Meeting the fair, balanced and understandable challenge

Make your corporate reporting count

September 2013
Directors of premium listed companies which are subject to the UK Corporate Governance Code1 take note: new ‘fair, balanced and understandable’ (FBU) requirements are in force. Listed company directors will have to state in their annual report and accounts (ARA) that they consider their ARA to be FBU, and that the ARA ‘provides the information necessary for shareholders to assess the company’s performance, business model and strategy’.

It is a matter for judgement
This is a new requirement of the UK Corporate Governance Code, affecting reporting periods beginning on or after 1 October 2012. It poses a few challenges for listed company reporters: regulators have not defined exactly what they mean by FBU and no further guidance is likely.2 Management and the boards of listed companies therefore need to apply their own judgment to decide what FBU means to them and their company’s reporting. In forming this view, we would encourage them to refer to existing helpful guidance issued by the Financial Reporting Council (FRC) and others on what makes for good corporate reporting.3

Insider challenge
Whilst an outsider can form a view on whether the ARA is understandable, only the board, management and auditor can judge fairness and balance. Boards and management teams must consider the concepts of fairness and balance when identifying, writing and approving the ARA. The chairman, CEO, CFO and chairs of other board committees need to take personal responsibility for this content; if they do, their sections and the whole ARA are more likely not only to be FBU, but also to have a much more positive impact on readers.

The FBU reporting requirement is not the only new challenge facing company reporters, however. Other regulatory changes will require 2013 ARAs to contain additional or revised content, such as a new Strategic Report and a two-part Directors’ Remuneration Report. FBU principles must be applied to this material as well.

In fact the whole ARA has to be FBU – not just the narrative. International Financial Reporting Standards can lead to complexity in financial reporting, but the ARA still needs to explain that complexity in a way that is understandable by non-accounting experts.

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1 Hereafter ‘listed companies’
2 In August 2013, the Financial Reporting Council issued draft guidance on the strategic report, with reference to FBU, but it remains to be seen whether further detail will be added on FBU in this or the 2014 review of the UK Corporate Governance Code.
FBU insights

Given the challenge facing companies, we reviewed the most recent ARAs of a few listed companies across a range of sectors, assessing key sections for their ease of understanding. We also attempted to assess the ARAs for their fairness and balance, whilst recognising that only company boards and management can truly judge this. We identified FBU indicators, drawing both on FRC publications and our own experience.

Our findings represent our own judgment of what makes for FBU reporting. Though not scientific, they offer insight for companies in terms of what they can do to enhance FBU in their reporting, to comply with the new requirements but also to enhance communication with shareholders.

Fair and balanced: good examples, but room for improvement

The concepts of ‘fair’ and ‘balanced’, though different, are interlinked: an ARA cannot be fair if it is not balanced. We therefore considered these two attributes together.

In identifying the features of an ARA that would indicate appropriate fairness and balance, we highlighted openness and honesty – the reporting of weaknesses, difficulties and challenges as well as successes. Consistency between different ARA sections – including between the narrative and the financial statements, is also suggestive of a fair and balanced approach. So too are clear explanations of key performance indicators (KPIs), strong linkage of KPIs to strategy and consistent measures of progress over time. Important ideas or messages also need to be introduced upfront, and followed through in ensuing ARA sections.

Did we find indications of fairness and balance in the 15 ARAs we reviewed? Yes. Many listed companies are delivering elements of a fair and balanced ARA, giving appropriate weighting to setbacks, reporting in an informative way, and linking the business model, strategy and KPIs. Good examples include:

► A chairman’s statement discussing not only company achievements, but also setbacks – such as the industrial action at two operations that led to the division making a loss.
► A CEO’s review being honest about the control issues faced by the company and giving a flavour of what these were, such as significant losses on a major project, inconsistent group-wide application of accounting policies and inadequate forecasting in light of deteriorating trading conditions.
► Openness about negative feedback from employees on the company’s approach to performance management, personal development and career management, and actions taken in response.
► An audit committee report discussing specific accounting and auditing issues.
► Information provided on a significant environmental event, including process, status and financial impact in 2012, with details of the significant uncertainties and how these will impact the company, and links given to other relevant sections of the ARA.
► Achievement against KPIs reported honestly, including a clear graphical depiction of which ones were met, on track and not met.
► Clear explanation of how and why a safety KPI was changed during the year.
► Clear linkage from strategy to KPIs and a clear track record in terms of KPI achievement.
► Presentation of adjusted and unadjusted figures, with both used consistently in the company’s analysis.
Room for improvement does exist, however, in relation to fair and balanced reporting. For example, some chairmen’s and CEO’s statements fail to address missed targets or significant uncertainties affecting the business, leaving readers to discover these later in the ARA. Some listed companies use inconsistent KPIs, or different sets for different purposes in different ARA sections. Others fail to explain why particular KPIs are used, or make no use of non-financial KPIs. We also found situations where companies identify factors which are key to their business or strategy – such as sustainability or their people – but then fail to follow through in the rest of the ARA how these factors contributed to their success.

**Understandable: the good and not so good**

What characteristics of an ARA help it to be understandable by readers? Again drawing on FRC guidance and our experience, we identified a range of indicators. These include simple explanations of business models, strategies and accounting policies, using precise and clear language. Reader understanding is also supported where narrative is broken up by quotes, tables, case studies and other graphics. The more understandable ARAs also tend to have a consistent tone across all sections and provide clear signposting to where additional information can be found.

**Good examples include:**

- Company strategy being presented by means of an analogy – engaging the reader and bringing the strategy to life, with case studies used to demonstrate achievements against the strategy.
- A personal letter from the chair of the Remuneration Committee, showing his passion for his role and desire for readers to understand the remuneration report.
- A performance section providing a clear and concise explanation of all KPIs, including how they are measured, results and targets.
- A governance section clearly mapping out how governance decisions are made, project by project.
- Primary statements accompanied by commentary to help readers understand movements between years.
- Individual disclosure notes having a ‘headline’ explaining in simple terms what the disclosure shows.

Again, substantial opportunities exist for listed companies to make their ARAs more understandable. For example, some business model descriptions fail to explain clearly what the company does, or use boilerplate wording or jargon. Some listed companies confuse the presentation of their strategy and business model, or give no indication of how competitive advantage will be maintained over time, which a good explanation of a company’s strategy should do. We also found cases where listed companies fail to differentiate their principal risks from other risks or give generic descriptions. Some ARAs fail to explain what needs to be done where KPIs are not fully met. Sometimes identical (or very similar) text is repeated in different ARA sections. And whilst graphics are often helpful, some ARAs include charts or graphical images that are more confusing than informative.
Plan early, allow time

Listed companies that want to enhance FBU in their ARAs need to plan ahead and start work early. Sections of the ARA that are not dependent on company results can be written ahead of the rest, so that the necessary attention is spent on them in order to achieve FBU goals. Similarly, design agencies should be involved early. They may have good suggestions for innovative presentational techniques, but time needs to be allowed for assessing their FBU qualities.

Sufficient time should also be allowed later on in the ARA drafting timetable. Those responsible need to be able take a step back and assess whether the ARA, taken as a whole, really is FBU. If not, they need to have time to make adjustments.

Listed companies should also keep their auditors in the planning loop. Auditors too have a new reporting duty on FBU and will need to plan ahead in order to fulfil it.

See the bigger picture

Whilst listed company directors are required to make sure the ARA is FBU, the same principles should be applied to all corporate communications, including preliminary announcements and interim reports. Consistency between one ARA and the next is also important. If reporting one year on actions being taken to address a specific issue, the story should be completed the following year. Readers of the ARA will want to know whether the actions bore fruit, or whether a different approach is now being taken.
What now?

The need to achieve FBU reporting should not be labelled as a pure compliance task, but as an opportunity to improve communication with shareholders and other ARA users. Listed company boards and management teams could begin their FBU preparations now by asking themselves a couple of key questions.

Questions for company boards:
► Is the company portrayed in the ARA the same company we discuss in the boardroom?
► Could a private shareholder with limited knowledge of our company understand our ARA?

Questions for management teams:
► Does everything in the most recent ARA need to be there, or could some information be placed elsewhere, such as on the company website?
► How can we best plan our ARA drafting process to ensure we achieve the goals of communicating in a way that is FBU?
Contact us

To discuss FBU or any of the issues raised here in more detail please contact a member of our Corporate Governance team listed below or your usual EY contact.

An earlier EY publication discussing FBU and changes to audit committee reporting is also available from the Corporate Governance team.

Ken Williamson
Tel: + 44 20 7951 4641
Email: kwilliamson@uk.ey.com

Andrew Hobbs
Tel: + 44 20 7951 5485
Email: ahobbs@uk.ey.com

Mala Shah-Coulon
Tel: + 44 20 7951 0355
Email: mshahcoulon@uk.ey.com

David Parrish
Tel: + 44 20 7951 0513
Email: dparrish@uk.ey.com
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