of the strategy. They can be shown as numerical values (or a range of numerical values) or a narrative discussion of next year's targets or those over a longer term.

- Consider the principles of integrated reporting when identifying KPIs. KPIs should be identified based on a holistic assessment of the way a company creates value for its stakeholders, not just a narrow focus on financial performance.

- When identifying KPIs, keep in mind the measures that are used to determine directors' performance-related pay. 74% (2015: 67%) of the companies in our sample identified at least some of these measures as KPIs. See chapter 4 for more details.

**Keep an eye on**

- The ESMA Guidelines on Alternative Performance Measures (i.e. non-GAAP measures). These are now effective, so listed companies will need to bear them in mind when preparing their next annual report. The use of non-GAAP measures is on the rise – for 97% (2015: 81%) of the 95 companies that identified financial KPIs at least one of them was a non-GAAP measure. The ESMA Guidelines will make many of the disclosure elements recommended below mandatory for APMs – for more detail see chapter 3.

- How well KPIs measure all aspects of business performance, not just the financial ones. The Act requires non-financial KPIs to be included in the strategic report where relevant but 26% (2015: 28%) of the companies that clearly identified their KPIs did not include any non-financial measures.

**Introduction**

The Companies Act 2006 requires that, to the extent necessary for an understanding of the development, performance or position of the company's business, a company's strategic report must include an analysis using financial and, unless the company qualifies as medium-sized, where appropriate, non-financial key performance indicators (KPIs).

The FRC’s Guidance on the Strategic Report and the <IR> Framework both include guidance for companies on how to identify appropriate KPIs and the information that should be given in relation to them. Although the law does not specifically require it, it is generally accepted practice for companies to identify explicitly the measures that they consider to be their KPIs.

Used properly, KPIs can be hugely effective in showing investors how the company has performed against its objectives and how effectively it has implemented its strategy. However, there is also potential for them to mislead users and as a result disclosure of KPIs is an area of focus for regulators. In their Corporate Reporting Review Annual Report 2015,60 the FRC highlighted that companies should consider whether ratios that are discussed prominently in the strategic report should be identified as KPIs. They also challenged companies where KPIs could not be reconciled to IFRS information, an area that is likely to receive an even higher level of scrutiny this year with ESMA’s Guidelines on Alternative Performance Measures (APMs) coming into force – see chapter 3 for more detail on these. For APMs (also known as non-GAAP measures) that are identified as KPIs, many of the disclosures discussed throughout this chapter that were previously ‘best practice’ will now be mandatory.

**Choice of KPIs**

95 (2015: 90) out of the 100 annual reports surveyed clearly identified their KPIs. Unless otherwise stated the statistics quoted in this chapter are percentages of those 95 companies.

As the name suggests, KPIs should be those metrics which really are ‘key’ to assessing a company’s performance, both in terms of progress in achieving its objectives and in implementing its strategy. The FRC’s Guidance on the Strategic Report also looks to those metrics used to monitor exposure to the company’s principal risks (see chapter 8 Principal risks and uncertainties for details on linkage between KPIs and risks).

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KPIs and the <IR> Framework

The <IR> Framework does not prescribe specific KPIs or other measurement methods, instead acknowledging that those responsible for the preparation and presentation of the integrated report need to exercise judgement to determine which matters are material and how they are disclosed. It also acknowledges that KPIs could be helpful in explaining how a company creates value, as well as demonstrating how the company has performed during the period.

The concept of integrated reporting requires management to take a holistic view of the company when determining which measures are most appropriate (or ‘key’) to monitor value creation and performance. This would include considering all relevant aspects of the company’s business model, including the material capitals that impact or are affected by the company’s activities (i.e. the inputs, outputs and outcomes). Naturally, this would drive the consideration of a range of non-financial metrics.

While most companies identified a combination of both financial and non-financial KPIs, and some linked KPIs to their strategy, many companies are not necessarily looking holistically at their business when determining their KPIs. For example, a number of companies made positive statements regarding the importance of their employees, describing them in some cases as the company’s “greatest asset”, yet there were no KPIs in place that appeared to measure, for example, employee engagement or employee retention. Applying integrated thinking would challenge this, as human capital would have been identified as a material resource in the company’s business model.

Non-GAAP measures

In terms of financial KPIs, which were presented by all of the 95 companies that included KPIs, the FRC Guidance encourages the use of generally accepted measures to aid comparability. At the same time it acknowledges that comparability should not override the need for KPIs to effectively assess the performance of the company’s own business. Such effectiveness can often be achieved by the use of non-GAAP measures, i.e. numerical measures that adjust the most directly comparable ones determined in accordance with GAAP. Non-GAAP measures often eliminate the impacts of ‘exceptional’ items, FX movements, acquisitions and so on, to allow a like-for-like comparison on progress made in the core business. They are often industry specific too.

It is perhaps surprising to see in Figure 7.1 that just over a quarter of the companies surveyed had financial KPIs that were all non-GAAP measures. In the current year this was assessed by reference to the ESMA Guidelines on APMs, thus capturing items such as return on capital employed. Such metrics for the purposes of our survey would not historically have been regarded as non-GAAP measures and the comparative figures in figure 7.1 have not been restated.

In light of the ESMA guidelines, now effective, companies should ensure they are on top of the requirements which apply to any non-GAAP measures e.g. EBITDA, not just to those measures that have various ‘exceptional’ items stripped out. For more details, see the regulatory overview in chapter 3.

Non-financial KPIs

As discussed later in this chapter, it is common for companies to use non-financial metrics within their Corporate Responsibility information, when assessing the progress in certain areas. Where these were not labelled explicitly as KPIs, they were not considered as non-financial KPIs in our survey.

Figure 7.2 shows the most common non-financial KPIs identified by companies that included such measures in their annual report. Largely consistent with last year, companies surveyed mostly identified non-financial KPIs under one of five common categories, namely customer related, employee related61, health & safety, environmental (excluding GHG) and GHG/carbon footprint. However, a significant proportion of them had ‘other’ non-financial KPIs, which covered a wide range and many of which were industry specific. Common examples included production level, market share, and inventory turns.

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61 According to the recent study published by the FRC ‘Corporate Culture and the Role of Boards’, healthy corporate culture promotes long-term business success and corporate culture is usually assessed by employee related measures.
Surprisingly, we only saw a marginal increase (from 72% to 74%) in the percentage of companies that included non-financial KPIs in their annual report. With increasing investor focus on corporate responsibility and integrated reporting, we would expect to see increasing pressure on companies to present non-financial as well as financial KPIs.

Other observations

<table>
<thead>
<tr>
<th>Average number of financial KPIs included in reports surveyed that included financial KPIs</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>6</td>
<td>5</td>
</tr>
</tbody>
</table>

The same average number of KPIs was observed across companies surveyed in different sizes.

<table>
<thead>
<tr>
<th>Average number of non-financial KPIs included in reports surveyed that included non-financial KPIs</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>4</td>
<td>3</td>
</tr>
</tbody>
</table>

The average for FTSE 100 companies surveyed jumped from three in 2015 to six in 2016. Though six does not seem excessive, it is useful to keep in mind that while it can be insightful to link various aspects of the business to KPIs, identifying too many KPIs undermines the identification of them as ‘key’.  

<table>
<thead>
<tr>
<th>Percentage of reports that disclosed a change in selected KPIs from prior year</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>6%</td>
<td>7%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>9%</td>
<td>9%</td>
</tr>
<tr>
<td>Others</td>
<td>3%</td>
<td>5%</td>
</tr>
</tbody>
</table>

A change in strategy is likely to give rise to a corresponding change in KPIs and this is what was seen in the survey.

Six companies disclosed a change in selected KPIs from prior year and one mentioned a potential change of KPIs. Five out of the six companies discussed the reasons for the change, and they were mainly to do with changes in strategy. A good example of disclosing the change with an explanation was provided by Intermediate Capital Group PLC (Example 7.5).

<IR> Measurement of dual benefits

As noted above, the <IR> Framework does not specify how KPIs should be identified, but it is clear that a company which embarks on a journey of integrated thinking would consider a broad range of relationships and resources when determining appropriate measures to capture the value created by or performance of an entity.

The <IR> Framework introduces the notion of ‘dual benefit’ measures. These are measures (not necessarily needing to be KPIs) that combine financial measures with other components (e.g. the ratio of greenhouse gas emissions to sales) or narrative that explains the financial implications of significant effects on other capitals and other causal relationships (e.g. expected revenue growth resulting from efforts to enhance human capital). Such measures may be used to demonstrate the connectivity of financial performance with performance regarding other capitals. In some cases, this may also include monetising certain effects on the capitals (e.g. carbon emissions and water use).

In short, a measure that demonstrates dual benefit can be used to demonstrate to investors the financial value creation of the company while implementing strategic decisions around non-financial capitals in which other stakeholders have material interests.
Linkage between KPIs and strategy

As mentioned above, a KPI is likely to be ‘key’ if it is used to measure progress against the company’s strategy and objectives. The best annual reports illustrate this linkage so users can understand why a KPI is particularly relevant to the business and so they can assess the performance of management.

A basic way for a company to help a user navigate the annual report is to provide a cross-reference between the KPIs and the section that sets out strategy, i.e. by giving a page reference to the strategy section within the KPIs section. However, such a general reference by itself does not illustrate linkage between the sections.

As shown in Figure 7.3, the majority of companies do not provide any sort of link between their KPIs and strategy. A few provide just a basic cross reference and some go further, illustrating the linkage on a deeper level.

7.3 How well do companies link the KPI section of the report to the section that sets out strategy?

Rather than just a cross-reference, it is more helpful for companies to specifically illustrate the links that exist between individual elements of their strategy and individual KPIs. There are no specific rules about how to present this linkage and, ignoring which way round it went and whether it was presented more than once, 41% of the companies surveyed provided linkage between some or all of their KPIs and strategy elements. 17% of those surveyed demonstrated linkage in both their strategy section and their KPIs section. As indicated in chapter 6, only 27% of the companies surveyed provided linkage in the strategy section.

Per Figure 4.7, nearly a third of companies clearly linked some or all of their KPIs to elements of the company’s strategy, i.e. users of the annual report could tell from looking at the KPI section which element(s) of the company’s strategy were measured by which KPI.

Effective ways of achieving this were by showing the strategy and KPIs in one section (i.e. strategy and KPIs presented next to each other in one table) or by putting icons that represent strands of the strategy next to individual KPIs. Another alternative was to discuss the linkage to strategy within the narrative given for each KPI - a number of companies did this. This makes the linkage more meaningful by explaining why and how it works in words. Acacia Mining PLC (Example 7.1), G4S PLC (Example 7.3), Gresham Computing plc (Example 7.4) and The Unite Group plc (Example 7.2) demonstrated linkage through the use of icons; Intermediate Capital Group PLC (Example 7.5) presented their KPIs and strategy together in one table. Mondi Group (Example 7.6) discussed such linkage within the narrative given for their KPIs.

Figure 7.4 What proportion of companies provided a link between some or all KPIs and the strategy of the business?

Out of the 100 companies surveyed this year, 22 of them clearly linked all KPIs to elements of strategy; six did this for some of their KPIs.
Please note that the above discussion is looking at linkage from KPIs to elements of strategy. See chapter 6 for details on linkage from elements of strategy to KPIs and chapter 5 where overall linkage throughout the annual reports surveyed is discussed.

Presentation of KPIs
As seen in Figure 7.5, although not required to, a majority of the companies surveyed presented KPIs in a clear separate section of the annual report. A similar pattern is seen across FTSE 350 and other companies, though FTSE 100 companies had a higher percentage of 89%. Although presenting KPIs in a separate section is helpful for users, it is also important to integrate KPIs appropriately into narrative discussions to illustrate the linkage between them and other aspects of the annual report and to identify the purpose of selected KPIs.

Indeed we would expect that the measures discussed most prevalently throughout the annual report would be those that are identified as the company’s KPIs.

It is also interesting to note that three companies had separate KPI sections for each of their core business areas, unlike most of the companies where KPIs were given for the business as a whole.

Figure 7.5 Where are KPIs shown in the narrative reporting section of the annual report?

Understanding KPIs
The FRC Guidance recommends that a company should identify and disclose all relevant information necessary to enable users to understand each KPI presented in the strategic report. It indicates that, for each KPI, this information should include, at a minimum:

- its definition and calculation method;
- its purpose;
- the source of underlying data;
- any significant assumptions made; and
- any changes in calculation method or relevant accounting policies compared to the previous financial year.

The ESMA Guidelines on APMs, which are now effective and will apply to next year’s annual reports, will require that all of this information, and more, is given for any APMs (non-GAAP measures) used as KPIs. For more details, see the regulatory overview in chapter 3 and also discussion of the presentation of APMs in companies’ summary sections in chapter 5.

Report gives numerical values for KPIs

<table>
<thead>
<tr>
<th>Report gives numerical values for KPIs</th>
<th>All</th>
<th>Some</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>91%</td>
<td>9%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>85%</td>
<td>15%</td>
</tr>
<tr>
<td>Others</td>
<td>98%</td>
<td>2%</td>
</tr>
</tbody>
</table>

The majority of the KPIs without numerical values were non-financial KPIs. Companies tended to discuss if target was achieved or if there was an improvement from prior year, though no numbers were given.
As shown by Figure 7.6, more companies defined their KPIs this year and explained the calculation method for them. Such a disclosure can be relatively brief in some circumstances and may even be unnecessary for commonly-used GAAP measures such as revenue or gross profit margin, which are self-explanatory and have a generally understood calculation method.

It is much more important for companies using industry or company-specific non-GAAP measures to give a clear definition of the measure and explain the adjustments made to GAAP figures to obtain it. The same is also often the case for non-financial measures, which are often quite company-specific. A few companies found a good way to do this without over-crowding the KPIs section by presenting all definitions and calculation methods within an appendix or glossary and cross-referencing that to the KPIs section.

Intermediate Capital Group PLC (Example 7.5) gave a good example of presenting their definitions within a Glossary.

59% (2015: 58%) of the companies surveyed gave the purpose of at least one KPI, as illustrated by Figure 7.7. Explanations were more common among the larger companies surveyed, with 78% of FTSE 100 companies giving them compared to 65% of the FTSE 250 and 45% of other companies.

Acacia Mining PLC (Example 7.1), Gresham Computing plc (Example 7.4) and Rexam Plc (Example 7.7) are good examples of how companies can disclose the purpose of their KPIs effectively.

The source of numbers used for financial KPIs is usually the financial statements (or a reconciliation to them for a non-GAAP measure). However, for non-financial KPIs the data sources can be much more varied.

The FRC Guidance suggests that companies should give a reconciliation between the financial KPIs and the financial statements where the financial KPIs cannot be directly identified in the accounts. Such reconciliations are now required by the ESMA Guidelines on APMs (non-GAAP measures). Including such reconciliations means that users of annual reports have sufficient information to recalculate the measures themselves, without having to resort to guesswork regarding their ‘components’ or spending a significant amount of time hunting around to find them.
Figure 7.8 shows how transparently the non-GAAP measures used as KPIs by companies are reconciled to the financial statements. With the EMSA Guidelines on APMs now in force, we would expect a significant increase in the level of reconciliations being given in next year’s reports.

Where financial KPIs can be identified directly from the financial statements, some companies found a good way of directing users to the relevant part in the financial statements by giving each KPI a page reference to the relevant note.

Where a reconciliation was shown elsewhere in the annual report, a number of companies gave a page reference to the reconciliation in the KPIs section. The G4S PLC Integrated Report and Accounts 2015 (Example 7.3) and Gresham Computing plc Annual Financial Report 2015 (Example 7.4) give good examples of such reconciliations.

Despite the increase in the average number of non-financial KPIs, a higher percentage of companies surveyed disclosed the source of the underlying data used to determine at least some of these KPIs, as shown in Figure 7.9. Most of the underlying data came from employee or customer satisfaction surveys. The Unite Group plc Annual Report and Accounts 2015 (Example 7.2) gives a good example of including such information. Reporting systems specifically designed for health and safety purposes were also mentioned. The source of underlying data for other types of non-financial KPIs was rarely given.

As seen in Figure 7.10 the vast majority (82%, 2015: 78%) of companies surveyed gave prior year comparatives for all KPIs, especially financial KPIs.
Inclusion of comparatives helps investors to understand how the company’s current year performance compares to its historical track record – the more years of comparatives given, the clearer the picture. Figure 7.11 shows the number of years of comparatives given and the result is largely in line with last year.

Comparatives were sometimes missing for non-financial KPIs. This was the case in particular for those ones discussed in a different part of the annual report (e.g. corporate responsibility statement), where a different format and style of writing to the stand-alone KPIs section tended to be used or where a KPI was new in the year.

Even where a new KPI is adopted because of a change in strategy (for example), where possible companies should give a prior year comparative for the new measure. This is something that the ESMA Guidelines specify should be provided when a company starts presenting a new APM.

Quantifying business objectives is one of the most efficient ways of helping investors to assess the future prospects of the company and the success of strategic implementation. However per Figure 7.12, less than one third of the companies surveyed commented on future targets for KPIs, i.e. numerical targets and/or narrative explaining the target was provided. This is consistent with last year and is possibly due to perceived commercial sensitivity as well as caution in setting targets that may prove unachievable in today’s unstable economic and political environment. The most commonly seen form for a target was a numerical value (or a range of numerical values) or a narrative discussion of next year’s targets or those over a longer term.

A good example of how commentaries on future targets can be presented are given by Rexam Plc (Example 7.7) and The Unite Group plc (Example 7.2).
Good practice examples
Example 7.1
Acacia Mining PLC Annual Report and Accounts 2015 (p20-21)

- Clear linkage between KPIs and strategy through the use of icons.
- Providing the purpose of KPIs and their relevance to strategy.

We assess our performance against the following key performance indicators, each of which is linked to our long-term strategy.
Clear linkage between KPIs and strategy through the use of icons.

Commentary on future targets for each KPI.

Disclosure of the source of underlying data (surveys) used in the non-financial KPIs.
Example 7.3
G4S plc Integrated Report and Accounts 2015 (p36-37)

- Page reference to the section that set out the strategy.
- Clear linkage between KPIs and strategy through the use of icons.
- Page reference to reconciliations for non-GAAP measures.
### Key performance indicators (“KPIs”)

<table>
<thead>
<tr>
<th>KPI</th>
<th>2014</th>
<th>2015</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>EBITDA</strong></td>
<td>£0.7m</td>
<td>£1.7m</td>
<td>140%</td>
</tr>
<tr>
<td><strong>Adjusted EBITDA</strong></td>
<td>£0.4m</td>
<td>£0.9m</td>
<td>145%</td>
</tr>
<tr>
<td><strong>Adjusted EBITDA/total revenue</strong></td>
<td>45%</td>
<td>51%</td>
<td>212%</td>
</tr>
</tbody>
</table>

### Financial review

**Dear shareholder,**

I am pleased to present this financial review for the year ended 31 December 2015 which has seen a breakthrough year for CTC and a validation of our ongoing strategy to grow CTC and other non-Clareti revenues from a base of sustainable partner and legacy revenues.

**Operating performance**

As CTC has become ever more central to our business we can more accurately assess operating performance. CTC software and services revenues, and CTC-related partner and legacy revenues, are now the principal revenue streams driving our Group’s performance and have become the principal focus of our growth strategy. CTC provides a clear and measurable indication of the underlying progress of the Group’s strategy and progress towards delivering its overall objectives.

In particular it recognises the continued importance to the Group of retaining high margin revenue. Adjustments are made for exceptional items, interest income, share-based payments charge and business combinations to provide high visibility of revenue into future years and a basis from which to drive profitable growth. Adjustments are also made for share-based payments charge, interest income and exceptional items.

### Financial highlights

<table>
<thead>
<tr>
<th>Description</th>
<th>2014 (£m)</th>
<th>2015 (£m)</th>
<th>Change (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic earnings before tax</td>
<td>£1.2m</td>
<td>£2.7m</td>
<td>145%</td>
</tr>
<tr>
<td>Statutory profit before tax</td>
<td>£0.9m</td>
<td>£2.4m</td>
<td>165%</td>
</tr>
<tr>
<td>Statutory profit before tax per share</td>
<td>1.10</td>
<td>1.60</td>
<td>45%</td>
</tr>
<tr>
<td>Share-based payments charge</td>
<td>0.11</td>
<td>0.05</td>
<td>(56%)</td>
</tr>
<tr>
<td>Amortisation and depreciation</td>
<td>0.88</td>
<td>1.27</td>
<td>50%</td>
</tr>
<tr>
<td>Statutory profit before tax per share, adjusted</td>
<td>1.09</td>
<td>1.55</td>
<td>42%</td>
</tr>
</tbody>
</table>

**EBITDA** provides a measure of our core profitability and growing non-Clareti revenues. For the years 2015 and 2014 Clareti revenues were solely attributable to CTC, and our expectation for future years is that this segment will include revenues from other applications running on the same Clareti platform as CTC. Further discussion of the Group’s strategic performance is set out in note 4 of the Group financial statements.

*Example Report*
Example 7.5
Intermediate Capital Group PLC Annual Reports and Accounts, 2016 (p10-13)

- Clear linkage between KPIs and objectives.
- Discussion of change and potential change of KPIs and why.
- Page reference to the Glossary for definitions of non-GAAP measures.
Example 7.6

Mondi Group Integrated report and financial statements 2015.
(p18)

- Linkage to strategy discussed within the narrative for KPIs.
- Page reference to the section that sets out the strategy.

Our key performance indicators

Tracking our progress

We track our long-term performance against strategic, financial and sustainable development key performance indicators (KPIs).

These KPIs are intended to provide a broad measure of the Group’s performance. We set individual targets for each of our business units in support of these Group KPIs.

Our Remuneration report, on pages 115 to 131, describes how our executive directors and senior management are remunerated in line with these KPIs. In particular, the executive directors are set specific targets relating to ROCE, EBITDA and safety for purposes of the Bonus Share Plan (BSP) incentive and on Total Shareholder Return (TSR) and ROCE for the Long-Term Incentive Plan (LTIP).

Strategic

We have a clear strategic objective to grow our packaging interests, while investing appropriately to maintain and improve the competitiveness of our uncoated fine paper operations.

Our strategic value drivers provide a framework for pursuing value-creating growth opportunities.

2015 performance

We invested €595 million in capital expenditure, of which 82% was allocated to packaging. Our packaging interests represent 78% of the Group’s capital employed.

TSR provides a market-related measure of the Group’s progress against our objective of delivering long-term value for our shareholders.

TSR measures the total return to Mondi’s shareholders, including both share price appreciation and dividends paid.

2015 performance

Mondi declared a dividend of 52.0 euro cents per share and realised a TSR of 37%.

Read more in our Chief executive’s review and in Our strategy on pages 20 to 25 and 34 and 35.

Total shareholder return (TSR)

5-year 138% 3-year 254% 1-year 37%

Growth in packaging

% of capital employed

Other

Packaging

2011 2012 2013 2014 2015

Read more about the performance of each of our businesses on pages 52 to 69.
Example 7.7

Rexam PLC Annual Report 2015 (p20-21)

- Providing the purpose of each KPI.
- Commentary on future targets for each KPI.
- Page reference to further information.

KEY PERFORMANCE INDICATORS

<table>
<thead>
<tr>
<th>KPI</th>
<th>What we measure and why</th>
<th>Performance</th>
<th>Target</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales growth</td>
<td>Based on consistent business performance from continuing operations. Shows our success in driving additional profit and sales, helping to encourage and maintain operating margins appropriate for the level of organic capital expenditure and acquisitions.</td>
<td>£200m</td>
<td>£250m</td>
</tr>
<tr>
<td>Underlying profit growth</td>
<td>Based on the financial metrics for the relevant parts of our operations to assess the results of our efforts to improve our cost base and maintain margins, adjusted for the impact of strategic decisions.</td>
<td>£250m</td>
<td>£300m</td>
</tr>
<tr>
<td>Free cash flow</td>
<td>Based on the financial metrics to assess the ability of the business to generate funds in excess of capital requirements.</td>
<td>£200m</td>
<td>£250m</td>
</tr>
<tr>
<td>KPIs:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Example 7.7

Organic sales growth, which adjusts for the impact of foreign currency translation, was 4% in 2014, broadly in line with our volume growth.
Principal risks and uncertainties

Enter the chapter
Principal risks and uncertainties

Top Tips

• Provide a clear statement that the directors have carried out a robust assessment of the principal risks facing the company - only 85% of the companies surveyed clearly made this newly required statement. To avoid any regulatory challenge companies should also consider using the full wording set out in Code provision C.2.1.

• Explain the specific processes undertaken to robustly assess the principal risks - of those companies providing a robust assessment statement 12% of the accompanying risk management process disclosures appeared insufficient to demonstrably corroborate the directors’ assertion.

• Avoid any perception that risk disclosures are treated as an ‘afterthought’ or a compliance exercise and make them easy for investors to find by making sure that they are given sufficient prominence within the annual report – 78% of companies surveyed discussed principal risks or risk management in the first 20% of their report.

• Meet investor demands by tailoring risk descriptions to the specific circumstances of the company. Only 60% (2015: 61%) of companies surveyed provided risk descriptions that were all clearly specific to the company.

• Improve the quality of information provided by disclosing changes in the level of risks, their respective likelihoods and the magnitude of potential impacts – only 51% (2015: 35%), 8% (2015: 7%) and 12% (2015: 11%) of companies surveyed respectively provided these.

Keep an eye on

• Whether there is sufficient linkage between principal risks and strategy in order to create a more cohesive and integrated annual report. Of the companies surveyed, only 38% (2015: 27%) linked some or all of their principal risks to their strategy. Alternatively, provide a signpost cross reference from the risk section to strategy.

• Whether the linkages illustrated between principal risks and strategy elements are logical and clear, rather than superficial. We considered that the linkage obviously made sense for 47% of the companies including such linkage in their risks section.

• The FRC’s current focus to address the quality of financial reporting by smaller listed companies. A recent FRC report63 highlights that reporting of principal risks and uncertainties is one of the areas where smaller listed companies are lagging behind in terms of the quality of disclosures – this is borne out by our findings.

Introduction

In its strategic report, a company is required by the Companies Act 2006 to give a description of the principal risks and uncertainties facing the company. However, companies applying the UK Corporate Governance Code are expected to give more than just a description of the risks themselves – they are also expected to disclose how the risks are managed and mitigated and increasingly to give a detailed description of the company’s process for determining which are its principal risks and what the appropriate mitigating activities are.

In September 2014 the FRC published the 2014 version of the UK Corporate Governance Code, which, as well as governance more widely, has changed the requirements around risk reporting. The modifications to the Code and the issuance of the FRC’s Guidance on Risk Management, Internal Control and Related Financial and Business Reporting64 (FRC Risk Guidance) have increased the emphasis on the directors’ responsibilities relating to the company’s risk management and internal control systems, with the board needing to be comfortable that the operation of these allows them to confirm that they have “carried out a robust assessment of the principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity”. As well as making this statement, many companies have also increased the level of narrative disclosure to demonstrate how the directors are able to confirm this.

The FRC’s Guidance on the Strategic Report and the <IR> Framework also include further guidance on effective risk reporting.

Risk reporting is a perennial focus area for the FRC in its reviews of annual reports and the change in the reporting requirements is likely to mean that it moves even further up the agenda. In their most recent Corporate Reporting Review Annual Report, they noted that companies should ensure that the risks and uncertainties disclosed are genuinely principal and make sure they discuss how risks are managed or mitigated – this is a problem area for smaller companies in particular.

Of the companies surveyed, one company did not, in our view, include a clear description of principal risks and uncertainties within its annual report. References in this chapter to ‘the companies surveyed’ therefore are to the 99 companies that did disclose principal risks and uncertainties.

Assessment and monitoring of principal risks
A new Code provision, C.2.1, came into force in October 2014, requiring the directors to confirm in the annual report that they have carried out a robust assessment of the principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity.

As indicated in Figure 8.1, only 85% of the companies surveyed clearly made this statement. Whilst the boards of the remaining 15% may well have undertaken robust assessments, the fact that they had done so was not clearly stated in their annual reports. With the increasing regulatory focus on how companies are identifying and managing risks, such companies should ensure that they provide an explicit statement, bearing in mind that it demonstrates good governance in addition to complying with the Code’s requirements.

Companies may also look to avoid any risk of regulatory challenge by following the full wording set out in Code provision C.2.1. For 76% of those companies that did provide a clear statement, this was the approach that they followed. The remaining 24% of statements tended to be curtailed versions, indicating that the board had undertaken a robust assessment but omitting an explicit statement that they included those risks that would threaten the business model, solvency or liquidity.

Of those companies that did provide a clear statement, this was typically provided as part of the longer term viability statement or in the principal risks section of the strategic report. These are both logical places to incorporate the directors’ statement.

Indeed, disclosure in the viability statement helps to demonstrate the linkage between these two areas (see the linkage section later in this chapter) and how the board has considered the assessment of principal risks in informing its longer-term viability statement (for more on going concern and longer-term viability see chapter 9). In deciding on a location directors may also want to bear in mind the fact that they are afforded protection under safe harbour provisions for material included in, or scoped into, the strategic report or the directors’ report (or the directors’ remuneration report).

A few of the companies that provided the statement chose to provide the statement in more than one location. There were a variety of combinations that were chosen by these companies; the most popular being in both the viability statement and the risk section of the strategic report, or in the risk section of the strategic report and the risk management section of the corporate governance section. This likely reflects the fact that the statement can be seen as relevant to multiple sections of the report, although preparers should consider whether such duplication is really necessary. On occasion the statement was also incorporated into broader directors’ responsibility statements, with directors perhaps feeling it was helpful to gather together all the confirmations they now have to make in a single place.
As shown by Figure 8.2, of those 84 companies presenting a statement that the board had made a robust assessment of the principal risks, 12% of the accompanying disclosures setting out risk management processes appeared insufficient to demonstrably corroborate the board’s assertion.

In the absence of suitably comprehensive disclosure (including options such as those set out in the table to the right), users will not have enough information to fully understand the company’s risk management process and this could cause them to question whether they agree with the board’s assertion that a robust assessment of the principal risks has been undertaken.

For those looking to improve their disclosure around risk management and identification, National Grid Plc (Example 8.5) provided a comprehensive description of its bottom-up and top-down risk process, supported by a diagram of the risk management process and description of a three lines of defence model. Other good examples include Pearson plc, Capita plc, Mitie Group plc, Cobham plc, Thomas Cook Group PLC and Fresnillo plc.

54% of the companies surveyed included diagrams to help users understand their risk management process. Of those companies that did present a diagram, the most common approaches were a responsibilities structure (29 companies) or a diagram summarising the risk management framework (25 companies). These types of diagrams are best when they complement or incorporate any narrative text.

Figure 8.2 Did companies’ description of their risk management process support the statement that they had made a robust assessment of principal risks?

For those companies whose risk management process descriptions would demonstrably support a statement that there had been a robust assessment of principal risks*

<table>
<thead>
<tr>
<th>Companies whose risk management process descriptions would demonstrably support a statement that there had been a robust assessment of principal risks*</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>86%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>97%</td>
</tr>
<tr>
<td>Others</td>
<td>71%</td>
</tr>
</tbody>
</table>

Process descriptions varied but the better ones made references to ‘top-down’/’bottom-up’ risk assessments, three lines of defence models, continuous assessments and narrative around how risks are collated into risk registers and reviewed at various levels including ultimately by the board.

The lower results for smaller companies may reflect a lack of resources available to develop comprehensive risk management frameworks.

<table>
<thead>
<tr>
<th>Companies that explicitly stated they had refreshed their assessment of principal risks in the year</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>32%</td>
<td>25%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>41%</td>
<td>33%</td>
</tr>
<tr>
<td>Others</td>
<td>20%</td>
<td>14%</td>
</tr>
</tbody>
</table>

Whilst not a requirement, this information, typically found at the beginning of the risk management section, can help a reader to understand the outcome of the risk assessment process and reasons for adding/removing risks in the current year. It can also help evidence that a robust assessment has been undertaken. In the absence of an explicit statement other companies may have felt that indicators of change in the level of risk in their risk table (51% of companies surveyed provided this information – see later) or their descriptions of the risks themselves made it self-evident that the risk assessment had been refreshed.

*Including those that did not provide a clear robust assessment statement from the board.
Risk appetite

As set out in the FRC’s guidance on risk management and internal control, an important part of a robust risk assessment process entails the board defining and setting an appropriate risk appetite. An effective risk appetite framework can help directors to identify and determine the relative positions of the company’s risk capacity, risk profile and risk appetite when evaluating and pursuing strategy and to take corrective action where necessary. There is no mandatory requirement to discuss risk appetite in the annual report, although it would typically be expected of those in the financial services sector.

As shown by Figure 8.3, 63% of the companies surveyed disclosed that risk appetite had been incorporated into the risk assessment process. However only 39% of those companies provided more than a brief mention. Brief mentions typically included generic statements around the board responsibilities for setting risk appetite or highlighting that the board uses a risk appetite framework to determine the nature and extent of the risks that it is prepared to accept.

The better disclosures on risk appetite constituted a specific section on it and some companies even identified risk appetite per principal risk (11% of those mentioning risk appetite).

Cobham plc (Example 8.1) and Marks and Spencer Group plc (Example 8.2) provided good discussions of risk appetite and how it is used in the decision making process. Both Marks and Spencer Group plc (Example 8.2) and The Weir Group plc (Example 8.6) provided an example of a risk appetite statement. There were a variety of ways that risk appetite per principal risk was demonstrated – good examples were Halma plc (Example 8.4), which provided risk appetite for each specific risk, and Intermediate Capital Group PLC (Example 8.12) and Mothercare plc (Example 8.13), which both chose to show risk appetite per specific risk separately from the main disclosures of principal risks and uncertainties. Other good examples included Capita plc, LSL Property Services plc and Fresnillo plc.

Figure 8.3 What proportion of companies mentioned risk appetite?

<table>
<thead>
<tr>
<th>0%</th>
<th>20%</th>
<th>40%</th>
<th>60%</th>
<th>80%</th>
<th>100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>63%</td>
<td>72%</td>
<td>49%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FTSE 350</td>
<td>72%</td>
<td>49%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td>49%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

How risk appetite was described for those that did mention it

<table>
<thead>
<tr>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very brief/in passing</td>
</tr>
<tr>
<td>Clear description of how risk appetite is assessed</td>
</tr>
<tr>
<td>Clear description of how risk appetite is assessed and used in decision making</td>
</tr>
</tbody>
</table>

A number of companies mentioned that risk appetite was in the process of being formally documented and set and risk appetite statements prepared.

Number of principal risks

Companies should not be disclosing every risk that may have been identified in their risk assessment process and included in their risk register. As indicated in the FRC Risk Guidance, the board should only be focusing on those risks that it has assessed as ‘principal’ risks. These are defined in the FRC’s Guidance on the Strategic Report as risks or a combination of risks “that can seriously affect the performance, future prospects or reputation of the entity” and include “those risks that would threaten its business model, future performance, solvency or liquidity”.

Number of principal risks
Figure 8.4 shows the number of risks identified by companies surveyed, split by FTSE 350 and others (those outside of the FTSE 350), plotted on a cumulative basis. There is very little difference in the number of risks identified between FTSE 350 and others, suggesting that the size of the company has minimal impact upon the number of risks that it identifies. These results are broadly consistent with the results of our 2015 survey.

Figure 8.4 shows the number of risks identified by companies surveyed, split by FTSE 350 and others (those outside of the FTSE 350), plotted on a cumulative basis. There is very little difference in the number of risks identified between FTSE 350 and others, suggesting that the size of the company has minimal impact upon the number of risks that it identifies. These results are broadly consistent with the results of our 2015 survey.

Types of risks identified by companies
Year on year comparison
Figure 8.5 shows the types of risks most commonly identified by companies that we surveyed.

Whilst the size of the company may not change the number of risks that it faces, it is clear that it does affect the types of risks that it identifies, as discussed in the next section.

Figure 8.5 What are the main categories of risk disclosed (year-on-year)?

- **Overall**: 98% (2016), 95% (2015)
- **FTSE 350**: 98% (2016), 98% (2015)
- **Others**: 98% (2016), 91% (2015)

<table>
<thead>
<tr>
<th>Risk Category</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>98%</td>
<td>95%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>98%</td>
<td>98%</td>
</tr>
<tr>
<td>Others</td>
<td>98%</td>
<td>91%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Risk Category</th>
<th>Median number of principal risks</th>
<th>Number of companies that chose to discuss 'other' risks in addition to their 'principal' risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>10</td>
<td>5</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>9</td>
<td>4</td>
</tr>
<tr>
<td>Others</td>
<td>9</td>
<td>4</td>
</tr>
</tbody>
</table>

*Not identified as a separate category in 2015.
Types of risks identified by companies

There is a great deal of consistency between the types of risks disclosed in 2015 and 2016. However, with the provisions of the Code now requiring directors to consider those risks that would “threaten its business model, future performance, solvency or liquidity” it is perhaps surprising that only 7% (2015: 6%) and 34% (2015: 28%) of the companies surveyed discussed risks relating to solvency and liquidity respectively.

IT issues continue to show a significant increase with 71% (2015: 60%) of companies surveyed indicating that these are considered a principal risk. The increase in the current year has likely been driven by more companies identifying principal risks in relation to cyber and data security. In the current year we saw 51% of companies surveyed identifying cyber risks and 41% data protection risks. This trend is expected, with cyber-attacks, data losses and cyber-security dominating many boardroom discussions at present.

As shown by Figure 8.6 on the next page, a higher proportion of the FTSE 350 companies surveyed disclosed risks in relation to cyber and data security compared to the smaller companies surveyed. In December 2015 the FRC published[65] year-end advice to larger listed companies which specifically suggested that they should consider whether data protection or cyber security should be principal risks, which might explain the comparatively higher proportion of FTSE 350 companies that identified these compared to those in the ‘other’ group. On a related note, in May 2016 the government published the FTSE 350 Cyber Governance Health Check Report 2015[66].

Other observations are summarised in the table to the right.

<table>
<thead>
<tr>
<th>Risk category</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brexit</td>
<td>16%</td>
<td>Not surveyed</td>
</tr>
<tr>
<td>Other</td>
<td>85%</td>
<td>70%</td>
</tr>
</tbody>
</table>

Only 16% of companies surveyed explicitly indicated that “Brexit” or the result of the UK referendum on EU membership was a principal risk in their annual report. Although the longer-term political and economic effects of the decision to leave the EU are still unclear, recent FRC guidance[67] suggests that additional principal risks may be identified as a result of the vote to leave. Additionally, a number of companies’ half-yearly financial reports have, subsequent to the referendum result, made clear that they are in the process of assessing the potential effects on their business.

A large majority of the companies surveyed included a number of ‘other’ risks that did not fall within any of the other categories. The most popular of these were health and safety, counter-party credit risk and adverse movements in interest rates. This category also includes risks specific to the operations of those companies surveyed.

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65 https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Year-end-advice-to-preparers-larger-listed-compa.pdf
By size of company
Although the size of the company does not have a significant impact upon the number of principal risks that it identifies, Figure 8.7 shows that it does have an impact upon the types of risks that it faces. Possible explanations for some of the most significant differences are given in the accompanying table.

### Table: Risk Disclosed by Size of Company

<table>
<thead>
<tr>
<th>Risk Category</th>
<th>FTSE 350</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>IT issues*</td>
<td>74%</td>
<td>39%</td>
</tr>
<tr>
<td>Cyber risk</td>
<td>66%</td>
<td>29%</td>
</tr>
<tr>
<td>Data protection</td>
<td>48%</td>
<td>32%</td>
</tr>
</tbody>
</table>

As noted previously, FRC advice in December 2015 to larger listed companies might explain the comparatively higher proportion of FTSE 350 companies that identified these risks compared to those in the ‘other’ group. Hackers may also be more likely to target larger, more high-profile businesses.

### IT issues
As larger companies often operate in multiple jurisdictions and can be exposed to more tax regulations than smaller companies we would expect this risk to have been identified by a higher proportion of FTSE 350 companies.

### R&D
Smaller companies may be at the ‘start up’ phase of their operations and might be performing research and development activities to develop new products. Many larger companies will have already completed research and development activities and, in most cases, will have products that are under patent and are actively being sold.

- *Excluding cyber risk and data protection shown separately

**Figure 8.6 What are the main categories of risk disclosed (by size of company)?**

**Risk category**

<table>
<thead>
<tr>
<th>Risk Category</th>
<th>FTSE 350</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax</td>
<td>28%</td>
<td>20%</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>22%</td>
<td>39%</td>
</tr>
<tr>
<td>Reliance on key customers</td>
<td>7%</td>
<td>46%</td>
</tr>
</tbody>
</table>

Smaller companies might face more working capital issues and difficulties in raising finance when compared to larger companies, including more challenging lending covenants.

**Risk category**

<table>
<thead>
<tr>
<th>Risk Category</th>
<th>FTSE 350</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquisition related</td>
<td>41%</td>
<td>27%</td>
</tr>
</tbody>
</table>

Larger companies tend to be more acquisitive and due to their size may find it more difficult to integrate systems and strategies.

<table>
<thead>
<tr>
<th>Risk Category</th>
<th>FTSE 350</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reliance on key customers</td>
<td>7%</td>
<td>46%</td>
</tr>
</tbody>
</table>

Smaller companies might be expected to rely on a number of key customers for trading and working capital. It is more likely that larger companies will have a sufficiently diverse customer base to not have to rely on any one customer.
Presentation and description of risks

Prominence of risk disclosures

With the increasing focus on how risks are identified and managed, companies should look to avoid any perception that risk disclosures are treated as an ‘afterthought’ or a compliance exercise. One of the obvious ways this can be done, which also reflects the importance many investors place on such information, is to give it suitable prominence and make sure that it isn’t buried in, what nowadays tend to be, very lengthy reports. Of the companies surveyed only 22% did not discuss their principal risks or risk management in the first 20% of their annual report.

As indicated in Figure 8.7, 53% of the companies surveyed included their principal risks and uncertainties section in the first 20% of their annual report. The earliest and latest that this disclosure was provided was 6% of the way into and 48% of the way into the annual report respectively, indicating varying degrees of prominence which companies are giving to risk disclosures.

Where the principal risks and uncertainties section was not included within the first 20% we then assessed whether, and to what degree, the company had mentioned principal risks or risk management within the first 20% of the report. As indicated in Figure 8.7 most did still provide some disclosure early on. This was typically in the form of a section which linked principal risks to areas such as strategy and KPIs.

A good example of this was provided by Marks and Spencer Group plc (see Example 8.7) who provided a section linking the business model to related risk factors with a cross reference to the principal risks and uncertainties section. Other good examples were provided by Acacia Mining plc, Cobham plc and JP Group plc.

Figure 8.7 Is the principal risks and uncertainties section within the first 20% of the annual report?

<table>
<thead>
<tr>
<th>No mention of principal risks in the first 20%</th>
<th>No mention of risks in the first 20% but a discussion of risk management</th>
</tr>
</thead>
<tbody>
<tr>
<td>22%</td>
<td>2%</td>
</tr>
<tr>
<td>4%</td>
<td>9%</td>
</tr>
<tr>
<td>10%</td>
<td>52%</td>
</tr>
<tr>
<td>Yes</td>
<td>No, but brief mention of principal risks in the first 20% with no cross reference</td>
</tr>
<tr>
<td>No, but brief mention of principal risks in the first 20% with a cross reference</td>
<td></td>
</tr>
</tbody>
</table>

Descriptions of risks

When making disclosures around principal risks and uncertainties in the annual report, the FRC Risk Guidance indicates that the board should ensure that risk descriptions are tailored to the company’s specific circumstances and should avoid using standardised or ‘boilerplate’ language “which may be long on detail but short on insight”. Some risks may be specific to the entity, for instance related to the industry in which they operate, others may be more generic. Where risks fall into the latter category, it is even more important that the risk description makes it clear how the risk might affect the company specifically.

It is slightly disappointing, therefore, that only 60% (2015: 61%) of companies surveyed provided risk descriptions that were all clearly specific to the company – the remainder provided risk descriptions that were either generic (7%, 2015: 4%) or a mixture of generic and specific (33%, 2015: 35%). Certain companies provided very generic, boilerplate descriptions. Examples would include ‘failures of information security’, ‘legal/regulatory risk’, ‘health and safety’ and ‘people’ as a description without further providing insights to enable the reader to understand why such risks are applicable to the company.

Looking at the proportion of specific risk descriptions given by those companies surveyed within the FTSE 350 (60%, 2015: 56%) and those companies surveyed outside of the FTSE 350 (59%, 2015: 67%) it is evident that the descriptions of risk have become less company-specific for those outside of the FTSE 350. This finding resonates with some of the concerns the FRC has expressed over risk reporting by smaller listed companies.
The FRC Risk Guidance suggests that the description of a risk could include possible impacts of that risk on the company. Of the companies surveyed, 71% provided a clear indication of the impact of all of the risks on the company. Typically, for the majority of companies surveyed, this was included either within the risk description itself or in a separate column entitled ‘impact’. For 26% of companies, however, it was not entirely clear what the impact of all of the principal risks was. Companies following the guidance should look to include a clear description of the impact of each risk. A columnar approach might be the best way to achieve this clarity, although a narrative approach would be equally acceptable. Halma plc, which provided information about the general impact for all principal risks, (Example 8.4) is an example of a columnar approach which clearly distinguishes the impact of the risk. Another good example is Xaar plc.

Mitigating actions
With regards to mitigating actions, the FRC’s risk management guidance indicates that it expects companies to provide a “high-level explanation of how the principal risks and uncertainties are being managed or mitigated”. Such an explanation is also required by provision C.2.1 of the Code. In line with the overall spirit of the FRC’s risk management guidance it would be expected that the mitigating actions are, as well as the risk descriptions, specific to the company.

Of those companies surveyed, a significantly higher proportion (89%) provided specific descriptions of the mitigating actions that they were taking in relation to the principal risks identified compared to only 60% providing company-specific descriptions of the risks themselves.

This is unsurprising, since by their nature mitigating activities are describing what the company is doing and will therefore tend to be company-specific rather than generic.

Presentation of risks
Of the companies surveyed, the majority tended to present their principal risks and uncertainties disclosure in a tabular format (i.e. columns for items such as risk description, impact, mitigating actions, link to strategy, link to KPIs) although there were companies who presented risks in just a narrative format. Either approach is acceptable provided that the information required by the Code is included and the FRC Risk Guidance has been considered. Halma plc (Example 8.4) provided an example of a tabular format whilst Cobham plc (Example 8.3) provided an example of a narrative format.

The FRC Risk Guidance indicates that disclosures should highlight and explain significant changes in principal risks – such as a change in the likelihood or possible impact, or the inclusion of new risks.

Only 51% (2015: 35%) of the companies surveyed provided evidence of the overall change in the level of individual risks from the prior year. Whilst this proportion has shown an increase, it is still disappointingly low in light of the guidance provided by the FRC, which says that such information should be provided. The proportion of FTSE 350 companies surveyed who disclosed such a change (60%, 2015: 44%) was considerably higher than the other companies surveyed (37%, 2015: 23%). Evidencing the change in the level of risk, in the absence of an explicit statement from the directors as highlighted above, will also demonstrate that the company has refreshed their assessment of principal risks in the year.

<table>
<thead>
<tr>
<th>Companies setting out mitigating actions addressing some or all of their principal risks</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>100%</td>
<td>96%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Companies not making it clear that there were mitigating actions for all risks</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>3%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>2%</td>
</tr>
<tr>
<td>Others</td>
<td>5%</td>
</tr>
</tbody>
</table>

A columnar approach where mitigating actions are provided separately from the risk description can help ensure all risks are addressed.
As in the previous year, few companies provided any indication of either the likelihood (8%, 2015: 7%) or the magnitude of the potential impact (12%, 2015: 11%) of principal risks, despite the FRC Risk Guidance suggesting these might be included. Where information on likelihood was provided it was usually in the form of a heat map. This was similarly the case for disclosing magnitude, with both these attributes sometimes being reflected on separate axes in a combined heat map. However, Johnson Matthey Plc (Example 8.9) chose to indicate the magnitude in the form of a traffic light system whilst Halma plc (Example 8.4) and Rexam PLC (Example 8.10) provided narrative alongside each principal risk.

Whilst the FRC Risk Guidance seeks to improve the level and quality of disclosures, these statistics show that limited progress has been made in this area. In order to provide better quality information to investors on the risk environment affecting the company, these might be areas that companies, especially those outside of the FTSE 350, may wish to focus on over the following year.

Linkage of principal risks to the rest of the annual report

Strategy and KPIs

The FRC’s Guidance on the Strategic Report encourages companies to provide linkages between pieces of information presented within the annual report, particularly the strategic report, such as between principal risks and uncertainties, strategy and business model and KPIs. The ability of a company to achieve its strategy will be linked to the principal risks that it faces and how it is managing and mitigating these to an acceptable level.

The best risk disclosures are those that illustrate this linkage, for example linking specific risks and elements of a company’s strategy. Failing that, a simple cross-reference between sections does aid a user somewhat.

There are no specific rules about where this linkage could be provided and, ignoring which way round it went and whether it was presented more than once, 38% of the companies surveyed provided linkage between some or all of their principal risks and strategy, 12% of those surveyed demonstrated linkage in both their strategy section and their principal risks and uncertainties section. As indicated in chapter 6, only 18% of the companies surveyed provided linkage in the strategy section.

In terms of linkage presented in the risks section, 29% (2015: 27%) of the companies surveyed provided linkages from each of their principal risks to elements of the company’s strategy, with the proportion of those outside the FTSE 350 rising from 16% last year to 24%. A small minority of companies surveyed (3%) only provided linkages to strategy in their risks section for some of the principal risks. Whilst this only shows a moderate increase on the prior year, it is pleasing that more companies are attempting to display such linkages to provide investors with a fuller understanding of the current performance and future prospects of the company and produce more cohesive and integrated annual reports.

Linkages to strategy were typically achieved through the use of a key (such as numbers, a symbol or diagram). Many companies such as Rexam PLC (Example 8.10), Halma plc (Example 8.4) and AO World plc (Example 8.11) followed this somewhat ‘traditional’ approach. Johnson Matthey Plc (Example 8.14) chose a slightly more interesting, and equally acceptable, grid-based approach.

Whilst not all companies surveyed provided linkage between individual risks and strategy, 4% did at least attempt to connect the two by providing a cross-reference from the risks section to the strategy section.
Less obvious, but still useful, is linking principal risks and KPIs, with 8% of those companies surveyed (2015: 7%) providing linkage for all or some of their principal risks (either in the risk section or the KPIs section or both). This linkage can help to show the impact of risks on the performance of the business, as well as the extent to which mitigation strategies are effective in managing risk, in order to deliver the business’ strategic objectives. We would expect this statistic to increase as investors’ expectations for more ‘integrated’ reports advance.

### <IR> Risk reporting

The <IR> Framework requires companies to discuss the specific risks and opportunities that affect an organisation’s ability to create value and how they impact the availability, quality and affordability of relevant capitals in the short, medium and long term. (Please refer to the Regulatory overview at chapter 3 and Overall impressions at chapter 4 for more background on <IR>). The requirements of UK Company Law and the Code mean UK Companies already discuss the principal risks affecting the business, and whilst not required by law, the FRC’s Guidance for the Strategic Report does encourage the discussion of opportunities arising from internal or external factors (see chapter 6 for information on how companies have discussed opportunities in their annual reports). However, the concept of ‘integrated thinking’ is a new concept introduced in the <IR> Framework. This is more than just linking sections of the report through cross referencing; it’s about providing a holistic picture of the combination, inter-relatedness and dependencies between the factors that affect the business’ ability to create value over time.

#### Where linkage between principal risks and strategy was provided in the risks section (32 companies), was it logical?

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Completely</td>
<td>47%</td>
</tr>
<tr>
<td>In part</td>
<td>53%</td>
</tr>
</tbody>
</table>

Just under half of those companies that provided linkage between risks and elements of the company’s strategy, provided linkage where the relationship between the two obviously made sense. For others the linkage seemed superficial as it was unclear how a logical relationship could exist. When providing linkages companies should evaluate whether a logical relationship exists and whether it will be obvious to the reader. Intermediate Capital Group PLC provided a good example of logical linkage between all principal risks and elements of strategy.

#### Where linkages were provided (8 companies), was the linkage between principal risks and KPIs logical?

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>All links appear logical</td>
<td>75%</td>
</tr>
<tr>
<td>Some links do not appear logical</td>
<td>25%</td>
</tr>
</tbody>
</table>

Although only a small number of companies provided linkages between principal risks and KPIs, the majority of these obviously made sense. As with linkages to strategy above, companies should evaluate whether a logical relationship exists for disclosed linkages and, if it does, should consider whether the linkage will be obvious to the reader. Intermediate Capital Group PLC provided a good example of logical linkage between principal risks and KPIs.

#### Proportion of companies who provided linkage between the risk section of the report and further information

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>30%</td>
<td>15%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>36%</td>
<td>23%</td>
</tr>
<tr>
<td>Other</td>
<td>22%</td>
<td>5%</td>
</tr>
</tbody>
</table>

Linking risks to other areas of the annual report (by providing linkages between specific risks and further information) can be an effective way of ensuring a concise report where relevant information which is specific to the risks can be clearly signposted to avoid repetition. A good example of this was provided by Rexam PLC (Example 8.10).

### Going concern and longer-term viability statement

The best companies provide a clear link between the principal risks and the directors’ viability statement (see chapter 9) indicating how risks (especially those related to solvency and liquidity) have been considered in making that statement, insight that investors will welcome.

The majority (61%) of companies surveyed provided either a cross a reference between the risks section of the report and the viability statement or included the viability statement within the principal risks and uncertainties section. Only 46% of those companies surveyed outside of the FTSE 350 did this, compared to 71% of those companies surveyed in the FTSE 350.

There is also likely to be a degree of overlap between the disclosure on principal risks and any material uncertainties related to the going concern basis of accounting, and companies should consider how best to link these too.
Good practice examples
For each example, the aspects of good practice that it illustrates are listed next to it.

Example 8.1
Cobham plc Annual Report and Accounts 2015 (p33)

• Comprehensive discussion of risk appetite and how it is used in the decision making process.

• Shows risk appetite for each category of risk.

Example 8.2
Marks and Spencer Group plc Annual Report & Financial Statements 2016 (p48)

• Comprehensive discussion of the approach to determining risk appetite and how it is used in the decision making process.

• Inclusion of an example risk appetite statement.
Example 8.3
Cobham plc Annual Report and Accounts 2015 (p35)

Narrative way of presenting principal risks.

Example 8.4
Halma plc Annual Report and Accounts 2016 (p30)

- Example of risk appetite being set against each specific principal risk.
- Clearly distinguishes the impact of the risk from the risk description itself.
- Clearly distinguishes the mitigating activities from the risk description itself.
- Example of a tabular way to present principal risks.
- Linkage to strategic objectives through diagrammatic means that corresponds to the diagrams used in the strategy section.
- Indication of the level of magnitude of the risk in the form of narrative against each principal risk.
- Change in the level of risk denoted by up/down arrow.

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Example 8.5
National Grid Plc Annual Report and Accounts 2015/16 (p26)
Comprehensive description of a risk management process including bottom-up and top-down risk process, supported by a diagram of the risk management process and description of a three lines of defence model.

Example 8.6
The Weir Group PLC Annual Report and Financial Statements 2015 (p21)
Example of a risk appetite statement.
Example 8.7
Marks and Spencer Group plc Annual Report & Financial Statements 2016 (p12-13)

- Example of how principal risks can be displayed prominently within the annual report even though the actual principal risks and uncertainties section might be further on.

- This links the business model to related risks and provides a cross reference where further information on those risks (i.e. the actual principal risks and uncertainties section) can be found.

---

**CONNECTED VALUE**

We are committed to delivering sustainable value for stakeholders. Here, we summarise how our business model drives value creation, how the process is managed, and how we measure the value created.

---

**CORE OBJECTIVES**

<table>
<thead>
<tr>
<th>Objective</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Improve profitability</td>
<td></td>
</tr>
<tr>
<td>Drive growth</td>
<td></td>
</tr>
<tr>
<td>Strategic responsible operations</td>
<td></td>
</tr>
<tr>
<td>Sourcing products</td>
<td></td>
</tr>
<tr>
<td>Sharpen focus on customer</td>
<td></td>
</tr>
<tr>
<td>Grow Group revenue</td>
<td></td>
</tr>
<tr>
<td>Group financial performance</td>
<td></td>
</tr>
<tr>
<td>Increase earnings</td>
<td></td>
</tr>
</tbody>
</table>

---

**RELATED RISK FACTORS**

- Strategic accountability
- Financial accountability
- Non-financial performance risks
- Key non-financial measures
- Strategic performance risks
- Key strategic measures
- Strategic value creation

---

**OUR BUSINESS**

- CORE OBJECTIVES
- RELATED RISK FACTORS
- ACCESSIBILITY
- SUPPORT
- OUTCOMES

---

**ACCOUNTABILITY**

- SENIOR LEADERSHIP GROUP
- OPERATING COMMITTEE
- BOARD

---

**IMPROVING PROFITABILITY**

- Driven by growth
- Delivering higher margins
- Reducing costs

---

**DRIVING GROWTH**

- Strong cash generation
- Invest to grow
- Enhancing customer experience

---

**STRATEGIC REPORT 12**

- See KPIs p18
- See KPIs p19

---

**STRATEGIC ACCOUNTABILITY**

- Key performance measures
- Financial performance
- Non-financial performance

---

**OUR PEOPLE**

- OUR RESOURCES
- OUR FINANCIAL
- OUR NATURAL

---

**RESOURCES**

- Our resources and relationships
- Stakeholders and channels
- Our people

---

**FINANCIAL**

- How our activities deliver non-financial value
- How our activities deliver financial value

---

**NATURAL**

- How the process is managed, and how we measure the value created.

---

**OUR BUSINESS MODEL**

- This links the business model to related risks and provides
- Example of how principal risks can be displayed prominently within the annual report even though the actual principal risks and uncertainties section might be further on.

---

**MARKS AND SPENCER GROUP PLC**

- STRATEGIC REPORT
- 12

---

**STRATEGIC REPORT 12**

- See KPIs p18
- See KPIs p19

---

**M&S.com weekly site visits**

- M&S.com sales
- International operating profit
- International sales
- Sales growth

---

**Food LFL sales growth**

- Food gross margin
- Greenhouse gas emissions
- Employee engagement score
- Number of shops per customer

---

**Non-financial performance risks**

- Key non-financial measures
- Strategic performance risks
- Key strategic measures
- Strategic value creation

---

**Key performance measures**

- Growth
- Profitability
- Non-financial performance
- Financial performance

---

**See Remuneration p52-53**

- See Governance on p42-46

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**See Risk p28-29**

- See Risk p28-29

---

**See KPIs p18**

- See KPIs p19
Example 8.8
Thomas Cook Group PLC Annual Report & Accounts 2015 (p59)
Linkage of principal risks that were taken into account in making the longer-term viability statement.

Example 8.9
Johnson Matthey Plc Annual Report and Accounts 2015 (p31)
- Indication of the magnitude of the risk in the form of a traffic light system.
- Change in the level of risk indicated by narrative description.
### Example 8.10

**Rexam PLC Annual Report 2016 (p24)**
- Each strategy is numbered and then linked to each specific risk.
- Indication of the magnitude of the risk in the form of narrative against each principal risk.
- Risks are linked to other relevant areas of the annual report that relate to this risk.
- Linkage of principal risks that were taken into account in making the longer-term viability statement.

### Example 8.11

**AO World plc Annual Report and Accounts 2016 (p23)**
- Example of linkage to strategic objectives through the use of small pictures that tie through to those used in the strategy section earlier on in the report.
- As well as showing impact on the strategic objective this also shows the impact of the principal risk on the business model.

---

**Summary of Principal Risks and Uncertainties**

<table>
<thead>
<tr>
<th>Risk and description</th>
<th>Potential impact and key mitigations</th>
<th>2015 Assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Competitive environment risks:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Falling to develop Rexam's strength of our commercial relationships to reflect our rate of growth and in emerging markets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strategic priorities: 1, 3, 4</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Customer relationship changes:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Likely to impact profitability of our sales</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strategic priorities: 1, 3, 4</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial impact from currency based inflation:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Failure to manage the risk and exposure inherent in currency movements and legal uncertainties</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strategic priorities: 5, 6</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---

**A clear vision | Annual report insights 2016**
Example 8.12
Intermediate Capital Group PLC Annual Report and Accounts 2016
A different way of showing risk appetite per principal risk apart from inclusion against each specific risk.

Example 8.13
Mothercare plc Annual Report and Accounts 2016
A variant of showing risk appetite per principal risk apart from inclusion against each specific risk.
A variation on how to link principal risks to strategic objectives apart from including them in the principal risks and uncertainties table.

Linkage of principal risks that were taken into account in making the longer-term viability statement denoted by a ‘v’.
Going concern and viability statements
Going concern and viability statements

**Top tips**
- Consider the most appropriate period of assessment for the longer term viability statement and explain clearly why this period was selected. 83% of companies surveyed used a three year period in this first year of longer term viability statement reporting.
- Assess whether specific qualifications or assumptions have been used in the analysis for the longer term viability statement and disclose those in the statement – in particular where there are assumptions on financing, maintaining sales prices or volumes or the success of mitigating actions. Only 48% of companies surveyed this year reported on specific qualifications or assumptions.

**Keep an eye on**
- The 2014 Code requirement for a board statement on going concern and another on viability. The former states whether the going concern basis of accounting was considered appropriate, and the latter explains how the board has assessed the prospects of the company (taking account of its current position and principal risks), over what period they have done so and why they consider that period to be appropriate, together with qualifications or assumptions. In order to achieve clear and concise reporting, consider whether information can best be streamlined by linking these statements, through presenting them side by side or through clear cross-referencing.
- Whether there are opportunities to further integrate reporting on risk management, principal risks, going concern and longer term viability to reduce duplication, including between the risk management section and the corporate governance section of the annual report.

**Introduction**
The 2014 updates to the UK Corporate Governance Code introduced changes to the way in which companies report on their future prospects, with the aim of making a clearer distinction between the meaning of going concern in the broad context meant by Lord Sharman and the narrower context used in the accounting standards. They also ask companies to make a clearer link between the assessment of risks to the viability of the business and the broader risk assessment that should form part of a company’s normal risk management and reporting processes. The extent to which the companies surveyed have revised their risk reporting to emphasise this link has been discussed further within chapter 8.

In establishing the new provisions with respect to going concern and viability, the FRC attempted to balance the information needs of investors with setting appropriate reporting requirements. The result of this is that directors are now required to include two statements in the annual report regarding the health of the business.

- A statement of whether they consider it appropriate to adopt the going concern basis of accounting, and any material uncertainties identified in assessing this, which should be identified in the financial statements.

This statement must cover a period of at least twelve months from the date of approval of the financial statements and is required in half-yearly reports as well as annual reports.

- A statement that, taking account of the company’s current position and principal risks, the directors have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due, drawing attention to any qualifications or assumptions as necessary. The period covered by this assessment should also be stated, along with the reasons why that period is appropriate. It is expected that, except in rare circumstances, the period will be significantly longer than 12 months from the date of approval of the financial statements.

This chapter examines in more detail how companies have applied these requirements, with a particular focus on the second of these statements (commonly known as the ‘longer term viability statement’).
The longer term viability statement
This year the focus of the board’s exercise has largely changed to the new longer term viability statement, with the hurdle for the going concern statement being much easier to manage in comparison – going concern now refers exclusively to the basis of accounting and therefore not being a going concern is a very high hurdle.

The longer term viability statement was introduced as a new requirement of the 2014 Code and requires directors to state whether they have a “reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment” (Code provision C.2.2). It is also based on the directors’ new confirmation in the annual report that they have carried out a robust assessment of the principal risks facing the company (Code provision C.2.1), since the principal risks are a key element of the directors’ assessment – see chapter 8.

It is encouraging that in this first year we have seen numerous examples of good disclosure covering various elements encouraged by the Code and the FRC’s Guidance on Risk Management, Internal Control and Related Financial and Business Reporting.99% of companies in our survey sample produced a longer term viability statement; the company that did not do so (one of the smaller companies) had reported on compliance with the outdated 2012 version of the Code.

The FRC has encouraged companies to include their longer term viability statement in the strategic report, alongside the disclosures on principal risks. This makes sense as those principal risks are a key part of the directors’ assessment and it avoids cumbersome cross-referencing. In addition, longer term viability is likely to be of strategic importance to most companies.

The FRC has also published a letter from the then Department for Business, Innovation and Skills indicating that the strategic report is within the scope of safe harbour, again making it a sensible place to include a longer term viability statement.71 In total, 73% of our sample included their statement in the strategic report; a further 15% included the statement in the directors’ report and 8% in the corporate governance statement.

Chapter 8 explains that, similarly, the directors’ statement on the robust assessment of principal risks is largely to be found either in the principal risks section of the strategic report or in the longer term viability statement itself.

Despite the huge variations in industry and nature of listed companies, Figure 9.1 shows that 83% of our survey sample looked out over a three year period.

Four companies included disclosure suggesting that the lookout period might change in future. None of these companies had used a three year period – two had used a longer period due to recent forecasting over that longer period and two had looked out over only two years due to current uncertainties in their environment. Kingfisher plc has used a five year lookout period and expects it to reduce to three years in future (Example 9.1).

---

Table 9.1 – How companies reported on the analysis performed for the longer term viability statement

<table>
<thead>
<tr>
<th>The viability statement refers to the nature of the analysis undertaken</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>91%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>93%</td>
</tr>
<tr>
<td>Others</td>
<td>88%</td>
</tr>
<tr>
<td>Smaller company disclosures are almost as comprehensive as FTSE 350 company disclosures.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>The nature of the analysis undertaken</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scenario planning</td>
<td>58%</td>
</tr>
<tr>
<td>Sensitivity analysis</td>
<td>63%</td>
</tr>
<tr>
<td>Detailed modelling</td>
<td>10%</td>
</tr>
<tr>
<td>Qualitative analysis</td>
<td>8%</td>
</tr>
</tbody>
</table>

Over 80% of companies performed a good level of analysis, in many cases combining both scenario planning and sensitivity analysis.

<table>
<thead>
<tr>
<th>The viability statement indicates which principal risks have been considered</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>55%</td>
</tr>
</tbody>
</table>

92% of our survey sample met the Code requirement to report on why they considered the lookout period selected to be appropriate – this is a relatively easy requirement to meet so it is most likely that the companies that did not had simply overlooked the need to do so.

The Code provision requires companies to report on how they have assessed the prospects of the company. We looked at whether they had described the nature of the analysis they undertook, the nature of the analysis and how they explained which principal risks had been considered.

The final requirement of the Code provision is that companies should draw attention to any qualifications or assumptions as necessary. This would seem to be a great help for companies, meaning that they can explain the basis of their analysis to the reader and allow them to understand fully the exercise undertaken. Therefore, we were surprised to find that, in this first year, fewer than half of our survey sample included qualifications or assumptions. This was compounded as certain of the companies that did not include qualifications or assumptions had ongoing funding requirements that could have been captured in an assumption about availability of funding – which was the most common assumption reported, by 27% of our sample.
None of the FTSE 100 financial services companies in our sample disclosed the qualifications or assumptions underlying their analysis.

Companies providing clear reporting on qualifications or assumptions include Shaftesbury PLC (Example 9.3) and Dairy Crest Group plc (Example 9.4).

The listing Rules requirement has now changed, as has the FRC’s guidance on what the disclosure should include. With the advent of the longer term viability statement, there is now a separate disclosure that requires the directors to set out their reasoning regarding viability over a longer period, which is now where directors would be expected to include assumptions or qualifications as necessary, in line with 2014 Code provision C.2.2. This year, we expected to see a change to the nature of the separate going concern statement, a reduction in detail provided by companies (to be replaced by disclosure in the longer term viability statement) and we expected fewer companies, where conclusions on going concern should be straightforward, to include a statement in the front half of the annual report. The FRC’s Guidance on Risk Management, Internal Control and Related Financial and Business Reporting is clear that the statement referred to in Code provision C.1.3 regarding going concern and any material uncertainties should be in the financial statements.

We have not provided comparative detail for 2015 as the nature of the going concern statement was different under the 2012 Code.

The following table (overleaf) differentiates in most cases between disclosures in the front half of the annual report and those in the financial statements – each question is clear about which version of the going concern statement is considered.

---

Figure 9.2 – How many companies have reported on qualifications or assumptions?

| Overall | 48% |
| FTSE 350 | 52% |
| Others | 43% |

See Examples 9.1 and 9.3

Figure 9.3 – What qualifications or assumptions were disclosed?

<table>
<thead>
<tr>
<th>Availability of funding/ refinancing</th>
<th>Availability or success of mitigating actions</th>
<th>Sales volumes or pricing</th>
<th>Contract renewals</th>
<th>Cost management</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>27%</td>
<td>13%</td>
<td>8%</td>
<td>7%</td>
<td>6%</td>
<td>17%</td>
</tr>
</tbody>
</table>

Other qualifications or assumptions were largely industry or company specific in nature.
Table 9.2 – The going concern statement – how did companies meet the requirements

<table>
<thead>
<tr>
<th>A statement in the front half by the directors that the business is a going concern</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>97%</td>
</tr>
</tbody>
</table>

The number of companies making the disclosure in the front half of their report was substantially higher than we expected under the new requirements of the 2014 Code. Last year, all companies included a going concern statement in the front half.

<table>
<thead>
<tr>
<th>How detailed are the going concern disclosures in the financial statements?</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not mentioned at all</td>
<td>7%</td>
</tr>
<tr>
<td>Prepared on a going concern basis</td>
<td>26%</td>
</tr>
<tr>
<td>Prepared on a going concern basis with a cross-reference to front half going concern disclosure</td>
<td>34%</td>
</tr>
<tr>
<td>More detailed disclosure</td>
<td>25%</td>
</tr>
<tr>
<td>More detailed disclosure with a cross-reference to front half going concern disclosure</td>
<td>8%</td>
</tr>
</tbody>
</table>

The significant variation in the level of disclosure in the financial statements shows that there is not yet consistency in market practice when meeting the new Code requirements, with some companies including detail in the front half, some in the back half and some in both places. We would expect, and the FRC’s guidance encourages, a statement explaining the going concern basis of accounting in the financial statements.

<table>
<thead>
<tr>
<th>Where is the front half statement on going concern positioned?</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate governance statement</td>
<td>19%</td>
</tr>
<tr>
<td>Directors’ report</td>
<td>42%</td>
</tr>
<tr>
<td>Strategic report</td>
<td>31%</td>
</tr>
<tr>
<td>Other</td>
<td>8%</td>
</tr>
</tbody>
</table>

The ‘other’ category here largely represents reports where the statement was in the directors’ responsibilities section, or where there was no front half statement. Where there is a more complex conclusion to be reached on going concern, or material uncertainties, the importance of the disclosures could merit including them in the strategic report.

<table>
<thead>
<tr>
<th>What are the main cross-references from the going concern statement (from either front half or financial statements)</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal risks</td>
<td>34%</td>
</tr>
<tr>
<td>Liquidity</td>
<td>51%</td>
</tr>
<tr>
<td>Entire strategic report</td>
<td>29%</td>
</tr>
<tr>
<td>Other (mainly financial risk management)</td>
<td>26%</td>
</tr>
</tbody>
</table>

How detailed is the going concern statement? 2016

<table>
<thead>
<tr>
<th>How detailed is the going concern statement?</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>‘Boiler plate’ disclosure</td>
<td>31%</td>
</tr>
<tr>
<td>Some (limited) detail with no cross-references</td>
<td>15%</td>
</tr>
<tr>
<td>Some detail with clear and specific references</td>
<td>31%</td>
</tr>
<tr>
<td>Very detailed disclosure</td>
<td>23%</td>
</tr>
</tbody>
</table>

Again, there is not yet consistency in market practice when meeting the new going concern requirements. All companies in our sample with material uncertainties included a disclosure we judged to be ‘very detailed’. Last year there were fewer companies with disclosure we assessed as ‘boiler plate’ (13%). This suggests that companies have taken the opportunity to reduce disclosure on going concern and replace with longer term viability statement disclosure.

<table>
<thead>
<tr>
<th>The period for which the going concern assessment has been considered</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unclear</td>
<td>12%</td>
</tr>
<tr>
<td>12 months</td>
<td>23%</td>
</tr>
<tr>
<td>Foreseeable future – no explanation</td>
<td>51%</td>
</tr>
<tr>
<td>Foreseeable future – with explanation</td>
<td>9%</td>
</tr>
<tr>
<td>Other</td>
<td>5%</td>
</tr>
</tbody>
</table>

We consider the high level of companies describing the period as the ‘foreseeable future’ with no further explanation is due to the prevalence of the assumption that the ‘foreseeable future’ is 12 months. However, under the previous version of the going concern statement, 93% did not specify the period they had considered. The change is likely to be due to companies wanting to differentiate the period for the going concern statement from that for the longer term viability statement. The ‘other’ category largely represents those who indicated a period other than 12 months for the statement – most commonly 15 months.
We also considered material uncertainties outlined in the statement, where we would expect similar outcomes to previous years despite the change in the nature of the going concern statement. We have therefore included and assessed 2015 comparatives. All material uncertainty disclosures in our 2016 sample discussed concern about financing, shareholder support and potential breach of covenants. It was noticeable that the number of material uncertainties disclosed in the going concern statement had decreased markedly since 2015. This may be attributable to financing cycles as companies renegotiate funding and reconsider financing options. Several companies in our sample in 2015 that had material uncertainties in that year have undertaken rights issues or renegotiated finance during the year. In each of these cases there is no longer an emphasis of matter in the enhanced auditor’s report and in some the auditor provides an explanation of why going concern is no longer a key risk.

**Linking the going concern statement and the longer term viability statement**

We also wanted to know about the interaction between the going concern statement and the longer term viability statement.

In line with previous surveys\(^{73}\), we have undertaken, the linkage between the two is clear for just over half of our sample (with certain cross-references being for the same companies as those positioning the going concern statement next to the viability statement).

An example of a company laying out the going concern statement and the longer term viability statement side by side is Compass Group plc (Example 9.4) and of a company combining the two statements is HSBC Holdings plc (Example 9.5).

**Table 9.3 – Was there any interaction between the going concern statement and the longer term viability statement?**

<table>
<thead>
<tr>
<th>Was there any interaction between the going concern statement and the longer term viability statement?</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>The going concern statement is positioned next to the viability statement</td>
<td>Overall 43%</td>
</tr>
<tr>
<td>The going concern statement and viability statement are combined</td>
<td>Overall 8%</td>
</tr>
<tr>
<td>The going concern statement cross-refers to the viability statement*</td>
<td>Overall 17%</td>
</tr>
</tbody>
</table>

* Nine of these cross-references were from the front half; eight were from the financial statements

---

73 Governance in brief: Risk management, internal control and longer term viability – how companies have tackled the new Code provisions (May 2016)
Going concern and viability statements – good practice examples
In this section we highlight a number of going concern and longer term viability statement disclosures which we believe illustrate aspects of good practice. For each example, the aspects of good practice that it illustrates are listed next to it.

Example 9.1
Kingfisher plc Annual Report 2015/16 (p35)

Shows rationale for five years in the current year with plans to reduce to three years.
Example 9.2

Thomas Cook Group plc Annual Report & Accounts 2015 (p57-59)

- Refers to principal risks table to indicate which risks are considered to have a direct link to the viability statement – they are clearly indicated there through a star.
- Clear reasons for a three year lookout period.
- Refers to consideration of risks occurring “both individually and in unison.”
- Specific detail regarding sensitivities.
Example 9.3
Shaftesbury PLC Annual Report 2015 (p66)

- Clear reasons for a five year outlook period.
- Detailed descriptions of key assumptions.
- Analysis of impact of principal risks on viability, setting out scenarios considered.

Example 9.4
Dairy Crest Group plc Annual Report 2016 (p61)

- Shows positioning of going concern statement next to viability statement.
- Clear reasons for a three year outlook period.
- Detail about financing assumptions and focus on covenant compliance.
Example 9.5
HSBC Holdings plc Annual Report and Accounts 2015 (p277-278)

• Shows combined going concern and viability statement.
• Clear reasons for a three year outlook period.
• Clearly states that all of the principal risks have been considered and why.
• Details about nature of testing, including reverse stress testing.
• Helpful cross-references to other information.

Going concern and viability

The financial statements were prepared on the going concern basis as the Directors have a reasonable expectation that the Group will continue in operation and be able to realize its assets and meet its liabilities as they fall due over the next three years. This expectation is underpinned by strategic situations, management performance and the capital position of the Group, regulatory and supervisory expectations and the support of shareholders.

The Directors have carried out a robust assessment of the capital position of the Group, regulatory and supervisory expectations and the support of shareholders. The Directors have a reasonable expectation that the Group will continue in operation and be able to realize its assets and meet its liabilities as they fall due over the next three years.

The Directors have confirmed in accordance with the requirements of the Companies Act 2006, that the directors have a reasonable expectation that the Group will be able to continue in operation over the period to which the financial statements relate.

Employees

HSBC is committed to providing equal opportunities for all and to promoting equal opportunities and combating discrimination. In the UK, as in the rest of the Group, we have a commitment to providing equal opportunities and combating discrimination, including in relation to age, religion, disability, sexual orientation and gender identity, and to maintaining a diverse and inclusive culture.

Health and safety

HSBC is committed to providing a safe and healthy environment for its employees, customers and the public. We aim to contribute to both the economic and social wellbeing of the communities in which we operate, and to promote the health and safety of our employees and customers.

A clear vision | Annual report insights 2016

Employee relations

We are committed to a culture of respect and collaboration with our employees, customers and the public. We are committed to providing equal opportunities and combating discrimination, including in relation to age, religion, disability, sexual orientation and gender identity, and to maintaining a diverse and inclusive culture.

Health and safety

HSBC is committed to providing a safe and healthy environment for its employees, customers and the public. We aim to contribute to both the economic and social wellbeing of the communities in which we operate, and to promote the health and safety of our employees and customers.
10

Corporate governance

Enter the chapter
Corporate governance

Top tips

• Comply or explain – a meaningful explanation should be provided for all departures from a Code provision during the year, regardless of when the non-compliance first took place. The explanation should include company-specific context and any mitigating actions. This year we considered that 68% of companies surveyed provided an adequate explanation of the reasons for any non-compliance.

• Good explanations of departures from the Code are an opportunity to describe to users of the annual report the approach the company takes to corporate governance and to make its journey real.

• Additional information on directors is particularly helpful for FTSE 350 companies, where there is a requirement for annual re-election, but all companies should consider adding detail on the contribution each director makes to the board – this was done by 38% of companies surveyed this year.

• Make sure to maintain a focus on current key topics: culture and succession planning. Is there a good story to tell?

• Consider including information on how the board monitors and shows ownership of the corporate culture, with cross-references as necessary to the strategic report. How does the board hold management to account? This year 35% of companies surveyed included a good discussion of corporate culture, either in the strategic report or the governance section.

Keep an eye on

• Whether it is clear in the annual report that the board is monitoring risk management and internal control systems on an ongoing basis. 85% of companies surveyed had disclosures that made it clear that the board monitors risk management and internal control systems on an ongoing basis.

• Whether a significant failing or weakness has been identified as part of the annual review of effectiveness of internal control. If so, remember to make it clear what actions have been or are being taken to remedy the failing or weakness identified – this was a change in the FRC’s 2014 Guidance on Risk Management, Internal Control and Related Financial and Business Reporting.

• Vulnerability to cyber risk, a current area of focus. It is worth reporting on the governance activities undertaken at board level to understand and set a strategy around cyber risk and to hold the executive to account in this area. Overall, 43% of companies surveyed included disclosure about board activity on cyber risk.

Introduction

Listed companies are required by the Listing Rules to make certain disclosures about corporate governance in their annual reports. Companies with a premium listing are required to state how they have applied the main principles set out in the UK Corporate Governance Code (the Code), in a manner that would enable shareholders to evaluate how the principles have been applied, and a statement of compliance with all relevant Code provisions, identifying provisions that have not been complied with and providing reasons for this non-compliance. During the period covered by this year’s survey companies had to report on their compliance with the 2014 Code, which is supported by the associated FRC documents Guidance on Risk Management, Internal Control and Related Financial and Business Reporting and the 2012 version of the Guidance on Audit Committees, both of which recommend various disclosures for inclusion in the annual report.

The Disclosure Guidance and Transparency Rules (the DTR) also requires companies listed on the main market, amongst others, to include certain corporate governance disclosures, such as a description of the main features of the company’s internal control and risk management systems in relation to the financial reporting process (DTR 7). There is a degree of overlap between the requirements of the Code and of the DTR.

The 2014 Code introduced changes to the requirements in three principal areas: going concern and longer term viability; risk management and internal control; and remuneration and shareholder engagement.
Going concern and statement of longer term viability:
The annual report should include two distinct statements – the board’s confirmation of the appropriateness of the going concern basis of accounting and a broader, longer term assessment by the Board of the company’s ongoing viability. (See chapter 9 ‘Going concern and viability statements’).

Risk management and internal control: Boards have to monitor risk management and internal control systems on an ongoing basis, rather than reviewing effectiveness once a year. They should also undertake a robust assessment of the principal risks that might threaten the company’s business model, future performance, solvency or liquidity and explain actions taken to remedy any failings or weaknesses identified. (See chapter 8 ‘Principal risks and uncertainties’).

Remuneration and shareholder engagement: Boards should focus on the long-term success of the company when setting remuneration policy and include clawback and malus provisions. There is also a provision requiring companies to explain what action they intend to take in response to situations where a significant proportion of votes have been cast against a resolution at any general meeting. This is likely to be relevant where there is a significant vote against accepting the directors’ remuneration report. The way in which companies structure their remuneration reports is discussed in chapter 4.

Where we consider it informative, we have analysed the results between FTSE 100, FTSE 250 and other listed companies separately, to allow trends within those categories to be identified.

<IR> Governance
The <IR> Framework requires an integrated report to provide insight about how the governance arrangements contribute to a company’s ability to create value. What a company chooses to disclose can be substantially affected by a company’s understanding of the focus its stakeholder groups have on its governance arrangements.

Areas of focus could include the following.
• The corporate governance statement, for example:
  – the way that regulatory requirements influence the design of the governance structure and whether the structure put in place meets or exceeds regulatory requirements;
  – processes used by the company to make strategic decisions and to establish and monitor the company’s culture, especially with regard to risk management;
  – actions those charged with governance have taken to influence the strategic direction of the company; or
  – how the board promotes and enables innovation.
• The nomination committee report – the skills and diversity of those charged with governance
• The remuneration committee report – how remuneration and incentives are linked to value creation and the effects on the capitals.

In the UK environment, many of the goals set out in the <IR> Framework coincide with the goals of the FRC to provide sufficient insight to stakeholders in the company. As such, a genuine focus on applying both the spirit and the letter of the UK Corporate Governance Code and its guidance, together with some additional cross-referencing, will lead to a company’s report meeting the requirements of the <IR> Framework.

Compliance with the Code
The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that will contribute to the long-term success of the company.

All companies in our sample included a statement of compliance or partial compliance with the Code. The number of companies reporting full compliance with the 2014 Code increased to 56%, from 51% reporting full compliance with the 2012 Code last year.

We continue to see full compliance diminishing with the size of the company, despite the Code having some relaxations for smaller companies. This year 79% (2015: 78%) of the FTSE 100 companies surveyed reported full compliance with the Code, compared with 56% (2015: 51%) of FTSE 250 companies surveyed and only 45% (2015: 40%) of the companies outside the FTSE 350.
Comply or explain
The Listing Rules require companies to set out the provisions they have not complied with along with the reasons they have not complied. In general, the quality of explanations has been improving over the last few years and this is supported by our survey (68% of companies provided an adequate explanation of the reasons for their non-compliance) and has been highlighted by the FRC in their annual Developments in Corporate Governance and Stewardship reports. A high quality explanation can provide useful information to investors enabling them to come to a view of the company’s departure from a Code provision and, in many cases, to understand the company’s position.

Despite this improving picture on explanations for non-compliance, we did note that some companies had failed to provide an adequate explanation where a non-compliance had taken place (and may have been explained) in a previous year, but no explanation was given this year of the continuing non-compliance. Several of these had not complied with Code provisions A.2.1 and/or A.3.1, which are the provisions that require that the role of chairman and chief executive are not exercised by the same person, and that a chief executive should not go on to become chairman of the same company. We consider that it is helpful to investors – and compliant with the Listing Rules – to provide reasons even where the original non-compliance took place in a prior year.

Although Johnson Matthey Plc’s departure from the Code first took place in a previous year, the quality of the explanation is high and actions to mitigate the effect of the departure are explained (Example 10.1). Other examples of good explanations include AO World Plc and Bodycote plc.

Figure 10.1 shows the most common areas of non-compliance with the code.

Figure 10.1 What are the most common areas of non-compliance with the Code across all companies surveyed?

<table>
<thead>
<tr>
<th>Number of companies that have not complied with the provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>A.2.1 Separation between chairman and chief executive</td>
</tr>
<tr>
<td>A.3.1 Chairman’s independence</td>
</tr>
<tr>
<td>A.4.1 Senior independent director</td>
</tr>
<tr>
<td>A.4.2 Non-executive only meetings</td>
</tr>
<tr>
<td>B.1.2 Board composition – independent and non-executives</td>
</tr>
<tr>
<td>B.2.1 Nomination committee and composition</td>
</tr>
<tr>
<td>B.2.4 Nomination committee report</td>
</tr>
<tr>
<td>B.6 Board performance evaluation</td>
</tr>
<tr>
<td>B.6.3 Performance evaluation – chairman</td>
</tr>
<tr>
<td>C.3.1 Audit committee and composition</td>
</tr>
<tr>
<td>D.1.1 Clawback and malus</td>
</tr>
<tr>
<td>D.2.1 Remuneration committee and composition</td>
</tr>
<tr>
<td>E.1.1 Interaction with shareholders</td>
</tr>
</tbody>
</table>

The most common areas of non-compliance relate to board and committee composition, the independence of the chairman and board performance evaluation. This is broadly consistent with the nature and proportion of non-compliance that we saw in 2015.

One company reported temporary and partial non-compliance with a new element of a provision in the 2014 Code, provision C.2.3, reporting that ongoing monitoring by the board started part-way through the year. This was a good example of a company explaining its journey towards compliance with the new requirements and acknowledging the work it has been performing towards full compliance with the Code.

Ownership of corporate governance
The preface to the Code encourages chairmen to report personally on how the principles relating to the role and effectiveness of the Board have been applied. The most common approach from chairmen continues to be the provision of an introductory letter to shareholders at the start of the corporate governance section and cross-reference to other parts of the corporate governance statement or Strategic Report (for risk management and the viability statement) as appropriate. This year, 77% of chairmen (2015: 81%) clearly took ownership of the corporate governance section of the annual report. Of the 92% of companies that included a chairman’s statement in the strategic report, 33% included reference to governance arrangements which address how the principles have been applied in that statement.

NMC Health plc provided a good example of reporting personally in the chairman’s statement in their strategic report (Example 10.2), whilst good examples of chairman’s introductions to the corporate governance section include The Unite Group plc (Example 10.3) and Barclays PLC (Example 10.4).

We discuss board performance evaluation in chapter 11 on nomination committee reporting.

The board of directors

Two areas where we are seeing developments in reporting are:

- a move to explain more clearly the contribution each board member makes; and
- companies providing more detail around the rigorous review applied to a non-executive director term beyond six years (Code provision B.2.3).

Both of these are very helpful to investors, particularly investors in FTSE 350 companies who are asked to vote every year on the re-election of directors. A greater understanding of what each board member brings to the table and what relevant expertise they have derived from their past C.V. can be used alongside the summary of experience when drawing conclusions on the value the board member offers. 38% of our full survey sample provided such disclosure this year and 48% of the FTSE 350 survey sample. Good, yet very different examples, include Centrica plc (Example 10.5) and Jardine Lloyd Thompson Group plc (Example 10.6).

Similarly, where the board is putting forward a long-serving non-executive director for re-election, it is helpful for investors to understand the reason the board believes retaining the director is in the best interests of the company and whether and how the director continues to be deemed to be independent. This disclosure was provided by 30% of our full survey sample in the current year and 33% of the FTSE 350 survey sample, in both cases this percentage based on those companies that had non-executive directors who had served for over six years. Good examples include Fidessa group plc (Example 10.7) and Savills plc (Example 10.13).

We explore the diversity and succession of the board in chapter 11 Nomination committee reporting.

Culture

The FRC has now issued a report of observations emerging from its culture project: Corporate Culture and the Role of Boards75. This gives a clear message that companies need to have a strong purpose, culture and ethical values to succeed and be sustainable in the longer term. The public, the media and government are asking more questions about corporate purpose, including contribution to society, taxation and the behaviour of directors.

The FRC believes that more can be done to improve corporate reporting in this area, with investors believing there is not enough visibility on culture and values in annual reports. There are opportunities to provide meaningful insight into culture through the annual report, including:

- providing a sufficiently good explanation of the business model and the principal risks to the business to enable the reader to understand actions the company takes around culture;
- focusing on actions the company has taken around culture, ethics and human capital initiatives;
- practical illustrations of how the company expects its business to be conducted in given circumstances; and
- non-financial metrics, including on human capital.

Good examples of discussion of corporate culture in the corporate governance section include Marks and Spencer Group plc (Example 10.14) and Pearson plc (Example 10.15), where culture is the responsibility of the Reputation and Responsibility Committee.

Good examples of discussion of corporate culture in the strategic report include Rotork Plc (Example 10.16) and Premier Oil plc (Example 10.17).

Only two companies in our sample referred to any assurance being undertaken around culture within the organisation. An example of a case study around embedding culture throughout the business is given by Unilever (Example 10.18). This echoes one of the FRC’s recommendations to illustrate the work performed.

Internal control and risk management

Code provision C.2.3 requires that the board should monitor the company’s risk management and internal control systems and, at least annually, carry out a review of their effectiveness, and report on that review in the annual report. The FRC’s Guidance on Risk Management, Internal Control and Related Financial and Business Reporting76 clarifies that monitoring needs to take place on an ongoing basis. This year, 100% of our sample (2015: 100%) provided an internal control statement in line with the Code and 85% had disclosures that made it clear that the board monitors risk management and internal control systems on an ongoing basis.

Good examples are Findel plc (Example 10.8) and G4S plc (Example 10.9).

Table 10.2 – Internal control statement – what does it include?

<table>
<thead>
<tr>
<th>A summary of the process which the board has applied in reviewing the effectiveness of the systems of risk management and internal control</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
</tr>
</tbody>
</table>

The increase is likely attributable to the increased focus on risk management arising from the implementation of the 2014 Code.

A definition of ‘material controls’ is provided

| Overall | 2% | Not surveyed |

There is no requirement to do this but the FRC Guidance refers to monitoring of ‘material controls’.

Have any internal control breakdowns been identified?

| Yes | 8% | Not surveyed |
| Confirmation that no breakdowns have occurred | 44% | Not surveyed |
| No comment | 48% | Not surveyed |

We would expect a higher proportion of companies to report clearly on the outcome of the board’s review.

There is an explanation of what actions have been or are being taken to remedy any significant failing or weakness identified from the review

| Overall | 4% | Not surveyed |

This represents only half of companies that reported a breakdown in internal control.

Non-financial metrics and indicators need to be relevant to investors and appropriate to the company and its industry, with the goal of reliable and consistent data allowing measurement year on year and against peers – also see chapter 7 Key performance indicators.

The FRC’s figures are that only 14% of annual reports discuss corporate culture – the following table shows our findings based on our survey sample. It is disappointing to note that the results of our survey show that good disclosure of how the board owns and drives corporate culture has actually reduced somewhat since 2015. Perhaps that is a result of companies waiting for the results of the FRC’s project; we hope to see a significant increase in our 2017 survey sample.

Table 10.1 – How has corporate culture been discussed in the annual report?

<table>
<thead>
<tr>
<th>How has corporate culture been discussed in the annual report?</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>There is specific discussion of how the board owns and drives corporate culture</td>
<td>11%</td>
<td>15%</td>
</tr>
<tr>
<td>There is a good discussion in the strategic report</td>
<td>26%</td>
<td>19%</td>
</tr>
<tr>
<td>There is discussion but it is not sufficiently specific</td>
<td>12%</td>
<td>20%</td>
</tr>
</tbody>
</table>

Cyber security and governance

Organisations have never been more at risk from cyber-attacks. Recent high-profile attacks on companies in the retail, media and industrial sectors have highlighted the type of damage that can be done by hackers and cyber terrorists. This growing threat comes at a time when there is also increasing focus on how organisations manage risk. Regulators, investors and senior executives are putting companies under pressure to explain how they identify risks to their business and how they ensure these are being managed within an agreed risk appetite. The increasing incidence of cyber risk or IT security risk in annual report principal risks is highlighted in chapter 8.

The UK Government runs an annual survey of cyber governance covering the FTSE 350. The most recent results showed that board awareness of the nature and impact of cyber risk continues to improve, demonstrated by a notable increase in the number of companies who include cyber as a primary group risk, to 49% from 29%. 71% of the respondents to the Government’s survey expected net cyber risk to increase over the next year. Our survey findings in chapter 8 indicate that, of our FTSE 350 sample, 66% identified cyber risk as a principal risk.

We would expect this increase in attention and in cyber risk being identified as a principal risk to lead to an increase in board activity around cyber risk and IT security. Given the external focus on this risk and the publicity around data breaches, we wanted to see how many boards reported on the activity they undertook to understand cyber risk, to set a strategy and to challenge the executive around the work they had done to manage the risk.

<table>
<thead>
<tr>
<th>Table 10.3 – Board activity around cyber risk/IT security</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board activity around cyber risk / IT security</td>
</tr>
<tr>
<td>Overall</td>
</tr>
<tr>
<td>FTSE 100</td>
</tr>
<tr>
<td>FTSE 250</td>
</tr>
<tr>
<td>Others</td>
</tr>
</tbody>
</table>

Most FTSE 350 boards undertook activity themselves around cyber risk, compared to smaller companies who rarely reported such activity.

The table shows that, for FTSE 350 companies, there is a significant increase in the board referring to activity around cyber risk and IT security compared to last year.

Similar to last year, there was a wide variety of approaches taken to disclosure around board activity on cyber risk and IT security. Disclosures included:

- mention of the risk as an area of board focus in the chairman’s introduction to the corporate governance section;
- receipt and review of reports or presentations on the topic by the audit committee, the risk committee or the full board;
- review of the results of the Government’s Cyber Governance Health Check Tracker Report;
- part of a deep dive risk review;
- an area of focus for internal audit;
- an area on which the board has received independent assurance;
- the establishing of a committee, such as a technology committee or cyber security committee, as a committee of the board or a sub-committee of the executive committee;
- part of training for directors; or
- an area of focus for the year arising from previous board performance evaluation.

Only 3% of our survey sample indicated that they had a director on the board with cyber security or IT expertise.

Given the variety of approaches, disclosures are of varying length and quality, however good examples include National Grid plc (Example 10.10) and IP Group plc (Example 10.11).

Corporate governance – good practice examples
In this section we highlight a number of disclosures of governance arrangements which we believe represent good practice. For each example, the aspects of good practice that it illustrates are listed next to it.

Example 10.1
Johnson Matthey Plc Annual Report and Accounts 2016 (p97)

- Description of the Code provision not complied with.
- Clear reasons for non-compliance with the provision.
- Approach to mitigating non-compliance.

Example 10.2
NMC Health plc Annual Report and Accounts 2015 (p4)

- Chairman’s statement in the Strategic Report addresses the board’s approach to more than one Principle of the Code.
- Recognises new developments in governance landscape.
- Highlights new developments in the board’s approach.
Chairman’s introduction to the corporate governance statement.

Demonstrates how good governance contributes to company success.
Example 10.4
Barclays PLC Annual Report 2015 (p40)

- Part of the Chairman’s introduction to the corporate governance statement.
- Company-specific and year-specific – entitled “What we did in 2015.”
- Calls out focus on key areas – succession planning, culture.
Example 10.5
Centrica plc Annual Report and Accounts 2015 (p44-45)

- Board of directors biographies disclosure.
- Focuses on skills and experience, including sector and specialism.
- Includes cross-references to where full biographies can be found.
Example 10.6
Jardine Lloyd Thomson Group plc Annual Report 2015 (p56)

- A visual approach to highlighting the experience each director contributes.
- Helps the reader understand whether there are gaps and how important those are.
- Allows for list of former roles to be provided in the board of directors section.

Example 10.7
Fidessa group plc Annual Report and Accounts 2015 (p17)

- Disclosure of why long serving director remains independent.
- Explains tenure and experience of director.
- Explains director’s positive contribution to board discussions.
- Details the rigorous review of independence and contribution and its conclusion.
Example 10.8  
Findel plc Annual Report & Accounts 2016 (p58)

- Disclosure in corporate governance statement on outcome of annual assessment of internal controls.
- Provides context for the annual review.
- Clearly identifies and explains areas of exception.
- Provides some detail of actions to respond to exceptions and timing of those actions.
Disclosure in audit committee report on outcome of annual assessment of internal controls.

Context of breakdown in financial reporting controls.

Detailed explanation of actions put in place.

Example 10.9
G4S plc Integrated Report and Accounts 2015 (p72-73)
Example 10.10
National Grid plc Annual Report and Accounts 2015/16 (p46)

- The Chairman discussing the board’s approach to cyber security in his introductory letter highlights the board’s focus on this matter.
- Includes information about training and future strategy on cyber security.

Example 10.11
IP Group plc Annual Report and Accounts 2015 (p89)

- The audit committee report includes detail on the committee’s approach to cyber security, which highlights the committee’s focus on this matter.
- Details external assurance over cyber security.
- Uses external framework to assess progress.
- Clear and specific about actions taken.

Letter from the Chairman and Corporate Governance contents

Corporate Governance contents

A clear vision | Annual report insights 2016

Long Term Viability
In 2016, the Audit Committee spent time discussing how best to assess the long term viability of the Group and it was decided to use the Group’s board members and the Group’s external auditors to provide possible scenarios for the business, but judged against five topics. These topics included changes in the competitive landscape, the ability to raise further capital, internalisation of the business, scaling the business and changes in the FRC’s approach. During the year, the Group’s external auditors considered the risks that may affect the Group’s viability and the Board was provided with a copy of the auditor’s report on risk and its impact on the Group and progress in assessing the Group’s viability. The Board considered these factors in a board meeting held during the year and a risk assessment of the Group’s viability was made in the year to date. The Board has also been reviewing the Group’s strategy on an annual basis and has identified a number of key areas for future development.

Cyber Security
The Board also considered the threats that may affect the Group’s long term viability. It recognised that the Group’s investment in and focus on cyber security is a key element of the Group’s strategy for the short and long term, the Group’s investment in and focus on cyber security is a key element of the Group’s strategy for the short and long term and the Group is committed to enhancing the level of security to protect the Group from cyber threats. The Board is also committed to enhancing the level of security to protect the Group from cyber threats and the Group is committed to enhancing the level of security to protect the Group from cyber threats.

Whistleblowing Policy
There is a formal whistleblowing policy which has been in place since 2014. This policy provides information on the process to follow in the event that any employee or other third party believes that there has been a breach of the Group’s code of conduct or other relevant law or regulation. The policy provides information on the process to follow in the event that any employee or other third party believes that there has been a breach of the Group’s code of conduct or other relevant law or regulation. The policy provides information on the process to follow in the event that any employee or other third party believes that there has been a breach of the Group’s code of conduct or other relevant law or regulation. The policy provides information on the process to follow in the event that any employee or other third party believes that there has been a breach of the Group’s code of conduct or other relevant law or regulation.
Example 10.12
Rotork Plc Annual Report 2015 (p65)

- This UK Corporate Governance Code Compliance Statement, in the corporate governance report, provides clear reasons for temporary and partial non-compliance with Code provision C.2.3.

- Demonstrates the company’s journey towards improved governance.

- Keeps the explanation brief and refers to further detail about the new reporting structures.

Example 10.13
Savills Plc Report and Accounts 2015 (p46)

- Providing a view about the independence of the non-executive directors in the section of the corporate governance statement dealing with board effectiveness.

- Highlights the considerations around a long-serving non-executive director, including the value he brings to the board and the board's view of his ongoing independence of character and judgement.
Corporate culture - good practice examples
For each example, the aspects of good practice that it illustrates are listed next to it.

Example 10.14
Marks and Spencer Group plc Annual Report and Accounts 2016 (p30)

- Provides details about succession planning approach for executive, non-executive and senior leadership.
- Cross-reference to detailed discussion in the strategic report.
- Focuses on board culture and highlights that some of the focus comes from board evaluation.
Recognises that employee engagement is critical.

Reputation & responsibility committee responsibilities

Reputation & responsibility committee report

The committee has written terms of reference which set out its authority and duties. These are available on Pearson plc’s website and can be found on the company’s corporate responsibility website.

Throughout the year, the committee provided oversight and input as Pearson continued to develop its sustainability practices, including the launch of Project Literacy and progress towards efficacy reporting. Our priority is to ensure Pearson’s activities and policies align with our business strategy and stakeholder priorities.

Areas of focus Progress

• Brand and corporate reputation: ensuring that clear roles have been established within the company and that the company’s sustainable business initiatives and our reputation are maintained and enhanced. Pearson’s approach to reputation measurement, including Pearson’s approach to its brand, continues to evolve to ensure that clear, meaningful metrics are in place. Brand tracker updates were conducted throughout the year; the most recent of these, for the financial period ending in March 2016, can be found at www.pearson.com/corporate/csr/brandtracker

• Regulatory risk: managing the reputational risks associated with Pearson’s US operations and ensuring that clear, meaningful metrics are in place. The committee continues to monitor its US markets, through in-country personnel and central oversight by the risk management team, and receives regular reports on these activities.

• Health and safety: ensuring that health and safety issues are properly considered from strategy through to execution. We will oversee Pearson’s continuous progress in embedding social impact into our strategy and business model, continue to monitor our corporate culture, ensuring employee engagement and values remain strong, and help ensure Pearson is in good shape for the future, and we will undertake a review of the existing strategy.

Committee members

The committee’s remit has been formalised in 2014, and the remit of the reputation & responsibility committee expanded during 2015, reflecting Pearson’s continuing commitment and ambition around corporate reputation, our belief in the importance of fulfilling our obligations to the communities in which we work, and maximising Pearson’s positive impact on society.

The committee’s work is closely aligned with the company’s sustainability business initiatives and our meetings are now preceded by meetings of the financial and risk management committee.

The committee has written terms of reference which set out its authority and duties. These are available on Pearson plc’s website and can be found on the company’s corporate responsibility website.

The committee has written terms of reference which set out its authority and duties. These are available on Pearson plc’s website and can be found on the company’s corporate responsibility website.

Committee members

Harish Manwani

Josh Lewis, Linda Lorimer, Vivienne Cox, Paul Wakefield

Chairman

External members: Vivienne Cox, Josh Lewis, Colm Condon, Fran Chreamen

“Throughout the year, the committee provided oversight and input as Pearson continued to develop its sustainability practices, including the launch of Project Literacy and progress towards efficacy reporting. Our priority is to ensure Pearson’s activities and policies align with our business strategy and stakeholder priorities.”

Committee responsibilities

<table>
<thead>
<tr>
<th>Area</th>
<th>Responsibility</th>
<th>Activity</th>
<th>Strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reputation</td>
<td>Oversee the development of a reputational risk strategy, ensuring that clear, meaningful metrics are in place.</td>
<td>Developing a robust reputational risk strategy that achieves clarity of insight and ensures that reputational risks are managed effectively.</td>
<td>Achieved reputational risk strategy that achieves clarity of insight and ensures that reputational risks are managed effectively.</td>
</tr>
<tr>
<td>Risk</td>
<td>Oversee Pearson’s approach to risk management, including the development of a risk management strategy.</td>
<td>Developing and implementing a comprehensive risk management strategy that achieves clarity of insight and ensures that reputational risks are managed effectively.</td>
<td>Achieved reputational risk strategy that achieves clarity of insight and ensures that reputational risks are managed effectively.</td>
</tr>
<tr>
<td>Social impact</td>
<td>Engage with Pearson’s activities and policies to ensure they align with our business strategy and stakeholder priorities.</td>
<td>Developing and implementing a comprehensive risk management strategy that achieves clarity of insight and ensures that reputational risks are managed effectively.</td>
<td>Achieved reputational risk strategy that achieves clarity of insight and ensures that reputational risks are managed effectively.</td>
</tr>
<tr>
<td>Brand</td>
<td>Engage with Pearson’s activities and policies to ensure they align with our business strategy and stakeholder priorities.</td>
<td>Developing and implementing a comprehensive risk management strategy that achieves clarity of insight and ensures that reputational risks are managed effectively.</td>
<td>Achieved reputational risk strategy that achieves clarity of insight and ensures that reputational risks are managed effectively.</td>
</tr>
<tr>
<td>Culture</td>
<td>Engage with Pearson’s activities and policies to ensure they align with our business strategy and stakeholder priorities.</td>
<td>Developing and implementing a comprehensive risk management strategy that achieves clarity of insight and ensures that reputational risks are managed effectively.</td>
<td>Achieved reputational risk strategy that achieves clarity of insight and ensures that reputational risks are managed effectively.</td>
</tr>
<tr>
<td>Ethics</td>
<td>Engage with Pearson’s activities and policies to ensure they align with our business strategy and stakeholder priorities.</td>
<td>Developing and implementing a comprehensive risk management strategy that achieves clarity of insight and ensures that reputational risks are managed effectively.</td>
<td>Achieved reputational risk strategy that achieves clarity of insight and ensures that reputational risks are managed effectively.</td>
</tr>
</tbody>
</table>
Disclosure regarding corporate culture in the strategic report.

Covers whistleblowing policy, employee views and direct communication and briefings.

Includes a pervasive focus on ethical business dealings.
Example 10.17
Premier Oil plc 2015 Annual Report and Financial Statements (p.60)

- Information about governance and business ethics given in the strategic report.
- Includes specific metrics used.
- Highlights code of conduct, other policies, whistleblowing.
- Embedded in business through champions.

Example 10.17
Unilever Annual Report and Accounts 2015 (p.29)

- Example of actions taken to embed appropriate culture throughout the business.
- Discussion of challenges faced and actions taken.

Example 10.18
Nomination committee reporting
Nomination committee reporting

Top tips
• Improve disclosure around human capital metrics and any assurance gained by the board over human capital, including ethics, or culture audits.

• Make it clear whether succession planning focuses on executive, non-executive or other senior leadership, the time period it covers and provide solid examples of activity during the year. This year only 11 FTSE 100 companies, 10 FTSE 250 companies and 2 smaller companies included clear disclosure around succession planning.

Keep an eye on
• Whether the nomination committee is meeting frequently enough to adequately consider succession planning and keep skills and experience matrices up to date. On average this year, nomination committees met three times.

• Developments around the FRC’s update to the Guidance on Board Effectiveness. Review the nomination committee terms of reference promptly when changes occur.

• Diversity, including gender diversity but also broader diversity. This is not simply a regulatory challenge but about ensuring each board has the strength and depth to address threats and take advantage of opportunities – and there is a lot of work still to do to ensure the executive pipeline is sufficiently diverse.

Introduction
The UK Corporate Governance Code requires companies to describe the work of their nomination committee, including a description of the board’s policy on diversity, including gender, any measurable objectives it has set for implementing the policy, and progress on achieving the objectives.

Nomination committee reporting is an area of increased regulatory focus at the moment, with the FRC currently undertaking a project focussed on the importance of succession planning. In response to the FRC’s initial discussion paper on this subject there was some support for further guidance, particularly in relation to the role of the nomination committee and on reporting on succession planning. This is likely to take the form of changes to the FRC’s Guidance on Board Effectiveness, which will be reviewed in 2017 and will also incorporate any changes thought necessary as a result of the Culture project. The FRC’s recent paper arising from the project, Corporate Culture and the Role of Boards78 recommends a series of measures to improve communication around culture in annual reports – we provide more detail in chapter 10.

Presentation of the nomination committee report
The Code requires there to be a separate section of the report which describes the work of the nomination committee in discharging its responsibilities. Although the Code specifies that information on the work of the nomination committee should be included in a ‘separate section of the annual report’, this could be a subsection within the overall corporate governance report.

86% of our survey sample presented a separate nomination committee report, including 100% of FTSE 100 companies and 92% of FTSE 250 companies. The smaller companies were less likely to have a nomination committee and often included some commentary on the role of the nomination committee within the broader corporate governance statement.

On average, nomination committees had met three times in the year, although FTSE 350 companies had on average met more often at around four times in the year. 23% of nomination committees had met once or less during the year – 6% in the FTSE 250 and 17% from the smaller companies.

Code provision B.2.4 encourages the nomination committee to disclose “the process it has used in relation to board appointments”. Overall, we found that 60% of companies that had made board appointments during the year provided a disclosure around the process they had used for those appointments. Moreover, 28% described the process they had used for board appointments in general – 61% of those companies had also provided a disclosure around specific board appointments during the year. Booker Group plc, instead of providing a disclosure in the annual report, referred to “Board approved procedures” around board appointments being available on their website.

Board diversity

Diversity continues to be a hot topic, in the context of Board composition as well as the wider staff population (as discussed in chapter 6). The Women on Boards Davies review issued its five year summary in October 2015 which has revived the discussion on gender diversity. Lord Davies extended his recommendations from the FTSE 100 to the FTSE 350, increased the target of representation on boards to 33% and has strongly encouraged more executive positions and development of the leadership pipeline for women in business.

The preface to the Code extends diversity beyond gender diversity, bringing in “differences of approach and experience”. We continue to see improvements in the nature of the discussion around broader aspects of diversity.

In 2015, we commented that we expected to see the target 25% of women on the boards of FTSE 100 companies reached in our 2016 survey – it was 24% last year. We’re pleased to say that the proportion of women directors in the FTSE 100 companies in our survey was 27%. This compares, however, to 21% for FTSE 250 companies and only 10% below the FTSE 350 population. There were no women executive directors at all in our survey sample below the FTSE 350. Although there has been substantial achievement, there is therefore still a long way to go.

Only 9 companies from our sample indicated that they had a future target to achieve for gender diversity on the board. There is a concern that, with the initial target set by Lord Davies having been achieved, companies consider their job is done.

Figure 11.1 shows the distribution of companies which have female directors. The overall percentage of companies with women directors has increased from 72% last year to 79% this year.

It is important to remember that when the Code talks of board diversity, it is diversity in its broadest sense. It was encouraging to see that 64% (2015: 63%) of companies surveyed made reference to wider aspects of diversity in their disclosures, taking advantage of different ideas and perspectives to gain the benefits of a highly functional board, adaptable to market circumstances, with a good level of challenge and debate.

The most common areas of diversity mentioned were experience (39%), race or ethnicity (36%), skills (32%), nationality or geographical origin (25%), background (23%), knowledge (15%), age (16%) and disability (12%).

Good discussions of diversity were provided by Marks and Spencer Group plc (Example 11.1) and by National Grid plc (Example 11.2).

Board performance evaluation

In accordance with Code principle B.6, the board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors. The Code recommends that companies in the FTSE 350 have board performance evaluations externally facilitated at least once every three years.

External facilitation once every three years has an important role, as a good external facilitator can add much external perspective which a board would otherwise not be able to access.

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In terms of descriptions of both prior year and current year findings and actions, there is a substantial difference in the proportion of companies including high quality disclosure in the FTSE 350 compared to smaller companies. However, there is considerable room for improvement.

Premier Oil plc provided a good example of disclosure around an internal performance evaluation (Example 11.3).

Other examples of disclosure focused on the findings and actions taken regarding board evaluation and include Tate & Lyle PLC (Example 11.4) and Rexam PLC (Example 11.5).

### Succession planning

In October 2015, the FRC issued a discussion paper UK Board Succession Planning⁵⁰ which sought views on various issues surrounding succession for both executives and non-executives. The FRC’s interest stemmed primarily from the fact that the quality of succession planning was one of the most frequent issues highlighted as a consequence of board evaluation. The FRC believes that unless Boards are planning over the medium to long-term, for both executive and non-executive positions, they will struggle to ensure that there is the right mix of skills and experience needed as the company evolves.

The feedback to the FRC’s paper⁵¹ highlighted that an active nomination committee is key to promoting effective board succession and the importance of succession planning being aligned to company strategy. It encourages regular nomination committee meetings and the regular and detailed review of matrices set up to manage the skills, experience and competencies on the board.

The FRC is considering providing nomination committee guidance as part of its review of the Guidance on Board Effectiveness, planned for 2017.

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81. [https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Feedback-Statement-Succession-Planning-Discussion.pdf](https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Feedback-Statement-Succession-Planning-Discussion.pdf)

### Discussion of internal performance evaluation in the current year

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>70%</td>
<td>78%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>64%</td>
<td>71%</td>
</tr>
<tr>
<td>Others</td>
<td>79%</td>
<td>88%</td>
</tr>
</tbody>
</table>

Discussion of internal performance evaluation has decreased both for FTSE 350 companies and smaller companies. This is not fully offset by a small increase in the number of companies that conducted external evaluations compared to 2015.

### An external evaluation has been conducted this year or is planned to be conducted within a three year period

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>56%</td>
<td>58%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>84%</td>
<td>83%</td>
</tr>
<tr>
<td>Others</td>
<td>17%</td>
<td>23%</td>
</tr>
</tbody>
</table>

### There is a good description of current year findings and actions

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>27%</td>
<td>Not surveyed</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>36%</td>
<td>Not surveyed</td>
</tr>
<tr>
<td>Others</td>
<td>14%</td>
<td>Not surveyed</td>
</tr>
</tbody>
</table>

A further 25% of companies included some description of current year findings, but no action points or no real detail.

### There is a good description of prior year findings and actions

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>20%</td>
<td>Not surveyed</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>29%</td>
<td>Not surveyed</td>
</tr>
<tr>
<td>Others</td>
<td>7%</td>
<td>Not surveyed</td>
</tr>
</tbody>
</table>

A further 6% of companies included some description of prior year findings, but no action points or no real detail.
Our survey examined whether there had been a reference to succession planning and whether, if so, it constituted a clear explanation of the board’s activities in this area.

It is encouraging to see an increase in companies providing a relatively clear explanation of some of the board’s activities relating to succession planning, with this year, smaller companies in our sample including more detail. One of these offered a tailored response to board evaluation findings, including describing focus on the pipeline of executive talent in subsidiaries. The other was in the FTSE 250 until recently and has maintained the quality of disclosure in this area.

78% of companies describe a focus on executive directors for succession planning purposes, 76% on non-executive directors and 56% on other senior leadership roles. Several of the companies that mentioned senior leadership roles and the pipeline of internal talent outlined clear programmes introduced to develop senior talent and also explained that this focus was in response to board evaluation findings – showing that performance evaluation has a genuine and pervasive impact.

We examined some of the main suggestions included in the FRC’s feedback statement on its succession planning discussion paper and how far companies incorporate them into annual reports.

This demonstrates that there is a lot of opportunity for companies to substantially improve their disclosures around succession planning; we will look at these disclosures with interest next year.

Chesnara plc (Example 11.6) and Thomas Cook Group plc (Example 11.7) included elements of good disclosures around succession planning activities, some of which were proactive in nature.
Diversity - good practice examples

For each example, the aspects of good practice that it illustrates are listed next to it.

**Example 11.1**
*Marks and Spencer Group plc Annual Report and Financial Statements 2016 (p33/41)*

- Diagrams from board of directors disclosure and text from nomination committee report.
- Visually engaging diagrams covering more aspects of board diversity than gender alone, here international experience and length of non-executive director tenure.
- Split between executive and non-executive gender representation is in line with the new focus of the Women on Boards initiative.
- Disclosure answers questions regarding the board’s approach to diversity and provides practical, specific examples of activity.
Example 11.2
National Grid plc Annual Report and Accounts 2015/16 (p62)

- The Nominations Committee provides detailed reporting on board gender diversity.
- Clearly laid out, presents objectives on diversity and the board’s progress against its objectives.
- Notes more recent recommendations of the Davies Review and commits to reviewing in the coming year.

Board diversity and the Davies Review
At National Grid, we believe that creating an inclusive and diverse culture supports the attraction and retention of talented people, improves effectiveness, delivers superior performance and enhances the success of the Company. Our Board diversity policy promotes this culture and reaffirms our aspiration to meet and exceed the target of 25% of Board positions being held by women by 2015, as set out by Lord Davies. In October 2015, Lord Davies published his final report on women in the boardroom and recommended an increase to 25% of Board positions to be held by women by 2020. In April 2016, the Nominations Committee discussed progress made against our Board diversity policy and noted the new target.

We currently have 27% women on our Board and 22% women on our Executive Committee. The number of women in senior management positions and throughout the organisation is set out on page 45 along with examples of the initiatives to promote and support inclusion and diversity throughout our Company.

In February 2014, the Nominations Committee set out eight measurable objectives to support our Board diversity policy. During the year, the Committee reviewed the Board diversity policy and progress made against the objectives which support the implementation of the policy as set out below.

<table>
<thead>
<tr>
<th>Objective</th>
<th>Progress</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>The Board aspired to exceed the target of 25% of Board positions to be held by women by 2015. Objective met. We currently have 27% women on our Board, which will increase to 33% when Nicola Shaw joins in July 2016. Lord Davies recommended in his final report that the target be increased to a voluntary 33% target by 2020. The Board has noted this new target.</td>
</tr>
<tr>
<td>2</td>
<td>All Board appointments will be made on merit, in the context of the skills and experience that are needed for the Board to be effective. Objective met. The appointment of John Pettigrew as Chief Executive and Nicola Shaw as Executive Director, UK were made on merit.</td>
</tr>
<tr>
<td>3</td>
<td>We will only engage executive search firms who have signed up to the Voluntary Code of Conduct on Gender Diversity. Objective met. Korn Ferry, Russell Reynolds Associates and The Zygos Partnership are signed up to the Voluntary Code of Conduct on Gender Diversity.</td>
</tr>
<tr>
<td>4</td>
<td>Where appropriate, we will assist with the development and support of initiatives that promote gender and other forms of diversity among our Board, Executive Committee and other senior management. Objective met. See page 44 for further details.</td>
</tr>
<tr>
<td>5</td>
<td>Where appropriate, we will continue to adopt best practice in response to the Davies Review. Ongoing – as appropriate. The Nominations Committee reviewed and noted the recommendations of the Lord Davies report published in October 2015 and best practice will be adopted as appropriate and reported on next year.</td>
</tr>
<tr>
<td>6</td>
<td>We will review our progress against the Board diversity policy annually. Objective met. Ongoing.</td>
</tr>
<tr>
<td>7</td>
<td>We will report on our progress against the policy and our objectives in the Annual Report and Accounts along with details of initiatives to promote gender and other forms of diversity among our Board, Executive Committee and other senior management. Objective met. Ongoing.</td>
</tr>
<tr>
<td>8</td>
<td>We will continue to make key diversity data, both about the Board and our wider employee population, available in the Annual Report and Accounts. Objective met. Ongoing.</td>
</tr>
</tbody>
</table>

Progress against the objectives, the policy and the new targets will continue to be reviewed annually and reported in our Annual Report and Accounts.
Board evaluation – good practice examples
For each example, the aspects of good practice that it illustrates are listed next to it.

Example 11.3
Premier Oil plc 2015 Annual Report and Financial Statements (p74)

- Visually engaging description of how internal board evaluation is conducted.
- Separates into clear stages with defined responsibilities.
- Focus on outcomes.
Example 11.4
Tate & Lyle PLC Annual Report 2016 (p50-51)

- Provides detail of findings and actions.
- Specific detail provided on review conducted in response to other factors.
- Clear on whether actions have been taken, will be taken or are in progress.
PROVIDES COMPANY-SPECIFIC DETAIL OF FINDINGS AND ACTIONS.

Example 11.5

Rexam PLC Annual Report 2015 (p43-44)

Provides company-specific detail of findings and actions.
Succession planning – good practice examples
For each example, the aspects of good practice that it illustrates are listed next to it.

Example 11.6
Chesnara plc Annual Report and Accounts 2015 (p46)

• Recognises recent regulatory focus.

• Highlights that this has been considered by the company.

• Explains that work has been conducted to address points raised.
Heart”, our online recognition scheme, which is underpinned by our impact and influence results, aligning their interests with those for our executives and senior leaders across the Group, who can We remain committed to operating a performance share plan introduced into the business to complete a two-year programme incredibly successful work-based learning Apprenticeship programme. This unprecedented result in travel apprenticeships puts In the UK, we are proud to achieve an “Outstanding” rating across identified talent to create a leadership pipeline for senior roles, Our Emerging Talent programme focuses on fast tracking newly during 2015. a better understanding of our talent pools deeper in the organisation Committee (“GMC”) and PLC Board. This process has enabled us to gain approach, holding separate sessions with our Group Management our internal capability. In 2015, we conducted our first Group-wide SUCCESSION PLANNING TALENT DEVELOPMENT AND PLc Board GMC TCLC TC Group 38% 8% Male 69 Female 31% 77 % 23% 61THOMAS COOK GROUP PLC ANNUAL REPORT & ACCOUNTS 2015 personal characteristics. As a global organisation our focus on delivering world class customer We continue to focus on making strategic appointments at a senior level to strengthen our diversity. Our Code of Conduct, Values, recruited nearly 70% into our business. All of them are well educated, after completing their studies. For the dual education programme, we They will finish their apprenticeship after experiences of working in the travel industry through our university industry with enough variation to fill their entire career if they agreed to take on the position of Senior Independent Director and we This year has seen additional change at the Board level, as Carl Company. The review identified both talented individuals to be succession review, covering the most critical 130 roles in the proven track record in the Thomas Cook UK business, together with We identified Peter during the succession planning process as an Board equipped with the right motivation, skills and experience CEO Peter Fankhauser. As we embark on the next stage of our The Board oversaw the successful transition to our new Group out the key governance activities we have undertaken over the Dear Shareholder every one of our employees. and to demonstrate this culture through the behaviours of each and governance this year, but at the same time recognise that we cannot indicated an improvement in all areas of the Board's operation over reviewing to ensure all Non-Executive Directors continue to have the topic will form a regular item on the agenda. The Chairman and Group Company Secretary will review Non-Executive the review is given on page 61. Director requirements and address any training needs. The Chairman and Group Company Secretary will review Non-Executive the visit can be found on page 76. Directors, conducted an evaluation of the Chairman. The outputs from 2015 evaluation were debated by the Board in the absence Senior Independent Director and with input from the Executive Separately, the Non-Executive Directors, under the leadership of improvement. The Board has agreed an action plan, which is being on the visit can be found on page 76. Directors, conducted an evaluation of the Chairman. The outputs Annual report insights 2016
Audit committee reporting
Audit committee reporting

Top Tips

- Make it clear how the significant issues considered in relation to the financial statements have changed from the previous year and why they remain relevant for the current year. Consider providing suitable cross-references to elsewhere in the annual report rather than repeating disclosure.

- Consider making appropriate disclosures in the audit committee report where you have had interaction with the FRC’s Corporate Reporting Review team or Audit Quality Review team. This year, two companies disclosed interacting with the Corporate Reporting Review team and ten companies disclosed that an audit of the company had been reviewed by the Audit Quality Review team.

- Use the FRC’s Audit Quality Practice Aid to assist in structuring the disclosure on how the audit committee has assessed the effectiveness of the external audit process – and do remember it is how the effectiveness of the audit process has been assessed, not that it has been assessed. This year we considered 23% of these disclosures were comprehensive, compared to only 9% in 2015.

Keep an eye on

- Developments in reporting on auditor independence. The 2016 Guidance on Audit Committees encourages more clarity in disclosure of non-audit services, fees and safeguards to protect auditor independence.

- The audit committee terms of reference and non-audit services policy. Make sure these have been reviewed in light of the 2016 Code changes and the Guidance on Audit Committees and Ethical Standards.

- Changing requirements regarding auditor rotation. For FTSE 350 companies, don’t forget to make a statement of compliance with the CMA Order – only 65% of companies subject to the Order did so this year.

Introduction

The UK Corporate Governance Code requires there to be a separate section of the report which describes the work of the audit committee in discharging its responsibilities. Although the Code specifies that information on the work of the audit committee should be included in a ‘separate section of the annual report’, this could be a subsection within the overall corporate governance report. Reflecting the increasing profile of the audit committee’s activities, nowadays most companies present a clearly separate audit committee report within the governance section of their report. This separation is useful as it provides a clear definition between the work of the audit committee and the work of the board as a whole.

The Code requires that the audit committee report includes not just a description of the audit committee’s responsibilities but also detail about what the audit committee has done during the year under review to fulfil those responsibilities. This level of transparency gives shareholders a much clearer picture of what the key issues considered by the committee are and how they are addressed and what the audit committee does to oversee the external audit relationship.

The 2014 version of the Code requires FTSE 350 companies to put the audit out to tender at least every ten years, subject to transitional provisions – although this provision is removed in the 2016 Code as it has been superseded by a tendering requirement under UK legislation.

In September 2014 the Competition & Markets Authority published its Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014 (the CMA Order), which applies to FTSE 350 companies with periods commencing on or after 1 January 2015. This introduced a requirement that FTSE 350 companies put their statutory audit engagement out to tender at least every ten years. However, under the Statutory Auditors and Third Country Auditors Regulations 2016, going forward all listed companies will be required to tender their audit at least every 10 years, with a change of auditor required at least every 20 years.

In addition to the new rules around tendering, the CMA Order also gave FTSE 350 audit committees increased responsibilities for auditor independence and oversight, plus reporting obligations detailed later, which came into force for periods commencing on or after 1 January 2015.

83 https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Audit-Committees(2).pdf
84 https://assets.publishing.service.gov.uk/media/547325/eea4d09b61342000b4/The_Order.pdf
86 https://assets.publishing.service.gov.uk/media/547325/eea4d09b61342000b4/The_Order.pdf
87 www.legislation.gov.uk/uksi/2016/649/contents/made
Presentation of the audit committee report

99% (2015: 100%) of the companies in our survey presented an audit committee report in accordance with the Code.

The level of responsibility taken on by the audit committee, which increased with the FRC’s Guidance on Risk Management, Internal Control and Related Financial and Business Reporting in 2014, is set to increase again in the coming years given that June 2016 saw the release of the new 2016 Code and, importantly, new FRC Guidance on Audit Committees including additions to audit committee responsibilities and substantial additions to audit committee reporting recommendations.

As such, it is no real surprise to note that the number of companies presenting a stand-alone audit committee report within the corporate governance section of the annual report has increased again this year, with 89 companies (2015: 83, 2014: 67) presenting such a report. This separation is useful as it provides a clear definition between the work of the audit committee and the work of the board as a whole. There has also been another notable increase in the number of audit committee chairmen showing clear ownership of the audit committee report at 84% (2015: 74%). Most audit committee chairmen do this through an introductory address, although some sign the audit committee report and a couple write the full audit committee report from a first person perspective.

Significant issues considered by the audit committee

The Code requires audit committees to describe the significant issues considered in relation to the financial statements and how those issues were addressed. The interrelationship between the significant issues in the audit committee report, the risks disclosed by the auditors in the enhanced audit report and the critical accounting judgements and key sources of estimation uncertainty in the financial statements is addressed in chapter 4.

Only two of the companies we surveyed (2015: three) had not disclosed the significant issues considered by the audit committee and how they were addressed. One of those had not included an audit committee report at all, the other, a FTSE 100 company, had disclosed significant issues but not how they had been addressed – a critical component of the Code requirements, which are designed to encourage audit committees to inform the reader on how they have exercised their responsibility to pursue the integrity of financial reporting.

For the third year running, the average number of issues disclosed across the three company size categories has been the same. This is set out in Figure 12.1.
Echoing the increase in quality of disclosure on the significant issues overall, more audit committee reports cross-referenced these disclosures to elsewhere in the annual report this year, at 43% (2015: 41%) – a slight, but positive trend.

We considered that good examples of disclosures on significant issues this year included The Weir Group PLC (Example 12.1) and Lonmin Plc (Example 12.2). We have also included an example from Findel plc (Example 12.3), which is unusual in its detailed description of the areas of challenge identified by the audit committee on each of the significant issues – this gives increased confidence in the robustness of the audit committee’s process.

To achieve a rating of comprehensive we would have seen many of the characteristics referred to below (from the Financial Reporting Lab’s report on Reporting of Audit Committees) in the disclosure.

- Reporting should be bespoke, company specific and tailored to the year under review.
- Providing context to the issue helps to communicate the specific story, e.g. quantifying the issue, identifying the related business unit, geography, contract or transaction type, describing the nature of the issue as being related to a specific policy or involving a specific assumption or estimate.
- Providing greater depth on how the audit committee fulfilled its role and the robustness of the steps it undertook to assess each significant issue and reach conclusions.
- Using more descriptive, ‘active’ language stated in the past tense, as this provides assurance that the audit committee has positively taken specific steps to address the issue.
- Disclosing ranges or scenarios taken into consideration, key assumptions, and whether reported amounts fall within an acceptable range.

Those FTSE 100 and FTSE 250 companies that reported the most significant issues in our sample had one more significant issue than in the prior year. In both cases, these companies included a significant issue relating to the new longer term viability statement, explaining the increase year on year.

Using our own judgement we rated the disclosures on the significant issues as brief, moderate or comprehensive. We considered 14% to be brief, 58% moderate and only 28% comprehensive. This is however an improvement on 2015, where we considered 23% brief, 52% moderate and 22% comprehensive, and indicates that there were more companies providing a more comprehensive disclosure of the significant issues they had considered and how those were addressed.

We looked for disclosure that explained the process undertaken; the method of assessment; key parties involved, both internal and external to the company; other information taken into account (if any) and some detail about which aspects of the audit process had been assessed. Examples of good disclosure were given by Mondi Group (Example 12.4) and Croda International Plc (Example 12.5).

Following the recommendation of the Competition & Markets Authority that audit committees of FTSE 350 companies whose audit had been reviewed by the FRC’s Audit Quality Review Team should disclose this, the FRC has consulted upon this and included a recommendation in the 2016 Guidance on Audit Committees.

Effectiveness of the external audit process
Almost all audit committees explained that they had assessed the effectiveness of the external audit process. However, some continue to fail to meet the Code requirement to explain how they have assessed the effectiveness of the external audit process. This year, 95% of FTSE 100 and FTSE 250 companies met the requirement (2015: 100% and 95%), whilst 79% of the smaller listed companies met the requirement – an increase on prior years (2015: 73%; 2014: 61%).

Using our own judgement, we rated the quality of the disclosure on how the audit committee had assessed the effectiveness of the external audit process as brief, moderate or comprehensive. We considered 36% to be brief, 41% moderate and 23% comprehensive. This is a significant improvement from 2015 where only 9% of companies were deemed to have included comprehensive disclosures.

We looked for disclosure that explained the process undertaken; the method of assessment; key parties involved, both internal and external to the company; other information taken into account (if any) and some detail about which aspects of the audit process had been assessed. Examples of good disclosure were given by Mondi Group (Example 12.4) and Croda International Plc (Example 12.5).
This year, 20 audit committees in our sample mentioned the Audit Quality Review team’s report on the firm. Of these, 10 referred to a specific AQR inspection of their own company (2015: one company).

The FRC’s guidance indicates that audit committees should, where a company’s audit has been reviewed by the FRC’s Audit Quality Review team:

• discuss the findings with their auditors;
• consider whether any of those findings are significant; and
• if so, make disclosures about the findings and the actions they and the auditors plan to take.

The FRC advises that this discussion should not include disclosure of the audit quality category and indeed, none of the companies in our sample did so (2015: none). Almost all included their disclosure in the discussion on how they had assessed the effectiveness of the external audit process. Chesnara plc mentioned the Audit Quality Review team’s overall report on the firm and carried on to make it clear that their auditor had not been subject to a specific AQR inspection in respect of their audit. None of the companies in our sample provided any specific detail on significant findings.

Only two audit committees made any reference to discussions with the FRC’s Corporate Reporting Review team. This was lower than expected given the number of letters issued by the CRR team in 2014/15. One audit committee commented on the finalisation of the “routine review” of the 2013 report and accounts; the other stated that “as a result of the correspondence, the group refined the wording of certain of its significant accounting policies and extended certain disclosures.” This year we also saw examples of audit committees stating that there had been no correspondence from regulators in respect of financial reporting, including Vodafone Group Plc.

Audit tendering

The CMA Order applies to FTSE 350 companies with periods commencing on or after 1 January 2015. The first mandatory disclosures in our sample related to years ending on 31 December 2015. The two disclosure requirements imposed on FTSE 350 companies by the CMA Order, one a statement of compliance with the provisions of the Order and one a disclosure about the timing of future tendering if there has been no audit tender for five years, must be included in the audit committee report. These are legal requirements, so it was surprising to see just 65% of companies subject to the requirements including a statement of compliance with the Order, and only 58% of those required to include a statement regarding future tendering doing so. Most statements of compliance were very brief. Rotork Plc’s is helpful in explaining to the reader some of the requirements of the Order over and above the tendering requirement (Example 12.6).

As might be expected, the number of companies providing information on the tenure of the incumbent auditor continues to increase, to 87% this year from 85% in 2015. Of those that did not clearly disclose the tenure of the incumbent auditor, several had information about an imminent tender or other disclosure – for instance, about partner rotation – from which some detail about the length of auditor tenure could be derived.

As Figure 12.2 shows, despite the overall average tenure of the external auditor being comparable to last year, that statistic conceals real change within the population.

The average auditor tenure for FTSE 100 companies has fallen noticeably, from 22 years to 12 years, showing that companies that have had the same external auditor for a long time have conducted audit tenders recently. This is not as clear-cut for the FTSE 250 population – we are one year on and average auditor tenure has increased by a year – and some of the change in the ‘Other’ population can be attributed to higher level of disclosure of auditor tenure by those who have had the same auditor for a long time.
**Auditor independence**

Of the companies surveyed, 97% had received some non-audit service(s) from their external auditor. Only 54% of these explained why the auditor had been engaged to provide the service and only 68% of companies that received significant other non-audit services included a description of what those services related to. Of the companies that had received significant non-audit services from their external auditor, only 28% described safeguards that had been applied to reduce the risk of impairing auditor independence.

Although 90% of audit committees (2015: 91%) included some detail on their non-audit services policy, fewer than half included description of those services which are prohibited, those which are pre-approved and those for which specific approval is required (we also accepted a cross-reference to a suitable policy on their website). With the 2016 Guidance on Audit Committees expecting audit committees to include more disclosure in this area, it will be interesting to see whether there is a gradual or a step-change in reporting this coming year. With the non-audit services that auditors are permitted to provide also being further restricted by the FRC’s Ethical Standard 2016, companies will need to consider whether their non-audit services policy needs to be amended.

**Internal audit**

We looked in more detail at internal audit disclosures this year, given the increased focus on internal audit in the FRC’s 2014 Guidance on Risk Management, Internal Control and Related Financial and Business Reporting and the FRC’s 2016 Guidance on Audit Committees.

When reviewing disclosures on internal audit, we did not focus solely on the audit committee report, but looked at risk committee reports and at risk management disclosures in the strategic report.

<table>
<thead>
<tr>
<th>Table 12.1 – Disclosures on internal audit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disclosures on internal audit</td>
</tr>
<tr>
<td>Overall</td>
</tr>
<tr>
<td>19 companies did not have an internal audit function (2015: 18); 6 companies with an internal audit function did not include the disclosure (2015: 6).</td>
</tr>
<tr>
<td>Reporting lines for internal audit are clear and involve a direct line to the audit committee</td>
</tr>
<tr>
<td>Overall</td>
</tr>
<tr>
<td>For a further 35% of companies there was insufficient evidence to conclude on this question.</td>
</tr>
<tr>
<td>Internal audit plans are clearly set with reference to the principal risks of the business</td>
</tr>
<tr>
<td>Overall</td>
</tr>
<tr>
<td>This is a recommendation of the FRC’s Guidance on Risk Management, Internal Control and Related Financial and Business Reporting.</td>
</tr>
</tbody>
</table>

If there is no internal audit function, there is an explanation of why one is not considered necessary

| Overall | 89% | Not surveyed |
Audit committee reporting – good practice examples
In this section we highlight a number of audit committee disclosures which we believe illustrate aspects of good practice. For each example, the aspects of good practice that it illustrates are listed next to it.

Example 12.1
The Weir Group PLC Annual Report and Financial Statements 2015 (p89-91)

-Disclosure of significant issues relating to financial reporting.

- Separation of disclosure between current period matters – with more detail – and recurring agenda items – with brief detail.

- Cross-referencing to notes and accounting policies in the financial statements.
Example 12.2
Lonmin Plc Annual Report and Accounts 2015 (p79-81)

- Disclosure of significant issues relating to financial reporting.
- Cross-referencing to notes and accounting policies in the financial statements.
- Clear summary including discussion of misstatements with management and auditor.
Audit & Risk Committee Report

On behalf of the Committee, I am pleased to present this year’s Audit & Risk Committee Report, which provides an overview of how we, as a Committee, have discharged our responsibilities, setting out the significant issues we have reviewed and concluded in the year.

The particular challenges by the Committee in relation to the matters listed above were:

(a) Receivables provisioning – were the outcomes consistent with what the Board’s monitoring of monthly results had led us to expect? Was the provision at the end of the period appropriate and as a result of reasonable and not absolute assurance against material misstatement or loss.
(b) Financial services redress provisioning – had the review of processes within Express Gifts been robust in identifying the areas of risk? Were genuine redress provisions made?
(c) Goodwill and Intangible asset recoverability – with the sale of Kitbag in February 2016 the risk of overstatement of intangible asset recoverability?
(d) Exceptional items – were the items truly exceptional in nature? Had all exceptional charges and credits been disclosed?
(e) Materiality – did the financial statements reasonably reflect the financial position and performance of the Company?
(f) At the planning stage of the audit, how the auditors defined and applied materiality in their audit. The Committee was satisfied that this materiality was agreed appropriately reflected in the provision for doubtful debts.
(g) towards the conclusion of the audit, the materiality of adjusted and unadjusted errors as reported by the external auditors to the Board.

The particular challenges by the Committee in relation to the matters listed above were:

(a) Receivables provisioning – were the outcomes consistent with what the Board’s monitoring of monthly results had led us to expect? Was the provision at the end of the period appropriate and as a result of reasonable and not absolute assurance against material misstatement or loss.
(b) Financial services redress provisioning – had the review of processes within Express Gifts been robust in identifying the areas of risk? Were genuine redress provisions made?
(c) Goodwill and Intangible asset recoverability – with the sale of Kitbag in February 2016 the risk of overstatement of intangible asset recoverability?
(d) Exceptional items – were the items truly exceptional in nature? Had all exceptional charges and credits been disclosed?
(e) Materiality – did the financial statements reasonably reflect the financial position and performance of the Company?
(f) At the planning stage of the audit, how the auditors defined and applied materiality in their audit. The Committee was satisfied that this materiality was agreed appropriately reflected in the provision for doubtful debts.
Example 12.4

Mondi Group Integrated report and financial statements 2015, (p101-102)

- Comprehensive disclosure on how the audit committee assessed the effectiveness of the external audit process.
- Includes details on what was evaluated, who was involved, how the evaluation was conducted, external information used and conclusions reached.
- Recognises that the assessment is “an ongoing review throughout the cycle”.

Corporate governance report

External audit independence, objectivity and effectiveness

A formal framework for the assessment of the effectiveness of the external audit process and quality of the audit that has been adopted by the company. It is described by the following:

External audit independence, objectivity and effectiveness

- Evaluation focus
  - Robustness of audit process
  - Auditor independence
  - Professional scepticism
  - Ethical standards required of audit firms
  - Handling; global team coordination; timeliness of communication and reporting
  - Confidence and communication
  - Independent of management
  - Audit planning and execution
  - Quality of reporting to the committee, the level of challenge and adherence to independence

- Inputs
  - Feedback from questionnaires issued at corporate, divisional and business unit level to management.
  - Feedback from questionnaires issued to committee members including views on auditor independence, objectivity and effectiveness.
  - Feedback from regular meetings held between the chairman of the committee and the external auditor on a regular basis and the audit team.
  - Auditors' reporting to the committee was clear, open and thorough, including regular monitoring of auditor independence, objectivity and effectiveness.

- Evaluation focus
  - Reviewing the coordination between the South African and UK audit partners, the quality of the audit team, technical skills and experience in the allocation of resources during the audit.
  - Reviewing the quality of reporting to the committee, the level of challenge and adherence to independence.
  - Considered the appropriateness of the audit planning including the scope, coverage, materiality levels and significant audit risks.
  - Considered the effectiveness of the audit partner, the audit team, technical skills and experience in the allocation of resources during the audit.
  - Formal reporting of the audit partner, the audit team, technical skills and experience in the allocation of resources during the audit.
  - Considered how audit and management interact and the level of challenge, especially where appropriate to the audit.

- Independent Deloitte audit partner, who had no other connection with Mondi, including the requirements for pre-approval of such services.

- The audit committee considered the appropriateness of the audit planning in the allocation of resources during the audit.
- The audit committee concluded that it was satisfied that the audit had been well planned and delivered with work completed on schedule.
Example 12.5  
**Croda International Plc Annual Report and Accounts 2015 (p52)**

- Comprehensive disclosure on how the audit committee assessed the effectiveness of the external audit process.
- Includes details on what was evaluated, who was involved, how the evaluation was conducted, external information used and conclusions reached.
- Comments on additional insights received that added value.

Example 12.6  
**Rotork Plc Annual Report 2015 (p71)**

- Statement of compliance with the Competition & Markets Authority’s Order.
- Provides additional detail on the Order’s requirements over and above tendering.
Primary statements
Primary statements

**Top tips**

- Before preparing your annual report, it’s important to think about which measures are helpful, understandable and transparent to the users of financial statements. This may not always be the same information that management are focussed on. Consider therefore, whether there are instances where a statutory measure provides more relevance to the users of your financial statements than adjusted non-GAAP measures. For instance, instead of disclosing non-GAAP measures on the face of the income statement, consider whether additional line items to describe specific items of income or expense may be more appropriate. 85% of the companies surveyed that included non-GAAP measures in their financial statements did so on the face of the income statement.

- When including non-GAAP measures, ensure that these are explained individually, and where items are deemed to be exceptional explain why they are regarded as such. Companies should have an accounting policy in relation to exceptional items, which should help them to consistently determine whether an item is exceptional by nature.

- Where you have restricted cash balances, make sure you disclose the amount that can’t be used together with some commentary as to the nature of the restriction. 21% of companies surveyed disclosed restrictions on their cash balances.

**Keep an eye on**

- From December 2016 parents’ separate FRS 101 accounts can use IFRS terms rather than Companies Act terms for line items. Companies may therefore want to either merge their parent accounts with their group accounts, or change their parent accounts to be presented in a manner consistent with the group. This may also aid companies in achieving more clear and concise reporting by giving them the opportunity to cut pages out of the report.

- If an adjusted EPS figure is presented, ensure that both basic and diluted figures under that basis are included – 11% of companies presenting adjusted EPS measures did not comply with IAS 33 in this regard. Of those companies 88% had a different basic and diluted number, and so an adjusted diluted EPS number appeared necessary.

**Introduction**

IFRSs require all companies to present the following primary statements in their annual report.

- An income statement, which contains the majority of the items that make up a company’s financial performance. It can also include important subtotals such as gross profit, operating profit and profit before tax. Many companies choose to further analyse their income statement information into ‘underlying’ and ‘non-underlying’ items, resulting in the presentation of adjusted profit figures that management believe are helpful to allow users to understand the long-term performance of the business.

- A statement of comprehensive income, which can be combined with the income statement to form a single performance statement (although this is very rare in the UK). This includes specific items that certain IFRSs require to be excluded from the income statement, such as gains and losses on cash-flow hedges and actuarial movements in pension scheme balances. IAS 1 requires these items to be further subdivided into those that may be subsequently reclassified to profit or loss and those that will not.

- A statement of financial position, which sets out the assets, liabilities and equity balances of the group, identifying assets and liabilities as either current or non-current and analysing equity between amounts attributable to shareholders of the parent and those attributable to non-controlling interests.

- A statement of changes in equity, showing how the various components of the group’s equity have been affected by the year’s activities.

- A statement of cash flows, which presents the cash inflows and outflows that have occurred in the year, differentiating between whether they are operating, investing or financing cash flows. Operating cash flows arise from the principal revenue-generating activities of the group, while investing cash flows cover the acquisition and disposal of long term assets and other investments and financing cash flows are those that increase or decrease equity or borrowings.
Income Statements

Non-GAAP measures

Non-GAAP measures, or alternative performance measures (APMs), are generally regarded to be financial metrics which are not defined by the relevant GAAP, in the case of our survey, IFRS. For the purposes of this section, metrics such as profit before exceptional items were always regarded as non-GAAP measures, even if they were consistent with the figures for segment results presented in the IFRS 8 note, whereas unadjusted operating profit lines were not considered to be non-GAAP measures.

Although many believe that the use of non-GAAP measures can be beneficial to a reader, their use has been an area of concern amongst regulators and standard setters alike over the past few years. Bodies such as the FRC90, IOSCO91, ESMA92 and the IASB93 have issued reports and guidelines in recent years which generally call for a greater level of consistency in the use and disclosure of non-GAAP measures. They have also focussed on how non-GAAP measures should be presented alongside the audited financial information and the level of prominence that companies currently present them with.

Nevertheless, there is a clear and continuing upward trend of companies presenting information in the audited financial statements that is of a non-GAAP nature. This year we saw a 7% increase (2016: 81%; 2015: 74%) in companies disclosing non-GAAP measures in the audited financial statements (i.e. either on the face of the income statement or somewhere else in the back half of the report). This trend is also reflected throughout the annual report – indeed in one example we noted that a company used the word ‘underlying’ 222 times in their 180 page annual report! In instances such as these the prominence of the non-GAAP information that is being conveyed to the users of the financial statements could be open to challenge.

Users who focus primarily on the front half of the report may be at particular risk of being misled as to how a company has performed where presentation of non-GAAP measures is not appropriately balanced by use of GAAP-compliant information. The FRC’s FAQs94 on the ESMA APM Guidelines remind us that strategic reports are required to be fair, balanced and comprehensive and that, per the aforementioned guidelines, APMs should not be given more prominence, emphasis or authority than measures directly stemming from financial statements. It is also worth noting that ESMA’s guidelines specifically scope out the financial statements, but do apply to APMs used in the narrative part of companies’ annual reports. The use of non-GAAP measures in the narrative sections of the annual report is discussed in chapters 4 and 7.

Figure 13.1 Is a non-GAAP measure disclosed in the financial statements?

Our findings are consistent with a recent speech made by the chairman of the IASB, Hans Hoogervorst,95 who expressed concern over the growing use of adjusted profit measures, particularly when they ultimately give a more favourable picture of performance than the statutory profit or loss. He stated that costs such as impairment and restructuring are “part of daily life of any big company” and so argued that underlying profit figures which exclude figures relating to those activities are potentially misleading. Additionally, ESMA’s Guidelines on Alternative Performance Measures96, which became applicable in July 2016, state that items that “affected past periods and will affect future periods will rarely be considered as non-recurring, infrequent or unusual” and specifically gives restructuring and impairment costs as examples of such items. This is, therefore, clearly an item of focus for standard setters and regulators alike and given the increase in companies disclosing impairment losses as per figure 13.2 this is a pertinent point.
The FRC has also previously highlighted the fact that reorganisations and restructurings are, for many large businesses, a recurring or commonplace cost. This is something that many companies should consider, with 54% (2015: 61%) stripping out such costs from their non-GAAP measures, as per figure 13.2.

One potential solution to the increasing and varied use of non-GAAP measures, suggested by Hans Hoogervorst in his aforementioned speech, would be for the IASB to define more subtotals in the income statement. Indeed our findings show that of the companies who disclosed non-GAAP measures, 85% did so on the face of the income statement, and so this may be an avenue worth exploring. Requiring more disaggregation and subtotals on the face of the income statement may reduce the need for management to define their own measures.

IAS 1 already requires that material items of income and expense are disclosed separately in the income statement, so as to bring items of individual significance to the attention of users. Generally we would therefore expect such items (often referred to as ‘exceptional items’) to be one-off and material either by size or nature. It is important therefore that companies don’t separate out items which are clearly immaterial; something which we suspected in some cases.

In our survey we noted several instances of companies describing items as exceptional or special where this description potentially seemed inappropriate. For example, one company included a list of 15 individual line items in their note to describe the different exceptional items incurred during the current and prior year. Whilst some of those certainly appeared to be valid exceptional items, a number of them were very small in quantum. In such cases a clear explanation of what is regarded as ‘exceptional’ is important for a reader.

We also noted one instance where a company disclosed exceptional items relating to sale of a subsidiary, but the only discussion of these exceptional costs in the whole of the front half of the accounts was in the audit committee report. We would typically have expected to see discussion of such an item in the strategic report if management believed that it was of such significance as to treat it as exceptional. We discuss the broader point on significant or exceptional items, and how they are linked between the front and back halves of annual reports in chapter 14.

The level of detail provided as to why certain items had been stripped out of non-GAAP measures varied considerably, with many explanations being relatively generic. Where explanations were provided they tended to include the objective and criteria for stripping out items.

Although figure 13.2 shows a 17% increase in the number of companies surveyed that have stripped out impairment losses (excluding those from trade receivables) from non-GAAP measures, this was primarily driven by a 20% increase in the number of companies surveyed reporting impairments. Looking ahead, it will be interesting to see how companies disclose any effects of the UK’s decision to leave the EU (Brexit) and whether any such items will be described as exceptional.

We noted a slight reduction of 8% overall in our survey results relating to the number of companies that excluded acquisition costs from non-GAAP measures. As noted, our results showed that in the current and prior year 39 companies reported acquisitions in the year, and so the 8% drop represents a genuine reduction of these costs being stripped out of non-GAAP measures.

Kingfisher plc (example 13.1) provided a good example of well-defined and explained alternative performance measures, including the restatement of adjusted profit measures.

Barclays PLC (example 13.2) also provided an example of a clear explanation of how a non-GAAP measure is calculated.

Example 13.1
Kingfisher plc Annual Report and Accounts 2015 (p92)

- Good example of well-defined and explained alternative performance measures.
- Includes explanation of restatement of adjusted profit.

Example 13.2
Barclays PLC Annual Report 2015 (p218)

- Clear explanation of how a non-GAAP measure was calculated.
Earnings per share

IAS 33 prescribes the requirements for determining and presenting earnings per share (EPS) amounts in order to improve performance comparisons between different entities in the same period and between different accounting periods for the same entity. EPS is seen by many companies, investors and analysts as a key measure of profitability in the year.

In the previous section, we noted that adjusted profit measures are presented by the majority of companies, and in the same vein companies often present an adjusted EPS figure, which often strips out the same items as the adjusted profit measures.

The results of our survey found that 71 (2015: 70) companies decided to present adjusted EPS figures in their financial statements, of which 45% (2015: 55%) presented the figures on the face of the income statement and 55% (2015: 45%) disclosed the adjusted figures in the notes only.

The trend of companies moving adjusted EPS figures from the face of the income statement to the notes represents a more prudent position, since IAS 33 mandates that adjusted figures should be included in the notes to the financial statements, whereas it is not clear whether presentation of adjusted measures on the face of the income statement is permitted. In addition, where adjusted EPS measures are disclosed, this should be done for both basic and diluted EPS.

87% (2015: 91%) of those that included an adjusted EPS figure in their financial statements provided a basic and diluted adjusted EPS. Only 13% did not provide a diluted adjusted EPS but this also highlights an area for potential increased compliance, since IAS 33 requires adjusted diluted figures to be presented with any adjusted basic measures. Of those few companies 88% had a different basic and diluted number, and so an adjusted diluted EPS number appeared necessary.

Other income statement observations

<table>
<thead>
<tr>
<th>Other income statement observations</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies presenting a combined statement of profit or loss and comprehensive income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Overall</td>
<td>13%</td>
<td>14%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>10%</td>
<td>9%</td>
</tr>
<tr>
<td>Others</td>
<td>16%</td>
<td>21%</td>
</tr>
<tr>
<td>Companies overall continue to favour a separate approach for the income statement and statement of comprehensive income.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Companies presenting an operating profit figure or equivalent</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Overall</td>
<td>92%</td>
<td>91%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>90%</td>
<td>96%</td>
</tr>
<tr>
<td>Others</td>
<td>95%</td>
<td>84%</td>
</tr>
</tbody>
</table>

The number of companies that presented a line called “operating profit” or an equivalent variant broadly remained the same as last year. Although there is no requirement to present an operating profit measure in IFRS and so its inclusion is somewhat of an old UK GAAP legacy, it represents a figure that users are generally comfortable understanding and is relatively consistently used by comparable companies (in part due to the guidance within IAS 1’s basis for conclusions on how to present such a subtotal in the income statement).

Companies with discontinued operations in the year

| Overall | 12% | 9% |
| FTSE 350 | 10% | 9% |
| Others | 14% | 5% |

Overall the number of companies that disclosed discontinued operations is relatively few. Of those companies, 11 had sold operations in the year or had operations for sale at the year end. The other one company had both sold operations in the year and closed operations in the year.

Statement of Comprehensive Income

In July 2012, amendments to IAS 1 – Presentation of Financial Statements, came into force which addressed issues relating to the presentation of items of other comprehensive income. One of the most significant changes was a requirement to separately disclose those items which would be reclassified to the profit or loss in future periods from those items which will never be reclassified. Our survey found that of the companies that disclosed items of other comprehensive income, only 87% clearly disclosed the items that would or would not be reclassified to profit or loss. A good example of disclosing clearly which items would be reclassified to profit or loss was given by Marks and Spencer Group plc (Example 13.3).
Example 13.3
Marks and Spencer Group plc Annual Report and Financial Statements 2016 (p86)

Clearly distinguishes items of other comprehensive income that will be reclassified to profit or loss and those that will not.
Balance sheet
An area in which we have seen relatively little change over the past few years has been in the title of the balance sheet. Despite amending the terminology used in IAS 1 to refer to ‘statement of financial position’ as opposed to ‘balance sheet’ and giving companies the option of which title they use for periods commencing 1 January 2009, most companies surveyed by us have continued to use the term ‘balance sheet’ in their accounts (2016: 70%; 2015: 75%). There has been a small shift towards the term statement of financial position during FY15/16 in the companies that we surveyed, with 30% of companies surveyed using the newer terminology. That shift was most notable in companies outside of the FTSE 350, with 31% (2015: 21%) using statement of financial position – a 10% overall increase on last year.

Another point to bear in mind when preparing your balance sheet is the FRC’s continued focus on the concept of clear and concise reporting. The aggregation of immaterial line items is one of a number of factors that companies should consider when preparing their primary statements with the aim of cutting clutter, as noted in the technical findings slide deck that accompanied the FRC’s most recent Corporate Reporting Review Annual Report.

<table>
<thead>
<tr>
<th>Use of Net Assets in balance sheet presentation</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>76</td>
<td>75</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>42</td>
<td>39</td>
</tr>
<tr>
<td>Others</td>
<td>34</td>
<td>36</td>
</tr>
</tbody>
</table>

IAS 1 does not dictate the format of how the balance sheet should be structured. Either a Net Asset (NA) presentation or Total Equity and Liabilities (TEL) presentation is therefore acceptable. Consistent with previous years, our survey found that the majority of companies prefer the NA approach, with only 23 (2015: 24) preferring to use TEL. One company disclosed the sub totals total assets less current liabilities and total equity, which is unusual.

Restricted cash
Restrictions on the use of cash continues to be an area of focus for regulators, despite proposals to amend IAS 7’s disclosure requirements around liquidity being dropped for the time being.

Our survey this year found that 21 (2015: 19) companies disclosed restrictions in relation to the cash that they had available. Whilst there has been a slight increase in the number of companies that have disclosed restrictions in relation to their cash balances, only one company did not state the reason for the restriction, which is an improvement in the level of disclosure compared to last year. Of those companies that did give some reason for the restriction, eight (2015: four) were due to cash being pledged as security, five (2015: one) companies disclosed overseas exchange restrictions and two (2015: three) companies stated that balances were being held in escrow.

Thomas Cook Group plc (Example 13.4) displayed a good example of how to report restricted cash, clearly demonstrating the amounts in the context of the total cash balance, and with a clear comparative.
Example 13.4

Thomas Cook Group plc Annual Report and Accounts 2016 (p147)

- Good example of reporting restricted cash.
- Clearly shows restricted amounts in the context of total cash.
- Clear comparatives.
Parent company reporting

Companies that had been applying old UK GAAP with a 31 December or later year end were required to transition their accounts to a new accounting framework – either new UK GAAP (FRS 101 or FRS 102) or IFRSs, following the withdrawal of old UK GAAP as of 1 January 2015. As illustrated by figure 13.3, of the companies surveyed 45% chose to use FRS 101 in the accounts we surveyed. This is unsurprisingly popular for groups reporting under IFRSs, since it allows them to use the same recognition and measurement principles for their parent (or subsidiaries) without such extensive disclosure requirements. However, almost as popular is full IFRSs, with 44% of parent companies applying this in their separate financial statements.

It was interesting to note that relatively few companies applying IFRS last year seemed inclined to move to FRS 101. Instead, most of the 45 now adopting FRS 101 were companies that had bade farewell to old UK GAAP. Looking at the 45 companies in our sample both this year and last that reported under old UK GAAP in last year’s survey, 35 had moved to FRS 101. At the time of writing, companies transitioning to FRS 101 were required to inform their shareholders about their intention to move to that framework. However, the FRC issued draft amendments to FRS 101\(^2\) in July 2016 that propose to remove this requirement. If approved this may lead to an increase in parent companies moving from full IFRSs to FRS 101.

Of the 45 companies that had moved to FRS 101 for their parent accounts, only 11 early adopted the new 2015 accounting regulations, which allowed them to present their primary financial statements using line item terminology in accordance with an IFRS format. We expect that this is a helpful option to companies, and expect to see more companies use IFRS formats in the future once the accounting regulations have been fully adopted by all companies. Companies may also decide to integrate their FRS 101 parent accounts with their Group IFRS accounts in the future as a result of the flexibility to use an IFRS format for their primary statements, although of the ten companies that early adopted the 2015 accounting regulations, none decided to integrate their parent accounts with their group accounts this year.

The fact that FRS 102 was adopted by so few parent companies likely reflects the fact that given the consolidated accounts for listed groups need to be prepared under IFRSs, FRS 101 or full IFRS would appear a more obvious choice for them.

Of the nine companies surveyed that were still applying UK GAAP in their parent accounts, four stated in their accounts that they would be transitioning to FRS 101 in the next financial statements. The remaining five did not disclose which accounting framework they would be transitioning to next year.

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**Other findings**

<table>
<thead>
<tr>
<th>Companies taking the audit exemption for subsidiaries by guaranteeing their liabilities</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>10%</td>
<td>8%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>14%</td>
<td>11%</td>
</tr>
<tr>
<td>Others</td>
<td>5%</td>
<td>5%</td>
</tr>
</tbody>
</table>

Only ten companies (2015:8) have taken advantage of the ability to guarantee the liabilities of their subsidiaries, which we might expect to be more appealing to companies.

<table>
<thead>
<tr>
<th>Companies taking the exemption from disclosing a parent single company income statement</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>93%</td>
<td>94%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>91%</td>
<td>95%</td>
</tr>
<tr>
<td>Others</td>
<td>95%</td>
<td>93%</td>
</tr>
</tbody>
</table>

The vast majority of companies do not present a parent company income statement, as permitted by company law. However, of the 93% that do not present such a statement, seven do present a company-only statement of other comprehensive income, despite the fact that it is generally accepted practice that the law does not require this statement either. However, this exemption does not extend to the company-only statement of changes in equity – a primary statement that is required for the first time for companies adopting IFRSs, FRS 101 or FRS 102. Of the companies applying these standards, 9 did not present a company-only SOCE as a primary statement, an oversight that they should look to rectify next year.
Notes to the financial statements
Notes to the financial statements

Top tips

• Where you expect to be significantly impacted by a new accounting standard which is not yet effective, give specific information about how and the extent to which your company will be affected as early as possible so that users know what to expect. Of the 16 companies noting a potentially significant impact in respect of IFRS 15, only 20% gave specific information as to how they would be impacted. ESMA has recently published a position paper setting out what they expect to see companies disclosing regarding the expected effect of IFRS 15 adoption and is expected to publish another on IFRS 9 very soon.

• Ensure that you provide all information as required by IAS 1 in respect of capital management. Only 39 companies gave quantitative information about what the entity regards as capital, and only 46 clearly described their processes and procedures in relation to capital management. This is a current focus area for the FRC and for investors. Such information should also be presented within the audited financial statements.

• While keeping your explanations concise, don’t skip those that are necessary: they help the users of the accounts understand why certain judgements have been made and why items are being accounted for in a certain way. For example, explain why impairments, or reversals thereof, arose – only 60% of companies surveyed with impairments did so.

• Use discount and growth rates in impairment testing that reflect a CGU’s specific risks, its products, industry, locations and market. Of the companies surveyed, 22 used the same growth rate across all their CGUs with goodwill, and 21 the same discount rate. It is possible that these 21 companies chose to risk-adjust their forecast cash flows rather than the discount rate used, although a statement to that effect may be helpful in such cases.

• Check that divisions identified and discussed in the front half of the report are suitably consistent with the segments reported under IFRS 8. 16% of the companies surveyed had differences in these, usually a result of a higher level of detail in the front half.

Keep an eye on

• Whether adequate sensitivity disclosures are provided where economic uncertainty is giving rise to a risk of impairment. The number of companies surveyed reporting impairments, other than on trade receivables, has increased to 63, compared to 43 in 2015.

• Consistency between sensitivity disclosures and key sources of estimation uncertainty disclosed under IAS 1. Of the 31 companies stating that there were no reasonably possible changes in key assumptions that could cause a goodwill impairment 26 nevertheless identified the exercise as a key source of estimation uncertainty.

• Identifying separable intangible assets in a business combination. Of those companies surveyed with acquisitions, the percentage of companies recognising goodwill but no intangibles rose from 8% last year to 23% this year.

• Disclosing a description of the inputs used for fair values classified as level 3 in the fair value hierarchy. Only 75% of the 51 companies surveyed with level 3 valuations did this.

Introduction

The notes to the financial statements include all of the various analysis required by IFRSs to support the information provided in the primary statements, as well as narrative information to explain them in more detail. The notes broadly fall into four categories.

• The accounting policies and similar information, such as the basis of preparation, critical judgements and key sources of estimation uncertainty. These also include an assessment of the impact that future changes in IFRSs will have on the company, an area of regulatory focus with the implementation dates for IFRSs 15, 16 and 9 all approaching.

• Information supplementing the profit and loss account, such as analysis of operating expenses incurred or details of finance income and expenses.

• Information supplementing the balance sheet, such as details about defined benefit pension obligations or borrowings.

• Other supplementary information, such as disclosure about capital management or the use of financial instruments.

This chapter focusses on certain aspects of the notes that have been highlighted by the FRC as areas that companies could improve.
Accounting policies
As in previous years, the disclosure of accounting policies – where they are placed, what information they contain and to what level of detail and how they meet the needs of the users of the financial statements – has been a topic of interest for regulators and standard setters during the year. The FRC Lab has previously issued a detailed report covering these topics and integrating the theme of clear and concise reporting into those discussions. More recently they have covered the topic of accounting policies in their 2015 Corporate Reporting Review (CRR) Annual Report, addressing points on materiality and completeness of accounting policies.

Apart from one company including commentary from the audit committee stating that they encouraged management to be aware of findings from recent Lab reports, no other explicit references to the Lab or their findings were noted in the annual reports surveyed.

New standards not yet effective
In addition to these themes, both the FRC, in their year-end advice to preparers of financial statements and audit committees, and ESMA, in their public statement on issues for consideration when implementing IFRS 15 Revenue from Contracts with Customers, have called for companies to carefully assess the impact of new standards in issue but not yet effective (including IFRS 15 Revenue from Contracts with Customers, IFRS 16 Leases and IFRS 9 Financial Instruments). Issuers “should be able to provide progressively more entity-specific qualitative and quantitative information”.

IFRS 15 will become effective for companies from 1 January 2018, and as we approach that date we would expect the level of disclosure given by those companies who expect to be impacted by this change to increase. In their public statement, ESMA have stated that companies that expect to be significantly affected by the application of IFRS 15 should provide information about the accounting policy choices that are to be taken on first application, a disaggregation of the expected impact by revenue stream and an explanation of the nature of the impacts when compared to their existing practices.

ESMA has also stated that for most companies they would expect information about the impacts to be provided before the 2017 annual reports. They go on to state that any reasonably estimable quantitative information should not be withheld solely due to concerns that the actual figures might ultimately be different as a result of changes in the contracts in place or different economic conditions.

Only 16 companies surveyed disclosed that they believed the impact of adopting IFRS 15 was potentially significant. Of those 16, six gave no rationale at all as to why they had assessed that the impact was potentially significant, and seven gave fairly generic rationale about how they would be impacted. Given ESMA’s recent public statement we would expect those companies to significantly increase the level of disclosure they provide to become increasingly specific and clear as they get closer to the adoption of the standard. Indeed we would expect most companies – and certainly those who have not yet assessed the impact of IFRS 15 - to increase the level of disclosure with regards to this standard as the effective date becomes closer. The remaining three companies surveyed gave a relatively detailed rationale as to why they expected a significant impact on adoption of IFRS 15. Notably, two of those companies operated in the telecommunications industry – an industry that will be significantly impacted in several ways. A good example of the expected impact was provided by BT Group plc (Example 14.1) who went into a good level of detail about how various different revenue streams were likely to be affected.

98 https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Year-end-advice-to-preparers-larger-listed-compa.pdf
100 https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Year-end-advice-to-preparers-larger-listed-compa.pdf
As per figure 14.1, 41 of the companies that we surveyed stated that they had still not assessed the impact of IFRS 15, while 33 stated that they did not think the adoption of IFRS 15 would have a material impact on the Group. Only three of those companies gave a reasonable level of information as to why they perceived the impact to be immaterial. A brief statement explaining why anticipated impacts are not material may be helpful to evidence and reassure readers that an appropriate assessment has actually been undertaken.

Note that 7 companies surveyed completed published their annual report before the final publication of IFRS 16 and therefore were excluded from this assessment.

IFRS 16 Leases was only published in January 2016 and will be effective for periods beginning on or after 1 January 2019 subject to EU endorsement. As such, we would expect that companies are further behind in their assessment of the impact of this standard. That is certainly true of the companies that we surveyed, 46 of which stated that they had not yet assessed the impact of IFRS 16 as shown by figure 14.2. Despite companies having less time for their assessment given the relatively recent publication of IFRS 16, it is perhaps easier to identify an indicative impact in many cases, with IFRS 16 essentially meaning that existing operating leases will be coming on balance sheet.

Our survey revealed that the average amount of operating lease commitments that companies disclosed was almost £500m, although this figure was significantly higher amongst the FTSE 100 companies surveyed (almost £2bn), which skewed the overall average. In the companies outside the FTSE 350 the average operating lease commitment was £41m. Given the significant of these numbers it is no surprise that 21 companies stated that a potentially material impact was expected once IFRS 16 was adopted. Amongst those 21 companies, almost all explained that more assets would be on the balance sheet. Similarly to IFRS 15, we would expect these companies to give more specific and clear disclosure of the expected impact in future periods prior to the standard becoming effective.
Of the other standards or amendments not yet effective, 49% of companies surveyed provided a partial listing, 28% gave a full list, 12% simply stated that the remaining standards not yet effective would not have a material impact on the Group, and 11% companies provided no disclosure at all. Even if it is relatively obvious that a new standard will not affect a company, those companies should still make an explicit blanket statement of some sort covering such standards – this is consistent with the FRC Lab's guidance which noted that investors suggest that companies state that they have considered all the upcoming changes and only specifically disclosed those with a material or potentially material impact to the company.

**Changes to accounting policies**

IAS 8 *Accounting Policies, Changes in Accounting Estimates, and Errors*, requires companies to disclose if there have been any changes in accounting policies during the year. This may be due to new IFRS requirements or for voluntary changes in accounting policies. In its 2014 report on accounting policies the FRC Lab stated that investors like to see a clear rationale if a standard has been adopted early or voluntarily as well as a concise summary of any impact, including on prior periods. In our sample, 25 companies restated prior year amounts in their reports and 2 companies disclosed the early adoption of new standards (some annual improvements and IAS 1 amendments made under the IASB's disclosure initiative).

The last of the three major new standards which has been issued but is not yet effective is IFRS 9. Like IFRS 16, IFRS 9 has not yet been endorsed by the EU, but it is expected to become effective for periods commencing on or after 1 January 2018, and we would therefore expect companies to be more prepared in their assessment of IFRS 9. Figure 14.3 shows our findings in this respect. Out of our surveyed companies, 34 stated that they had not yet assessed the impact of the new financial instruments standard. 16 companies however made no disclosure at all in respect of IFRS 9. 13 companies stated that a possibly material impact is expected, although five of those companies gave no further disclosure as to why, and only one company gave something other than a relatively generic assessment of the impact.

Of those companies that had restatements, eleven were due to a change in segment analysis, six were as a result of a change in accounting policy and four appeared to be as a result of errors. The remaining four companies restated their balance sheets as a result of changes to acquisition values. Only three of these presented a restated balance sheet at the beginning of the comparative period, as required by IAS 1 where the restatement has a material impact. Even so it may be advisable for companies to state where no material impact is noted and therefore no third balance sheet prepared.

**Other accounting policy items**

One of the main focus areas of the accounting policies report produced by the FRC Lab was the significance of accounting policies. The report found that although different users had different views and requirements when it came to the disclosure of accounting policies, overall there was a clear message that the most significant accounting policies should be more prominent and easily accessible, and that the content of all policies included should be specific and not ‘boilerplate’. With this in mind it was encouraging to see an increase in the number of companies that made reference to materiality in their accounting policies note from two companies last year to eight in the current survey.
Companies who put the accounting policies note directly after the primary statements

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>88</td>
<td>88</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>48</td>
<td>51</td>
</tr>
<tr>
<td>Others</td>
<td>40</td>
<td>37</td>
</tr>
</tbody>
</table>

The same number of companies surveyed in the current and prior year chose to present their accounting policies note directly after the primary statements. The most popular alternative to this is combining the accounting policy with the relevant note, although only five companies surveyed presented their accounts in this way this year. This is potentially a good alternative, especially if significant accounting policies are still displayed prominently separately, since those users who do not want to review the detail of all the individual notes can understand the key policies and review information they are interested alongside the policy for that particular section. Other locations included before the primary statements (three companies) and in the final note (also three companies). One company in our survey disclosed their significant accounting policies directly after the primary statements, and disclosed all of the other accounting policies alongside the relevant note. The benefit of this is that it highlights to users which policies the company considers to be most significant.

Average length of accounting policy note (pages)

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>6.7</td>
<td>6.4</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>6.8</td>
<td>6.5</td>
</tr>
<tr>
<td>Others</td>
<td>6.5</td>
<td>6.2</td>
</tr>
</tbody>
</table>

The average length of accounting policies (where provided in a separate note) increased by 5% overall. It is difficult to say whether the FRC’s clear and concise project and the IASB’s disclosure initiative are making an impact in this area without looking at each set of accounts in detail, but it is clear that there is the potential for companies to at least consider whether they could remove some of their immaterial accounting policy disclosures, or at least relegate them to a later note/section. The shortest note in this year’s survey was three (2015: three) pages long whilst the longest had 19 (2015: 17) pages.

Critical accounting judgements and key sources of estimation uncertainty

Companies are required to disclose those sources of estimation uncertainty and assumptions about the future that have a significant risk of causing a material adjustment to the assets and liabilities within the next financial year. Those judgments made in applying accounting policies that have the most significant effect on the amounts recognised in the financial statements should also be disclosed.

In practice, many companies combine the disclosure of these items although our survey findings this year showed a 6% increase in the number of companies that clearly distinguished the two concepts as per figure 14.4. The majority (67) of companies continue to combine their judgements and estimation disclosures, with a small amount only appearing to disclose one or the other. Notably, the FRC in their 2015 CRR report have stated that, in their eyes, for these disclosures to be meaningful it’s important that judgements and estimations are identified and disclosed separately, so while investors may not differentiate, the regulators do. Whilst the Financial Reporting Lab report found that many investors do not differentiate between judgements and estimates in the same way that accounting standards do, they also noted that investors were specifically focussed on estimates, demonstrating the importance of the disclosures around this area. Investors also stated that an understanding of the “sensitivity of the balances and earnings amounts stemming from elements of estimation and judgement” was important. Whilst companies tend to be relatively good at this when it comes to areas such as impairment and pensions, where other standards explicitly require sensitivity disclosures to be provided in certain instances, other areas tend to be less well analysed in terms of their sensitivities.
Preparers should remember that IAS 1 explicitly cites sensitivity information as an example of something useful in helping readers understand the sources of estimation uncertainty.

Figure 14.4 How are critical accounting judgements and key sources of estimation uncertainty presented?

On average, companies in total disclosed between five and six areas of judgement and estimation uncertainty in both the current and prior year. More granularly speaking the average rose by 7% this year; though this did not impact the rounded amount of six. However, the appropriateness of the number of items disclosed will naturally vary from company to company. At either extreme, one company disclosed 15 items that they considered to be significant, and three companies only identified one item, although the appropriateness of either extreme in these examples is questionable. What is really important here is identifying all material areas and ensuring that the quality of the disclosures in these areas is sufficient for users. For more detail about what companies included within their identification of estimates and judgements refer to chapter four.

Structure of the notes

In the 2015 CRR report, the FRC continues to stress its commitment to clear and concise reporting, especially in relation to the removal of immaterial or irrelevant information from the annual report.

They continue to encourage companies to consider the disclosure principles of a particular standard when performing their ‘cutting clutter’ exercise. An assessment of the appropriateness of certain disclosures therefore remains an important exercise in this process. Where appropriate the removal of “clutter” is not only encouraged but is deemed necessary.

The areas in which the FRC identified the potential for improvement, in terms of clear and concise reporting, in their 2015 CRR report were:

- accounting policies – e.g. for items or transactions that were not material, for repetitive information or disclosure of new requirements with little or no future impact expected;
- tables with immaterial information – which could be eliminated or replaced with narrative;
- disaggregation of immaterial items included individually within primary statements;
- repetitive information that could be cross referenced elsewhere; and
- disclosures that have become irrelevant because the company’s circumstances have changed.

In our survey, we found that only five companies made reference to the fact that they had omitted some disclosure on the basis of materiality. This is much lower than last year where 16 companies made such a statement. This is perhaps due to the fact that the FRC has made it clear that companies do not need to include detail about what they have removed or a feeling that in the first year of omission an explanation is necessary but not in subsequent years.

It’s also worth bearing in mind that Amendments to IAS 1 – Disclosure Initiative becomes effective for annual periods beginning on or after 1 January 2016. These amendments add additional examples of possible ways of ordering the notes, clarifying that understandability and comparability should be considered when determining the order of the notes and that they need not be presented in the order listed in paragraph 114 of IAS 1.
Revenue recognition

In defining revenue recognition policies it was noticeable that companies in our survey varied widely in both the way in which they presented their revenue recognition policies and which items of income they included under this policy. For example, it sometimes contained interest income or dividends as opposed to purely what the company recorded as revenue in the income statement. This could potentially add to the level of ‘clutter’ in the accounting policies if those other income items are not material. We noted one company that combined their disclosure on revenue recognition with their critical accounting judgement on this area. Whilst this is a perfectly acceptable approach we would expect to see clear demarcation of what the accounting policy is and what the judgement is. Indeed in the previously mentioned Lab report it was noted that investors find it useful when the accounting policies also cover the judgements and estimates, provided a list of those items is also disclosed in a single place.

<table>
<thead>
<tr>
<th>Number of companies disclosing a clearly company-specific revenue recognition policy</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>77%</td>
<td>Not surveyed</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>78%</td>
<td>Not surveyed</td>
</tr>
<tr>
<td>Others</td>
<td>76%</td>
<td>Not surveyed</td>
</tr>
</tbody>
</table>

Overall, 77 companies in the year disclosed a revenue recognition policy that was at least in some way specific to that company. Of those 77, 57% gave detailed company information, whereas the remaining 43% gave relatively high level information which was still specific to the company. Overall therefore, 56% of companies surveyed could have given more detailed revenue disclosures.

<table>
<thead>
<tr>
<th>Average revenue recognition disclosure length (number of words)</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>259</td>
<td>244</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>271</td>
<td>246</td>
</tr>
<tr>
<td>Others</td>
<td>243</td>
<td>242</td>
</tr>
</tbody>
</table>

Our findings from this year’s survey showed an increase in the average length of revenue recognition policies of 6%, the vast majority of which was driven by an average increase in the FTSE 350 disclosure (by 10%). An overall increase isn’t necessarily an indication that the quality of the disclosure has increased – management should consider the best way of indicating the nature of all of their material revenue streams.

Capital management

Disclosures regarding the composition of capital, the objectives set by the board and the policies and processes that management follow in managing their capital are required by IAS 1 *Presentation of financial statements*. Companies should also be clear that ‘capital management’ isn’t synonymous with working capital, capital investment or share capital structure – during our survey we saw several references from the capital management note to such disclosures in the front half without appearing to give sufficient disclosure under the requirements of IAS 1. Indeed, the FRC has continually identified capital management disclosures as an area that requires improvement, most recently in the technical findings accompanying their 2015 Corporate Reporting Review annual report[102], particularly in relation to disclosures about what is managed as capital and the quantitative and qualitative disclosures relating to capital.

The structure and linkage of disclosures is also something that preparers should consider when thinking about capital management. Companies often give information about capital management in their front half, and this should be consistent with and supplementary to the information disclosed in the back half.

We noted several instances where groups had disclosed information in relation to capital management in line with the requirements of IAS 1, however that information was only presented in the front half whereas for IAS 1 purposes it must be included in the financial statements, which are of course audited. Capita plc (Example 14.2) provide a good example of capital management disclosure.

Number of companies discussing capital management in front and back half

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>40%</td>
<td>45%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>53%</td>
<td>58%</td>
</tr>
<tr>
<td>Others</td>
<td>21%</td>
<td>28%</td>
</tr>
</tbody>
</table>

Overall, we found that there was a fairly significant variety of practice across companies. Whilst it is encouraging that every company bar one had some discussion of capital management somewhere in the annual report, the number of companies that disclosed information in both the front and back halves was only 40, with 31 of those within the FTSE 350. In such cases, companies should take care to effectively link the two disclosures together, especially where they rely on one another in some way. This appeared to be an area where a number of companies could improve.

Companies who disclosed capital management objectives (in the front half or back half)

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>92</td>
<td></td>
</tr>
<tr>
<td>FTSE 350</td>
<td>54</td>
<td>Not surveyed</td>
</tr>
<tr>
<td>Others</td>
<td>38</td>
<td></td>
</tr>
</tbody>
</table>

Most companies met the requirement to disclose the capital management objectives of the company (92), and 77 companies were able to give a clear definition of what it was that they managed as capital. However only 39 companies explicitly gave quantitative information about the level of capital at the year end, and only 46 companies gave clear and specific information about the policies and processes that they follow when managing capital. This shows that there is plenty of room for improvement in disclosure in this area.

Debt reconciliations

In January 2016 the IASB published amendments\(^\text{103}\) to IAS 7 Statement of Cash Flows. The amendments’ objective is for entities to provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, similar to old UK GAAP’s net debt reconciliations (albeit cash is not required to be included in the IAS 7 reconciliation). Under the amendments, the following changes in liabilities arising from financing activities are to be disclosed (to the extent applicable): (i) changes from financing cash flows; (ii) changes arising from obtaining or losing control of subsidiaries or other businesses; (iii) the effect of changes in foreign exchange rates; (iv) changes in fair values; and (v) other changes. These amendments become effective for periods commencing on or after 1 January 2017, subject to EU endorsement, so this is an area that companies will need to get to grips with soon, albeit comparatives are not required.

Encouragingly, over half of all companies surveyed with financing arrangements disclosed a debt reconciliation of sorts. For these companies there should be less work to do in preparing for the forthcoming IAS 7 amendments.

An example of comprehensive information on net debt reconciliations was provided by Mondi Group (Example 14.3).

Companies with debt providing an net or gross debt reconciliation

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>55%</td>
<td></td>
</tr>
<tr>
<td>FTSE 350</td>
<td>66%</td>
<td>Not surveyed</td>
</tr>
<tr>
<td>Others</td>
<td>38%</td>
<td></td>
</tr>
</tbody>
</table>

Distributable reserves

Although there is no requirement under the law or accounting standards for a separate figure of distributable profits to be disclosed, 38 companies (2015: 40) in our sample (24 from the FTSE 350 (2015: 25) and 14 from the other group (2015: 15)) presented some information about distributable reserves in their financial statements. Of those companies 14 stated the actual amounts of distributable reserves available, the other 24 including some disclosure – for instance that a particular reserve is not available for distribution. See chapter 6 for more discussion of dividend reporting.

Segments

Companies are required by IFRS 8 Operating Segments to report segmental information to shareholders in line with the way it is reported internally to management. It was therefore surprising to see that 16% (2015: 12%) of reports surveyed discussed different reporting segments in the front half to those included in the notes to the financial statements. The average for the FTSE 350 was less, at 12% (2015: 11%) than for the companies outside this group at 21% (2015: 14%). The FRC is likely to challenge such differences, for example questioning the use of materiality or IFRS 8's aggregation criteria where the front half shows a greater level of disaggregation than is presented in the notes to the accounts.

<table>
<thead>
<tr>
<th>Companies with just one reportable segment</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>16%</td>
<td>12%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>16%</td>
<td>14%</td>
</tr>
<tr>
<td>Others</td>
<td>17%</td>
<td>9%</td>
</tr>
</tbody>
</table>

A single reportable segment is justifiable where the chief operating decision maker is only presented with aggregated information in order to make decisions about the allocation of resources and review performance; but the FRC will often approach such a conclusion with a degree of scepticism. There has been a slight rise in the number of companies with just one reportable segment; over half of these did give a clear justification of why this conclusion was reached. A good example of such disclosure is in the report of Electronic Data Processing PLC (Example 14.4).

<table>
<thead>
<tr>
<th>Companies with just one reportable segment without justification</th>
<th>2016</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>38%</td>
<td>Not surveyed</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>44%</td>
<td>Not surveyed</td>
</tr>
<tr>
<td>Others</td>
<td>29%</td>
<td>Not surveyed</td>
</tr>
</tbody>
</table>

Including a clear justification for why this conclusion was reached is advisable, to pre-empt challenge on why only a single reportable segment has been identified.

Goodwill

In a business combination, companies are required to recognise the difference between purchase price and the value of identifiable assets and liabilities as goodwill. This must then be assessed each year to ascertain that its value has not been impaired. The percentage of companies we surveyed that held goodwill at the year-end has remained fairly static for those we surveyed in the FTSE 350 at 91% (2015: 89%), whereas for the other companies surveyed the number has decreased to 57% (2015: 72%). This is at least partly as a result of impairments seen in goodwill compared to last year (see following section), as three of the companies surveyed outside the FTSE 350 recorded an impairment to goodwill during the year such that the year-end balance was nil.

All but two of the companies in our sample based their recoverable amounts on value in use, as opposed to fair value less costs to sell. IAS 36 requires that where value in use is used as the recoverable amount of a Cash Generating Unit (CGU) with significant goodwill, information is given about the period over which cash flow projections were based on budgets and forecasts (before potentially extrapolating over a longer period). There is an assumption that the period based on budgets and forecasts should not be longer than five years unless there is a good reason, in which case an explanation for this should be given. Only two companies surveyed had projections that utilised budgets or forecasts for a period exceeding 5 years.
Clear and specific sensitivity disclosures should be provided where a reasonably possible change in a key assumption would cause an impairment. This is done at varying levels of detail, as shown in figure 14.5. Where there is no reasonably possible change that would lead to an impairment, users of the accounts may appreciate a negative statement to this effect. Hill & Smith Holdings PLC (Example 14.5) and Findel plc (Example 14.6) give good examples of sensitivity disclosures.

Interestingly, of the 31 companies providing a negative statement that there was no reasonably possible change in a key assumption that could cause an impairment, 26 nevertheless described it as a key source of estimation uncertainty under IAS 1. Given that IAS 1 requires disclosure of those sources of estimation uncertainty “that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities” it seemed like there could be a disconnect here.

**Figure 14.5 How do companies disclose the sensitivity analysis they have done for impairment testing purposes?**

<table>
<thead>
<tr>
<th>% of companies surveyed with goodwill which disclose the allocation of goodwill to CGUs or groups of CGUs, not higher than segmental level</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>92%</td>
<td>96%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>92%</td>
<td>100%</td>
</tr>
<tr>
<td>Others</td>
<td>92%</td>
<td>90%</td>
</tr>
</tbody>
</table>

Where significant, IAS 36 requires that companies disclose the allocation of goodwill to each CGU or group of CGUs. IAS 36 requires that a group of CGUs for this purpose must not be bigger than an operating segment or the level at which goodwill is monitored internally. There remains a small number of companies surveyed who did not disclose any allocation of the value of goodwill.

<table>
<thead>
<tr>
<th>% of the above who provide an explanation for the same growth rate being used</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>45%</td>
<td>Not measured</td>
</tr>
</tbody>
</table>

The growth rate for each CGU should reflect their specific products, industry, locations and market. Companies should determine the appropriate growth rate(s), which may not be the same across different CGUs.

<table>
<thead>
<tr>
<th>% of companies surveyed with growth rates more than nil where growth rates have been justified with regards to the relevant long term average growth rate</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>40%</td>
<td>53%</td>
</tr>
</tbody>
</table>
Impairments
Impairment disclosures continue to be an area where regulators focus their attention, and asset impairment calculations and the disclosures around these are a common area of challenge. The percentage of companies recording an impairment, excluding impairments of trade receivables (given how common these are) increased from 43% in 2015 to 63% this year, the increase being comparable across FTSE 350 companies (46% to 67%) and other companies (40% to 57%). This may indicate a drop in economic confidence in these companies. The split of different areas where companies have recognised impairments is shown in figure 14.6.

<table>
<thead>
<tr>
<th>% of companies with more than one CGU using different discount rates for different groups of CGUs</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>70%</td>
<td>77%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>75%</td>
<td>85%</td>
</tr>
<tr>
<td>Others</td>
<td>57%</td>
<td>61%</td>
</tr>
</tbody>
</table>

As for growth rates, companies should determine an appropriate discount rate that may not be the same across different CGUs, due to the different risk factors to which they are exposed. As an alternative to risk-adjusting discount rates companies may instead risk-adjust their cashflows.

<table>
<thead>
<tr>
<th>% of companies using different discount rates that disclosed them as ranges</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>35%</td>
<td>39%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>44%</td>
<td>40%</td>
</tr>
<tr>
<td>Others</td>
<td>8%</td>
<td>36%</td>
</tr>
</tbody>
</table>

Figure 14.6 In what areas have companies recognised an impairment?

<table>
<thead>
<tr>
<th>Impairment</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies with an impairment loss not disclosing the events and circumstances that led to its recognition</td>
<td>Overall</td>
<td>40%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>33%</td>
<td>38%</td>
</tr>
<tr>
<td>Others</td>
<td>50%</td>
<td>41%</td>
</tr>
</tbody>
</table>

| Companies with an impairment reversal in the year (excluding trade debtors) | Overall | 4% | 4% |
| FTSE 350 | 5% | 4% |
| Others | 2% | 5% |

A large minority of companies reporting impairment losses did not report the events and circumstances that led to the recognition of the impairment loss. This may be due to materiality considerations. A good example of disclosure of the events and circumstances leading to an impairment is given in the Intertek Group plc (Example 14.7) report.

Levels of impairment reversals (again excluding trade receivables) remained at the same low level as last year. IAS 36 restricts some reversals of impairments, for example an impairment of goodwill can never be reversed.
Pensions
There are extensive disclosures required for companies with defined benefit schemes, including the regulatory framework, related risks and funding arrangements. Figure 14.7 shows the space that these disclosures take up in the report.

Figure 14.7 How many pages of notes do companies include for the IAS 19 disclosures?

More companies surveyed (69) had a defined benefit schemes than those surveyed in 2015 (66) – see figure 14.8 for analysis of the funding positions of these (note that some companies had more than one scheme). The proportion of those schemes in surplus that recognised an asset has increased from 82% to 95%. Companies with schemes in surplus should pay careful attention to IFRIC 14’s requirements to limit the recognition of plan surpluses, particularly in light of the proposed change which will require that gradual settlement cannot be assumed where trustees have a unilateral right to wind up a scheme.

An example of a company explaining why they made the decision to recognise a surplus, and in this case particularly commenting on the potential IFRIC 14 changes was BTG plc (Example 14.8).

The inclusion of sensitivity analyses within the pensions disclosure is a current area of focus from the FRC. 91% of the companies surveyed provided sensitivity analyses covering their actuarial assumptions. A good example of this disclosure is shown in the report of Vodafone Group Plc (Example 14.9).

Provisions
None of the companies surveyed took advantage of the exemption available in IAS 37 to not disclose information about a provision, contingent liability or contingent asset where it would seriously prejudice its position. This is in line with our expectation in this area, as such a situation is likely to be rare; additionally the FRC has stated that it is likely to challenge companies making use of this exemption.

Another regulatory hotspot is the discussion around uncertainty related to amounts or timing required for each class of provision under IAS 37. A wide variety was noted in terms of the level of detail companies were providing in this regard, although it appeared that there was room for improvement by many.
Companies disclosing increases in provisions, utilisation of provisions, releases of provisions and unwind of discounts on provisions separately

Overall 45%
FTSE 350 51%
Others 36%

Companies are required by IAS 37 to disclose a detailed split of movements in provisions, including increases to provisions, amounts used, unused amount reversed, and the unwind of discounts on provisions. Of these, the most common disclosure excluded was that of the unwind of discounts, presumably on materiality grounds. The KAZ Minerals Plc (Example 14.10) accounts give a good example of this.

Intangibles
IAS 38 requires companies to identify intangible assets and amortise them over their useful life. Companies recognise a variety of intangible assets, as shown in figure 14.9.

Figure 14.9 What classes of intangible assets do companies record?

Intangibles

<table>
<thead>
<tr>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Computer software</td>
<td>76%</td>
</tr>
<tr>
<td>Licences/jaun��</td>
<td>39%</td>
</tr>
<tr>
<td>Brands</td>
<td>29%</td>
</tr>
<tr>
<td>Customer related</td>
<td>62%</td>
</tr>
<tr>
<td>Development, expenditure</td>
<td>30%</td>
</tr>
<tr>
<td>Other</td>
<td>51%</td>
</tr>
</tbody>
</table>

Companies recognising intangibles other than goodwill

Overall 89%
FTSE 350 86%
Others 90%

Companies with intangibles assessed as having an indefinite life

Overall 20%
FTSE 350 21%
Others 19%

Companies with intangibles assessed as having an indefinite life that disclose the justification for this assessment

Overall 44%
FTSE 350 36%
Others 57%

IAS 38 requires companies to disclose the carrying amount of any assets held with an indefinite useful life, together with the reasons for the assessment that its life is indefinite; a description of factors that played a significant role in determining that the asset has an indefinite useful life should also be given. Over 50% of companies with intangible assets assessed as having an indefinite useful life failed to give this assessment. An example of a good explanation in this area is shown by LSL Property Services Plc (Example 14.11).
Business combinations

The number of business combinations (39 of the companies surveyed) has remained consistent with the prior year (39) and indeed with 2014 (36), indicating a relatively stable period of acquisition activity. The percentage of companies surveyed with combinations that did not identify what gave rise to goodwill increased from 16% last year to 19% this year. In accordance with IFRS 3, users of the accounts will want to know why the company paid a premium for the acquisition and a good description in this area will increase transparency. Companies who did identify what gave rise to goodwill mostly identified synergies as the main factor, as shown in figure 14.10. A good example in this area is that of The Weir Group PLC (Example 14.12), which distinguished between detailed information given for a large business combination and a high level summary for a smaller business combination.

The types of intangibles recognised as part of acquisitions remained comparable to the previous year, as shown in figure 14.11.

Figure 14.11 What types of intangibles did companies recognise as part of acquisitions in the year?

<table>
<thead>
<tr>
<th>Intangibles</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Computer software (including internally developed software)</td>
<td>9</td>
<td>7</td>
</tr>
<tr>
<td>Licences, patents and trademarks</td>
<td>9</td>
<td>10</td>
</tr>
<tr>
<td>Brands</td>
<td>10</td>
<td>9</td>
</tr>
<tr>
<td>Customer lists, contracts and/or relationships</td>
<td>25</td>
<td>26</td>
</tr>
<tr>
<td>Development expenditure</td>
<td>12</td>
<td>10</td>
</tr>
<tr>
<td>Other</td>
<td>5</td>
<td>5</td>
</tr>
</tbody>
</table>

Figure 14.10 How many companies recognised goodwill in business combinations as a result of stated factors?

<table>
<thead>
<tr>
<th>Stated Factors</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Synergies</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>Assembled workforce</td>
<td>15</td>
<td></td>
</tr>
<tr>
<td>Other intangibles not separately recognised</td>
<td>5</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Business combinations</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>% companies reporting business combinations that recognised goodwill</td>
<td>95%</td>
<td>82%</td>
</tr>
<tr>
<td>% companies reporting business combinations that recognised intangibles other than goodwill</td>
<td>77%</td>
<td>79%</td>
</tr>
<tr>
<td>Companies reporting business combinations with goodwill but no intangibles</td>
<td>23%</td>
<td>8%</td>
</tr>
<tr>
<td>Average value of intangible assets compared to intangible assets and goodwill combined</td>
<td>44%</td>
<td>42%</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>42%</td>
<td>43%</td>
</tr>
<tr>
<td>Others</td>
<td>49%</td>
<td>42%</td>
</tr>
</tbody>
</table>

The FRC has a focus on companies recording goodwill but no separate intangibles in business combinations. Despite this, the percentage of companies recognising goodwill on business combinations increased while the percentage recognising intangible assets remained the same.
Business combinations as of 2016 and 2015:

<table>
<thead>
<tr>
<th>% companies with contingent consideration where the nature of contingent considerations has been discussed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
</tr>
<tr>
<td>FTSE 350</td>
</tr>
<tr>
<td>Others</td>
</tr>
</tbody>
</table>

Not surveyed

Overall 48% 2016
FTSE 350 38% Not surveyed
Others 80%

As in other areas, companies did not always provide the appropriate level of detailed explanation, including in this case what kind of contingent consideration was agreed.

Companies with business combinations after the year end:

<table>
<thead>
<tr>
<th>Overall</th>
<th>9</th>
<th>Not surveyed</th>
</tr>
</thead>
</table>

As would be expected, the number of companies recognising JVs and JOs under IFRS 11 increased very slightly, since three of the companies surveyed last year had not yet adopted the standard. Otherwise these figures remain roughly consistent with last year.

Companies with joint ventures and joint operations:

<table>
<thead>
<tr>
<th>Joint ventures</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies with joint ventures</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Overall</td>
<td>42</td>
<td>40</td>
</tr>
<tr>
<td>FTSE 350 (58 surveyed)</td>
<td>32</td>
<td>29</td>
</tr>
<tr>
<td>Other (42 surveyed)</td>
<td>10</td>
<td>11</td>
</tr>
<tr>
<td>Companies with joint operations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Overall</td>
<td>8</td>
<td>5</td>
</tr>
<tr>
<td>FTSE 350 (58 surveyed)</td>
<td>5</td>
<td>1</td>
</tr>
<tr>
<td>Other (42 surveyed)</td>
<td>3</td>
<td>4</td>
</tr>
</tbody>
</table>

As required by IFRS 12 Disclosure of interests in other entities, six companies disclosed significant judgements about whether an entity was a subsidiary or an associate; six disclosed significant judgements about whether a joint arrangement was a joint venture or a joint operation. An example of the latter deliberation is shown in Anglo American plc (Example 14.13).

‘Package of five’ consolidation standards

‘Package of five’ consolidation standards

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Share based payments

Share schemes are becoming an increasingly common part of remuneration packages, with the number of companies surveyed using them increasing from 86 in 2014 to 91 last year and 96 in this year’s reports.

<table>
<thead>
<tr>
<th>Share based payments</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>34%</td>
<td></td>
</tr>
<tr>
<td>FTSE 350</td>
<td>45%</td>
<td>Not surveyed</td>
</tr>
<tr>
<td>Other</td>
<td>18%</td>
<td></td>
</tr>
</tbody>
</table>

The larger listed entities tend to have more share based schemes and tend to aggregate disclosures for their share schemes where permitted by IFRS 2. Aggregation can help keep this area of complex disclosure concise.

Consider aggregating some of the information: the descriptive disclosures such as vesting requirements, the maximum term of options granted, and the method of settlement can potentially be aggregated per IFRS 2.
Financial instruments

Both IFRS 7 and IFRS 13 require potentially extensive disclosures to be provided for financial instruments, the latter standard in relation to fair value measurements, especially where there are significant unobservable inputs i.e. measurements are level 3 in the fair value hierarchy. Our findings revealed that some companies appeared to be omitting all the necessary information on such items, resonating with calls from the regulator to improve disclosure in this area.

<table>
<thead>
<tr>
<th>Joint ventures</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies with items classified as level three in the IFRS 13 fair value hierarchy</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Overall</td>
<td>51</td>
<td>40</td>
</tr>
<tr>
<td>FTSE 350</td>
<td>35</td>
<td>28</td>
</tr>
<tr>
<td>Other</td>
<td>16</td>
<td>12</td>
</tr>
</tbody>
</table>

% of the above not disclosing information on unobservable inputs and quantitative factors (where amounts exceeded audit materiality)

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>25%</td>
<td>20%</td>
</tr>
<tr>
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<td>23%</td>
<td>21%</td>
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<tr>
<td>Other</td>
<td>31%</td>
<td>17%</td>
</tr>
</tbody>
</table>

IFRS 13’s fair value hierarchy indicates that items classified as level three have significant unobservable inputs used in determining fair value. The number of companies surveyed who recorded items classified as level three increased this year. A quarter of companies surveyed who had material level three items did not disclose information on the unobservable inputs used. A good example of clear disclosure of these unobservable inputs is shown in the accounts of Mondi Group (Example 14.14).

[34x439]Financial instruments
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Good practice examples

Example 14.1

BT Group plc Annual Report 2016 (p170)

- Identification of different revenue streams with an assessment of what the likely qualitative impact of IFRS 15 will be.
- Clearly explained that the fact was an ongoing process and that management is continuing to assess the impact.
- Included detailed company specific information.

Example 14.2

Capita plc Annual report and accounts 2015 (p147)

- Provide clear definition of what is managed as capital.
- Clearly define what is managed as capital.
- Provide quantitative information in respect of the capital managed including comparative figures.
- Provide detailed disclosure as to what management processes are performed in respect of capital management.
Example 14.3

- Provided comprehensive information about the level of net debt in the company, for instance by showing the maturity profile of their net debt and the currency split.
- They also provided a clear definition of what they managed as capital, and how much that amounted to at the year end.
- Provided clear linkage between the front and back half that was understandable and consistent.
Example 14.4

Electronic Data Processing PLC Annual Report and Accounts 30 September 2015 (p34)

Segmental information – clear explanation of why a single operating segment was chosen.

Example 14.5

Hill & Smith Holdings PLC Annual Report 2015 (p110)

Goodwill - disclosure of sensitivity in impairment testing.

Example 14.5

Notes to the Consolidated Financial Statements

Segmental information – clear explanation of why a single operating segment was chosen.

The IASB has issued the following standards with an effective date after the date of these financial statements and early adoption has not been applied (forming part of the financial statements).

Abstracts of IAS/IFRS

New standards not applied continued


IAS 28 (amended December 2014) Investments in Associates and Joint Ventures 1 January 2016

IAS 16 (amended May and June 2014) Property, Plant and Equipment 1 January 2016

IAS 1 (amended December 2014) Presentation of Financial Statements 1 January 2016

IFRS 14 Regulatory Deferral Accounts 1 January 2016

IFRS 12 (amended December 2014) Disclosure of Interests in Other Entities 1 January 2016

IFRS 11 (amended May 2014) Joint Arrangements 1 January 2016

The Directors are currently assessing the likely impact that adoption of IFRS 15 Revenue from Contracts with Customers will have on the Group’s financial results.

Goodwill impairment reviews have been carried out as at an operating segment level on all cash generating units to which goodwill is allocated. Impairment tests on the carrying value of goodwill and certain US Galvanizing brand names of £6.9m (2014: £10.4m), which are the Group’s only other indefinite life intangible assets, were performed by creating the carrying value scenarios for each cash generating unit and comparing them with the IFRS 3.10 test. The Group’s goodwill and certain US Galvanizing brand names are tested at least annually.

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Example 14.6
Findel plc Annual Report & Accounts 2016 (p97)

Goodwill – disclosure of sensitivity in impairment testing.

Example 14.7
Intertek Group plc Annual Report and Accounts 2015 (p110)

Impairments – explanation of why an impairment was incurred.
Example 14.8

**BTG plc Annual Report and Accounts 2016 (p109)**

- Giving an explanation of why the company chose to recognise a defined benefit scheme surplus as an asset.

- Commenting on potential changes to this decision as a result of proposed changes to IFRIC 14.

Example 14.9

**Vodafone Group Plc Annual Report 2016 (p144)**

Pensions - Sensitivity analysis on key assumptions in measuring defined benefit obligation.
Provisions – disclosure showing all required movements during the year, including the unwinding of discount.

Intangible assets – explanation for where an indefinite life was selected for intangible assets.
Example 14.12
The Weir Group PLC Annual Report and Financial Statements 2015 (p153)

Business combinations – a description of what gave rise to the goodwill acquired in current year business combinations.

Example 14.13
Anglo American plc Annual Report 2015 (p118)

‘Package of five’ – joint venture assessment.

Example 14.12

Example 14.13

FINANCIAL STATEMENTS AND OTHER FINANCIAL INFORMATION

NOTES TO THE FINANCIAL STATEMENTS

Critical accounting judgement: Impairment of assets

The impairment charges of £0.4m related to Linatex (note 14), with an impairment charge in the year of £6.7m recognised in relation to the brand names in the Pressure Control CGU. The assessment of recoverability of the brand names is subjective and the use of different valuation assumptions could have a significant impact on financial results. Further information on the estimation uncertainty is provided in the fair value hierarchy, as defined in IFRS 13, by factors such as estimates of future production, commodity price assumptions, and discount rates. Factors which could impact useful economic lives of assets and Ore Reserve categorizations are also given in note 39k. Judgement is required in determining this classification through assessment of the arrangements are in substance satisfied by cash flows received from the arrangements are primarily designed for the provision of output to the parties, their continuity of the operations of the arrangement, this indicates that the arrangements are classified as joint operations. These arrangements may have to be distinguished in the present and ongoing earnings and cash flows from their own operations or in those of the financial statements through consideration of the arrangements’ economic characteristics and underlying activities in determining the classification of arrangements

Key management

The Group's tax affairs are governed by complex domestic tax legislations and regulations, and the assessment of fair value is principally used in accounting for business combinations. A clear vision

A clear vision | Annual report insights 2016
13 Forestry assets continued

The fair value of forestry assets is a level 3 measure in terms of the fair value measurement hierarchy (see note 30b) and this category is consistent with prior years. The fair value of forestry assets is calculated on the basis of forward cash flows arising on the Group’s owned forestry assets, discounted based on a pre tax yield on long-term bonds over the last five years.

The following assumptions have a significant impact on the valuation of the Group’s forestry assets:

- The net selling price, which is defined as the selling price less the costs of transport, harvesting, extraction and loading. The net selling price is based on third-party transactions and is influenced by the species, maturity profile and location of timber. In 2015, the net selling price used ranged from the South African rand equivalent of €9 per tonne to €33 per tonne (2014: €10 per tonne to €35 per tonne) with a weighted average of €20 per tonne (2014: €22 per tonne).
- The conversion factor used to convert hectares of land to standing timber, which is dependent on the species, the maturity profile of the timber, the geographic location, climate and a variety of other environmental factors. In 2015, the conversion factors ranged from 8.9 to 25.2 (2014: 8.8 to 25.2).
- The discount rate of 15.2% (2014: 10.6%) based on a pre tax yield from long-term South African government bonds matching the average age of the timber and adjusted for the risks associated with forestry assets.

The valuation of the Group’s forestry assets is determined in rand and converted to euro at the closing exchange rate on 31 December of each year.

The reported value of owned forestry assets would change as follows should there be a change in these underlying assumptions:

<table>
<thead>
<tr>
<th>€ million</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effect of €1/tonne increase in net selling price</td>
<td>11</td>
</tr>
<tr>
<td>Effect of 1% increase in conversion factor (hectares to tonnes)</td>
<td>2</td>
</tr>
<tr>
<td>Effect of 1% increase in discount rate (2)</td>
<td>0</td>
</tr>
<tr>
<td>Effect of 1% increase in EUR/ZAR exchange rate (2)</td>
<td>-</td>
</tr>
</tbody>
</table>

14 Inventories

<table>
<thead>
<tr>
<th>€ million</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valued using the first-in-first-out cost formula</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Raw materials and consumables</td>
<td>22</td>
<td>24</td>
</tr>
<tr>
<td>Work in progress</td>
<td>9</td>
<td>12</td>
</tr>
<tr>
<td>Finished products</td>
<td>22</td>
<td>29</td>
</tr>
<tr>
<td>Total valued using the first-in-first-out cost formula</td>
<td>53</td>
<td>65</td>
</tr>
<tr>
<td>Valued using the weighted average cost formula</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Raw materials and consumables</td>
<td>321</td>
<td>324</td>
</tr>
<tr>
<td>Work in progress</td>
<td>102</td>
<td>106</td>
</tr>
<tr>
<td>Finished products</td>
<td>362</td>
<td>348</td>
</tr>
<tr>
<td>Total valued using the weighted average cost formula</td>
<td>785</td>
<td>778</td>
</tr>
<tr>
<td>Total inventories</td>
<td>838</td>
<td>843</td>
</tr>
<tr>
<td>Of which, held at net realisable value</td>
<td>138</td>
<td>150</td>
</tr>
</tbody>
</table>

Combined and consolidated income statement

<table>
<thead>
<tr>
<th>€ million</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of inventories recognised as expenses</td>
<td>2,912</td>
<td>2,812</td>
</tr>
<tr>
<td>Write-down of inventories to net realisable value</td>
<td>-24</td>
<td>-24</td>
</tr>
<tr>
<td>Aggregate reversal of previous write-down of inventories</td>
<td>19</td>
<td>16</td>
</tr>
<tr>
<td>Green energy sales and disposal of emissions credits</td>
<td>68</td>
<td>81</td>
</tr>
</tbody>
</table>

Notes to the combined and consolidated financial statements for the year ended 31 December 2015

Mondi Group Integrated report and financial statements 2015
Appendix 1 – Survey methodology

To put together this document, the annual reports of 100 UK listed companies were surveyed to determine current practice. Our sample was selected from among all of the UK incorporated companies with a premium listing of equity shares on the London Stock Exchange. We excluded investment trusts (apart from real estate investment trusts) from our sample, due to their specialised nature. Investment trusts are those companies classified by the London Stock Exchange in the ‘Equity Investment Instruments’ sector.

In the current year we have updated our sample to reflect the composition of the market at 30 April 2016. This year our sample includes 19 FTSE 100 companies, 39 FTSE 250 companies and 42 companies outside the FTSE 350. Although the overall sample is, as far as possible, consistent with that used in last year’s survey, as a result of takeovers, mergers, de-listings, changes in market capitalisations over the last 12 months and late publication of reports, it could not be identical. Replacements and additional reports were selected to ensure that overall the composition of our sample remains consistent with that of the market as a whole. The annual reports used are those for years ending on or after 30 September 2015 and published before 28 June 2016.

Although our survey data uses only companies from this sample, when selecting examples of good practice we have used material from the reports of companies that, in our view, best illustrate a particular requirement or innovation, regardless of whether they are in our sample or not.
Appendix 2

Enter the chapter
Appendix 2 – Glossary of terms and abbreviations

Act
Companies Act 2006

BIS
The Department for Business, Innovation and Skills

CEO
Chief Executive Officer

CGU
Cash generating unit

CODM
Chief Operating Decision Maker

Conduct Committee
A body established by the FRC with legal authority to ensure that the annual accounts of public and large private companies comply with the Act and applicable accounting standards.

CMA
Competition and Markets Authority
An independent public body which helps to ensure healthy competition between companies in the UK for the ultimate benefit of consumers and the economy.

CR Corporate responsibility
Corporate responsibility is about how businesses take account of their economic, social and environmental impact.

DTR
Disclosure Guidance and Transparency Rules
These rules of the FCA include requirements for periodic financial reporting to meet the requirements of the EU Transparency Directive.

EBITDA
Earnings before interest, tax and amortisation

EC
European Commission

EPS
Earnings per share

ESMA
European Securities and Markets Authority
An independent EU Authority that seeks to ensure the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection.

ESMA Guidelines
Guidelines on Alternative Performance Measures, a set of rules concerning the presentation of APMS, published by ESMA.

FTSE 100/250/350
Indices ranking listed companies by size, published by the FTSE Group.

FRC's Financial Reporting Lab
Facilitated by a steering group and FRC staff, the Lab provides an environment where investors and companies can come together to develop pragmatic solutions to reporting needs.

FRC
Financial Reporting Council
The UK’s independent regulator responsible for promoting confidence in corporate reporting and governance and issuing accounting standards.

FRC Guidance
Guidance on the Strategic Report, issued by the FRC, setting out recommendations on how to produce an effective strategic report.

GAAP
Generally accepted accounting practice

<IR>
International Integrated Reporting Framework
A framework produced by the IIRC to bring greater cohesion and efficiency to the reporting process, and help companies adopt ‘integrated thinking’ as a way of breaking down internal silos and reducing duplication.

IAS
International Accounting Standard
IASB
International Accounting Standards Board
The IASB is an independent body that issues International Financial Reporting Standards.

IFRS IC
International Financial Reporting Standards Interpretations Committee (formerly IFRIC)
IFRIC is the term given to describe Interpretations issued by the Committee which has been renamed the IFRS Interpretation Committee (IFRSIC). It develops interpretations of IFRSs and IASS, works on the annual improvements process and provides timely guidance on financial reporting issues not specifically addressed by the existing standards.

IFRS
International Financial Reporting Standard(s)

IIRC
International Integrated Reporting Council
A global coalition of regulators, investors, companies, standard setters, the accounting profession and NGOs, which maintains and updates the <IR> framework.

KPI
Key performance indicator
A factor by reference to which the development, performance or position of the company’s business can be measured effectively.

Listed company
A company, any class of whose securities is listed (i.e. admitted to the Official List of the UK Listing Authority).

Listing Rules
The Listing Rules made by the UK Listing Authority for the purposes of Part VI of the Financial Services and Markets Act 2000.

Market capitalisation
A measure of company size calculated as share price multiplied by the number of shares in issue at a certain point in time.

PPE
Property, plant and equipment

Quoted company
Section 385 of the Companies Act 2006 defines a quoted company as a company whose equity share capital:

a. has been included in the official list in accordance with the provisions of Part 6 of the Financial Services and Markets Act 2000; or

b. is officially listed in an EEA State; or

c. is admitted to dealing on either the New York Stock Exchange or the exchange known as Nasdaq.

Regulated market
Regulated market is defined in the Markets in Financial Instruments Directive. The European Commission website also includes a list of regulated markets at: http://ec.europa.eu/internal_market/securities/isd/index_en.htm

SEC
U.S. Securities and Exchange Commission
Regulator of all securities exchanges within the United States of America.

SOCIE
Statement of Changes in Equity

UK Corporate Governance Code
The UK Corporate Governance Code sets out standards of good practice on issues such as board composition and development, remuneration, accountability and audit, and relations with shareholders.

UKLA
UK Listing Authority
The FCA acting in its capacity as the Competent Authority for the purposes of Part VI of the Financial Services and Markets Act 2000.
Contacts

If you would like further, more detailed information or advice on specific application of the principles set out in this publication, or would like to meet with us to discuss your reporting issues, please contact your local Deloitte partner or:

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Resources

Enter the chapter
Resources

UK Accounting Plus
For the latest news and resources on UK accounting, reporting and corporate governance, go to www.ukaccountingplus.co.uk. UK Accounting Plus is the UK-focused version of Deloitte’s hugely successful and long-established global accounting news and comment service, IAS Plus.

GAAP 2017 Model annual report and financial statements for UK listed groups (due out around the end of 2016)
This Deloitte publication illustrates the disclosures in force for December 2016 year ends, including material encompassing all of the revised reporting requirements discussed herein. If you would like to obtain a copy of this publication please speak to your Deloitte contact.