



Annual reporting in 2016/17:

broad perspective,
clear focus

September 2017 | Fourth edition

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Welcome

to our fourth review of annual reports and accounts (ARAs) in the FTSE 350.

In our review last year, *Evolving communication in a changing world*, we concluded that the year to come was likely to include few reporting changes, providing a window of opportunity for reporting to evolve to suit the needs and expectations of a changing economic and business world.

While this has remained true to an extent, the uncertain environment following the Brexit referendum and the ensuing Government focus on corporate governance reignited a discussion of many reporting-related questions and proposals.

The Government published its long awaited response to reform the UK's corporate governance framework on 29 August 2017. The reform proposals require the engagement of, and work by, several organisations but it is clear that reporting is a large part of the Government's solution set. Change will come via revisions to the UK Corporate Governance Code as well as some secondary legislation to amend reporting requirements.

Companies are increasingly being challenged on their role and broader contribution to society. The annual report is an opportunity to articulate this clearly and engender support from a range of stakeholders. With this in mind, our report this year looks into the latest key areas of focus in corporate governance and how these are being reflected in annual reporting.

We have focused on the following areas:

- ▶ Purpose, business model and risks
- ▶ Wider stakeholder engagement, sustainability and culture
- ▶ Governance reporting
- ▶ Future trends in reporting, including views on preliminary announcements and analyst presentations
- ▶ Recent and upcoming reporting requirements

We spoke to the Financial Reporting Lab, ICSA: The Governance Institute, the Investment Association, HSBC Holdings plc and the Head of Equities at USS to hear their views on issues such as viability statements, digital reporting, stakeholder engagement, concise reporting and more. Once again, we have included case studies, an updated 'acid test' and an interactive aide mémoire (available on our **website**) as practical tools for preparers aiming to enhance their 2017/18 reporting. For those looking for a quick read, our introductory Q&A and executive summary will be helpful.

Our key findings show that the quality of annual reporting in the FTSE 350 remains high and some boards and preparers are moving towards ensuring that their annual reports are responsive to the new and changing expectations of investors, stakeholders and the public. However, there is still work to do in ensuring that a company's broader engagement with its stakeholders, and its reporting, is focused and specific to its strategy and operations.

We look forward to hearing your feedback and views.

Ken Williamson

Head of Corporate Governance
EY UK & Ireland
ey.com/corporategovernance

Introduction

Q&A

with Ken Williamson and Mala Shah-Coulon
of EY's Corporate Governance team



Ken Williamson



Mala Shah-Coulon

Q *What are your views about the increased demands being placed on annual report preparers in recent years and do you think reporting in the FTSE 350 is moving in the right direction?*

Mala: Considering the annual report alone, there has been a brief period of stability in the disclosures in the front half. This should have given companies time to refine and evolve their narrative reports. The standard of reporting across the FTSE 350 remains high. Companies are doing relatively well to keep up with new issues of interest to shareholders and stakeholders, such as culture, purpose and sustainability. However, there is still work to be done in these and other areas – for example, viability statement reporting, stakeholder engagement and, in some cases, governance reporting – to ensure disclosures are sufficiently specific to the company and focused on actions and outcomes, rather than just processes.

Most of the recent changes that companies have had to deal with in the last two years require reporting outside the ARA (on corporate websites or external portals) – the gender pay gap, Modern Slavery Act,

Payment Practices, etc. Boards and preparers must make sure that all these additive disclosures (whether in the ARA or outside) are viewed cohesively, as many are linked indirectly. Reporting can sometimes be seen as an easy answer to complex issues. However, the key point is that underlying behaviours and processes have (in most cases) to be reviewed or changed too for the reporting change to really tackle the heart of the issue. There have been successes: for example, from companies we have spoken with, the disclosures required by the Modern Slavery Act led to companies looking at their supply chains more closely to understand the risks.

Q *What do you see as the key areas of focus preparers should keep in mind for next year?*

Ken: We have long felt that business model disclosures are very important and we continue to challenge preparers to effectively explain their value chain and competitive advantage, focusing on how their key tangible and intangible assets create value for a variety of stakeholders. This is especially important given the emerging dialogue between the public and the business community

about the importance of articulating a broader purpose that encapsulates value creation beyond just financial value. Also, given the uncertainty in the business environment as well as the pace of disruption, it is important for companies to think about and articulate how their business models are capable of coping with new risks or indeed the opportunities presented by disruptive forces.

Risk reporting is certainly moving in the right direction but viability statements seem to have stagnated, and in some cases, moved backwards. In the sample of 100 reports we reviewed, average reported time horizons have reduced since the first published statements, and the specificity and quantification of scenario analysis and assumptions disclosure have not improved significantly. We would like to see more engagement with the investment community to ensure that these statements remain fit for purpose; otherwise the viability statement will just become a bland, boilerplate disclosure similar to the going concern disclosure it was designed to enhance.

For the first time this year, we also compared (for a smaller sample) preliminary results announcements and analyst presentations to the annual report. In the same way that

it's important to ensure various sections of an annual report are connected and overseen as a whole, we feel there's scope for ensuring more consistent messaging between these various communication channels.

Finally, with the focus on Section 172 of the Companies Act 2006, which addresses directors' responsibilities for having regard to the company's wider stakeholders, preparers should bear in mind how consideration of this duty can be best disclosed. Many companies will already be actively engaging with their stakeholders but may not be giving themselves enough credit through their disclosures. The disclosures shouldn't just detail the activity or engagement channel; more importantly, they should also explain the issues discussed, the feedback received from stakeholders, and where relevant and material, how this has been taken into account into the board's decision-making process.

Q *In the last year, what impact do you think the business environment and Brexit have had on annual reporting?*

Mala: Public sentiment is increasingly concerned with non-financial issues and impacts. This has resulted in a

raft of new non-financial reporting regulations or proposals from various bodies. It is challenging for preparers to keep up with these while also ensuring that overall their corporate reporting (across the annual report and other media) still tells a coherent story and discloses matters in sufficiently specific detail but without too much repetition. It is important for reporting to be clearly framed by the business model and strategy and also to explain how issues are overseen from a governance perspective.

The discussion of Brexit in general features in many more reports this year (last year's ARAs were published before the referendum result), although only a small minority include it as a principal risk. Understandably, it is difficult to provide disclosures on issues that are shrouded in so much continuing uncertainty. However, given the scale of the issue, if companies perhaps broke it down and examined impact (as well as reporting implications) on discrete aspects (for example, business model, strategy, prospects, risk and viability), they may be more able to provide assurance on how they are monitoring developments and considering the potential impact of various scenarios.

We have summarised the key reporting considerations in relation to Brexit for boards and audit committees in Section 1: *Purpose, business model and risks*.

Q *Looking to the bigger picture and longer term, what changes to annual report formats do you think we might see in the future?*

Ken: From what we've gathered from our conversations with investors and regulators, the move to a completely digital annual report is not quite imminent, in part due to the legal requirement for a hard copy annual report to be submitted to Companies House, as well as user demand. So PDFs remain the main format but we are likely to see more website-based summaries and highlights. It will be interesting to see whether these incremental digital changes are able to better support a company's engagement with its stakeholders. In addition, if the European Single Electronic Format is adopted in the UK – which is uncertain given Brexit – it will represent some degree of change for companies. We discuss this and other potential developments in Section 4: *Future trends in reporting*.

Our 'acid test': a practical aid

As a practical tool for preparers and boards looking to ensure their annual report covers key qualitative aspects of leading practice, we include our 'acid test'. These are the key questions we believe a reader should be able to answer after having read the narrative report. We update these each year in line with changing expectations.

Purpose and strategy:

- ▶ What is the company's purpose and does it clearly inform its strategy?
- ▶ What are the company's strategic objectives? Are they clear and measurable?

Business model:

- ▶ How does the company make money?
- ▶ What are the company's key inputs, processes and outputs (for shareholders and stakeholders)?
- ▶ How are the company's key tangible and intangible assets (including its physical assets, IP, people, culture, technology, etc.) engaged in the value chain?
- ▶ How is capital allocated across short and long-term priorities, for example, R&D activities, shareholder payments, tax, pensions, employee salaries and bonuses?
- ▶ What is the company's competitive advantage and how is it sustained over time?
- ▶ How does the business model help deliver the strategy?

Key performance indicators (KPIs):

- ▶ What are the key metrics the board uses to measure progress against its strategic objectives? Are these focused on activities or rather on outcomes in order to better measure performance against strategy?
- ▶ How has the company performed against these metrics over time and how has this influenced the remuneration of key executives?
- ▶ Are alternative performance measures (APMs) clearly signposted, reconciled to statutory measures and their use balanced with statutory measures?

Risk appetite and principal risks:

- ▶ What are the levels of risk that the board is willing to take in pursuit of its strategy and how is this monitored by the board?
- ▶ What are the key risks to the successful delivery of the strategy and operation of the business model?

- ▶ What are the risks that pose the greatest threat to the viability of the company (i.e., solvency and liquidity risks)?
- ▶ How, specifically, might these risks manifest themselves in the company?

Risk management and internal control disclosures:

- ▶ How are the principal risks mitigated and controlled by the company's systems of internal controls and risk management and how does the board monitor these controls?
- ▶ What did the board's review of the effectiveness of these systems and controls encompass and what were the findings?
- ▶ Has the board identified significant failings or weaknesses?
- ▶ What was the basis for determining what is 'significant'?
- ▶ Is it clear what actions have been or will be taken to address significant failings or weaknesses?

Viability statement:

- ▶ Over what timeframe has the board considered the viability of the company and why?
- ▶ What process did the board use to assess viability?
- ▶ Does the board understand which, if any, severe but plausible risks (or combination of risks) would threaten the viability of the company and has appropriate disclosure been provided?
- ▶ What assurance did the board obtain over relevant elements (e.g., stress testing)?
- ▶ What assumptions did the board use in reaching its conclusion?

Governance:

- ▶ What did the board and its committees actually do in the year to govern the company – what specific governance issues arose and how were they addressed?

- ▶ What, if any, changes were made to governance arrangements during the year and why?
- ▶ What areas for improvement were identified from the board and committee evaluations and what progress was made against actions from the previous evaluations?
- ▶ How is board and committee composition and succession planning being managed, giving due regard to the evolving strategy of the group, skills, experience and diversity?
- ▶ Are the key stakeholders of the company clearly identified and how did the board seek to understand the views of both shareholders and stakeholders during the year (with reference to feedback and actions)?



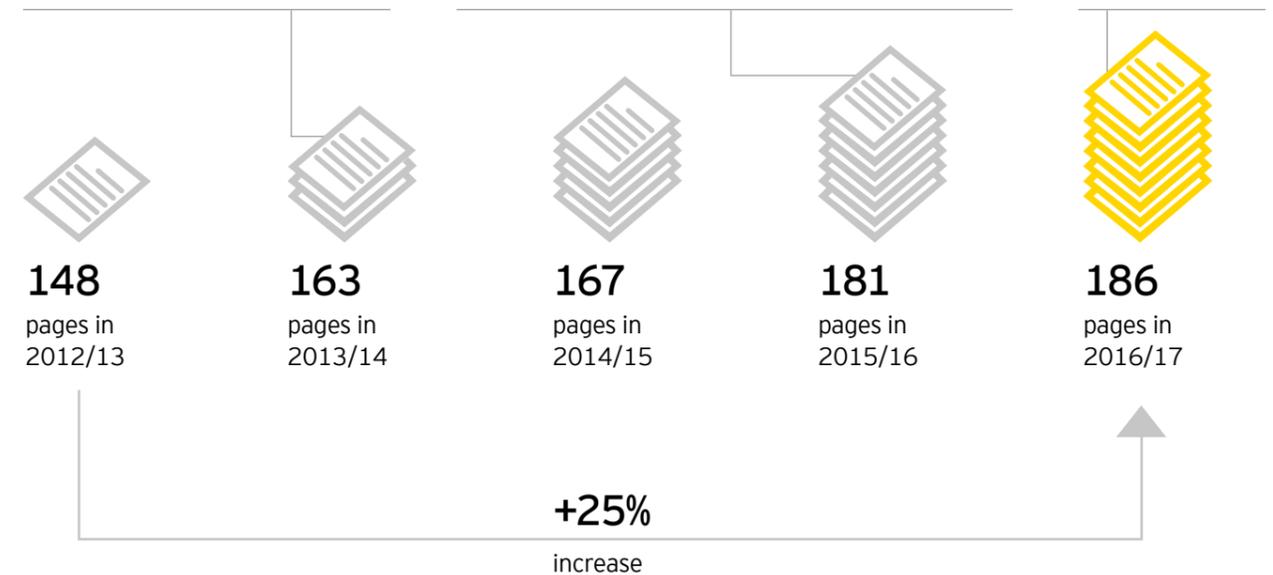
Executive summary

Annual reports have continued to steadily increase in length. Looking ahead, the implementation of the EU Non-Financial Reporting Directive into UK law, as well as proposals by the Government for companies of a significant size to explain how their directors comply with s172 of the Companies Act to have regard to the interests of stakeholders, will result in more disclosure. The challenge for preparers to keep reports clear and concise remains.

Average length of ARAs

(introduction of new Strategic Report and Directors' Remuneration Report regulations)

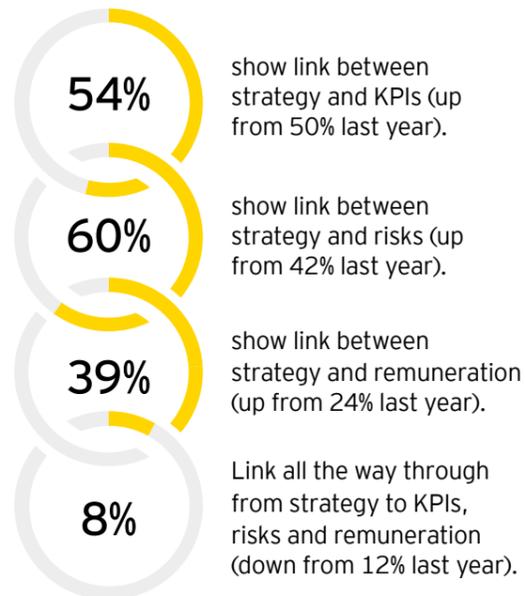
(new requirement to disclose a full list of subsidiaries in the notes to the financial statements under s409 of the Companies Act 2006)¹



¹ Concession that was available under s410 Companies Act 2006 whereby companies could list only their 'principal' subsidiaries and other significant holdings in their annual report and file a complete list with their annual return was removed. For periods commencing on or after 1 January 2016 the address of the registered office of each subsidiary or significant holding was also required to be disclosed.

Linkages

Links between strategy, KPIs, risks and remuneration are increasingly prevalent but consideration of the linkage across the whole piece can still be improved in the majority of reports.



Viability statements risk becoming increasingly bland and boilerplate. More companies chose a three-year period and the majority still lack useful disclosure of scenarios tested, including quantification and assumptions.

Time period chosen for the viability statement:



Purpose, business model and risks

Companies are increasingly expected to articulate a broad purpose, which drives strategy and encapsulates value creation beyond just financial value. While 41% articulate a broad purpose, it is also important to link this to the strategic objectives to ensure the purpose is 'lived'.

There is still scope for business models to explain better how the company makes money and its competitive advantage. More companies are using the 'inputs,

processes and outputs' format to present their business models and articulating, at a high level, the value they create for different stakeholders.

The quality of risk disclosures has improved in a number of respects, but there is still a tendency for rather generic descriptions of principal risks and their potential effects on the business. More companies made risk disclosures relating to disruption, cyber-security and Brexit.



41% of reports communicate a broad purpose, but only about half of these companies clearly linked this to their strategic objectives

Wider stakeholder engagement, sustainability and culture



81% of companies explain who their wider stakeholders are

The Government's response to its consultation on corporate governance reform further emphasises the responsibility that companies have for wider stakeholder engagement. Our review found that many companies explain who their stakeholders are and in some cases how the company engaged with them but very few disclose topics discussed or issues raised and the company's response. Stakeholder engagement is also rarely discussed in the governance report.

Corporate culture has been a key area of focus for regulators and other stakeholders, and while discussion of culture features in more reports, the information could better include insight into how the board monitors and gets assurance on culture.



31% of reports disclose information around potential disruption risks to the business



43% of reports include cyber-security as a principal risk (up from 31% last year)



93% of reports disclose some form of information around Brexit and the impact on their business (up from 25% last year)



14% of companies do not have any non-financial KPIs (unchanged since prior year)

The majority of sustainability reporting is still done in a separate section rather than integrated throughout the report. Performance metrics used in the sustainability section only overlap with the main KPIs in 18% of reports. We suggest that a better approach is to integrate the sustainability content with the strategy and therefore have one set of broad KPIs.



Governance reporting

Governance reporting should be focused on decisions, actions and outcomes, rather than roles and processes alone. Preparers should consider structuring their governance reports differently – for example, by not limiting themselves to the structure used in the UK Corporate Governance Code ('the Code') and also moving standing information to appendices or the website (regulations permitting) to avoid repetition and help articulate the governance story better.

Compliance with the Code is slightly lower than previous years. However, less than 5% report non-compliance with more than two provisions. We concur with the FRC's view that there is room for improvement in the quality of explanations for non-compliance.

We continue to see improvement in board evaluation disclosures.

Information on shareholder engagement lacks insight into topics discussed and any actions taken as a result of engagement.

As a result of the EU Audit Reform, there are a number of changes impacting audit committees including new recommended disclosures. Although not yet applicable to the sample in our review, a number of audit committees have complied and provided disclosures ahead of time, in areas such as composition, performance and effectiveness.

Remuneration committee reports faced particular scrutiny as many policies were up for binding vote this year. This meant that many companies published their policies in full, contributing to an increase in average length. Some companies voluntarily published CEO-to-average employee pay ratios.

Future trends in reporting

Investors and others obtain information about companies from a variety of sources. However, annual reports remain the primary source of holistic information about a company, particularly for investors making an initial investment decision. There is scope for improvement in the consistency and balance of messaging across preliminary results announcements, analyst presentations and the ARA.

The move to a fully digital annual report is not quite imminent. The majority of companies (69%) still produce their ARA in simple PDF format only. Digital enhancements shouldn't just be an end in themselves, for example, to improve the look and feel of content. The focus should be on enabling

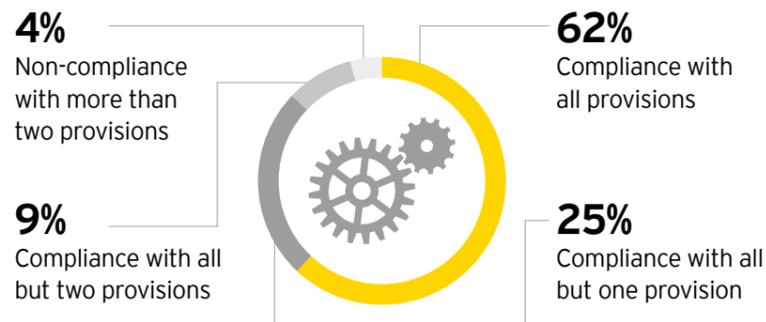
higher quality engagement with shareholders and stakeholders.

In line with calls for reporting to be more holistic and consider the needs of a wide set of stakeholders, EY has proposed a proof of concept framework – The Long Term Value (LTV) Framework – to understand, measure and communicate the broader value companies create through their investments in their purpose, brand, intellectual property, products and employees, environment and communities. This framework is being tested via The Embankment Project – a pilot involving 20 global companies from across the investment chain – asset creators (companies), asset managers and asset owners.



69%
of companies still produce their ARAs in simple PDF format only

Compliance with the UK Corporate Governance Code



Recent and upcoming reporting requirements

Improvement is needed on clearly identifying or labelling Alternative Performance Measures (APMs) used, the clarity of explanations provided on why each APM has been used, the balance of emphasis between APMs and IFRS figures, the ease of finding reconciliations and the basis/rationale for deductions and add-backs made from statutory results.

Although it is not mandatory to include the Modern Slavery Act statement in the ARA, some companies have included a summary of the steps taken to prevent or tackle modern slavery issues and a reference to the website disclosure.

If they haven't already done so, companies should also be aware of and start preparing for the following new disclosures:

- ▶ Additional disclosures in the audit committee's report primarily arising from the EU Audit Reforms (periods commencing on or after 17 June 2016).
- ▶ Increased disclosure in the Strategic Report arising from the EU Non-Financial Reporting Directive.
- ▶ Gender pay gap disclosure (from April 2017, website only).

Further detail on all the points raised in this executive summary can be found in the full report.

Purpose, business model and risks

Articulating a broad purpose

Business today faces new demands and challenges. Businesses are being asked more than ever to articulate not only how they 'do no harm', but also how they make a positive contribution to society through their activities. A recent study by EY's Beacon Institute found that 66% of almost 1,500 global business leaders surveyed are fundamentally rethinking their purpose as a result of the current disruptive environment.²

The Big Innovation Centre defines a purposeful company as one that is 'inspired by a clear role in the world that offers a reason for being'.³ They identify six categories in which selected companies have organised their purpose: Innovation, Excellence, Universalisation, Fresh Challenge, Global Responsibility, and Human Values. Our review of

annual reports this year found that 41% articulate a broad purpose in one of these categories. This mirrors the EY Beacon Institute survey, in which 40% of business leaders said their business had a 'capital P' purpose, which EY defines as one that 'creates value for a broad set of stakeholders, including society and the environment'.

It is important, however, that statements of purpose are not just statements alone. Companies should explain how 'purpose informs its existence, determines its goals, values, and strategy, and is embedded in its culture and practice'.³ We found that only about half of the companies articulating a broad purpose actually link it in some way to their strategic objectives.

The concept of business purpose has been a hot topic for discussion this year, and this is set to continue, particularly with potential updates to the FRC's Strategic Report Guidance to include recommendations on articulation of purpose. If more companies articulate their purpose next year, it will be interesting to see whether this results in any practical business change.



41%

of reports communicate a broad purpose, but only about half of these companies clearly link this to their strategic objectives

Case studies

The Crown Estate 2016/17 ARA

(pages 2 and 3)

- Defines purpose: 'to create brilliant places through conscious commercialism'
- Links to business model and strategy

Pearson plc 2016 ARA

(pages 1, 15-19)

- Defines purpose: 'to help people make progress in their lives through learning'
- Links to strategic goals are clearly explained

AstraZeneca plc 2016 ARA

(page 8)

- Defines purpose: 'we push the boundaries of science to deliver life-changing medicines'
- Purpose articulated prominently at centre of business model

² EY Beacon Institute, *How can purpose reveal a path through disruption?*, 2017.

³ The Big Innovation Centre, *The Purposeful Company – Policy Report*, February 2017, pg9.

Business model reporting

The number of business models that clearly articulated how the company makes money stayed stable at 59%. This year, as an additional completeness test, we compared the business model disclosures in the Strategic Report with the revenue note in the financial statements. For example, this note might include how revenue from 'after sales services' is accounted for, so we looked at the business model disclosures to see whether this activity/revenue

stream was clearly noted. Using this additional lens for analysis, we found that only 39% of companies clearly explain how they make money and in a way that seems complete and aligned with the revenue recognition note. So there is still progress to be made.

Although only one report in our sample was an official integrated report (and last year there were also just a few), the number of business models using the 'inputs, processes and outputs' format has increased. This potentially shows the growing influence of the Integrated Reporting

<IR> Framework. For example, although not an official integrated report, **Marshalls plc** clearly outlines its inputs, how it operates, and its outputs for various stakeholders with links to strategy and risks, as well as key strengths and values, as shown in Figure 1.

As well as how the company makes money, the other key feature that investors look for is an explanation of a company's competitive advantage. We have been highlighting this message for a few years now and this year there has been a slight increase in the number of companies

How we do business

Marshalls is the UK's leading hard landscaping manufacturer supplying superior natural stone and innovative concrete products to the construction, home improvement and landscape markets since the 1890s.

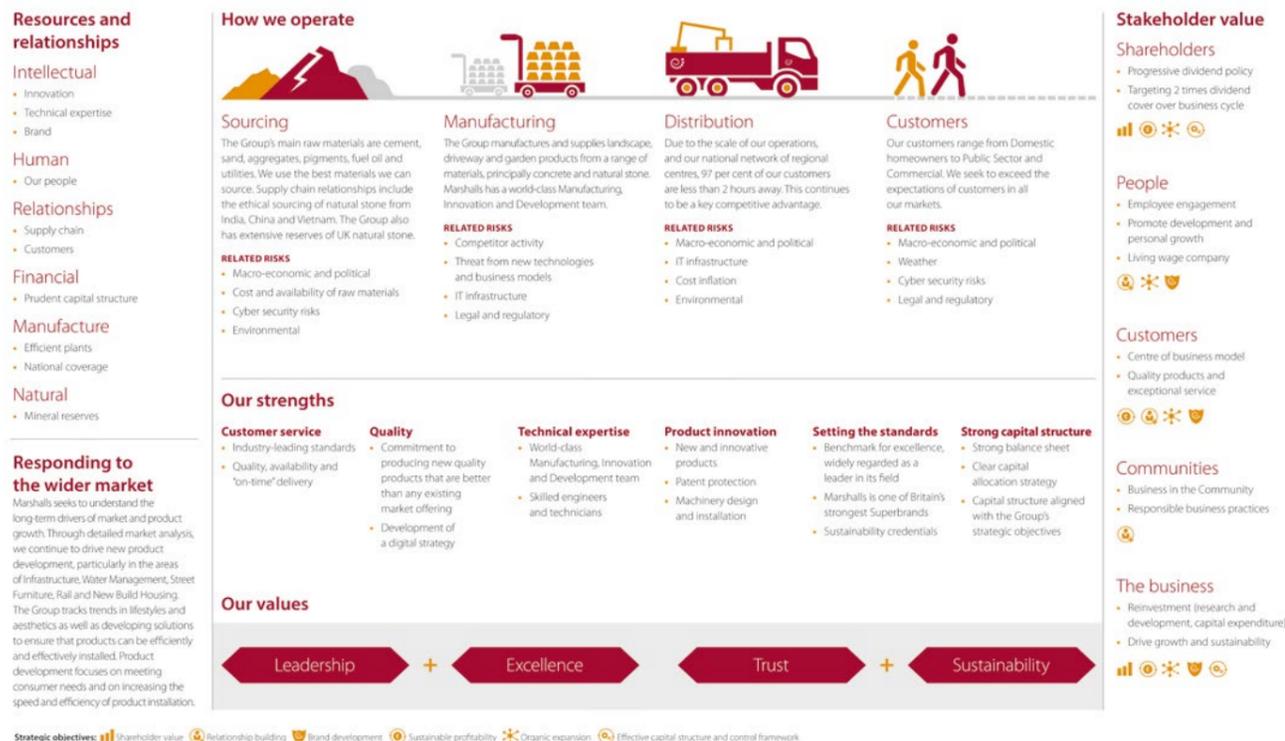


Figure 1. Marshalls plc 2016 ARA (pages 6 and 7)



schemes, and spend related to employees (including salaries and bonuses, skills and training). 33% of reports include some indication of their capital allocation framework, however only very few give a comprehensive coverage of most of these areas and none cover all of them. Also, most disclosures are focused on the past year rather than a long-term view of the capital allocation strategy. **Tullow Oil plc**, in its 2015 ARA, provides an example of disclosure on financial value allocation over a long time horizon, and they also link this to non-financial value created for stakeholders (as shown in Figure 2, overleaf).

While not a requirement, capital allocation disclosure is an emerging area where investors are calling for better information. In May 2017, the Investment Association (IA) issued its *Long Term Reporting Guidance*⁴, which addresses capital management and allocation disclosures, among other things. While voluntary, its implementation will be monitored by the IA's Institutional Voting Information Service through its analysis of ARAs of years ending on or after 30 September 2017.

To make sure that this capital allocation is paying the right 'dividends' there are calls for companies to move to outcome based metrics (as opposed to activity based). That is, how has investment in these areas led to long-term performance against strategy? What outcomes has the investment created and how are these being measured? For example, where a company has invested capital in employee engagement, how do employee engagement scores translate into employee retention? Equally, where capital is invested into customer satisfaction, how

that clearly explain their competitive advantage (up to 48% from 42% last year). Some companies in our sample operate in highly specialised areas, which in itself makes them different. For these, we suggest trying to explain why other companies don't do or can't do what the company does.

There is also the issue of companies being able to maintain or enhance their competitive advantage, which has become more pressing in the disruptive and uncertain times we live in. Brexit could have a direct, material impact on some business models, particularly in certain sectors such as the airline, food and hospitality, automotive, manufacturing and financial services. Boards need to

consider whether specific negotiating issues such as access to the customs union (e.g., changing the costs of imports) or access to the EU labour market may impact their business model and consequently whether any disclosures on this are warranted.

Capital allocation

For the first time this year we looked at how companies articulate their overall capital allocation across different long and short-term priorities. These could include, for example, research and development, capital distributions including dividends, share buybacks, debt repayments and servicing, tax payments, payments to pension

Case Study

HSBC reduced the length of its ARA from 502 pages in 2015 to 286 pages in 2016. With preparers continuously tasked with making their ARAs clear and concise, we spoke to Peter Bowman in HSBC's Company Secretarial team to learn more about how HSBC managed this feat.



Peter Bowman
Assistant Company Secretary,
HSBC Holdings plc

Q Who drove the change and why?

The Group Finance Director, Iain Mackay initiated and personally drove the project from start to end. He had a very clear objective, based on feedback on HSBC's past reports, to produce a simpler, clearer and shorter report. HSBC is a complex business, operating in 67 jurisdictions, with two primary stock exchange listings, that is required to produce its ARA in both English and Chinese. It is essential therefore that we communicate our key messages as clearly as possible.

In addition, HSBC does not publish prelims – we publish a full ARA at the time of the results announcement, usually around the third week of February. If we started to release our results later in the year, our closed period (under the Market Abuse Regulation) would extend, thereby increasing the period in which we are unable to conduct any transactions relating to our shares or debt

instruments. A clear, concise and therefore shorter ARA helps us to continue to meet these timeframes.

Q What was the process to cut out c.200 pages and how was it managed?

Each of the departments that contributes to the ARA was given a hard target of a 20% page count reduction. They had to present to our Disclosure Forum, chaired by Iain Mackay, on how they were going to achieve this target and if not, justify why.

Although process was driven by the aim of producing a more usable and accessible document for our stakeholders, we still had to ensure that we had robust processes in place to ensure compliance with our disclosure obligations. We went through every sentence and note to understand what drove it. This way we made sure we did not remove any disclosures required by regulation

or law. We did have to make calls along the way, with some disclosures regarded as standard practice in the market being removed, cross referenced or streamlined, where we thought that they did not improve the quality of the report. The key was to highlight what was material to our stakeholders, whilst bringing out the story of a complex Group in simple terms.

This process made us review the content very closely, avoiding the normal traps of layering on additional/new content, without taking a holistic look at the existing disclosures, which can lead to duplicative content being rendered less relevant over time.

The Group Audit Committee were involved in the process from the inception of the project. It had a role to ensure that the ARA remained relevant and useful as well as complying with all applicable requirements.

Q What are the key areas of change?

There were some easy wins – e.g., a number of risk and capital disclosures were moved into the Pillar 3 report, which is made available on the website at the same time as the ARA. In the past we had a detailed index, which we decided to put online. Our remuneration policy was not up for vote this year so we decided to include it just on the website with a clear cross reference.

The bulk of the changes were harder. We reduced the board committee reports by eight pages, part of which involved losing the introductory letters from the respective committee chairs. It was a tough call, but we found that the information was often duplicative with other areas of the document. We integrated the key messages into the body of the committee reports and used cross references to direct the reader to the other relevant content elsewhere.

We also had a good editor who really challenged and tightened wording, working across the whole document to achieve a consistent style and reduce duplication.

Q What feedback have you had and what are the plans for the 2017 ARA?

The feedback has been positive – as acknowledged by our shareholders at the AGM. It has also led to a cultural/mind-set shift internally. While it was a challenging task, there were rewards too, with awards given to those who made significant contributions and departments that met their target. More importantly the team has really gained from the disciplined approach we had to go through. We have already started planning the 2017 annual report and aim to build on the improvements we achieved in 2016.

Principal risks

Boards and management have to ensure their risk management processes and internal control systems are appropriately designed to respond to new challenges and risks. Overall we have seen an improvement in risk disclosures from last year. Most reports now include leading practice features, the most common being an indication of the change in individual risks since the prior year, or inclusion of a heat map displaying the likelihood and impact of each risk. Companies that provide some introductory narrative (e.g., above their principal risk table), on what changed and why, convey better assurance that their process for the year has robustly considered their risks in light of changes to the business and environment. For example, **Intu Properties plc's 2016**

ARA (page 37) discusses the change to the company's risk profile over the year, which in 2016 was affected by "increased uncertainty in the UK economy and real estate markets following the EU referendum vote", and outlines monitoring activity. It notes that there are no new risks, and uses a heat map to illustrate the change in the level of risk posed by each principal risk.

Significantly, 60% of companies in our sample clearly link their principal risks to strategic objectives (an increase from 42% last year). However, articulation and quantification of risk appetite could still be improved. **Debenhams plc's 2016 ARA** (page 21) is an encouraging example, showing a risk ranking and risk appetite matrix,

including a 'treatment timeframe' and risk acceptance owner.

The average number of principal risks disclosed is 11, in line with last year. However, only 50% of companies provide risk disclosures that are sufficiently specific to the company. The most commonly disclosed categories of risks (as shown in Figure 3) are consistent with previous years but, perhaps unsurprisingly given the various events of the year, cyber-security as a standalone principal risk is now included in 43% of reports (as compared to 31% in 2015/16 and 17% in 2014/15). The more common risks have more generic descriptions, particularly regulatory/legal/compliance, HR/talent/people/succession planning and cyber-security. Leading practice

disclosures include a description of the relevance of these more common risks to the company's specific business. For example, what are the specific risks, challenges and mitigations related to succession planning in *your* business? How do

changes in technology impact *your* business model? Which talent and people risks are most relevant given *your* workforce, business model and industry?

Disruption risks

Disruption has been defined as something that 'displaces an existing market, industry, or technology and produces something new and more efficient and worthwhile. It is at once destructive and creative'.⁶ This often comes in the form of a new business model that improves value and convenience for customers.

Only 31% of companies in our sample disclose information around potential disruption risks to the

business, usually included as part of the overall market trends section, but in some cases also as a principal risk. A few companies give leading practice disclosures by providing a description of how the company remains relevant despite their industries being disrupted, including those outlined in the case studies here. It's also important to discuss opportunities that the company will be seizing and how the business is innovating to keep up with change.



60%
of reports clearly link principal risks to strategic objectives

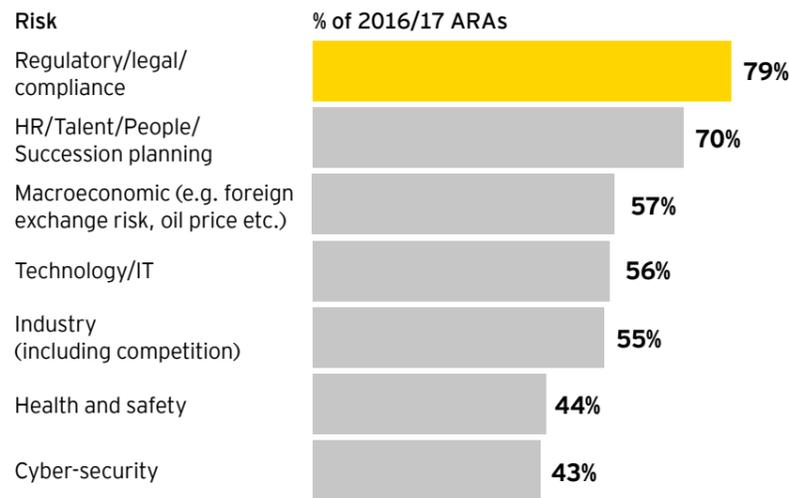


Figure 3. Most common principal risks disclosed



31%
of reports disclose information around potential disruption risks to the business



43%
of reports include cyber-security as a principal risk (up from 31% last year)

Case studies

Aviva plc 2016 ARA
(pages 6, 7, 13, 19, 24 and 30)

- Highlights the opportunities created for the company from disruption and how it will aim to use digital platforms to 'offer customers better, more personalised products and services'

Centrica plc 2016 ARA
(pages 10, 11 and 17)

- Considers the opportunities created from disruption, including as part of its competitive advantage
- Provides detailed information on how customer needs and expectations are evolving and investment in innovative customer offerings

Cineworld Group plc 2016 ARA
(pages 4, 23 and 24)

- Discusses how changing technology has provided other mediums for customers to access films (e.g., 3D television or online streaming) and the group's response during the year, which included installing improved technologies (e.g., IMAX) into its cinemas to improve the customer experience and reinforce its market-leading position

Cyber-security risks

Almost half of all UK businesses suffered a cyber-breach or attack in the 12 months to May 2017, with the frequency rising to nearly seven out of 10 in the case of large businesses.⁷ Cyber-security is a significant issue that costs larger companies millions of pounds and it is mentioned in some way by almost all companies in our sample this year, including 43% that list it as a standalone principal risk (an increase from 31% last year). This indicates that more companies are starting to fully appreciate the cyber-security threat to their business and how their systems would need to respond to any cyber-attacks.

Our review went deeper this year by looking at how companies disclose information around the resources and governance arrangements in place to address the cyber-security risk. Of those that include cyber-security as a principal risk, 82% provide some discussion of the resources they have

in place to mitigate the risk and 45% include some information around their governance arrangements to monitor the cyber-security risk. However, the majority of these disclosures are only high level, stating that either the board or audit committee reviewed the risk as part of their 2016 key activities. Only 15% give detailed insight into specific governance arrangements, including the outcomes and resulting actions from senior reviews. We recommend that companies disclose how the board has challenged management on cyber-security issues, what the key cyber-security risks are and how they are being mitigated.

As we have previously flagged, boards also need to be aware of and be preparing to comply with the new EU General Data Protection regulation (EU GDPR) coming into force in May 2018. It applies to all companies processing and holding

the personal data of data subjects residing in the European Union, regardless of the company's location. The EU GDPR will be woven into UK legislation via a new Data Protection Bill later this year, which will also update the 1998 UK Data Protection legislation.

Case studies

ITV plc 2016 ARA (page 72)

- ▶ Audit committee report discloses how the committee reviewed the cyber-security risks, along with the outcomes of its review

Paddy Power Betfair plc 2016 ARA (pages 57 and 83)

- ▶ Disclosure of cyber-security as a standalone principal risk, including the resources in place to mitigate the risk
- ▶ Case study included in the risk committee report to disclose the governance oversight processes of the cyber-security risk (see Figure 4)

TalkTalk Telecom Group plc 2017 ARA (page 20)

- ▶ Disclosure of cyber-security risk, including resources in place to mitigate (with reference to the cyber-attack in October 2016)

Brexit implications for risk reporting

The reports we reviewed last year were published before the June 2016 referendum on EU membership. Many companies did not include specific disclosures around the impact of potential referendum results and it was unclear whether this was because they didn't consider a potential EU exit to be a risk, or because they had not considered it carefully enough. This year, 93% of companies in our sample disclose some form of information around Brexit and the impact to their business – a significant rise from 25% last year. Most make a high level comment in the CEO statement, market review, or general risk narrative. However, 12% of companies list Brexit as a standalone risk, and 10% specifically state that

they do not believe Brexit will have a material impact on their business (an increase from 1% last year). Few companies provide insight into the mitigating actions being taken to address the risk from Brexit. This could be due to the uncertainty around the ongoing negotiations, but some insight into potential impacts on business model, strategy and viability based on different scenarios and the company's potential response would be leading practice.

EY's recent paper, *The impact of Brexit on corporate reporting*,⁸ explores considerations for preparers and audit committees analysing whether and where the impact of Brexit should be disclosed given the requirements in Companies Act

2006 and the Code. In respect of the Strategic Report specifically, the following considerations are relevant:



93%
of reports disclose some form of information around Brexit and the impact on their business (up from 25% last year)

Understanding and Managing our Principal Risks

Principal risk/uncertainty	Why we need to manage this	Impact / Likelihood	How we manage and mitigate the risk
Data management and cyber security	The inability to adequately protect customer and other key data and information could result in formal investigations and / or possible litigation resulting in prosecution and damage to our brands.	Impact: High Likelihood: High	The Group has made significant investment in IT security resources and works with a variety of external security specialists to ensure security arrangements and systems are up-to-date with emerging threats. The Group's Information and Security team continuously assesses the risks and controls around security and IT operations. We have in place a number of data protection policies in order to protect the privacy rights of individuals in accordance with the relevant data protection legislation, including working towards ensuring compliance with the new EU-wide General Data Protection Regulation which comes into force in 2018. The Group's Legal and Compliance teams ensure that the business adheres to industry best practice standards and relevant laws of data protection and privacy.

Risk Committee Report Accountability

Case study: Consideration of Technology-related risks, including cyber-risk
Cyber-threats are a feature of operating e-commerce businesses and the Board is acutely aware of the risk. Accordingly, the Board, the Risk Committee and the Audit Committee spent time during the year considering the risk and how we manage it. This included briefings from the Chief Technology Officer and the Director of Technology Security. Management of this risk includes:

- a team of over 50 in-house IT security professionals globally;
- a dedicated Cyber and Threat Management team;
- a 24/7 sweep of the network perimeter to look for weakness;
- regular security testing of all products and services;
- an in-house 'ethical hacking' team that tests our sites and products in the same way as hackers would;
- defensive measures, procedures and teams to protect from malicious distributed denial of service ("DDoS") attacks;
- processes in place to ensure security is built in to product development;
- sharing of proactive threat intelligence as part of industry reviews and discussions;
- a formal Technology Risk Management function to ensure that risks are being appropriately managed; and
- significant annual investment in people, process and technology to stay ahead of threats.

Figure 4. Paddy Power Betfair plc 2016 ARA (pages 57 and 83)

Requirements under Companies Act s414c – The Strategic Report must contain:

"A fair review of the company's business"
"The review required is a balanced and comprehensive analysis of the development and performance of the company's business during the financial year and its position at the end of the year."

"A description of the principal risks and uncertainties"

"Information on the main trends and factors likely to affect the future development, performance and position of the company's business (to the extent necessary for an understanding of the development, performance or position of the company's business)"

Consideration for boards and audit committees

Consider whether Brexit has had an impact on the current year's performance and development, and if so, disclose its impact in a balanced manner.

Consider whether the impact of Brexit represents a change to principal risks in itself or indirectly (e.g., as part of other risks such as foreign exchange). The Financial Reporting Council published reminders in July 2016⁹, drawing attention to:

- ▶ Directors should consider the nature and extent of risks and uncertainties from the result of the EU Referendum and the impact on the future performance and position of the business. Those which the board judge to be principal risks should be disclosed and explained.
- ▶ Company-specific disclosures are important in understanding how those risks and uncertainties are relevant, given the specific facts and circumstances of the company.
- ▶ Boards should be encouraged to provide an explanation of any steps that they are taking to mitigate those risks.

Where relevant, companies should include some forward-looking analysis and discussion on the likely impact Brexit has on the future performance and development. This could feature in a CEO's review or a 'market overview' section of the ARA.

15% of companies included commentary around Brexit in the CEO's statement, and 16% in the 'market overview' section.

Purpose, business model and risks

Directors should also consider whether Brexit has an impact on the viability statement (VS). For example, if a new or heightened principal risk has arisen as a result of Brexit that impacts the company's solvency or liquidity, this will need to be considered in scenario planning and stress testing. Equally, disclosures on assumptions underpinning the viability assessment may need to be reviewed and revised. For example, the viability assessment could be underpinned by an assumption made

by directors on the likely outcome of the Brexit process.

Four companies' ARAs in our sample this year include Brexit in the VS. For example:

- ▶ **Associated British Foods plc's 2016 ARA** (page 53) provides detail around how the Brexit risk was considered as part of the viability assessment, and the implications of the business model structure on the viability of the company.

- ▶ **easyJet plc's 2016 ARA** (page 22) highlights that its viability assessment included an assumption around the terms on which the UK will leave the EU, in line with the prior year assumption.

Viability statement

We find that many companies are still taking a prudent approach to the VS and there is an increasing risk of this disclosure becoming boilerplate and not delivering its intended purpose. Leading practice disclosures should tell a story to the reader around the key risks to the company's viability, how they have been assessed and modelled, and conclusions drawn, including the key assumptions these are based on.

five years, as highlighted in Figure 5. This indicates increased conservatism and may be a result of increased uncertainty following Brexit, although this does not come through in the time period explanations.

The majority of companies (76%) provide the rationale of the chosen time period as being in line with the strategic plan. If this is the case, leading practice disclosures would explain why that is the strategic plan period for the company. Also, we reiterate the recommendation by the Investment Association (IA) that there should be more variation in the time horizons chosen given the variation in business models, and the long-term nature of equity capital.¹⁰

Time period

The trend in terms of reported time horizon is toward shorter periods. 81% of companies chose a three-year time period, an increase from 74% in the prior year. The remaining companies chose a period of four or



Figure 5. Time periods chosen for viability statements

Case studies

ITV plc 2016 ARA (page 57)

- ▶ Clear rationale for the time period chosen with links to various aspects including changing technology in the industry and pension fund obligations

UDG Healthcare plc 2016 ARA (page 20)

- ▶ Explanation of scenarios tested when assessing viability, including quantification

Shaftesbury plc 2016 ARA (page 71)

- ▶ Explanation of assumptions made when assessing viability, including quantification

31% of reports in our sample show an apparent disconnect between the time period chosen in the VS and other parts of the ARA (e.g., the strategic timeline or investment cycle or lifecycle of key resources), but only 7% acknowledge and explain this disconnect.

For example, **Great Portland Estates plc's 2017 ARA** (page 67) explains why the company chose a three-year time period even though the full forecast financial statements cover five years. We encourage investors to question and challenge any such disconnects and use the VS as a hook for gathering insight.

Link to principal risks, stress testing and assumptions

Clear linkage between the VS and principal risks is still an area for significant improvement.

- ▶ 30% of companies in our sample include a list of the specific principal risks they considered in their VS, and 5% include the link in the principal risks section itself, usually through a key showing which principal risks are most relevant for viability.
- ▶ 49% of companies include a description of the scenarios tested (a small increase from 45% last year).
- ▶ Of these, 13% quantify these scenarios (an increase from 7% last year).
- ▶ 39% overall include a description of the assumptions

applied (an increase from 22% last year), but only 5% quantify these assumptions.

Among the IA's other key recommendations was a suggestion that statements should include disclosure of both viability and prospects and a link to dividend policy. We found that only 11% of companies include some information around the future prospects of the company beyond the viability assessment period and only 2% of companies link the VS to the dividend policy.

Going forward, to avoid the VS disclosure diminishing into boilerplate, we strongly encourage investors to engage more with boards around their VS so that these can be made as relevant and useful as possible.

Risk management and internal controls

Provision C.2.3 of the Code states 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." We found that while most ARAs include some general qualitative information on risk management systems, there

has been little improvement in the quality of disclosure on the board's review since last year. It is still the case that very few reports provide detailed insight into the board's specific role and outcomes/actions from the annual review.

65% of companies in our sample (32% last year) refer to the significant

failings or weaknesses in their risk management and internal controls systems. Of these, 52% positively confirm none were found. Very few companies detail the actions taken or to be taken to address these as recommended in the FRC's Guidance.¹¹ Figure 6 highlights the breakdown of the disclosures in detail.

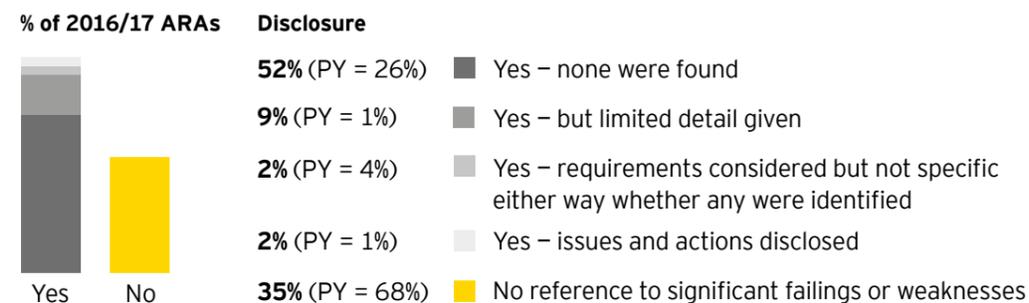


Figure 6. References to significant failings or weaknesses in the risk management and internal controls systems

Viewpoints



Phil Fitz-Gerald
Director,
The Financial Reporting Lab

Q *Have you seen an evolution in viability reporting given, for example, the Investment Association's Guidelines and the work done by the FRC to remind companies on what you expect to see?*

They do continue to evolve but there is still much to do. That is why we launched our project on risk and viability. Our project is still ongoing, and so these observations are preliminary, based on our discussions with companies, institutional investors and a survey of private investors.

We have been very encouraged to hear that the process that companies have been through in preparing the VS has resulted in a greater focus by boards on risk management. Investors have also recognised

this and noted improvements in risk disclosures and the quality of engagement with companies on risk.

However, the VS doesn't always reflect the quality of the process that has been undertaken and therefore companies perhaps aren't getting the credit they deserve for more robust consideration of their risk management. There is a little bit of confusion too around the differences between going concern disclosures and the VS, and sometimes the process to arrive at the latter can just be an extension of the process used to determine going concern, which was not the original intention of the introduction of the VS in the Code.

Broadly we found that there is sometimes a disconnect between companies and investors in terms of what they want the VS to do and

therefore at the moment they are not as useful as they could be.

Many investors have commented that the period chosen for the VS is not clearly explained. In the mining sector, for example, it is sometimes not clear why a three to five year period has been chosen when the cycle from exploration to production and beneficiation is much longer. Investors would like to see companies "bridge" this gap by providing appropriate explanations or reconsidering the viability period.

Overall, from a disclosure perspective, it seems that companies are in a "wait and see" space and maybe, as with many things, require more time to fully embed this relatively recent requirement.



Wider stakeholder engagement, sustainability and culture

Stakeholder engagement has been the subject of much discussion over the last year. In particular, there has been much debate about whether the voice of key stakeholders at board level needs to be strengthened.

The Government, in its recent response on corporate governance reform¹² (published in August 2017), made two proposals:

- ▶ To ask the FRC to consult on a Code provision for companies to adopt, on a 'comply or explain' basis, one of three employee engagement mechanisms (i.e., a designated non-executive director, a formal employee advisory council or a director from the workforce).
- ▶ To introduce secondary legislation to require all companies of significant size (yet to be defined but to include private as well as public companies) to explain how their directors comply with the requirements of Section 172 of the Companies Act to have regard to the company's wider stakeholders (and in particular employees) in promoting the long-term success of the company for the benefit of its members.

Our review this year found a couple of annual reports showing awareness of this evolving discussion by mentioning or alluding to their Section 172 duties, but most had not made any obvious related changes. In the meantime, we looked at existing stakeholder engagement disclosures and how reporting has improved in areas such as sustainability, culture and diversity. Given the upcoming updates to secondary legislation, the Code and the Guidance on Strategic Reporting¹³, there is likely to be even more to report in this area next year.

Wider stakeholder engagement

Companies are increasingly expected to engage with a wider group of stakeholders due to declining trust in business and a perceived need to rebuild social licence to operate. No companies in our sample had consumer or employee representatives at board level (although we are aware of instances outside our sample), but we did see evidence of the idea being considered and there are other ways to gather stakeholder input without board representation (e.g., through forums and surveys with relevant groups).

Most annual reports have a corporate responsibility section in which they include information on how the company creates value for stakeholders, for example, employees, suppliers and the community. However, only a minority also include how they interact and engage with these stakeholders and even where this is included, we feel this reporting could be more

specific – explaining what issues were discussed during interactions between the company and different stakeholders and how these were considered by the board as part of their strategic decision-making and governance.

We note that many reports include disclosures on employee engagement surveys, although these tend to be high level and there is little evidence of surveys of any other stakeholders. However, we suspect that many companies may already be doing work on stakeholder engagement that they are not currently giving themselves credit for. For example, we have spoken with boards who conduct site visits to meet employees informally or invite vocal customers in for lunch to gather feedback.

Leading practice reporting on stakeholder engagement also requires clarity about who the companies' key stakeholders are.

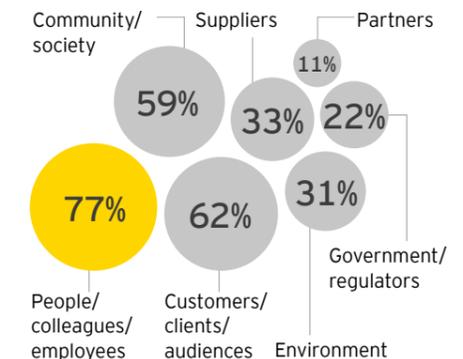


Figure 7. Breakdown of most common stakeholders mentioned

81% of companies we reviewed identify who their stakeholders are, beyond shareholders (see Figure 7 for the most common stakeholders identified). However, where not obvious from the business model, we suggest it is useful to explain why certain groups are considered the key stakeholders. Very few companies currently do this apart from a limited number that mention

¹² Department for Business, Energy & Industrial Strategy, *Corporate Governance Reform: The Government response to the green paper consultation*, August 2017.

¹³ FRC, *FRC consults on non-financial reporting guidance*, August 2017.

Wider stakeholder engagement, sustainability and culture

licence to operate, sustainability, culture and purpose. **Bodycote plc** is one company that clearly identifies its key stakeholders and why they are considered relevant (see Figure 8).

Leading practice companies would also be specific about these stakeholder groups. For example, if a company refers to the 'community', in what locations is the company engaged with the community? Or if a company refers to suppliers, what are the supplier industries that the company relies on most?

Interestingly, of the 41 companies that define their purpose well, 34 also define their stakeholders clearly. So it seems that having a clearly defined purpose may help with identifying stakeholders and establishing a clear rationale for their connection to the company.

Also, stakeholder engagement is mostly only discussed in the Strategic Report. In the governance report, disclosures are limited to the engagement with shareholders as required under the Code. However, given that engagement with both is a responsibility of the board, it may be worth considering broadening existing shareholder engagement disclosures to cover both in one place.

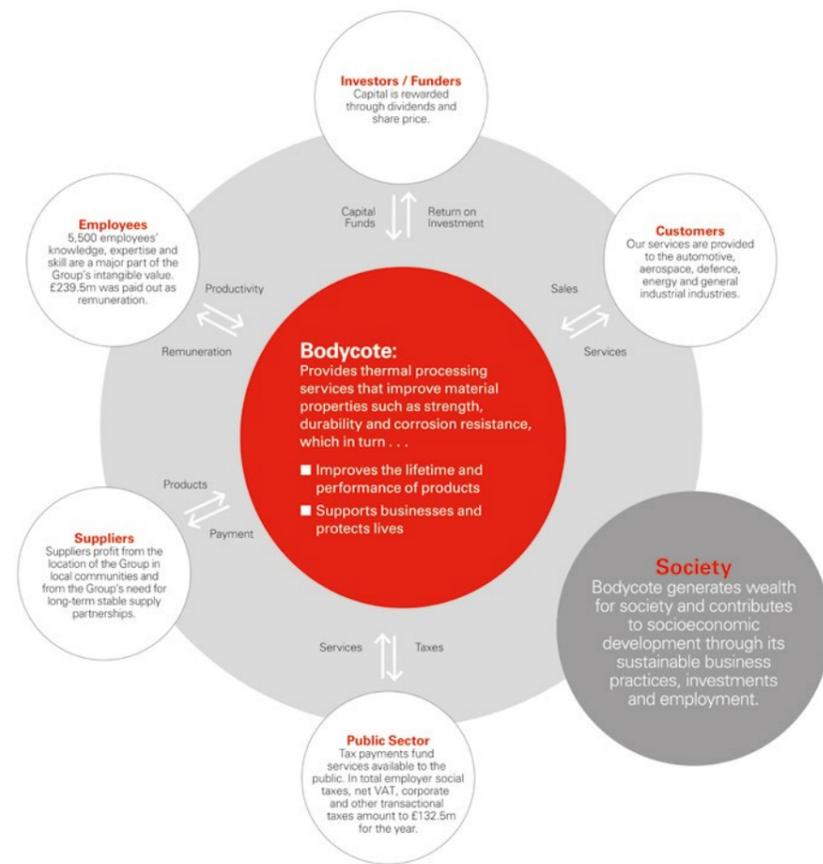


Figure 8. Bodycote plc 2016 ARA (page 29)

Case studies

Next plc 2017 ARA (page 36)

- Discloses a forum of employee representatives who attend meetings with directors and senior managers

Rolls-Royce Holdings plc 2016 ARA (page 58)

- Planning on holding an 'AGM for employees', with an independent NED taking the lead on strengthening boardroom-employee links

Royal Bank of Scotland Group plc 2016 ARA (page 86)

- Stakeholder engagement process by the Sustainable Banking committee is clearly disclosed



Viewpoints

ICSA and the IA announced a project in February 2017 to tackle concerns that the voices of key stakeholder groups such as employees, customers and suppliers are not being heard at the highest levels of British business. The project aims (with input from companies and others) to identify different approaches to stakeholder engagement and existing good practice, and to produce practical guidance to assist with boards' duties under Section 172 of the Companies Act 2006. The guidance is due to be published in late September, but we caught up with Peter and Andrew to get their thoughts. This initiative is one of the workstreams under the Government's corporate governance reform proposals announced on 29 August.



Andrew Ninian
Director, Stewardship and
Corporate Governance,
The Investment Association (IA)



Peter Swabey
Policy and Research Director,
ICSA: The Governance Institute

Q *What role do investors have to play in being agents for change and encouraging better stakeholder engagement? In some way are they conflicted i.e., as companies are run on a shareholder primacy model, is it in their interests that boards take into account wider stakeholders?*

Andrew: Speaking as long-term investors, we want long-term returns for our clients. For companies to do this, they need to manage their business for the long-term taking into account views of stakeholders and the risks and opportunities from ESG issues. A company is unlikely to have a licence to operate in the long term if it doesn't factor these into its decision-making process.

Q *Trust in business in the UK is at an all-time low. Do you think better stakeholder engagement (and reporting on it) will help?*

Andrew: Transparency and good reporting are important constituents of building trust. Companies and specifically boards need to demonstrate that they are hearing the views of their stakeholders and then taking them into account in their decision-making process. It may be a cultural shift, for many companies to be more open about both these aspects but it is important and companies and investors need to work jointly to re-build trust in business.

Peter: The other issue is that under Companies Act 2006, s172, directors have to "have regard to" the interests of the company's stakeholders (among a wide set of other matters). It's a difficult balance, because boards inevitably will make some tough decisions where maybe one constituent stakeholder group "loses out". This group could say "our interests weren't taken into account by the board..." Being more articulate about how views were taken into account and the outcome i.e., impact on strategic decision making, will allay some of this and over time help with some of the trust issues.

Q *It sounds like reporting is definitely part of the solution set. However, where should this information be reported – aren't ARAs already too long?*

Andrew: For investors, the ARA remains a key communication tool. I admit they don't read it cover to cover, and dip in and out of it but I do think reporting on stakeholder engagement belongs in the ARA, because it goes to the heart of board governance and decision making. Also this reporting is (or should be) tied with the reporting on strategy, because you should be able to articulate what stakeholder activities and metrics (e.g., on employees) are key for implementing your strategy successfully and then report what you have done about them.

Peter: However, companies should use their website and social media to complement their ARA. A two-way feedback loop using different channels is important as stakeholders can compare what feedback they gave, what was done with it, and then re-engage or follow up as appropriate.

Sustainability reporting

83% of reports in our sample have a standalone Sustainability/Corporate Responsibility section, of which 26% include specific sustainability metrics or measures of performance. However, these overlap with the main KPIs in only 18% of cases. In line with last year, 14% of companies still do not include any non-financial KPIs. We suggest that a better approach is to integrate the sustainability content into the strategy and therefore have one set of KPIs covering sustainability metrics as part of a broad set of non-financial KPIs. If the sustainability content is not material or relevant to the strategy (nor required by regulation, as with greenhouse gas (GHG) emissions), should it be included? Many companies hold meetings with stakeholders to discuss the materiality assessment and help decide what information should be included in sustainability reporting. Perhaps these same forums could

be used for engaging stakeholders on wider business issues as well, as discussed in the previous section.

Shareholder and stakeholder engagement on sustainability issues arising from climate change has increased – and not just for the more obvious industries such as oil and gas. Mark Carney, the governor of the Bank of England, made a landmark speech in 2015 highlighting the risks from climate change faced by insurers and investors and the implications they have for financial stability.¹⁴ We found that even financial institutions are being proactive on this issue. The Task Force on Climate-related Financial Disclosures (TCFD), part of the Financial Stability Board chaired by Mark Carney, recently produced new recommendations for disclosures in annual reporting.¹⁵ Although only recently finalised,

the draft recommendations were published in December 2016 and some companies seem to have already taken the recommendations on board. These disclosures are voluntary for now, however calls have already been made to make them a requirement for companies listed on major stock exchanges.

31% of our sample include information about risks and opportunities from climate change in line with some of the TCFD recommendations and 23% include a description of the governance

arrangements in place, including the board's oversight and management's role in assessing and managing these risks and opportunities. 18% include the impact of these risks and opportunities on the company's strategy and financial planning and very few include a description of the potential impact arising from different scenarios, giving associated metrics or targets. 24% disclose targets for future reductions in GHG emissions. A new collaboration between the Carbon Disclosure Project, World Resources Institute,

the World Wide Fund for Nature, the United Nations Global Compact and one of the We Mean Business Coalition commitments, is calling for more 'science based targets'. This means using a methodology that aligns emissions reduction targets with the global carbon budget that will keep global temperatures below two degrees Celsius. They suggest that target setting using this methodology is already becoming part of many companies' reporting practices.

Culture and diversity

With more focus on corporate culture in recent years, annual report disclosures on this issue have increased. However, there are still very few that explain how boards measure and obtain assurance on culture. In our view, if a company is going to talk about culture, it should cover what the culture is, why it is relevant to the strategy/business model, how it is measured/assessed, and if relevant, what is being done to embed or change the culture. EY's report, *Governing Culture: practical considerations for the board and its committees*, sets out some of the key questions that boards and each of the committees can ask to gain assurance on culture.¹⁶ These will help prompt constructive boardroom discussions on the issue and may provide a basis for meaningful annual report disclosures.

Diversity disclosures are still almost exclusively about gender (see Section 5 for information about gender pay gap disclosures). We would like to see more discussion of other aspects, including ethnicity and background, both at the board level and company-wide. The Parker Review on ethnic diversity on boards and its recommendations has been a helpful contribution to this discussion.¹⁷ Leading practice disclosures on diversity at a company-wide level would also include information about company initiatives to encourage diversity and also, importantly, promote inclusivity. These could include, for example, the impact of mentoring programmes, networks or flexible working schemes rather than just their existence. This would give readers a practical lens through which to see whether initiatives have had the intended effect.

Case studies

Anglo American plc 2016 ARA (page 27)

- Disclosure of climate-related risks and opportunities resulting from shareholder resolution in the prior year's AGM

Hammerson plc 2016 ARA (pages 10, 35 and 58)

- Disclosure of climate-related risks and opportunities, including energy security in the CEO and sustainability reviews, and consideration of climate change impacts as a principal risk



83%
of reports have a standalone Sustainability/Corporate Responsibility section rather than using an integrated approach



24%
of reports disclose targets for future reductions in GHG emissions

¹⁴ Mark Carney, *Speech: Breaking the tragedy of the horizon – climate change and financial stability*, September 2015.
¹⁵ Task Force on Climate-related Financial Disclosures (TCFD), *Final Report: Recommendations of the TCFD*, June 2017.

¹⁶ EY, *Governing culture: practical considerations for the board and its committees*, June 2016.
¹⁷ Sir John Parker, The Parker Review Committee, *A Report into the Ethnic Diversity of UK Boards*, November 2016.

Governance reporting

Structure of the governance report

We have previously stated that good governance reporting provides confidence to investors that the board is governing the company effectively and provides hooks for higher quality engagement.¹⁸ However, we have noticed that governance reports have become increasingly process-oriented. This year, 40% of governance reports include information that is sufficiently action-based, focusing on decisions and outcomes in the year rather than roles and compliance. Law and regulation permitting, we continue to endorse putting information that remains constant year-on-year or that explains governance processes in an appendix or towards the back of

the governance report and referring users to it. This would help to achieve focused and informative governance reports. Other suggestions include formatting the introduction from the chairman as a Q&A covering significant activities and changes during the year, providing information about allocation of agenda time, calendars of meetings and activities (as shown on Figure 9), or 'governance in action' case studies, such as first-person accounts from newly inducted directors on their first year on the board.

The majority of reports (59%) follow the structure of the Code in their governance reporting. Others deviate

only to some degree (22%), whereas 19% use their own distinct structure for their governance disclosures. We favour the latter approach as it makes the disclosures less repetitive than when companies follow the Code's headings and sections. For example, disclosures against Section C of the Code (on Accountability) are typically spread across the risk section of the Strategic Report, the audit (and risk) committee's report and the general governance report and often contain duplicate content. One leading practice disclosure we observed was to provide an index to where disclosures on the application of the Code principles could be found as shown in Figure 10.



Figure 9. Aviva plc 2016 ARA (page 83)

Principle	Code of Practice	Company Disclosures	Page
Leadership	Every company should be headed by an effective board which is collectively responsible for the long-term success of the company.	Board of Directors	51 to 52
	There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision.	Composition of the Board	87
	The chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role.	Roles on the Board	85
Effectiveness	The board should ensure a clear assessment of the company's business strategy and ensure that the board is responsible for determining the company's strategic intent and for monitoring its progress.	Roles on the Board, non-executive directors should develop proposals on strategy.	85
	The board should ensure a clear assessment of the company's business strategy and ensure that the board is responsible for determining the company's strategic intent and for monitoring its progress.	Roles on the Board	85
Accountability	The board should ensure a clear assessment of the company's business strategy and ensure that the board is responsible for determining the company's strategic intent and for monitoring its progress.	Roles on the Board	85
Remuneration	Executive director remuneration should be designed to encourage the long-term success of the company and to be transparent, simple and rigorously applied.	Remuneration report	99 to 123
Relations with shareholders	There should be a dialogue with shareholders based on the mutual understanding of objectives. The board is not held responsible for ensuring that a satisfactory dialogue with shareholders takes place.	Stakeholder engagement	89 to 90
	The board should use general meetings to communicate with investors and to encourage their participation.	Stakeholder engagement	89 to 90

Figure 10. Barclays plc 2016 ARA (page 50)

¹⁸ EY, *Annual reporting in 2014: reflections on the past, directions for the future*, September 2015, pg28.

Case studies

Barclays plc 2016 ARA (page 50)

- ▶ Index to disclosures on application of the UK Corporate Governance Code principles (see Figure 10)

Shaftesbury plc 2016 ARA (pages 82 and 83)

- ▶ Clear overview of application of the UK Corporate Governance Code principles, with some details and cross-references, using a good visual diagram

Aviva plc 2016 ARA (pages 81 and 83)

- ▶ Governance report includes action-based information and a calendar of meetings with topics discussed (see Figure 9)

National Express Group plc 2016 ARA (pages 63 and 68)

- ▶ Governance report includes action-based information and a case study of the induction process for a new board member

Code compliance

Compliance rates for this review relate to the 2014 Code, which has since been replaced by the 2016 Code (applicable for accounting periods beginning on or after June 2016), although the changes to provisions are relatively minor. 62% of companies report compliance with all provisions of the Code (aligning with the 62% quoted by the FRC for last year)¹⁹ and 87% state compliance with all or all but one provision (89% last year). Only 4% are non-compliant with more than two provisions (5% last year).

Most of the companies that did not comply with all provisions either moved to compliance over the course of the year, or committed to do so in the future. However, for just under half of the companies failing to comply with all provisions, non-compliance was a clear and deliberate choice for the long term,

most commonly on issues such as chairman independence and remuneration package design.

Three of the top four provisions that were not complied with relate to board or committee composition – B.1.2 (board), D.2.1 (remuneration committee) and C.3.1 (audit committee) – as shown in Figure 11. In 88% of instances, companies pledged to move to compliance with these composition-related provisions or did so during the year, suggesting either an unexpected departure or lack of succession planning. Where this occurs, companies should disclose how they mitigate risks that may arise during the non-compliance period. One of the few such examples we saw was a company whose interim audit committee chair received additional training and support, and interacted more closely with the external auditor when the audit

committee was temporarily left without recent and relevant financial experience due to unforeseen circumstances.

Our **aide mémoire** (available online) includes the hallmarks of leading practice explanations for non-compliance, which reflect those set out in the Code:

- ▶ Ensure explanations for non-compliance with the Code are specific as to which element of the Code has not been complied with.
- ▶ Illustrate how actual practice is consistent with the underlying spirit of the relevant Code Principle and contributes to good governance and the delivery of business objectives.
- ▶ Describe mitigating actions taken to address any additional

risks that may have arisen as a result of non-compliance.

- ▶ Be clear on when the company expects to be in compliance with the Code Provision (where non-compliance is intended to be time limited).

None of the explanations in our sample include every element. Only 32% of non-compliance explanations detail how actual practice contributes to good governance and the delivery of business objectives, and only the same figure illustrate how actual practice is consistent with the underlying spirit of the relevant Code Principle. Even fewer (26%) describe mitigating actions for any additional risks. Overall, our findings echo the FRC's view that there is room for improvement in the quality of explanations for non-compliance.²⁰



32%
of non-compliance explanations detail how actual practice contributes to good governance and the delivery of business objectives

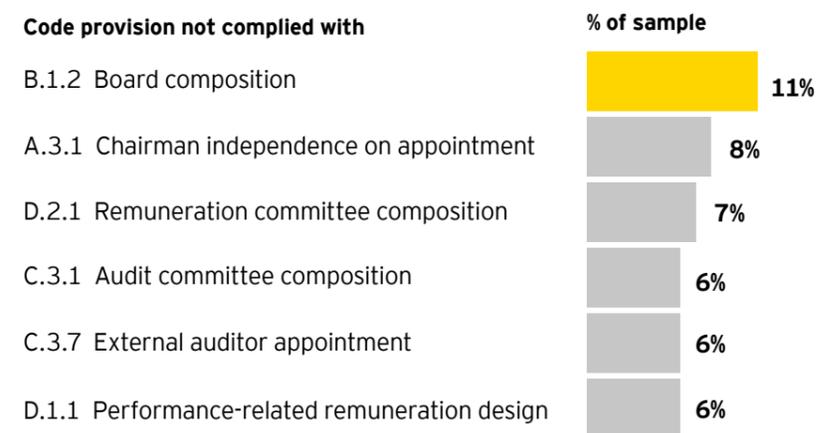
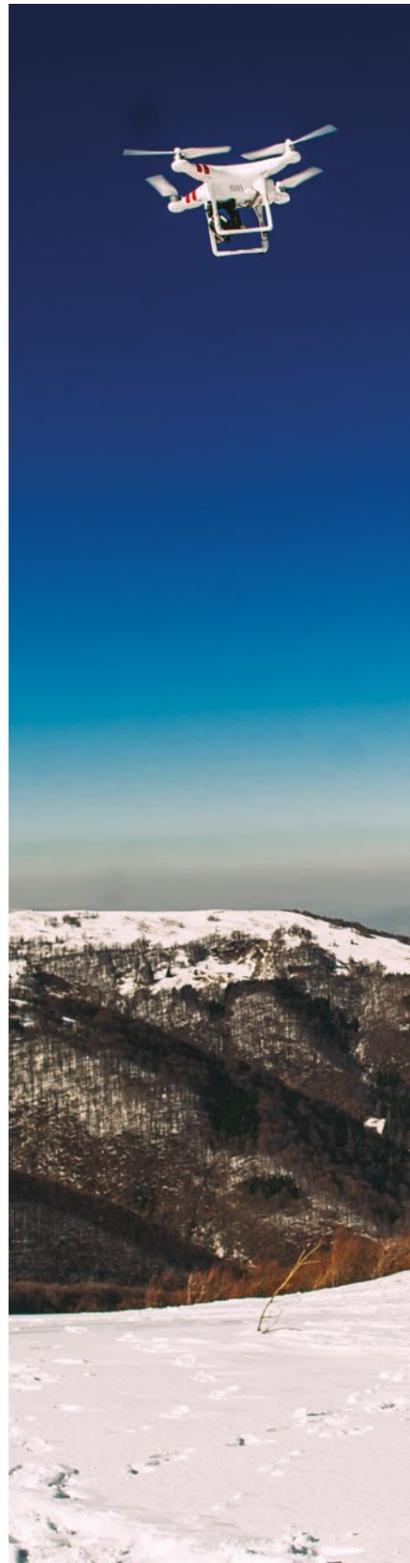


Figure 11. Most common provisions for reported non-compliance



Board skills

Most governance reports start with director biographies, yet too often these biographies only provide career histories – as in 51% of the reports we reviewed – rather than explaining the skills or knowledge brought to the table by each director. Insight into skills, accompanied by term lengths, allows investors to assess potential skills gaps against succession planning, providing hooks for engagement.

We would also like to see the diversity discussion broadened out to include the variety of educational and social backgrounds, knowledge and different types of professional experience. Encouragingly, our analysis identified some directors from outside the listed company world, including government, non-profit and academic backgrounds.

Board committees

Just over half the companies we analysed disclose board committees or advisory panels beyond the audit, remuneration and nomination committees. These are most often dedicated to corporate responsibility, sustainability, ethics, risk, safety and governance, but we also saw innovation to provide specific expertise and focus such as:

- ▶ **Rolls-Royce Holdings plc's** international advisory board, which meets annually with the board to provide perspective and to guide strategy development through discussions on the geopolitical

We have also seen more boards recruit directors with digital or technological expertise, but given the deep competition for these skills, it's worth boards considering other ways to gather this input. For example, **Aviva plc** (page 85 of their 2016 ARA) has a dedicated IT advisor to "provide further independent insight and expertise in the execution of the Company's Digital First strategy". **HSBC Holdings plc** (page 65 of their 2016 ARA) has a technology advisory board chaired by the chief operating officer and composed of a panel of experts to provide advice and guidance on the company's technology and digital strategy, helping the bank to capitalise on opportunities in areas such as artificial intelligence, biometrics, blockchain technology and data science.

and global economic landscape (page 57 of its 2016 ARA).

- ▶ **AstraZeneca plc's** science committee, which provides assurance to the board regarding the group's R&D activities and capabilities deployed, the quality and development of its scientists, and its decision making (page 85 of its 2016 ARA).
- ▶ **BP plc's** geopolitical committee, which monitors the company's identification and management of geopolitical risk (page 78 of its 2016 ARA).

Case studies

The Crown Estate 2016/17 ARA (pages 58 and 59)

- ▶ Detailed disclosure of the board evaluation process, clearly highlighting the key questions, outcomes and actions taken

Great Portland Estates plc 2017 ARA (pages 92 and 93)

- ▶ Balanced disclosure of board evaluation outcomes, progress on prior year actions and future focus areas, with an overview of the evaluation cycle

Board evaluation disclosures

Board evaluation disclosures have improved. 65% of reports in this year's sample include clear disclosures on the outcomes of the board evaluation, and 49% disclose steps taken or agreed upon to address the findings. The best also provide an update from the prior year evaluation (44%) as well as an overview of the review cycle and process. Understandably, given the sensitivity, boards may be reluctant to disclose fully in this area, but we believe a good balance can be struck to increase investor confidence in the board's continuous development processes and that corporate governance practice is improving.



65% include clear disclosures of the outcomes of the board evaluation

Shareholder engagement

Disclosures of shareholder engagement could still be improved. Only 31% of companies include disclosures around the specific topics discussed with shareholders or feedback received and only 6% disclose the company's response or actions taken. We also compared the disclosures made by companies in our sample with those in two investor stewardship reports (Standard Life Investments²¹ and Legal & General Investment Management²²) that reference specific engagements undertaken. 8% of companies in

our sample were named in these stewardship reports, but only half of these mention in their ARA the topics that the stewardship reports highlighted.

The most common topics for engagement are remuneration, strategy, financial performance, operations and shareholder returns. Encouragingly, there is also evidence of investors engaging on broader issues such as corporate responsibility, climate change, social and governance matters.

This year some companies report investor engagement on the impacts of Brexit and related impacts on the business environment, foreign exchange and cash flow. The absence of engagement on viability or audit-related matters is notable, and these topics were also absent from the stewardship reports we looked at. This makes us question whether the long-form reporting by auditors and audit committees is being used by the investor population it was designed to benefit.

²¹ Standard Life Investments, *Governance & Stewardship Annual Review 2016*, February 2017.

²² Legal & General Investment Management, *2016 Corporate Governance Report*, 2017.

Audit committee (AC) report

The implementation of the EU Audit Reform²³ into UK regulatory requirements and related guidance (the Code, the Financial Conduct Authority's Disclosure and Transparency Rules, and the 2016 Guidance on Audit Committees²⁴) affects the AC's operations, processes and composition as well as disclosure requirements in the ARA.

Some new disclosures (primarily contained in the Guidance on ACs), were also recommended and are as follows:

- ▶ How the AC composition requirements have been addressed, and the names and qualifications of all members of the AC during the period, if not provided elsewhere.
- ▶ How the AC's performance evaluation has been conducted.
- ▶ The name of the current external audit partner, and how long they have held the role.
- ▶ Advance notice of any retendering plans (Code Provision C.3.8).
- ▶ If the external auditor provides non-audit services, the AC's policy for approval of non-audit services.
- ▶ Audit fees for the statutory audit of the financial statements.
- ▶ Fees paid to the auditor and its network firms for audit-related services and other non-audit services, including the ratio of audit to non-audit work.
- ▶ For each significant engagement, or category of engagements, explain what

the services are and why the AC concluded that it was in the interests of the company to purchase them from the external auditor.

- ▶ An explanation of how the committee has assessed the effectiveness of internal audit and satisfied itself that the quality, experience and expertise of the function is appropriate for the business.
- ▶ The nature and extent of interaction (if any) with the FRC's Corporate Reporting Review team.
- ▶ Where a company's audit has been reviewed by the FRC's Audit Quality Review team, disclosures about any significant findings and the actions the AC and the auditors plan to take.

Although the companies in our sample were not yet required to adopt the changes arising from the EU Audit Reforms (as they apply for financial periods commencing on or after 17 June 2016), a number of ACs chose to make some changes to their practice and related disclosures ahead of the deadline. To help 2017/18 preparers, we have looked deeper into these instances of early adoption.

AC composition

Under the 2016 Code, the AC has to demonstrate that the committee members as a whole have competence relevant to the sector in which the company operates. The Guidance on ACs recommends disclosure of how the AC composition

requirements have been addressed, and the names and qualifications of all members of the AC during the period, if not provided elsewhere.

Encouragingly, 67% of companies in our sample already include a high level confirmation that the AC had relevant sector experience, although only 14% give more detail, for example, on how the requirement was met or a breakdown of the sector-relevant skills among AC members. We recommend that a link is made to the disclosures on succession planning (often in the nomination committee's report) to discuss any AC skills gaps and planned actions.

Relationship with the external auditor – tender process

The AC's primary role in initiating and managing the audit tender process was also a key change introduced by the EU Audit Reform. Although there aren't recommended disclosures



67%
of reports include a high level confirmation that the AC has relevant sector experience.

related to the AC's involvement in the tender process, some ACs chose to explain the tender process, selection criteria and rationale of the decision in the governance section. 24% of companies in our sample had an audit tender during 2016, and 13% give a detailed explanation of the tender process and criteria set. 8% go further, explaining how their final recommended choice met the set criteria. For example, one company explains that the auditor appointed had strong propositions in key regions, good knowledge of business and sector risks and demonstrated performance around delivery, planning and culture on non-audit engagements.

Of the 76% of companies in our sample that did not have a tender process, only 12% disclose some detail around the next tender process (e.g., expected timeframe or meetings held with potential candidates so far). We will no doubt see more of these disclosures next year, particularly as the 2016 Code requires disclosure on advance notice of tender plans.

Relationship with the external auditor – audit quality

Assessing audit effectiveness has many aspects. This year we looked at disclosures around FRC Audit Quality Review Team (AQRT) reviews of external audit as these form part of the wider set of indicators of external audit effectiveness and overall audit quality.

25% of reports in our sample disclose information around the AQRT review of the company's external audit. There may also be some companies that underwent an AQRT during the year but did not disclose this fact. Of those that do, only 11% include detail around the AC's involvement in this review process and its conclusions based on the auditor's response to the issues raised by the AQRT.

In July 2017, the FRC's Audit and Assurance Lab announced a pilot project to explore the role of the AC in promoting audit quality, and how investors' confidence in audit is enhanced by the AC's report in the ARA, as well as the communications by auditors to the AC (as required under auditing standards). A first phase project report will be published in time for consideration by December 2017 year ends. We encourage ACs to take a look at this report for further recommendations on improving their AC reports.

Assessment of the AC's own performance and effectiveness

The revised Guidance on ACs recommends that committees explain in the ARA how they conducted their evaluation. 23% of AC reports in our sample provide a detailed explanation of the AC's own annual evaluation process and 9% describe the outcomes of the evaluation and areas for improvement. The most common areas of improvement are:

- ▶ Involvement in the risk management and internal controls oversight process

- ▶ Knowledge of IT governance/ information security/cyber-security
- ▶ Skills and experience, including the training provided for new AC members
- ▶ Quality of their materials/ documentation (for example, duplication of board papers between the different committees and streamlining the AC's materials)

We recommend that ACs improve the quality of their disclosures around performance evaluation, ensuring that they make it clear how the assessment was performed, outcomes/findings and areas for additional focus. ACs can find help in our May 2017 publication, *Assessing the performance and effectiveness of the audit committee: a practical guide and toolkit*.



23%
of reports provide a detailed explanation of the AC's own annual evaluation process.

²³ Consisting of i) EU Audit Directive 2014/56/EU of The European Parliament and of The Council of 16 April 2014 which amended Directive 2006/43/EC on statutory audits of annual reports and consolidated accounts and ii) Audit Regulation (EU) 537/2014 of The European Parliament of the Council of 16 April 2014.

²⁴ FRC, *Guidance on Audit Committees*, April 2016 – aims to help ACs of companies with a premium listing of equity shares to implement the relevant provisions of Section C3 of the UK Corporate Governance Code but can be considered as best practice by other companies.



53%
of reports state that the AC reviewed the performance and effectiveness of the internal audit function

Internal audit performance and effectiveness

The revised Guidance on ACs recommends that the committee gives an explanation of how it assessed the effectiveness of internal audit and satisfied itself that the quality, experience and expertise of the function is appropriate for the business. 53% of companies in our sample stated that the AC had reviewed the performance and effectiveness of the internal audit function. However, only 14% of these provide detail on how the AC's assessment of the internal audit function's effectiveness was undertaken.

Given the importance of internal audit in most companies' overall risk management and internal control frameworks, we encourage ACs to disclose how their review was performed as well as overall findings and actions arising.



14%
of these provide detail on how the AC's assessment of the internal audit function's effectiveness was undertaken

Involvement of the AC in risk assessment

Only 30% of companies reviewed provide a detailed description of the AC's specific role in the risk assessment process, highlighting that this is still an area for improvement. 43% of companies disclose how the AC was involved in the viability assessment, including their:

- ▶ Review of the time period chosen
- ▶ Challenge to the scenarios tested and assumptions applied
- ▶ Oversight of the methodology used in the viability risk assessment process

With the viability statement at risk of becoming a boilerplate disclosure,

we strongly encourage ACs to maintain their involvement, to ensure that the statement delivers its intended objectives.

Significant issues considered by the AC in relation to the financial statements

On average, ACs consider five significant issues in relation to the financial statements (unchanged over the past two years), and these are mostly consistent with the issues identified in the external auditors' report. Again in line with past two years, the most common issues include revenue recognition, goodwill, asset valuations, impairment, pensions, tax and going concern. More ACs disclose the viability statement and alternative performance measures as being significant issues considered this year.

Case studies

London Stock Exchange Group plc 2016 ARA (page 67)

- ▶ Detailed listing of the AC's role in the viability assessment

Sage Group plc 2016 ARA (pages 76 and 77)

- ▶ Detailed listing of the AC's role in the viability assessment, including its review of the change in time period chosen

Remuneration committee report

In 2016, the third year following the introduction of the Directors' Remuneration Reporting (DRR) Regulations, many companies published their full policy again in line with the three year time frame for binding votes on policy. This may have contributed to the average increase in the page length of remuneration reports, up to an average of 21.5 pages (from 18 pages last year).

We highlighted last year that the majority of companies did not clearly articulate the link between the performance metrics used in remuneration and the company's KPIs and this remains an area for improvement. 44% of reports clearly showed the link between KPIs and annual incentive metrics. Many use symbols in the KPI section to show which ones are connected to remuneration or a narrative explanation of how particular KPIs are built into reward targets for particular executive directors. In line with the increased focus on value for stakeholders and culture, we looked specifically at whether non-financial KPIs are linked to remuneration. From our review, 40% of companies include some non-financial KPIs in their remuneration metrics (some others include non-financial metrics but these are either not clearly identified, or not KPIs which have been linked to strategy). An example of innovation we have seen is some companies including a remuneration section in the strategic report, which makes it easier to link remuneration to strategic issues and other parts of the narrative in the front half. For example, **HSBC Holdings plc's 2016 ARA** includes a two page

section (page 28-29) in the Strategic Report on how the remuneration policy supports the achievement of their strategic objectives and the remuneration for the executive directors in the year.

Long-term incentive plans (LTIPs) have been at the centre of attention lately, with a number of stakeholders seeking the simplification of long-term incentive arrangements to ensure these are fit for purpose. Around 10% of companies introduced a new LTIP in 2016, yet so far we have not seen much change in the market, with all new plans being in line with current market practice. Secondary legislation will be introduced requiring companies to provide clear explanations of the potential remuneration outcomes from complex LTIPs under various scenarios (e.g., significant share price growth).

Interestingly, despite the qualified support from some stakeholders for restricted shares as an alternative to the traditional LTIP, at least two companies pulled proposals to introduce restricted shares this year seemingly following lack of support from their wider shareholder base.

Shareholders and representative bodies have told us that the level and quality of engagement has increased significantly in the run up to this AGM season. We hope that this continues and that further simplification of remuneration reporting will help to enable more meaningful engagement on this issue.



44%
of reports clearly show the link between KPIs and annual incentive metrics



40%
clearly report using some non-financial KPIs in their remuneration metrics

Future trends in reporting



A holistic view of corporate reporting: preliminary announcements, analyst presentations and investor findings

Annual reports form part of a wider set of sources that investors use when assessing companies, including interim and preliminary results announcements and analyst presentations.

The IA recently reiterated the importance of annual reports, describing them as “the primary means of communication to the market” in its recent guidance on long-term reporting.²⁵

This is a view that we have heard from investors and long upheld. However, some companies still question the importance of the annual report because a lot of information is already available to the market before the annual report is published. To dig into this question a bit deeper, this year we also reviewed the preliminary results announcements and analyst presentations of a small number of companies from our sample.²⁶ We assessed both the quality of information presented in these wider corporate communications and the consistency of messages with ARAs.

Our research has shown us that the value placed by investors on different sources of information varies with the stage in the investment cycle. From a small sample of investors we surveyed separately (representing both governance and fund management professionals

within investment institutions) and conversations we have had with some others, it seems that for portfolio managers and others involved in the investment decision, the annual report is a primary source of research material when making a first time investment decision – although used alongside analyst presentations and meetings with executives, which are also ranked highly.

This echoes other recent EY research showing that when making an investment decision, those looking for non-financial information value annual and integrated reports most highly, followed by press coverage and business commentary (see Figure 12, overleaf).²⁷

Once the initial investment has been made, annual reports, although remaining important, lose prominence. Meetings with executives become the primary source of information, while analyst presentations and preliminary announcements gain importance. As might be expected, the smaller the investor and the less the resource available, the more likely they are to rely on third parties for analysis and recommendations.

This should not undermine the importance of annual reports. Although share prices are perceived to move more on preliminary announcements, this simply reflects that they are the first insight into the company's performance, not the best. Rather, within a wider set of sources used by a range of

stakeholders, annual reports retain primacy. They are the most read and disseminated document, are assured, are more detailed and holistic, and are the only source for many kinds of information (e.g., governance, business model and risks). The main challenge for companies is to ensure the consistency and balance of messaging across all corporate communications, especially as boards (in accordance with supporting principle C.1 of the Code) are required to present a fair, balanced and understandable assessment of the company's position and prospects in not only the annual report, but also interim and other price-sensitive reports.

Preliminary results announcements

Preliminary announcements (which have been voluntary for a decade in the UK) have also recently been in the spotlight. In April 2017 the FRC issued a consultation paper on the subject, although primarily focused on the assurance provided.²⁸

All the preliminary announcements we looked at contain financial statements, financial reviews and operational reviews, the last of which are either in a standalone section or integrated into CEO reviews. Almost all preliminary announcements have a comment personally signed by the CEO, although few contain comments from the chairman. A minority include disclosures of risks and strategy.

²⁵ The Investment Association, *Long Term Reporting Guidance*, May 2017, pg3.

²⁶ Analysis based on a hand-picked subset of 10 companies from our sample.

²⁷ EY, *Is your nonfinancial performance revealing the true value of your business to investors?*, 2017, pg18.

²⁸ FRC, *Discussion Paper – Invitation to Comment: Auditors and Preliminary Announcements*, April 2017.

Future trends in reporting

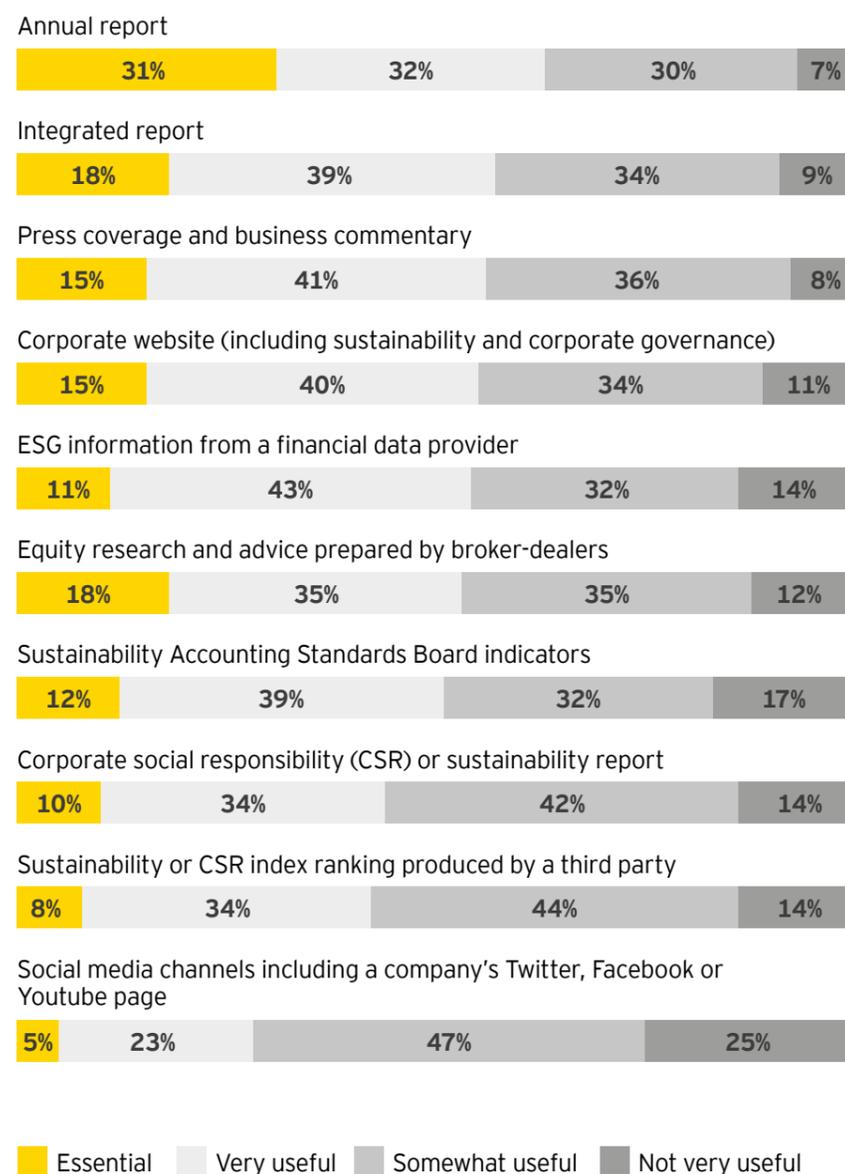


Figure 12. How useful do investors find the following sources of non-financial information when making an investment decision?

The average length of our small sample of preliminary results announcements was 41 pages. The information disclosed focuses mainly on financial and operational reviews (although streamlined) and overall is consistent with that in the annual report. Readers looking for a more complete picture, for example on risk management and governance, would need to turn to the ARA.

Analyst presentations

All companies we reviewed publish their presentations for analysts and investors on their websites.

The vast majority of analyst presentations contain disclosures on strategy and priorities for the future, but only half articulate the company's strategy in a way consistent with the annual report – and sometimes this information isn't clearly labelled as the company's strategy (with other priorities getting more prominence). Conversely, a few companies provide clearer narrative and graphics to articulate their strategy in their analysts' presentations than in their annual report. This raises questions around quality and efficiency – if something is done well, it makes sense for it to be used consistently across different channels rather than having various iterations.

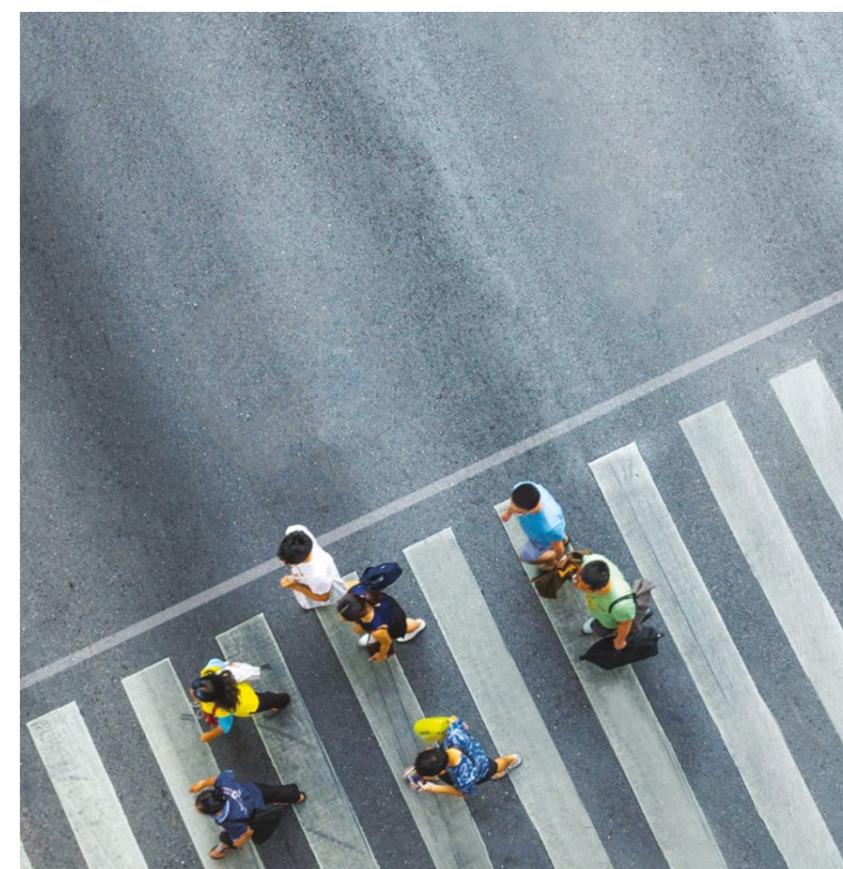
A significant proportion of analyst presentations convey messages that are inconsistent with those disclosed in the annual report.

Some presentations focus on different aspects of the company's activities to those highlighted most prominently in the annual report, while others portray a more positive and less balanced picture.

All analyst presentations disclose indicators of performance, but there is significant inconsistency with the KPIs disclosed in the annual report. Nine of the 10 companies we reviewed disclose non-financial KPIs in their annual reports, but only two also disclose them in the analyst presentation. Most of the presentations include additional metrics that were not KPIs in the annual report.

In all cases – whether the analyst presentations were more or less clear than the annual reports, had a different balance or were inconsistent in their use of KPIs – we see room for improvement. It's important to ensure that companies' positions and prospects are disclosed in a fair, balanced and understandable manner, consistently across different channels. Whilst preparers and boards should think about addressing the issues raised above in their disclosures going forward, we also challenge investors to engage with companies that continue to report inconsistently, so that the quality of reporting across all channels and media improves.

None of the analyst presentations we sampled provide information



on the company's governance, although two include slides on wider stakeholder engagement. These disclosures reiterate the importance of this subject to these companies – although the disclosures are at a high level and less holistic than those in the ARA. The choice of disclosures made in analyst presentations may reflect a company's judgement of the audience, with annual reports being used by a wider group of people.

As the Lab recently stated, users and other stakeholders "regularly identify the context of reported information as essential to their understanding of that information."²⁹ It is therefore important for companies to be clear about the purpose of and audience for each of their communication channels.

Viewpoints



Elizabeth Fernando
Head of Equities,
USS

Q *We often hear that annual reports aren't fit for purpose especially in this day and age where there are multiple and on-demand information sources. What is your view? Can they be made more relevant, what needs to be changed?*

The ARA has already changed a lot over time and introduction of interactive versions is a useful step. My own view is that it would be a real shame if the ARA goes away completely, because it is the one place that management properly pulls information together to put out the whole story of the company. There will be a danger if there is no requirement to produce the ARA, investors and other stakeholders don't have a holistic source to build their understanding of the business – and instead we start picking and choosing information, and in the process may miss some really critical information.

The ARA also goes through an extremely robust diligence process – directors and auditors know the repercussions of putting out incorrect statements, and as investors, we therefore take comfort and place extra weight on the ARA as one of our core sources of information.

In terms of what needs to be added, I would like to see more continuity and linkage between the different sections so that for example the remuneration report isn't a standalone section but is clearly linked to business strategy and performance. I would also like more detail on the debates and challenges that have taken place in the audit committee – audited statements rely on a number of judgements and very different pictures of a company's performance and financial health can be painted by making different assumptions.

Q *As an active fund manager once initial investment has been made, do you use the annual report on an ongoing basis? If so, how is it used and what importance does it hold versus other sources of information (e.g., analyst presentations and preliminary announcements)?*

I don't believe that investors will ever get to a point of not reading the ARA. There are often a few metrics in the financial statements which aren't available elsewhere that tell us that our initial investment thesis is still on track – for instance the receivables note could provide us with confidence in the sustainability of reported

revenue growth as well as whether the company has an emerging issue with bad debts. Similarly detailed divisional data can provide evidence that capital is being allocated in line with management's stated strategy and changes in warranty provisions may be an indicator of product quality and customer satisfaction.

We also read the narrative report in the front half of the ARA to understand the company's long-term strategy and the company's overall performance. The narrative reporting is more long-term focussed, whereas the numbers in the back half are a snapshot at a point in time and serve as proof or verification of whether the company is delivering what they set out in the narrative report. We cross-check the information between the two halves to ensure consistency of messages – that they work together to tell the same story.

On the front half, we also focus on remuneration, and how KPIs are aligned with the company's strategy and the overall pay package. We use the governance section, together with information we obtain from the company's website, to understand how directors are fulfilling their requirements.

However, it is not our only source of information. We use corporate websites too and details on static

information which doesn't change each year could be placed there rather than in the ARA (e.g., directors' profiles/experience). We have to be careful as an investor community as we seem to ask for more and more detailed disclosures and yet on the other hand we want shorter reports. So companies have to walk a fine line between detail and usability of the ARA.

Q *In the past three years several new disclosures have been added or enhanced in the front half of the ARA (e.g., the business model, and most recently VSs). Have these disclosures been useful for the investment industry?*

We are not convinced that disclosing the time period in viability statements, has done much, especially in light of the time horizons being reported. I feel that this risks undermining everything else, and being long-term investors, we have a much longer term view than the usual three to five years being disclosed in the VS. What is, of course, very useful is the discipline and rigour that the viability process (when done properly) has introduced. It should help boards challenge and think about risks in a more robust manner.

Q *In making investment decisions how do you consider the culture of the company (an area which is difficult to get true insight on)? Do you think annual reports play a part in giving you this insight?*

I think it is extremely hard to get a good understanding of culture from reading the ARA as it is very easy for companies to present the image they want us to see and not the true picture. If companies provided more metrics accompanied with balanced and honest contextual narrative, we would get more meaningful insight. For example, if a company disclosed staff turnover and the reasons for staff leaving, this may tell you something about the culture which you can corroborate from your interactions with executive management.

Q *Do you have any other advice/tips to give to preparers and boards?*

Consistency is extremely important. As long-term owner of businesses, we like to see how businesses evolve over time. If companies chop and change/move things (e.g., on how the business is organised/reported on), it is difficult to identify trends

and inflection points which heavily influence our estimates of fair value for a business. Similarly being able to see clearly how the KPIs on which management incentives are based align to the long-term business strategy and being able to calculate those metrics for ourselves using the ARA or other publicly available information is more likely to result in us supporting the remuneration report at the AGM.

My second bug bear is the increasing proliferation of non-GAAP measures. In some cases I have sympathy with preparers, as IFRSs have sometimes muddied the water rather than making it clear, which obliges companies to explain their performance using an alternative measure. However for many measures, there shouldn't be a need to use alternative metrics and at the end of the day the owners of the business own all the earnings – we don't get to choose to own only the earnings without the bad stuff.

Digital reporting

The Lab has been looking at digital reporting in recent years. In May 2017, the Lab issued a report on the first phase of the *Digital Future*³⁰ project, which takes forward the core findings from *Digital Present*.³¹ The report sets out a framework for the future of digital reporting and outlines the key characteristics that should be embedded in any future system of digitally-enabled reporting, as shown in Figure 13. It categorises these into three stages of reporting – production, distribution and consumption.

For the next phase of this project, the Lab is organising a series of workshops and roundtables to identify which technologies best meet these characteristics, aiming to release a blueprint by the end of 2017.

The majority of companies (69% in our sample) still produce their ARAs in simple PDF format only, but some

of these companies also provide key highlights or an option to separately download key sections of the ARA on their websites.

Others provide interactive reports, in the format of a flipbook or interactive PDF which include a range of features such as bookmarks, clickable cross-references and hyperlinks, content page click-through and fillable format. For example, **easyJet plc's 2016 ARA** interactive report contains a navigation bar at the top of the screen for additional functionality e.g., page preview and thumbnail preview, search tools, content list, send to and share (Twitter, Facebook, LinkedIn, Pinterest) and print. Less than 10% present their ARAs in full HTML format. **Ocado Group plc's 2016 ARA** is an example of this.

We note that there are barriers impeding greater digital reporting in the UK, such as the legal requirement

for a hard copy annual report to be submitted to Companies House, and the higher demand for the PDF format as compared to the website versions of the annual report. However, some companies in mainland Europe, such as BASF, Gebrit and LafargeHolcim, are embracing emerging technologies. The interactive HTML versions produced by these companies include interactive functions such as an option to download a mobile app to view the ARA on smartphones, an interactive chart generator allowing users to compare important values over a period of time, as well as a 'compare to last year' option for users interested in carrying out direct comparisons of an individual page with the corresponding page from the previous year's report.

The European Securities and Market Authority (ESMA) is exploring the use of a standard digital format, known as the European Single Electronic

Format (ESEF), which issuers in the EU must use to report their ARAs from 1 January 2020. This digital format will lead to the production of structured financial information, allowing users such as investors, analysts and auditors to carry out software-supported analysis and comparison of financial data more efficiently. With the uncertainty around Brexit, it is unclear whether this will affect UK preparers.

In our view, progress in digital reporting should not be constrained by an assumption that the PDF format is the best way to communicate. Preparers, users and regulators should collaborate to explore which technologies will meet their needs and satisfy all legal requirements without added burden. Like any other major advancement, successful implementation of a new solution would require acceptance and buy-in from all sides – in this case, both preparers and users.



69%
of companies in our sample still produce their ARAs in simple PDF format only.



Figure 13. Characteristics of Future Digital Reporting

Long term value reporting

Based on rigorous research and stakeholder consultations, EY has proposed a proof of concept framework – **The Long Term Value Framework (LTV Framework)** – to understand, measure and communicate the broader value companies create through their investments in their purpose, brand, IP, products and employees, environment and communities.

This framework will be further developed by the **Embankment Project**, led by the Coalition for

Inclusive Capitalism in collaboration with EY. Over an 18-month period, the Embankment Project brings together 20 global companies from across the investment chain – asset creators (companies), asset managers and asset owners – to jointly develop, test and validate EY's LTV Framework. If successful, the Framework will:

- ▶ Enable companies to deliver trusted information to material stakeholders – customers, employees, communities,

governments – to help improve the allocation of capital for the long term.

- ▶ Be a catalyst for change towards renewing the social contract of business with society.
- ▶ Be developed into an open-source methodology to achieve wide spread adoption.

Look out for the Project's interim report which is due to be issued in January 2018.

³⁰ Financial Reporting Lab, *Digital Future: A framework for future digital reporting*, May 2017.

³¹ Financial Reporting Lab, *Lab project report: Digital present – Current use of digital media in corporate reporting*, May 2015.

Viewpoints



Thomas Toomse-Smith
Project Manager,
The Financial Reporting Lab

Q *Have you seen companies leveraging different types of technologies in this year's reporting?*

UK reporters by and large have not progressed much in this area compared to some large European reporters who have used different technologies in their annual reporting – for example BASF, Gerbrit and LafargeHolcim. This is partly demand led – European companies see significant usage of their website versions of the annual report, however in the UK, the PDF copy of the ARA is much more popular.

From our work on our Digital Future project we know there isn't a single technological solution. The critical thing is that any additional digital features should be well thought through and should bring benefits, rather than being introduced for the sake of it.

Q *Can you tell us a little bit about the ESEF and whether it will have an impact on UK reporting if implemented?*

The Transparency Directive, as amended in 2013, requires issuers listed on regulated markets to prepare their annual reports using the ESEF from 1 January 2020 to foster comparability and aid analysis. ESMA has the task of developing the technical standards for the ESEF and consulted on this between 2015-16.

ESEF extends to the entire ARA – i.e., including the financial statements and the narrative/management report. Whereas the financial statements lend themselves well to transformation in a structured electronic format (using defined taxonomies) other parts, especially the narrative, follow a very limited defined structure. Because of this, ESMA has decided, at least for

the time being, to limit electronic reporting in a structured format to the consolidated primary financial statements prepared under IFRS, so for now narrative reports aren't being considered.

ESMA has concluded, based on its consultation and further research, that all annual reports will have to be prepared in xHTML (Extensible Hyper Text Markup Language) which if properly formatted, can be consumed by standard browsers without the need of specialised tools. Where the annual report contains IFRS consolidated financial statements, these have to be marked-up with XBRL (Extensible Business Reporting Language) tags according to the IFRS Taxonomy.

So, ESEF involves a combination of XBRL and HTML – and it's the latter that would bring about the most change as UK companies are more familiar with XBRL e.g., because of

use in their tax reporting. To adopt ESEF, companies would need to think 'HTML first' for the entire ARA not just those bits being tagged and turn the document into a PDF at the end (if needed) rather than start with a PDF document and create a HTML version at a later stage.

With all the uncertainty surrounding Brexit, it is difficult to tell how this might impact the UK. However, the FRC continues to be fully involved with ESMA activities in this area. It is also worth noting that with more than 4,000 listed companies across the continent creating xHTML files and delivering these to stakeholders, ESEF is likely to be a very influential driver of future best practice.

Recent and upcoming reporting requirements

In this section, we have looked into how companies have implemented some of the recently introduced disclosure requirements in the current year or voluntarily adopted some of the upcoming reporting requirements, and pulled out some examples of best practice disclosures for your use.

Recently introduced requirements

Alternative performance measures

In June 2015, ESMA published *Guidelines on Alternative Performance Measures* (Guidelines) for the purpose of promoting the usefulness and transparency of Alternative Performance Measures (APMs) in prospectuses or regulated information, including ARAs and interim statements. The goal is improved comparability, reliability and comprehensibility of APMs.

The FRC subsequently conducted a thematic review into the use of APMs in 20 sets of June 2016 interim statements to understand the extent to which the use of APMs is consistent with the Guidelines and to identify specific improvements companies could make. These included improving the clarity of explanations of the purpose of using specific APMs, the balance of emphasis given to APMs and IFRS numbers, the ease of finding reconciliations between APMs and IFRS numbers, and enhancing explanations of the basis for including or excluding certain elements from the IFRS numbers when deriving the APMs.

Of the companies in our sample, 96% report APMs in their ARAs, but only 65% clearly highlight the use of APMs

through the use of keys, symbols or a separate APM section.

Although 78% of companies explain the overall purpose of using APMs, many provide boilerplate explanations – for example, that APMs allow comparability with other companies or between periods, or that management can influence these measures and uses them to monitor performance. 37% give more detailed explanations on the purpose of each APM, although less than 10 companies provide a clear rationale.

Anglo American plc's 2016 ARA (pages 188 and 189) dedicates a separate section to APMs, which clearly summarises the measures used. Readers are able to understand the characteristics present in the mining sector that have driven the company's use of specific APMs. For each APM the company also provides a clear definition, the closest equivalent IFRS measure, adjustments to reconcile to primary statements and the rationale for adjustments.

Good explanations should enable readers to understand why an APM is useful or more meaningful, rather than simply stating that it is the case.

Companies should also aim to provide more information on why APMs, rather than IFRS figures, are used internally, by whom and for what purpose.

The ESMA Guidelines require companies to give the same level of emphasis to APMs and IFRS figures, but only just over half (56%) of the companies in our sample give equal prominence to APMs and IFRS results in their strategic reports. A small number of companies, such as BAE Systems plc, present APMs and IFRS numbers side-by-side in a tabular format for ease of comparison (see Figure 14, overleaf).

Clear reconciliations between APMs and IFRS figures should be presented to help readers understand the difference between the two. The majority (81%) of companies do provide these reconciliations, but even of these, some could make improvements. For example, sometimes not all APMs can be reconciled back to IFRS figures, or reconciliations are not clearly presented or easily found.

Recent and upcoming reporting requirements

When adjusting profit figures to arrive at an equivalent APM, companies often adjust for:

- ▶ Impairment gains/losses
- ▶ Amortisation of intangibles
- ▶ Restructuring costs
- ▶ Share-based payments
- ▶ One-off legal settlements
- ▶ Gains/losses from disposal of businesses or key assets

- ▶ Fair value movements on financial instruments

We encourage companies to consider carefully whether adjustments to statutory results are appropriate and justifiable especially when costs appear to recur. It's interesting to note that items added back vary within the same industry sector. We also found that some sectors such

as insurance, banking and real estate have more sector-specific APMs.

Annual slavery and trafficking statement under The Modern Slavery Act (MSA)

Companies with years ended on or after 31 March 2016 are required to publish an annual slavery and trafficking statement in a 'prominent' place on their website. Although this is not a mandatory disclosure in the ARA, we looked to see whether any reports include any discussion of this new requirement or a summary of the steps undertaken to ensure that slavery and human trafficking are not taking place in the business or supply chain.

Approximately one third of the companies provide some detail on how they have complied with the MSA in the ARA and 18% provide a cross-reference to the separate MSA statement on the company's website. **Antofagasta plc's 2016 ARA** (page 59) provides a high-level summary of the steps taken and its plan for next year, with a cross-reference to the full statement provided on the company's website.

In the governance section of **Shaftesbury plc's 2016 ARA** (page 84), the chairman provides an explanation of how the MSA applies to the company specifically, despite it having a small employee base: "As a property investment company,

human rights in a small head office of 27 people are easy to oversee. With our outsourcing model, we are concentrating our efforts on transparency in the supply chain. The legislation is now in force and we are talking with our first and second tier suppliers about the principles of the UN Global Compact and the Modern Slavery Act."

We are encouraged that the MSA is an example of a recent change that has stimulated companies to look beyond the reporting implications alone and into underlying processes and behaviours. We feel that many disclosure requirements should be viewed this way.

Upcoming requirements

Audit Committee report disclosures

Unless already addressed in the prior year, 2017/18 preparers should be mindful of the new AC report disclosures effective for financial periods commencing on 17 June 2016. Please refer to Section 3 (AC report) for further details.

New disclosures required by the EU's Non-Financial Reporting Directive

The *Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016* implement the EU Non-Financial Reporting Directive (NFRD) on disclosure of non-financial and diversity information by requiring a new 'non-financial information statement' as part of the Strategic Report. The new rules are applicable to certain large companies and qualifying partnerships³² with more

than 500 employees in relation to financial years beginning on or after 1 January 2017 onwards.

The FRC has published a factsheet³³ on the requirements of this non-financial information statement and is in the process of updating the Strategic Report Guidance to reflect the changes. In the draft updates to the Guidance, the FRC stipulates that the disclosures required under the non-financial information statement need not be made as a separate statement and can be embedded throughout the Strategic Report. This is helpful for ensuring that disclosures are placed and connected in a way that makes most sense for each company.

As many of the requirements of the EU NFRD are similar to those that quoted companies are currently required to make in their strategic reports, the FRC has highlighted

the new or additional information required.³⁴ This includes:

- ▶ A requirement for companies to provide information that enables an understanding of the impact of its activity.
- ▶ Disclosure of anti-bribery and anti-corruption matters.
- ▶ A description of any due diligence processes implemented by the company in pursuing the policies relating to non-financial matters, and the outcome of those policies.
- ▶ A description of the principal risks arising in connection with the company's operations including, where relevant and proportionate, a description of business relationships, products and services that are likely to cause adverse impacts in those areas of risk.
- ▶ How the company manages those principal risks.

Financial performance measures as defined by the Group	
We monitor the underlying financial performance of the Group using alternative performance measures. These measures are not defined in IFRS ³ and, therefore, are considered to be non-GAAP ⁴ measures. Accordingly, the relevant IFRS ³ measures are also presented where appropriate.	
Sales	KPI
£19,020m (2015 £17,904m)	Definition Revenue including the Group's share of revenue of equity accounted investments. Purpose Allows management to monitor the sales performance of subsidiaries and equity accounted investments.
Underlying EBITA	KPI
£1,905m (2015 £1,683m)	Definition Profit for the year before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items. Purpose Provides a measure of operating profitability that is comparable over time.
Underlying earnings per share	BONUS KPI
40.3p (2015 40.2p)	Definition Basic earnings per share excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items. Purpose Provides a measure of underlying performance that is comparable over time.
Operating business cash flow	KPI
£1,004m (2015 £681m)	Definition Net cash flow from operating activities excluding taxation after net capital expenditure, financial investment and dividends from equity accounted investments. Purpose Allows management to monitor the operating cash generation of the Group.
Net debt	BONUS KPI
£(1,542)m (2015 £(1,422)m)	Definition Cash and cash equivalents, less loans and overdrafts (including debt-related derivative financial instruments). Purpose Allows management to monitor the net cash generation of the Group.
Order intake⁵	BONUS KPI
£22,443m (2015 £14,921m)	Definition Funded orders received from customers including the Group's share of order intake of equity accounted investments. Purpose Allows management to monitor the order intake of subsidiaries and equity accounted investments.
Order backlog⁶	
£42.0bn (2015 £36.8bn)	Definition Funded and unfunded unexecuted customer orders including the Group's share of order backlog of equity accounted investments. Unfunded orders include the elements of US multi-year contracts for which funding has not been authorised by the customer. Purpose Supports future years' sales performance of subsidiaries and equity accounted investments.
Financial performance measures defined in IFRS ³	
Reconciliations from the financial performance measures as defined by the Group to these measures are provided in the Financial review on pages 24 to 30.	
Revenue	
£17,790m (2015 £16,787m)	Definition Income derived from the provision of goods and services by the Company and its subsidiary undertakings.
Operating profit	
£1,742m (2015 £1,502m)	Definition Profit for the year before finance costs and taxation expense. This measure includes finance costs and taxation expense of equity accounted investments.
Basic earnings per share	
28.8p (2015 29.0p)	Definition Basic earnings per share in accordance with International Accounting Standard 33, Earnings per Share.
Net cash flow from operating activities	
£1,229m (2015 £808m) ⁷	Definition Net cash flow from operating activities in accordance with International Accounting Standard 7, Statement of Cash Flows.
Other financial highlights	
Group's share of the net pension deficit	
£(6.1)bn (2015 £(4.5)bn)	Definition Net International Accounting Standard 19, Employee Benefits, deficit excluding amounts allocated to equity accounted investments.
Dividend per share	
21.3p (2015 20.9p)	Definition Interim dividend paid and final dividend proposed per share.

Figure 14. BAE Systems plc 2016 ARA (pages 6 and 7)

³² Traded companies, banking, authorised insurance companies or companies engaged in insurance market activities, with some exclusions. See s414CA of the Companies Act 2006 for further details.

³³ FRC, *Factsheet – Non-Financial Reporting*, July 2017.

³⁴ FRC, *Factsheet – Non-Financial Reporting*, July 2017, pg3.

Recent and upcoming reporting requirements

Although the reports in our sample were not yet caught by this new legislation, we were interested to find out how reporting may have already adapted to take into account some of the changes brought by the regulations in advance. We focused particularly on anti-bribery and corruption (ABC) and found that a large percentage (78%) of companies in our sample include some disclosure on how companies manage ABC matters and issues. However, under the regulations, companies should provide information on the ABC policy put in place, how it has been implemented, and outcomes of the policy. Where applicable, companies should also describe the principal risks relating to ABC arising from their operations, and how such risks are being managed.

Only 17% of companies in our sample mention that they have maintained a separate ABC policy. None give detailed explanations on how the policy is being implemented, its effectiveness or the due diligence

Voluntary disclosures

We highlight below other disclosures that companies have made/may need to make in the future, in response to calls from various stakeholder groups.

Pay ratio between CEO and UK employees

The Government has confirmed, in its response to the Corporate Governance reform consultation³⁵, that the requirement for companies to publish the pay ratio between their CEO and their UK employee population will be introduced as secondary legislation. This was also considered by the Department

processes implemented in relation to the ABC policy. On the other hand, only 15% of companies identify ABC as a risk in the Principal Risks and Uncertainties section and disclose the mitigating controls in place.

Gender pay gap

Businesses in the UK with more than 250 UK-based employees are required by law to publish specific figures about their gender pay gap annually on their own website and on a Government website. Entities affected are required to take a snapshot of their data in April 2017 and publish it by April 2018. The gender pay gap is the difference between the average earnings of men and women, expressed relative to men's earnings.

A quarter of the companies in our sample include some discussion of their preparation to meet this requirement and 4% of companies already report the actual gender pay gap figures in their ARAs as

of Business, Energy & Industrial Strategy's Select Committee in its inquiry on corporate governance.

Although the requirement has not come into effect a few companies have pre-emptively and voluntarily disclosed the ratio in their ARAs this year. For example, **Standard Life plc's 2016 ARA** (page 83) includes the pay ratio and explains the basis of calculation at a high level: "Based on the Chief Executive's single figure set out on page 88 the ratio of pay to the median of all other UK based employees is 61:1. Employee pay includes base salary, employer pension contributions,

a tangible demonstration of their commitment towards diversity. For example, **Hammerson plc's 2016 ARA** (page 42) states: "For some years, we have undertaken a Group internal pay audit where we compare the salaries, benefits and bonus payments made to our male and female employees. The results of our 2016 audit showed a gender pay gap of 32% when comparing the mean basic salaries of our UK and Ireland employees. In France, the figure stood at just under 23%. The variances reflect the relative over representation of male incumbents in our Board and senior management roles. However, when we consider the salaries paid to employees in similar roles, the mean for female employees was higher in 50% of cases; a similar position to that we experienced in 2015."

It will be interesting to see whether this topic continues to be addressed in annual reports rather than on the website alone, which is all the regulation requires.

benefits and incentive payments. There is no external guidance on the methodology to be used for the calculation of the pay ratio. The Remuneration Committee used the median as the comparator as it is affected less by changes in the remuneration of a small number of employees when comparing between years."

Investor calls for better human capital reporting

There are two recent initiatives from investors calling for better and more information on the quality of

workforce/human capital disclosures that preparers should be aware of:

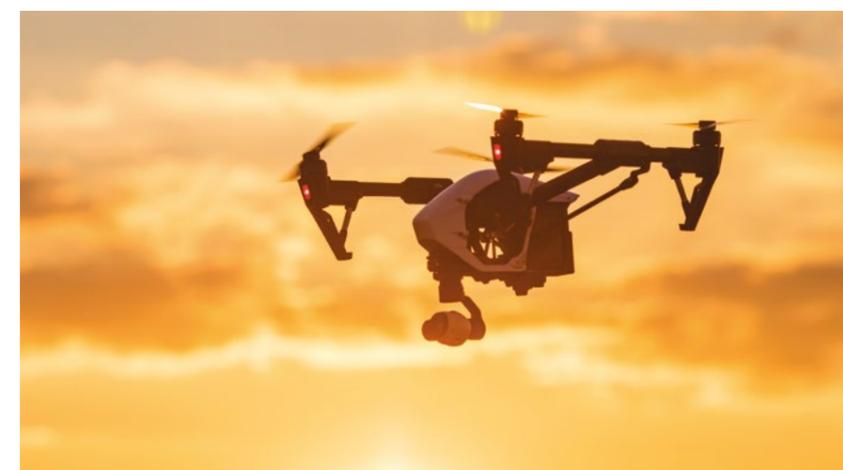
- ▶ In the UK, 79 investor signatories to the **Workforce Disclosure Initiative (WDI)**, with a US\$7.9 trillion in assets under management, requested in July FTSE 50 and 25 other global 'mega companies' to provide (via a survey) information on the composition of the workforce, its stability, training and development and engagement.
- ▶ In the US, the **Human Capital Management Coalition**, a group of 25 asset owners representing US\$2.8 trillion, petitioned the US SEC in July to change its rules in order to require company reporting on human capital management policies, practices and performance.

IA Long Term Reporting Guidelines

As noted in Section 1, the IA in its *Long Term Reporting Guidance* recommends companies provide disclosures on productivity, capital management and allocation, material environmental and social risks, human capital and culture. This Guidance is addressed to premium listed companies (with other listed companies encouraged to adopt as best practice), and while voluntary, preparers should note that its implementation will be monitored by the IA's Institutional Voting Information Service through its analysis of ARAs of years ending on or after 30 September 2017.

Climate related disclosures recommended by the TCFD

The TCFD's disclosure recommendations are structured around four thematic areas and



apply to organisations across sectors and jurisdictions:

- ▶ **Governance:** The organisation's governance around climate-related risks and opportunities.
- ▶ **Strategy:** The actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning.
- ▶ **Risk management:** The processes used by the organisation to identify, assess, and manage climate-related risks.
- ▶ **Metrics and targets:** The metrics and targets used to assess and manage relevant climate-related risks and opportunities.

Whilst the disclosures remain voluntary for now, calls have been made to make them a requirement for companies listed on major stock exchanges.

As evident above, there is growing demand for non-financial information from various stakeholders and representative interest bodies, and each group has valid reasons for why such disclosures are important. Many

of these disclosures have different scopes (e.g., varying size limits) and output is required to be published on different channels, such as a government portal or the company's website. While we remain supportive of many of these new disclosure initiatives, we are also mindful that, from a preparer perspective, they can cause confusion and fatigue as it is increasingly difficult to keep abreast of new recommendations. Many are also duplicative or over-lapping – yet companies are being held to account for making their reporting more concise. We call on regulators and interest bodies to work together where possible to help companies not only produce meaningful disclosures, but also examine their associated processes and behaviours.

Preparers could also benefit from having an overall internal 'gatekeeper' to coordinate responses to the various disclosure initiatives, rather than their consideration being compartmentalised by function. This would ensure that their disclosures remain cohesive and consistent.

³⁵ Department for Business, Energy & Industrial Strategy, *Corporate Governance Reform: The Government response to the green paper consultation*, August 2017.



Appendices

Appendix A: Methodology

Except where otherwise indicated, the sample consisted of 100 ARAs of FTSE 350 companies with September 2016 to January 2017 year-ends. The sample was weighted 45% FTSE 100 and 55% FTSE 250 companies. Our sample covered a range of industries that broadly reflects the composition of the FTSE 350, other than excluding investment trusts and mutual funds.

Our research compiled qualitative and quantitative findings on a broad range of measures and key themes, which we present throughout this report alongside recommendations for leading practice. The case studies highlight examples of leading practice from our sample or that we have become aware of from our wider work.

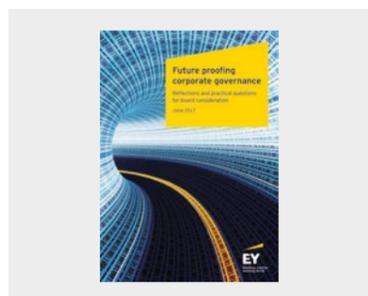
Appendix B: Other recent reports by EY's Corporate Governance team

Contact us at corporategovernance@uk.ey.com for hard copies of our reports or visit our website <http://www.ey.com/corporategovernance> to download them:



August 2017
The long and winding road to corporate governance reform

Summarises the headline proposals from the Government's response to reform the UK's corporate governance framework as announced on 29 August 2017.



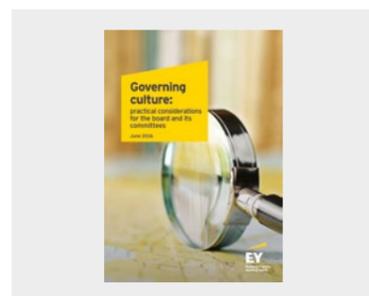
June 2017
Future proofing corporate governance – Reflections and practical questions for board consideration

Based on a series of roundtables where we explored how boards are responding to the accelerated pace of change in the world and business environment.



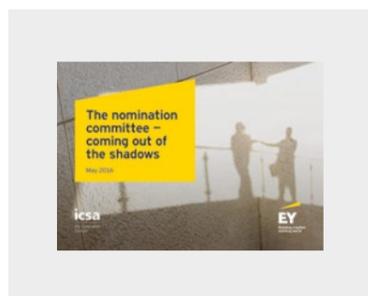
May 2017
Assessing the performance of the audit committee: a practical guide and toolkit

Helps audit committees to assess their performance and effectiveness, taking into account the latest UK regulatory updates.



June 2016
Governing culture: practical considerations for the board and its committees

Helps boards and committees address the impact of organisational culture, ensuring it is embedded in decision-making and oversight.



May 2016
The nomination committee – coming out of the shadows

Produced in partnership with ICSA: The Governance Institute, our report focuses on the nomination committee's role, and how boards can improve their work.



January 2016
Rising to the challenge – A review of risk and viability disclosures in September 2015 annual reporting

Analyses the first batch of annual reports required to comply or explain under the 2014 UK CG Code provisions on risk and the viability statement.

Appendix C: EY contacts

	If you want to know more about...	EY contacts		
Corporate governance	▶ Perspectives and trends in governance	Ken Williamson	kwilliamson@uk.ey.com	+44 20 7951 4641
	▶ Board composition and effectiveness	Mala Shah-Coulon	mshahcoulon@uk.ey.com	+44 20 7951 0355
	▶ Leading practices in corporate reporting			
	▶ Future developments in governance and reporting			
Performance and reward	▶ Executive remuneration including policy design, governance and reporting	Rupal Patel	rpatel15@uk.ey.com	+44 20 7951 0658
	▶ Incentive design for executive, management and all employee populations including equity incentives	Isobel Evans	ievans@uk.ey.com	+44 20 7951 3113
	▶ Share plan implementation in the UK and internationally, including addressing regulatory and tax matters	David Ellis	dellis@uk.ey.com	+44 20 7980 0163
	▶ Remuneration benchmarking and market surveys			
	▶ Gender pay gap			
Climate change and sustainability	▶ Sustainability strategy assessment and implementation	Doug Johnston	djohnston2@uk.ey.com	+44 20 7951 4630
	▶ Environment, health and safety risk			
	▶ Sustainable supply chains			
	▶ Sustainable finance solutions			
	▶ Integrated reporting and sustainability report assurance			
Long term value	▶ Perspectives and trends on long-term value creation and related investor dialogue	Hywel Ball	hball@uk.ey.com	+44 20 7951 2474
	▶ Measuring a company's long-term performance and full value in order to support better disclosures and decision making	Barend van Bergen	bvanbergen@uk.ey.com	+44 20 7951 1009

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