Out with the old, in with the new

Observations from EY’s review of December 2013 annual reports in the FTSE 350, with recommendations for 2014

September 2014
3. Fair, Balanced and Understandable (FBU)

The FBU test applies to the entire ARA, regardless of the complexities in financial reporting.

While the reader of the report decides whether it’s ‘understandable’, the onus is very much on the board, management and auditor to judge the ‘fairness’ and ‘balance’ of the ARA. The chairman, CEO, CFO and chairs of the board committees need to take personal responsibility for this content. This should help to ensure the ARA presents clear and concise information tailored to the specific circumstances of the company, avoiding boilerplate which may be long on detail but short on insight.

A good example is where a company discloses:

► What was planned (short and long term).
► What changed and/or rolled forward (how and why).
► What succeeded and failed.

Indeed, openness and honesty, by reporting weaknesses, difficulties and challenges as well as successes, makes for a ‘fair’ and ‘balanced’ ARA and builds trust with the investor community over time. An example is Amec plc which discloses ‘What didn’t go to plan in 2013’ at key junctures in its ARA.

Consistency between different ARA sections (including the narrative and financial statements) is also a good indication of a ‘fair’ and ‘balanced’ approach. So too are clear and simple explanations of the strategy, business model and KPIs, where KPIs are used consistently over time and linked to strategy and remuneration. Consideration also has to be given to explaining non-GAAP measures, at an appropriate level of detail and with more information provided discretely for readers who want to know more about the technicalities (e.g., reconciliations between GAAP and non-GAAP measures). Important ideas or messages also need to be introduced upfront and followed through from the beginning to the end of the ARA.

Leading practice presents all of this information by blending the written word with ‘pull-out’ quotes, tables, charts, case studies and other graphics. This helps to break up high density copy into digestible and navigable segments of relevant information. Care is also taken on the placement and cross-referencing of this information, so users of the ARA can orientate themselves with what they want to know with relative ease.
In the main, boards have taken their responsibility to assert that the ARA is FBU seriously. 79% of boards asked audit committees for their advice in making this assertion. However, few ARAs explain what these audit committees (or boards) actually did in making this confirmation.

We endorse the practice of disclosing what processes or measures are put in place to enable boards to conclude that their ARA is FBU. Whilst not required, it makes for fairer and more understandable reporting. Typically what process or measures might a board or audit committee undertake or put in place?

- A board conversation on what FBU means for the company’s reporting.
- A cross-check between board minutes, press releases, other corporate reporting etc. and the ARA to ensure key issues are reported in a fair and balanced manner in the ARA.
- Early preparation of draft ARA especially narrative content to allow for timely review by the board for consistency, completeness and messaging.
- Consistency checks – between different narrative sections (messaging, language and tone) and between the narrative and financial statements.
- Factual verification of data contained in the ARA.

Recommendations for FBU

- Debrief the process of producing your 2013 ARA for lessons learnt.
- Start work on your 2014 ARA as soon as possible. Sections of the report can be written before the results are finalised, allowing additional time for review.
- Involve designers as early as possible, to make sure their ideas pass the FBU test.
- Keep the external auditors in the planning loop.
- Apply FBU principles to other corporate communications, such as preliminary announcements and interim reports.
- Refer to guidance issued by the FRC, FRL and EY on what makes for good corporate reporting including:
  - *Cutting clutter: Combating clutter in annual reports* (FRC, 2011).
  - *Louder than words: Principles and actions for making corporate reports less complex and more relevant* (FRC, 2009).
  - *Financial Reporting Review Panel annual report* (FRC, 2012) which contains a succinct 9-point list of the characteristics of a good ARA.
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3. Fair, Balanced and Understandable (FBU)

Case studies:
BP plc (page 69)
- Board received an early draft of the annual report to enable time for review and comment.
- Audit committee and safety, ethics and environment assurance committees met jointly to consider the criteria for FBU and to review the process underpinning the compilation and assurance of the report, in relation to financial and non-financial management information.
- Following the joint meeting of the committees, the board then considered the ARA as a whole and discussed the tone, balance and language of the document, being mindful of new UK reporting requirements and consistency between the narrative sections and the financial statements.
- In assessing FBU the board reviewed the internal processes that form the group’s reporting governance framework, including the role of the corporate reporting steering group, content owners and legal and auditor review.

Taylor Wimpey (page 59)
The review of the Company’s Annual Report and Accounts took the form of a detailed assessment of the collaborative process of drafting them, which involves the Company’s Investor Relations; Finance; Company Secretary; and Internal Audit Departments, with guidance and input from external advisers. It ensured that there is a clear and unified link between this Annual Report and Accounts and the Company’s other external reporting, and between the three main sections of the Annual Report and Accounts – the Strategic Report; the Governance Reports; and the Accounts.
- Ensured that it correctly reflected the Company’s performance in the reporting year, as described on pages 10 to 39.
- Ensured that it correctly reflected the Company’s business model, as described on pages 14 to 22.
- Ensured that it correctly described the Company’s strategy, as described on pages 14 to 22.
- Ensured that it presented a consistent message throughout.
- Considered whether it presented the information in a clear and concise manner, illustrated by appropriate KPIs, to facilitate shareholders’ access to relevant information.

AMEC plc (page 54)
At the request of the board, the (audit) committee has also reviewed and provided advice on whether the annual report and accounts, when taken as a whole, is fair, balanced and understandable, to enable AMEC’s shareholders to assess the company’s performance, business model and strategy.
- Its own knowledge of the group, its strategy and performance in the year.
- The comprehensive guidance provided to all contributors to the annual report and accounts.
- A thorough internal verification of the factual content within the document.
- The comprehensive reviews undertaken at different levels in the group to ensure consistency and overall balance.
- A detailed review by senior management.

Towards clear and concise reporting (FRL, 2014).
Changes to communication and reporting for companies and auditors (EY, 2013).
Meeting the fair, balanced and understandable challenge: Make your corporate reporting count (EY, 2013).
Shareholder engagement and corporate reporting at a crossroads (EY, 2014).
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