Out with the old, in with the new

Early reflections from EY’s review of December 2013 annual reports in the FTSE 350

June 2014
A year of change in corporate reporting

2013 was clearly a year of change for corporate reporting. Annual reports and accounts (ARA) of listed companies now contain (amongst other things): a Strategic Report, enhanced audit committee and auditor reports, a board statement that the entire ARA is fair, balanced and understandable and expanded reports on executive remuneration.

The changes were introduced in response to the financial crisis amid calls for:

- Greater transparency of judgements made by boards and the link between company performance and executive pay.
- Auditors to provide more relevant and useful information to shareholders.
- Shareholders to hold management, boards and auditors to account by engaging effectively on key issues and judgements.

How did companies implement these changes?

EY’s review of December 2013 annual reports in the FTSE 350

Both September 2013 and December 2013 reporters have published ARAs under the new requirements, with March 2014 reporters soon to follow.

We have performed a review of a sample of FTSE 350 December 2013 reporters to assess how the changes have been implemented, identify any emerging practices/themes and provide our views on what the next reporting season may hold.

This publication provides our early reflections and views and our full report will be published later this summer.

Look out for our full report which will be published later this summer. This will cover:

- An in depth analysis of typical ARA sections
- Leading practice examples
- What you should consider for next year’s reporting

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i. Premium listed companies as regards the changes to the UK Corporate Governance Code and quoted companies as regards changes to company law in relation to the Strategic Report and executive remuneration.

ii. All statistics quoted in this publication are based on our sample, which at the date of reporting comprised 85 companies in the FTSE 350.
Overall analysis

Key observations
► ARAs are now 10% longer.
► Average ARA length is 163 pages (148 pages in 2012).
► The narrative report or ‘front end’ has increased by an average of 9 pages to 89 pages (80 pages in 2012).

Reflections
It is no surprise that ARAs are lengthier. A lot more information has gone in to comply with the new regulations, and not a lot has come out.
Companies had the challenge of dealing with all the regulatory changes and, bar a few exceptions, most did not have time to step back and consider whether information could be removed.

What’s next?
Refine and reduce
Companies should embrace the challenge to cut clutter. The next reporting season presents a good opportunity to do so given we expect limited regulatory changes.
To aid this, clarification is needed regarding what information can be placed outside the ARA (e.g., on a website) or within a supplemental section of the ARA itself.
We welcome the Financial Reporting Council’s Guidance on the Strategic Report finalised in June 2014. This provides guidance on the placement of information and encourages companies to consider and challenge the structure of their annual reports, to enhance communication.
We also encourage companies and investors to participate in the Financial Reporting Lab’s project ‘Corporate Reporting in a Digital World’.
### Key observations

- 79% of boards asked audit committees to advise them on whether the ARA was fair, balanced and understandable.

### Reflections

Boards having to assert publicly that the ARA is fair balanced and understandable has made them sit up.

Even where there is little or no information disclosed on how boards made their assertion, we know from our conversations with boards that they took it seriously.

### What's next?

What went on behind the scenes?

Emerging leading practice is to disclose briefly what processes or measures are put in place to enable the board to conclude that the ARA is fair, balanced and understandable.

We would like to see more of these disclosures because they help to make report fairer and more understandable.
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**Strategic Report**

**Key observations**
- On average, the Strategic Report represents 30% of the overall ARA.
- The average length of a Strategic Report is 43 pages.
- About 70% of companies have, to some extent, linked strategy, objectives and KPIs.
- An equal number also link their KPIs (in some manner) with performance measures used to determine variable remuneration.

**Reflections**
Overall the traditional structure of the front end has largely been maintained i.e., ARAs still include a Chairman's Statement, a CEO's review and a CFO's report. We are encouraged to see that companies are linking key aspects of their reporting more cohesively. However, on more specific disclosures, e.g., diversity, environmental and social matters, reporting is still poorly integrated with the strategy and risks of the business.

**What's next?**
The Strategic Report can be made simpler and more relevant
In addition to the points noted in our overall analysis regarding cutting clutter, Strategic Reports should:
- Contain information that is relevant i.e., material and entity specific to enable a shareholder to gain 'an understanding of the development, performance or position of the company's business'.
- Tell a story. We would like to see companies challenging convention e.g., consider removing the Chairman's Statement and CEO's review.

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**Directors’ Report**

**Key observations**
The Directors’ Report now only contains technical and detailed statutory disclosures.

**Reflections**
Since the introduction of the Strategic Report, the Directors’ Report (as legally defined), has somewhat paled into insignificance. It has become a ‘container’ for standing information which does not add value to the ARA.

**What’s next?**
Does the Directors’ Report have a place in the ARA anymore?
Given the remaining content in the Directors’ Report, the Government needs to re-visit its original intentions around an online Annual Directors’ Statement or equivalent.

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iii. Materiality cannot be applied to disclosures that are required by company law or its associated regulations unless explicitly allowed (for example, through the use of the terms such as ‘...to the extent necessary for an understanding of...’)

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## Key observations

- Audit committee reports are four pages long on average.
- Audit committees report 5 significant issues (on average) in relation to the financial statements.
- Taxation is top of mind: 47% of audit committee reports mention an aspect of taxation as a significant issue.
- Over half of FTSE 100 companies (2012: a third) now describe their tax strategy publicly, either in the ARA, on their websites, or in separate corporate social responsibility documents.

## Reflections

The best audit committee reports are concise, make effective use of cross referencing and give insight on how committees satisfy themselves on each issue.

There is a large degree of overlap between the audit committee and auditor's reports – expectedly so, but there could be good reasons for differences.

Tax issues are not only occupying audit committees but corporates more generally. The political and public debate continues to evolve, and we have seen companies continue to respond through additional public disclosure, in particular around the group's tax strategy or principles.

The nature and level of detail of these disclosures vary from company to company, but several common themes are emerging, for example around relationships with tax authorities and protecting value for shareholders.

## What’s next?

Audit committee explanations can be more insightful

Narrative on how audit committees address significant issues can be improved by providing insights on:

- Whether audit committees sought any third party evidence, in relation to the issues.
- Key aspects of issues committees were most concerned with and the subsequent challenges and debates on management’s approach and views.
- The areas of the business most impacted by the issue for e.g., a specific subsidiary.
- The conclusion or outcome and rationale.

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iv. Revenue recognition, impairment of intangible assets and goodwill and pensions are all mentioned in approximately 25% of audit committee reports.

### Key observations

Explanations of ‘how’ the audit committee assessed the effectiveness of the audit process are lacking in detail and substance.

Many limit the assessment to the auditor as opposed to the audit process and there is a skewed focus on looking at independence rather than the broader aspects of audit quality.

### Reflections

vi Whilst the auditor is in large part responsible for the effectiveness of the audit process, management and the audit committee have an important influence too, and their role should be considered in the overall assessment.

### What’s next?

Either the disclosure needs to change, the underlying assessment process, or both

If more robust assessments have occurred, corresponding changes in disclosure were not sufficient.

If the disclosures reflect the assessment undertaken, we challenge committees on whether the requirement in the Code is actually being met in terms of a holistic assessment of the audit process.

Explanations should include the criteria used and the evidence considered in reaching a conclusion, and we wish to see this come through in 2014 ARAs.
Directors’ Remuneration Reports (DRR)

Key observations
► The average length of the DRR is 20 pages.
► Beyond technical compliance, we would describe only 10% of DRRs as providing a comprehensive level of detail in all aspects of disclosure. However, 44% of DRRs did contain individual disclosures that provided significant depth of detail.
► 40% of DRRs provided a level of disclosure which included the actual targets set and the level of performance achieved.

Reflections
DRRs are generally consistent in their format, but there is a divergence of views on the level of detail required by the regulations.
There is a marked improvement in the level and depth of retrospective disclosure of performance against targets for the annual bonus.

What’s next?
Take stock, reach consensus
We expect most of those involved in the drafting of the DRR to take stock of the trends emerging from the first reporting season under the new regulations. This may result in a greater consensus on the level of detail expected by investors, as well as what constitutes leading practice for each aspect of disclosure.
The depth of disclosure by some will provide a welcome challenge to those who have perhaps been too cautious in the level of detail reported this year; particularly in regard to the annual bonus. The expectations of investors will therefore heighten, and justification for withholding information will need to be suitably robust.

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Nomination committee disclosures

Key observations

► 69% of boards clearly state their policy on board diversity.
► Over a third of companies are committed to meeting the Davies target of 25% female representation on boards.
► Of these, over two thirds state that they will meet the target by 2016.

Reflections

► Not many companies articulate the link between board composition and the business strategy.
► Board diversity has sometimes been limited to gender diversity.
► Gender diversity statistics (at all levels of the company) are generally provided in ‘isolation’.

What’s next?

Demonstrate the importance of diversity

In our view the following are leading practices:

► Board composition and succession planning should be linked to the long term strategy of the company i.e., diversity (in its broadest sense i.e., including skills, experience, gender etc.) should evolve as strategic direction evolves.
► Gender diversity disclosures at different levels within the company should be linked to board diversity disclosure. The talent of today’s female senior managers should be developed and managed such that they are the board members of the future.
► Companies should provide information on the actions they are taking to manage and improve gender diversity throughout the company.
So now you should have enough of a flavour of what is to come. Read our full report out later this summer. This will cover:

► An in-depth analysis of typical ARA sections
► Leading practice examples
► What you should consider for next year's reporting

Our full report will be published later this summer. If you wish to discuss the contents of this report, or the findings of our research more broadly, please speak with your usual EY contact or:

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EY resources  
Our recent publications and thought leadership, pertinent to the matters discussed above include:

► Shareholder engagement and corporate reporting at a cross roads
► A customisable toolkit to assess the effectiveness of the audit process
► Meeting the fair, balanced and understandable challenge

These and others can be found on:  
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