Deloitte.

A new beginning
Annual report insights 2013

October 2013

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1. Executive summary

The annual report, despite all the changes in recent years, remains the bedrock document for telling a company's story. It is at the heart of a company's ability to communicate with stakeholders, and particularly investors. And it is proof of the old cliché that the more effort you put into it the more benefits you will gain.

This publication combines both insight and best practice to provide you with the inspiration needed to make that effort effective and improve your annual report. And this year, with the new strategic report in mind, the overall aim is to communicate the most important elements of the story clearly to your audience.

This coming year is the time when the old business review makes way for the new strategic report, which comes into force for periods ending on or after 30 September 2013. The good news is that this process is more of an evolution than a revolution. Many of the best companies are already following some of the new requirements so we were able to include many of them as examples in the guidance which is woven into this publication alongside the Financial Reporting Council's draft suggestions on preparing a strategic report. Much of this has already taken hold. Some 44% of the companies we survey are already clearly disclosing their business model, albeit something which the UK Corporate Governance Code has suggested on a comply or explain basis for the last couple of years.

Where companies have tended to fall down in the quest to make their reports truly comprehensible to stakeholders and shareholders is in linking together different parts of the story. We found that only 28% of the companies surveyed were clearly linking together all the different components of their annual report. This is an improvement on last year when only 14% were doing so. And looking at specific elements of the annual report the use of effective linkage varied enormously. For example 90% of companies disclosing their objectives provided a link to these and the strategy employed to achieve them. But only 43% provided links to the measures used to assess the success of that strategy. And key performance indicators were employed erratically. One test of the coherence of an annual report is to check the consistency of the KPI figures given on the highlights page and the KPIs themselves elsewhere in the report. We found that 19% of companies were not including any KPIs at all on their highlights pages. If performance indicators really are 'key' you would expect them to be appearing upfront in the full report.

A real driver of change in financial statements as well as, to a slightly lesser extent, narrative reporting, is the effort made by the IASB through its disclosure framework project and the Financial Reporting Review Panel's (FRRP's) exhortations which should encourage companies to eliminate a mass of immaterial disclosures. This should reduce pages and by making key messages more prominent allow stakeholders and shareholders a better chance of seeing the wood for the trees. Despite this trend we found that the average pagination has gone up over the last year from 103 to 107 pages. It is a small rise but an unexpected one in the circumstances, though it could be explained by early adoption by some companies of extra disclosure requirements around directors' remuneration and by UK banks making a strenuous effort, unlike their counterparts overseas, to comply with the recommendations of the Enhanced Disclosure Task Force.

A tip for companies seeking to cut their clutter would be to look at accounting policies. We saw some companies excluding accounting policies for areas which appeared immaterial. Some went further and said they simply hadn't disclosed immaterial information in other parts of the financial statements. Aid may also come from the FRC's Financial Reporting Lab, which is currently working with a number of companies on case studies for cutting clutter.

There was also, as a result of more new legislation, increased disclosure relating to, for example, environmental issues and gender diversity. We found 42% of companies already disclosing some limited numbers on greenhouse gas emissions, although not typically enough to comply with the new regulations in this area, and 21% of companies providing employee gender diversity figures. And in the background the influence of the initiatives relating to integrated reporting is growing.

Meanwhile the area of reporting risk and uncertainty showed signs of maturity. 83% of companies were found to be clearly disclosing principal risks and uncertainties. 91% talked about mitigating activities – something the FRRP is particularly keen on. And only 5% of companies were judged to have only provided a 'boilerplate' list of principal risks and uncertainties.

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The year ahead will also see change as a result of the UK Corporate Governance Code requiring companies to produce a statement that the annual report and accounts, taken as a whole, is fair, balanced and understandable. That sounds, like motherhood, to be a very simple concept. But its implementation and achievement will be complex. To create a fair, balanced and understandable report which highlights the key messages and successfully integrates the different components is no mean feat. And alongside that task the FRC's guidance on audit committees has also been updated. Audit committees will have more to report on, for example the key financial reporting issues they have considered. But, as this publication shows, some 32% are already doing this. Companies will need to ensure an appropriate degree of consistency between those key financial reporting issues disclosed by audit committees, the risks addressed and disclosed by auditors in their new style reports, the IAS 1 disclosure around key sources of estimation, uncertainty and critical judgements and, to a lesser extent, a company's principal risks and uncertainties. Inevitably these disclosures will catch the eye of regulators, so there is much here to keep companies awake and alert.

Looking at financial statements specifically they also fall under the fair, balanced and understandable disclosure requirements and companies will find a key consideration in this area is the 'fairness' of any non-GAAP measures, such as adjusted earnings. We found that some 65% of companies were using these on the face of the income statement and frequently stripping out items such as restructuring costs and amortisation. Companies also need to look out for a heightened area of focus from regulators on non-GAAP measures generally in the coming year. ESMA, for example, is expected to produce updated guidance.

Meanwhile 2012 was a relatively peaceful year in the world of IFRSs. But both 2013 and 2014 are set to be busier and companies will need to keep clear heads. Compared to the narrative reporting arena the appetite for early adoption of new accounting requirements was far less – none of the companies in our survey early adopted any new standards or amendments. Looking ahead, some 20% of companies with joint ventures are using proportional consolidation – an area which will need to be revisited as IFRS 11 becomes effective.

One area of focus for regulators, particularly in the wake of the financial crisis, has been disclosure around capital management or capital risk management. It was therefore relatively pleasing to see that 93 companies disclosed such information in their financial statements. And in the field of voluntary disclosures we found 45 companies voluntarily disclosing net debt reconciliations or similar statements. The IASB is considering introducing a requirement for such information and the FRC's Financial Reporting Lab has also looked into this and prepared a report on it.

On the theme of voluntary disclosure, media attention was probably the driver for the six companies we found including a statement in their annual report around tax governance which went beyond the disclosure requirements laid down in IAS 12.

The numbers themselves revealed that impairments are still a big issue, with 80% of companies reporting such losses. On perhaps a more positive note, the level of acquisition activity was seen to be on the increase, with 39 companies reporting business combinations, compared to 31 in the previous year.

But overall the message for preparers of annual reports is a simple one. There is much change around, some complex, some logical and intuitive. Companies need to be alert and keep one step ahead. Preparers are in need of useful advice, guidance and inspiration. And that is what this publication provides. It is full of insight into what changes lie ahead, what people are already doing, what the innovators and best reporters have already done, and, as we show throughout this publication, what overall best practice currently looks like. Equipped with our publication, the latest requirements for the front half of annual reports present preparers with an opportunity for a new beginning.

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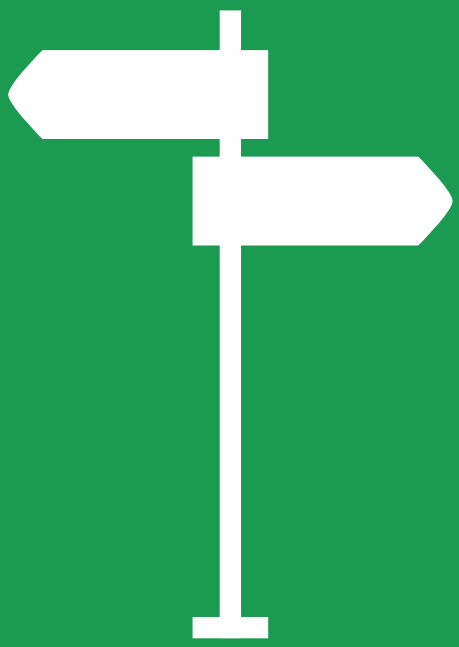
2. How to use this document



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2. How to use this document

This publication has been written with two main aims in mind. As well as being a survey, looking at historical trends in corporate reporting, it is also designed as a tool to help preparers develop and improve the structure and content of their annual report. Therefore, whether you're an audit committee member, you work in investor relations, you're a company secretary or a finance director, there is something in here for you.

As well as statistics and insight into historical trends and current reporting practice, there are thoughts and ideas around the impact of current and future changes in reporting requirements, along with plenty of examples of better practice identified from companies across the FTSE.

In appendix 1 we have distilled a wealth of ideas of pitfalls to avoid, regulatory developments to watch out for, ways in which you can choose to go above and beyond the minimum requirements and finally, areas that could be pruned to 'cut the clutter'.

What are the benefits of a good annual report?

The new narrative reporting legislation provides preparers with an opportunity to revitalise their reports and improve communication with stakeholders, with this publication providing inspiration on how best to achieve this goal. Investing time and effort to prepare a good annual report brings with it many benefits, a few of which are briefly outlined below.

- Investors are one of the main users of annual reports, but it's not just existing investors who look at it, it's potential investors too – a good annual report with clear communication of a business's performance and its prospects can help attract additional investment, while a bad report could make a potential investor think twice.
- A strong annual report will provide good publicity with other stakeholders too, whether it be employees, customers, suppliers or society at large.
- The directors are responsible for preparing an annual report, including the financial statements, and under the 2012 UK Corporate Governance Code are required to state that they consider the annual report and the accounts, taken as a whole, is "fair, balanced and understandable". A strong report will therefore reflect well on a company's governance.
- The FRC's Conduct Committee and its Financial Reporting Review Panel are responsible for monitoring the quality of corporate reporting in the UK. For obvious reasons it is desirable to avoid criticism from the regulator and the bad publicity this can bring.
- On a more positive note, prizes are awarded by a number of bodies for the best annual reports, bringing with them prestige and good publicity.

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Which parts of this document are most relevant to me?

The table below will help you identify those areas of the publication likely to be of most interest to you. For those looking for a quick steer on a specific disclosure issue, the interactive pdf contains links to further guidance and examples of good practice within annual reports in all of the chapters listed below.

Theme	Chapter	What is examined
Background information	3 – Regulatory overview	Sets out the backdrop for the requirements that UK listed companies are subject to, including regulatory hotspots and items that are new for 2013
	4 – Survey objectives	Provides an overview of the survey methodology and aims.
Annual report as a whole	5 – Playing the long game	Trends in overall report structure, from the length of the report and its various sections to the speed of reporting timetables, as well as the cohesiveness of the report as a whole.
Narrative reporting	6 – First impressions	How companies set the scene with an introductory summary section, covering the presentation of both financial and narrative information and the ways of linking this effectively to the rest of the report.
	7 – Towards a strategic report …	Disclosures in the business review and how these will translate into the strategic report, including the business model, objectives, strategy, presentation of business performance and corporate social responsibility information such as gender analysis and human rights issues. Directors' reports including carbon disclosures are also examined. Examples of early adopters are included.
	8 – Risks and uncertainties – what's keeping you awake?	Principal risks and uncertainties– commonly identified items, mitigating activities, ways of presenting the required information and linking to other parts of the annual report.
	9 – Unlocking performance	Key performance indicators – commonly identified measures, their understandability and linkage to other areas, including directors' remuneration.
Corporate governance	10 – Concerned about going concern?	The assessment and reporting of going concern, including the impact of the Sharman report and its recommendation in this area.
	11 – The governance debate	Compliance with the 2010 UK Corporate Governance Code and the level of engagement that companies have shown with the 2012 updates. There are examples of good practice in reporting compliance and presenting this information in an interesting and engaging way.
	12 – Auditing by committee	Audit committee reporting, in particular looking forward to the 2012 Code and FRC Guidance on Audit Committees and the additional information around significant issues the committee has considered in connection with the financial statements.
Financial statements	13 – Of prime importance	The primary statements, use of non-GAAP measures, IAS 1 compliance and tax governance disclosures amongst other items.
	14 – Taking note	The notes to the financial statements, including ideas for cutting clutter, impairment disclosures, discount rates, consistency with narrative reporting and much more.

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3. Regulatory overview

The requirements for a UK listed company's annual report are many and come from a variety of sources, the most significant of which include:

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

For years ended on or after 30 September 2013, new legislation will change the front half of annual reports as we have come to know them in recent years. Amongst other changes the business review will be replaced with a strategic report and the directors' remuneration report will also see an overhaul.

This section sets out an overview of the most significant regulatory requirements for UK listed companies' annual reports – it is not a comprehensive guide to all the requirements. Other publications produced by Deloitte, such as iGAAP: IFRS reporting in the UK and iGAAP: Annual report disclosures for UK listed groups provide more comprehensive detail on the many requirements, with the latter publication presenting a model annual report for a UK listed group.

What follows is a series of short guides, highlighting what the main requirements are for each of the following three components of a listed company's annual report:

- Narrative reports;
- Corporate governance statements (including directors' remuneration reports); and
- Financial statements.

Also included, for each of these areas, is an indication of the main changes in 2013, an idea of what the future holds and links to further resources. Regulatory hotspots are also identified and it is also worth noting that, in 2013/14 the FRC's corporate reporting reviews will, based on those industries which are considered to present the greatest risks, have the following priority sectors in their review of annual reports:

- support services;
- retail;
- natural resources/extractive industries; and
- construction.

Information on all the areas discussed, including news articles, thought pieces and supporting resources can be found on Deloitte's new one-stop-shop for all accounting, governance and regulatory matters – www.ukaccountingplus.co.uk.

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Narrative reports

Requirements

Section 415 of the Companies Act 2006 (CA06) requires a directors' report to be prepared as part of any company's annual report. For periods ending before 30 September 2013 all directors' reports (other than small companies) were required to contain a business review. For later periods the requirement to prepare a business review is replaced with a requirement to prepare a strategic report (see below).

Certain elements of the business review will remain in the newly required strategic report, including:

- a fair review of the company's business;
- a description of the principal risks and uncertainties facing the company;
- to the extent necessary for an understanding of the development, performance or position of the company analysis using financial key performance indicators (KPIs) and where appropriate, analysis using other KPIs, including information relating to environmental and employee matters;
- for quoted companies, information on the main trends and factors likely to affect the future development, performance and position of the company's business; and
- for quoted companies, information on environmental matters, employees and social and community issues, including any policies in these areas and their effectiveness.

Nothing in the business review or strategic report legislation requires the disclosure of information about impending developments or matters in the course of negotiation if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the company.

Many of the requirements for quoted companies have been extended in the current year as set out below.

New for 2013

The strategic report replaces the business review for periods ending on or after 30 September 2013. The strategic report should be separate to the directors' report, with a separate approval and signature. Quoted companies' strategic reports will need to include new information on the company's strategy, business model, human rights and gender diversity of its employees (not just the directors). Further information can be found in our 'Need to know' publication (see below).

New

An explanation of the company's business model has been required on a 'comply or explain' basis under the UK Corporate Governance Code since 2010. However, this disclosure will now be required by law and should form the backdrop for many other elements of the strategic report, which should link together as set out in the diagram below. At the time of writing the FRC has also published an exposure draft of guidance on how to prepare a strategic report (see 'Further information' below), providing examples of ways that different elements can successfully be integrated. This guidance will replace the 'Reporting Statement: Operating and Financial Review', published by the Accounting Standards Board.

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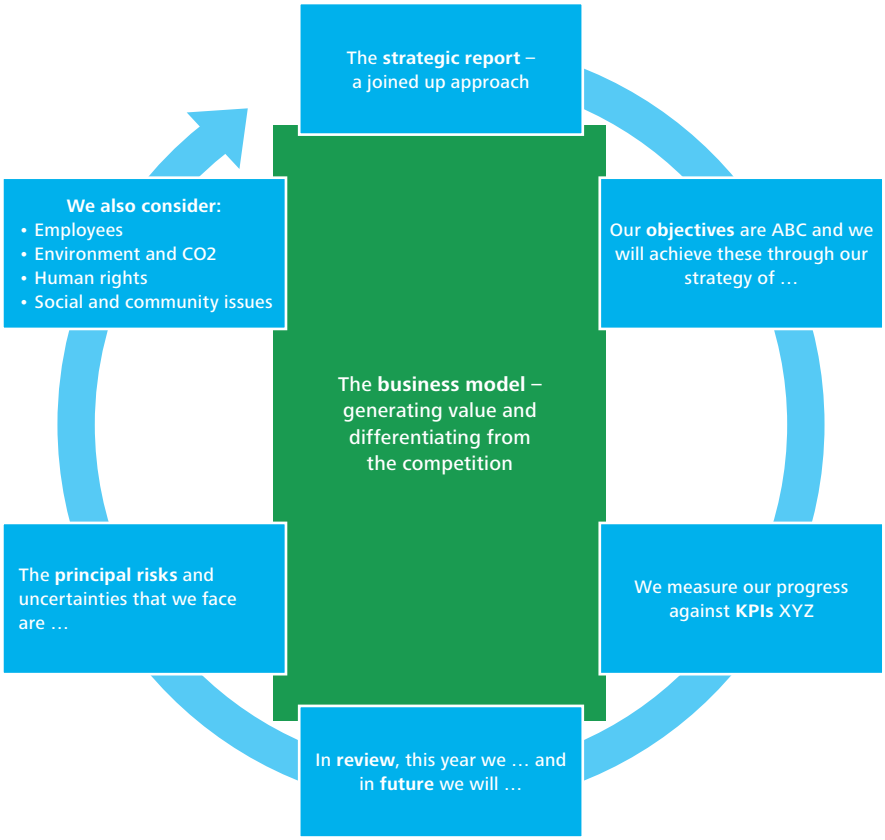

A small number of relatively minor disclosures previously required in the directors' report have been removed under the new legislation, including the company's principal activities and the policy and practice on payment of creditors. However, quoted companies' directors' reports will now need to include certain disclosures around greenhouse gas emissions. The protection afforded to directors by section 463 of the CA06 in respect of certain statements has also been extended from the directors' report to include the strategic report.

The option to provide shareholders with summary financial statements has also been replaced with an option to provide them with the strategic report and other specified supplementary material.

Regulators likely to focus on

Compliance with the new legislation described above will undoubtedly be an area of focus for the regulators this year and companies should check that all the newly required disclosures are included. As mentioned, integration of a report is key as well – making sure the narrative reporting tells a story that is consistent with the financial statements, for example by describing and explaining items identified as exceptional items, is vital.

Recent years have seen progress made in risk reporting, but pitfalls to avoid still include describing an excessive number of risks and uncertainties as 'principal' and omitting to mention mitigating activities, which the FRC's Conduct Committee believes is necessary. KPIs should also be clearly and consistently defined. These are in line with the current FRRP priorities as set out in their recently published annual report

What the future holds

2013 is a year of considerable change for narrative reporting and the changes represent the culmination of several years' of debate. Whilst the FRC are likely to issue finalised guidance on preparing a strategic report in early 2014, further legislative changes are likely to be minimal in the immediate future.

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On the international front the International Integrated Reporting Council's (IIRC's) initiative on 'integrated reporting' continues to gather pace. Whilst integration is undoubtedly a characteristic of a strong annual report, this is not to be confused with the IIRC's project. To enable companies to produce an 'integrated report' (distinct from a UK company's annual report) the IIRC has published a consultation draft of the international integrated reporting framework, with a finalised framework expected in December 2013.

The idea behind an 'integrated report' is that it goes beyond the financial statements and doesn't just report on financial capital, but also communicates information on five other capitals – namely manufactured, natural, human, social and intellectual. In the UK many aspects of this are already captured by the narrative reporting that forms part of a company's annual report, particularly following the new legislation introduced in 2013. However, for other parts of the world these ideas represent a more significant shift in communication with stakeholders.

UK companies may nevertheless look to embrace the principles of integrated reporting, placing increased emphasis on issues other than financial performance, such as the environment, social impact and reputation, talent, supply chain and innovation. Indeed it is not uncommon for the largest UK companies to already be preparing separate corporate social responsibility reports.

Whilst it is unlikely that the UK will mandate an integrated report in the short term, there are proposals from the EU to require additional disclosure around environmental matters, social and employee-related aspects, respect for human rights, anti-corruption and bribery issues, and diversity on the boards of directors.

Link to survey findings

Chapters 5 to 9 examine the current practices in respect of narrative reporting and provide ideas on how the new requirements for a strategic report could be met, based on examples where companies have, to an extent, been early adopting these new requirements.

Further information

- Strategic report legislation – http://www.legislation.gov.uk/uksi/2013/1970/pdfs/uksi_20131970_en.pdf
- Strategic report 'Need to know' newsletter – http://www.ukaccountingplus.co.uk/publications/uk/need-to-know/2013/need-to-know-uk-narrative-reporting-regs
- Practical guide on preparing a strategic report – http://www.ukaccountingplus.co.uk/publications/uk/other/the-strategic-report-2014-a-practical-guide
- FRC draft guidance on preparing a strategic report – http://frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Exposure-Draft-Guidance-on-the-Strategic-Report.aspx
- Deloitte UK Carbon Reporting Survey – http://www.ukaccountingplus.co.uk/publications/global/surveys/carbon-survey

Corporate governance statements

Requirements

Listed companies are required by the Listing Rules to make certain disclosures about corporate governance in their annual reports. Companies with a premium listing are required to state how they have applied the main principles set out in the UK Corporate Governance Code (the Code) and to provide a statement of compliance with the provisions of the Code, providing explanations for any failures to comply. The Code is accompanied by "Internal Control: Guidance to Directors" and the FRC's "Guidance on Audit Committees", both of which recommend various disclosures for inclusion in the annual report.

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The DTR also requires companies listed on the main market, amongst others, to include certain corporate governance disclosures, such as a description of the main features of the company's internal control and risk management systems in relation to the financial reporting process.

The Listing Rules and the Code both require a statement by the directors that the business is a going concern, together with supporting assumptions or qualifications as necessary. At the time of writing, this disclosure should be prepared in accordance with the "Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009", published by the FRC in October 2009, which focuses on the three key principles, discussed below.

- **Assessing going concern:** directors should make and document a rigorous assessment of whether the company is a going concern when preparing annual and half-yearly financial statements.

- **The review period:** directors should consider all available information about the future when concluding whether the company is a going concern at the date they approve the financial statements. Their review should usually cover a period of at least twelve months from the date of approval of annual and half-yearly financial statements.

- **Disclosures:** directors should make balanced, proportionate and clear disclosures about going concern for the financial statements to give a true and fair view. Directors should disclose if the period they have reviewed is less than twelve months from the date of approval of the annual report and explain their justification for limiting the review period.

An update to this guidance is expected in light of the Sharman Inquiry on going concern, with the FRC already encouraging adoption of the principles emerging from this review (see below).

Quoted companies reporting under CA06 are required to include a directors' remuneration report.

New for 2013

A number of revisions to the Code and FRC Guidance on Audit Committees are effective for periods commencing on or after 1 October 2012, with certain items being 'upgraded' from guidance to provisions of the Code. Significant new items include the below.

New

- The directors are required to state in the annual report that they consider "the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy". The board may ask the audit committee for advice in this area, but the board as a whole must form this judgement.

- The Code now requires the audit committee's report within the annual report to include information on the significant issues that it considered in relation to the financial statements and how these were addressed. An explanation of how the effectiveness of the external audit process was assessed should be provided as well. FTSE 350 companies will also need to put the audit out to tender at least every ten years, subject to transitional provisions.

- In describing the work of the nomination committee the annual report should also include a description of the board's policy on diversity, including gender, any measurable objectives it has set for implementing the policy, and progress on achieving the objectives. These diversity disclosures were announced as changes in October 2011, with early adoption strongly encouraged. Accordingly, for some companies this may not be a change in 2013.

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Following their consultation on implementing the recommendations of the Sharman Inquiry on going concern, the FRC has postponed amendments to their guidance on going concern. Nevertheless, they encourage all companies to consider and adopt the principles emerging from that review. In practical terms, we suggest that this means that directors of larger companies will want to:

- make a robust assessment of the significant risks facing the company's ability to deliver its strategy which includes solvency and liquidity risks and looks beyond the next twelve months; and
- review and agree how the identified risks will be mitigated.

The above steps may influence the existing disclosure of principal risks and uncertainties. In addition, the FRC's suggestion that risk assessment should be an ongoing process, rather than an annual exercise suggests that companies may look to improve their disclosures around principal risks and uncertainties, their internal control statement and their going concern statement – looking ahead, changes to the Code may well be made in these areas.

Quoted companies' directors' remuneration reports will also look very different for periods ending on or after 30 September 2013. The remuneration report will be split into a policy report (not subject to audit) and an annual report on remuneration (some elements of which are subject to audit). The policy report will be subject to a binding shareholder vote, which must take place in the first year beginning on or after 1 October 2013. The annual report on remuneration is subject to an annual advisory vote and includes a new 'single figure' directors' remuneration table. The GC100 and Investor Group has published guidance on the new requirements.

The requirements of the new directors' remuneration report are extensive and require a considerable amount of information that has not previously been required. Companies should take care to ensure they comply with the new legislation, bearing in mind the public interest in these disclosures.

Regulators likely to focus on

The new requirements of the Code and the new legislation on directors' remuneration reports will inevitably be parts of the annual report that attract scrutiny from regulators in the first year of implementation. In particular, a degree of consistency will be expected between the significant financial reporting issues considered by the audit committee, IAS 1's critical judgements and key sources of estimation uncertainty, the risks highlighted in the new-style auditor's report (see below) and, to a lesser extent, principal risks and uncertainties.

What the future holds

The FRC's Financial Reporting Lab has undertaken an investigation to better understand what the investment community wants to see reported by audit committees, in light of the 2012 revisions to both the Code and the Guidance on Audit Committees. A final report is expected in late October.

In light of the Sharman Inquiry's final report and recommendations of the panel of inquiry (the 'Sharman report') the FRC are set to consult on three main items in the world of going concern:

- integrated going concern and risk management guidance for entities applying the Code. This will incorporate the expected consultation on the Guidance on Internal Control;
- proposed changes to the Code to reduce the confusion between the use of "going concern" to refer to two different things – the requirements of accounting standards regarding the basis of preparation for financial statements and the broader assessment of risks affecting a company's viability; and
- separate simplified guidance for small and medium sized entities (SMEs).

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At the time of writing any revised proposals are expected to take effect in October 2014.

Following on from the new remuneration report legislation, the FCA are consulting on consequential amendments to the Listing Rules in respect of directors' remuneration, although at the time of writing these changes are proposed for periods beginning on or after 1 January 2014. It is hoped that the final changes may instead take effect for periods ending on or after 30 September 2013, to coincide with the new legislation described above.

On the topic of directors' remuneration, the FRC are also consulting on clawback arrangements, whether non-executive directors holding executive positions in other companies should sit on the remuneration committee and any actions that should be taken if a company fails to obtain a substantial majority in support of a resolution on remuneration. Responses are requested by 6 December 2013. Any consequential amendments to the Code are likely to apply for periods beginning on or after 1 October 2014.

Link to survey findings

Chapters 10 – 12 of our survey examine going concern and corporate governance disclosures. A separate survey is available looking at FTSE 100 directors' remuneration reports – copies can be obtained by emailing executiveremuneration@deloitte.co.uk.

Further information

New Code items:

- 2012 UK Corporate Governance Code – http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.aspx
- 2012 FRC Guidance on audit committees – http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Audit-Committees-September-2012.aspx
- Governance in brief: New Corporate Governance Code and FRC Guidance on Audit Committees – http://www.ukaccountingplus.co.uk/publications/corporate-governance/governance-in-brief/governance-in-brief-boardroom-excellence
- Governance in focus: Effectiveness of the external audit process – http://www.ukaccountingplus.co.uk/publications/corporate-governance/governance-in-focus/gif-external-audit-effectiveness

Going concern items:

- Sharman Inquiry recommendations – http://www.frc.org.uk/Our-Work/Publications/FRC-Board/Sharman-Inquiry-Final-Report.aspx
- Governance in brief: Going concern – Sharman implementation delayed – http://www.ukaccountingplus.co.uk/publications/corporate-governance/governance-in-brief/governance-in-brief-sharman-implementation

Directors' remuneration items:

- New directors' remuneration report legislation – http://www.legislation.gov.uk/uksi/2013/1981/pdfs/uksi_20131981_en.pdf
- Directors' remuneration report 'Need to know' newsletter – http://www.ukaccountingplus.co.uk/publications/uk/need-to-know/2013/need-to-know-directors-remuneration
- GC100 guidance on new directors' remuneration reports – http://uk.practicallaw.com/6-540-9731
- FRC consultation on directors' remuneration – http://frc.org.uk/News-and-Events/FRC-Press/Press/2013/September/FRC-to-consult-on-executive-remuneration.aspx

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Deloitte executive remuneration website – http://www.deloitte.com/view/en_GB/uk/services/tax/employers/e227e06e2e7d9310VgnVCM1000003156f70aRCRD.htm

Further information on corporate governance matters can be found at www.ukaccountingplus.co.uk or the Deloitte Global Centre for Corporate Governance at www.corpgov.deloitte.com/site/uk.

Financial statements

Requirements

Listed groups are required to prepare consolidated accounts under IFRSs as adopted by the EU. Listed entities that are not parent companies, such as many investment trusts, can still prepare UK GAAP financial statements, with the replacement standard, FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland,* now available for early adoption.

The separate financial statements of a 'qualifying entity' can be prepared under FRS 101 *Reduced Disclosure Framework*, which closely reflects IFRS accounting but with reduced disclosures. If eligible, this may be an attractive option for many parent companies' separate financial statements and for their subsidiaries. To apply FRS 101 a company must notify its shareholders in writing and they must not object to its use. Companies could provide this written notification in a note to their current financial statements, proposing FRS 101's use in the following year's financial statements.

New for 2013

Significant new items effective for periods commencing on or after 1 January 2013 include IAS 19 (revised 2011) *Employee Benefits*, which for defined benefit pensions replaces the expected return on plan assets and interest expense on the obligation in the income statement with a net interest number calculated on the net obligation – this will invariably negatively impact the income statement, albeit compensated for by increased actuarial movements in other comprehensive income. The revised standard also introduces a number of new disclosure requirements.

New

IFRS 13 *Fair value measurement* has the same effective date and sets out how fair value should be measured on an 'exit price' basis. The scope of IFRS 13 is far wider than just financial instruments and would, for example, also apply to revalued property, plant and equipment. Extra disclosure requirements are also introduced relating to fair value measurements and disclosures in the financial statements.

For those reporting under IFRSs as issued by the IASB, such as SEC registrants, the consolidation 'package of five' that includes IFRSs 10-12, IAS 27 (revised 2011) and IAS 28 (revised 2011) also represent significant standards that are newly effective in 2013. See the table below for a comprehensive listing of newly issued IFRSs becoming effective now and in the future.

The auditor's report on the financial statements must comply with the requirements of ISA (UK and Ireland) 700, which has been revised with effect from periods commencing on or after 1 October 2012. For those companies reporting under the Code, the auditor's report will look significantly different and will now include material on the most significant risks of material misstatement, materiality and the scoping of their audit work.

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Regulators likely to focus on

The use of non-GAAP measures remain an area of scrutiny from regulators. One would expect:

- such measures to be clearly defined and reconciled to IFRS measures;
- for an explanation to be provided as to why certain items are being stripped out;
- that the measures are defined consistently year on year; and
- that their use is consistent with the measures presented in the narrative reporting, bearing in mind the "fair, balanced and understandable" requirements described above.

Impairments and supporting disclosures will unsurprisingly remain as something that regulators will examine carefully. They are likely to focus on those value in use calculations with a higher risk of an impairment charge, challenging key assumptions and any missing sensitivity disclosures.

On a similar theme, critical judgements and key sources of estimation uncertainty always attract regulatory scrutiny. In the current year it will be important to ensure these disclosures have an appropriate degree of consistency with the significant financial statements issues disclosed in the audit committee report and the risks disclosed in the auditor's report.

Consistent with the European Securities and Markets Authority's (ESMA's) enforcement priorities, the FRC's Conduct Committee will also pay particular attention to the application of IAS 19 (revised 2011) and provisions.

What the future holds

The table below sets out the recently issued IFRSs, IFRICs and amendments to existing standards which are becoming effective now and in the future.

Title	**IASB mandatory effective date** (periods commencing on or after)	**EU-endorsed mandatory effective date** (periods commencing on or after)
Amendments to IFRS 1 – Severe Hyperinflation and Removal of Fixed Dates for First-time Adopters	1 July 2011	1 January 2013
Amendments to IAS 1 – Presentation of Items of Other Comprehensive Income	1 July 2012	1 July 2012
Amendments to IAS 12 – Deferred Tax: Recovery of Underlying Assets	1 January 2012	1 January 2013
Amendments to IFRS 1 – Government Loans	1 January 2013	1 January 2013
IFRS 13 – Fair Value Measurement	1 January 2013	1 January 2013
Amendments to IFRS 7 – Disclosures – Offsetting Financial Assets and Financial Liabilities	1 January 2013	1 January 2013
IAS 19 (revised 2011) – Employee Benefits	1 January 2013	1 January 2013
IFRIC 20 – Stripping Costs in the Production Phase of a Surface Mine	1 January 2013	1 January 2013
Annual Improvements to IFRSs: 2009-2011 Cycle	1 January 2013	1 January 2013
IFRS 10 – Consolidated Financial Statements	1 January 2013	1 January 2014
IFRS 11 – Joint Arrangements	1 January 2013	1 January 2014
IFRS 12 – Disclosure of Interests in Other Entities	1 January 2013	1 January 2014
IAS 27 (revised 2011) – Separate Financial Statements	1 January 2013	1 January 2014

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Title	IASB mandatory effective date (periods commencing on or after)	EU-endorsed mandatory effective date (periods commencing on or after)
IAS 28 (revised 2011) – Investments in Associates and Joint Ventures	1 January 2013	1 January 2014
Amendments to IAS 32 – Offsetting Financial Assets and Financial Liabilities	1 January 2014	1 January 2014
Amendments to IFRS 10, IFRS 12 and IAS 27 – Investment Entities	1 January 2014	TBC – endorsement outstanding
Amendments to IAS 36 – Recoverable Amount Disclosures for Non-Financial Assets	1 January 2014	TBC – endorsement outstanding
Amendments to IAS 39 – Novation of Derivatives and Continuation of Hedge Accounting	1 January 2014	TBC – endorsement outstanding
IFRIC 21 – Levies	1 January 2014	TBC – endorsement outstanding
IFRS 9 – Financial Instruments	1 January 2015	TBC – endorsement postponed until completion of all sections of IFRS 9

At the time of writing a new final IFRS on revenue was also expected in the near future.

For single listed entities reporting under UK GAAP, FRS 102 replaces the existing framework with effect from periods beginning on or after 1 January 2015, although early adoption is permitted. FRS 101 has the same effective date and also permits early adoption.

With all these new standards tending to bring with them new disclosure requirements, the IASB is intending to provide extra guidance around the application of materiality and is considering whether to clarify IAS 1's requirement to provide disclosure only where information is material. In the longer term, the IASB are also looking to develop a disclosure framework. In the UK, the FRC's Financial Reporting Lab is also working with a few companies on case studies looking at initiatives that have, or will, cut what they consider to be 'clutter' from across their annual reports.

The Financial Reporting Lab has also undertaken a project analysing approaches to disclosing accounting policy information that are considered to be most effective – an area where companies are beginning to innovate and adopt different approaches. A final report on this is expected in Q1 2014.

In relation to the use of non-GAAP performance measures, identified as a regulatory hotspot above, ESMA is updating its guidance on Alternative Performance Measures, which will be relevant for UK reporters presenting such measures.

Link to survey findings

Chapters 13 and 14 examine our survey findings in respect of the primary statements and the notes to the financial statements respectively.

Further information

- Governance in brief: Audit reports to be more informative – http://www.ukaccountingplus.co.uk/publications/corporate-governance/governance-in-brief/governance-in-brief-isa-700-audit-report-revisions
- New UK GAAP information – www.deloitte.co.uk/futureofukgaap
- Financial reporting lab website – http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-reporting/Financial-Reporting-Lab.aspx

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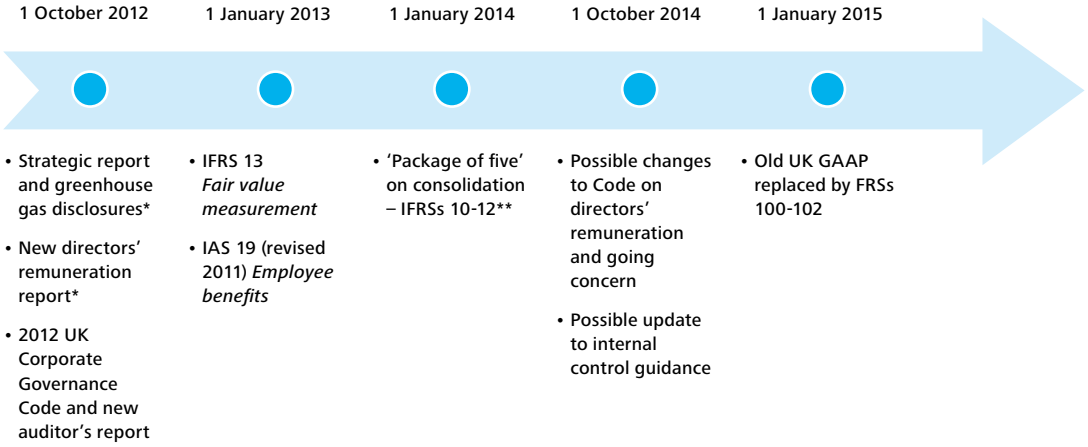
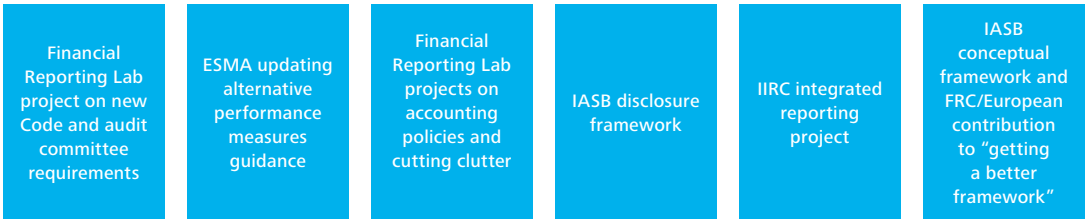
The world of corporate reporting in the UK

The timeline below provides an overview of various requirements that have recently come into force or will be doing so in the foreseeable future. Significant initiatives underway by UK and international regulators are also included as areas to be aware of, illustrating just how busy the world of UK corporate reporting is. Information on all the below can be found at www.ukaccountingplus.co.uk

Periods commencing on or after



Other significant initiatives underway



* These items are in fact effective for periods ending on or after 30 September 2013, rather than periods commencing on or after 1 October 2012.

** For those reporting under IFRSs as issued by the IASB the effective date is periods commencing on or after 1 January 2013.

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4. Survey objectives

The main objectives of the survey were to discover:

- the level of cohesiveness in annual reports where companies link together a company's strategy, KPIs, business model, remuneration and financial results;
- the way companies are structuring their narrative reporting, in particular whether any companies have adopted early the new strategic report structure;
- the content of business reviews, including the level of detail provided and common themes on principal risks and uncertainties;
- the use of non-GAAP measures in both narrative and financial reporting and which items are commonly being excluded from adjusted earnings measures;
- how companies are choosing to describe their business models;
- the level of compliance reported by companies with the UK Corporate Governance Code and common areas of non-compliance;
- how well companies deal with the significant volume of disclosures required by IFRSs, including areas of regulatory focus such as critical accounting judgements and key sources of estimation uncertainty; and
- how the results varied depending on the size of the company and compared with similar surveys performed in previous years.

The annual reports of 100 listed companies were surveyed to determine current practice. This sample of 100 excluded investment trusts, which have been surveyed separately and reported on in a separate publication, available at www.ukaccountingplus.co.uk. Investment trusts are those companies classified by the London Stock Exchange as non-equity or equity investment instruments (this excludes real estate investment trusts). They have been surveyed separately due to their specialised nature and the particular needs of their investors.

In certain instances, example disclosures have been included from companies that were not included within our survey where they illustrate a requirement well or show innovation.

In previous years the survey has grouped companies into three categories, being those within the top 350 companies by market capitalisation at 30 April, those in the smallest 350 by market capitalisation, and those that fall in between those categories (the 'middle' group). The total population from which the sample is taken has been decreasing over the past few years and this year the population of the middle group is significantly less than 350. As such, the grouping of categories in 2013 has changed and there are only two groups: those within the top 350 UK companies by market capitalisation, and those other listed UK companies – entities incorporated in the Channel Islands have been excluded in the current year. This, combined with the fact that the constituents of the FTSE 350 change over time and the way that the FTSE 350 is compiled, means that our 'top 350' UK companies does not correspond exactly to the FTSE 350.

The change in categories is designed to avoid the results becoming skewed due to the different size of population of each category. Additionally, the number of companies included within the two categories is now weighted based upon the size of the category, ensuring proportional representation of companies of different sizes in our overall findings. Where comparative figures are quoted for the 'other' group this represents the combination of our previous 'middle' and 'smallest 350' groups.

The overall sample is, as far as possible, consistent with that used in last year's survey. As a result of takeovers, mergers, de-listings and changes in market capitalisations over the last 12 months, the sample could not be identical. Replacements and additional reports were selected evenly across both categories. The annual reports used were those most recently available and published in the period from 1 September 2012 to 31 August 2013. Two companies within our sample had failed to meet the DTR requirement to publish their annual report within four months of their year end and so had their shares suspended. As such these two companies were removed from our sample and a further two chosen at random.

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Highlights

- Annual reports keep on getting longer, with a 4% increase in overall length from 103 to 107 pages.
- This is largely due to new regulations, such as early adoption of the revised remuneration disclosures and the Enhanced Disclosure Task Force (EDTF) recommendations on bank risk reporting.
- The balance between narrative reporting and financial statements continues to lean towards more narrative, with the average report now containing 51% narrative (2012: 51%).
- Only 45% of companies produce an electronic version of their report which is adapted in some way to make it more user-friendly for online readers.
- The pace of reporting continues to quicken, with the average company now producing its report in just 70 days (2012: 71 days).

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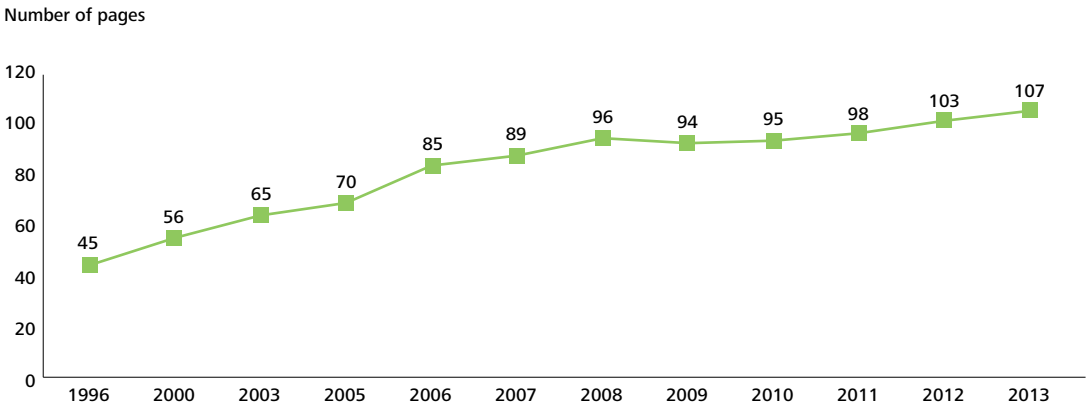
5. Playing the long game

This chapter examines the general trends in overall annual report structure, including the length of the report, the balance of the various sections of the report, the overall report presentation, the reporting timetable and the use of preliminary announcements.

Length of the report

As discussed elsewhere in this report, a number of companies are already 'looking forward' to the reporting changes that will come into force for periods ending on or after 30 September 2013. As a result of this it is not a surprise that the recent trend for annual reports to become longer each year has continued in our 2013 survey sample – see figure 5.1. As usual, it is the larger companies that have longer reports (see figure 5.2), partly because they tend to have more complex operations to describe but also because they tend to be more 'progressive' when it comes to early-adopting new regulations. For the top 350 group, reports ranged from 60 to 533 pages long, while the range for other companies was 25 to 169 pages. The statistics in figure 5.2 appear slightly anomalous due to the re-balancing of our survey sample to better reflect the composition of the FTSE (as set out in Chapter 4). However, the overall increase is not a result of the change in our sample – if we analyse the 90 companies which are consistent between the 2012 and 2013 surveys, the average number of pages has increased from 105 to 109.

Figure 5.1. How has the average length of the annual report changed over time?



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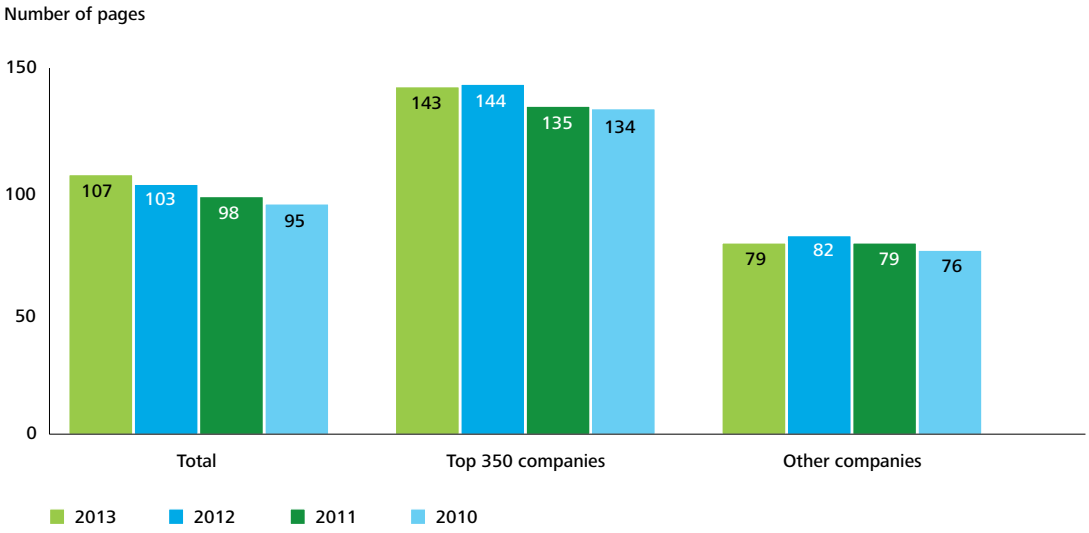
The average length of bank reports included in our sample, represented by the same companies year on year, has increased from 357 pages in 2012 to 415 in 2013.

Figure 5.2. What is the average length of the annual report?



Within the top 350 group itself, the banking groups in our sample continue to have the largest reports, in particular this year due to their efforts to comply with the recommendations of the Enhanced Disclosure Task Force (EDTF) around risk reporting. It is encouraging to see that despite the fact that the EDTF report was published relatively late in 2012, it has been taken on board rapidly by those affected. More detail on how the EDTF recommendations have been implemented can be found in Deloitte's publication 'Responding to the EDTF recommendations – A review of 2012 year end reporting', published in July 2013[1]. The average length of bank reports included in our sample, represented by the same companies year on year, has increased from 357 pages in 2012 to 415 in 2013.

1 See http://www.iasplus.com/en/publications/uk/other/edtf-recommendations

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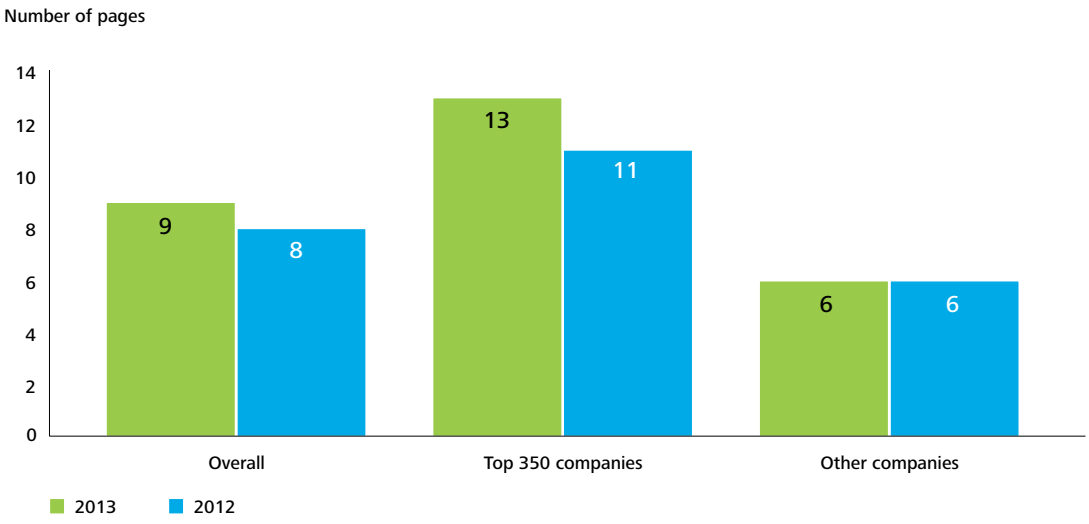
Another significant change this year has been the early adoption by some (particularly large) companies of the new regulations regarding directors' remuneration reporting and the splitting of the directors' remuneration report into 'the directors' remuneration policy' and the 'annual report on remuneration' (see Chapter 3). As can be seen from figure 5.3, this has had roughly a two page impact on the length of the remuneration report, and hence the annual report overall.

Figure 5.3. How long is the directors' remuneration report?

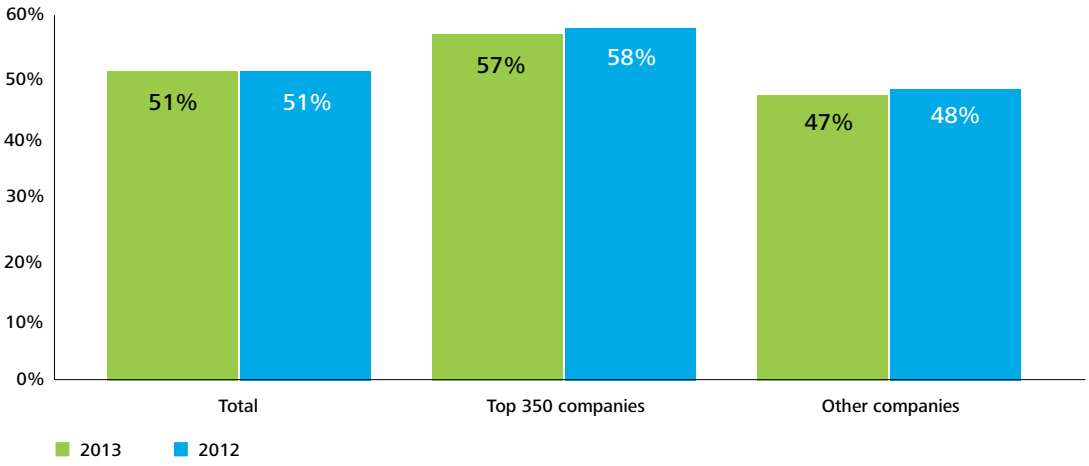


For UK issuers of securities traded in the US, compliance with the necessary SEC regulations in addition to the necessary UK regulations can also have a significant effect on report length. The number of SEC registrant companies in our sample remained static at seven this year. Excluding the banks discussed above, these companies have an average report length of 183 pages (2012: 176), well above even the average of the top 350 companies.

Balance of narrative and financial information

For the purposes of our survey, we assess any information not included in the audited financial statements (including the audit report) to be narrative. This includes the traditional 'front half', as well as additional information provided at the back of a report, such as a glossary or appendices expanding on items discussed in the business review.

Figure 5.4. What percentage of the report consists of narrative information?



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As shown by figure 5.4, for the largest companies in our sample the length of the narrative information now significantly exceeds that of the financial statements, and for the other companies it is rapidly approaching parity. This reflects not only an increase in the amount of information that companies are required to present but also their increased desire to tell the story of the business in a coherent and meaningful way. This is something that the government is keen to promote, with the introduction of the strategic report intended to encourage companies to really think about how they describe their business (see chapter 7).

The way in which companies link the various elements of their report together is something that many will need to consider carefully – the strategic report will need to be a single, coherent, linked discussion, not a collection of silos. Clearly linking the various elements of the report is something that only 28% of companies currently do, with the majority of these being in the top 350. This is an area where there has been improvement – only 14% of companies were considered to produce a cohesive report last year – but we will expect to see a big increase in this figure next year. It is also interesting to note that in a recent global survey undertaken by the CFA Institute[2], 80% of investors did not see the volume of disclosures made by companies as a significant concern. Rather, their key priorities included giving greater prominence to important information and better cross-referencing.

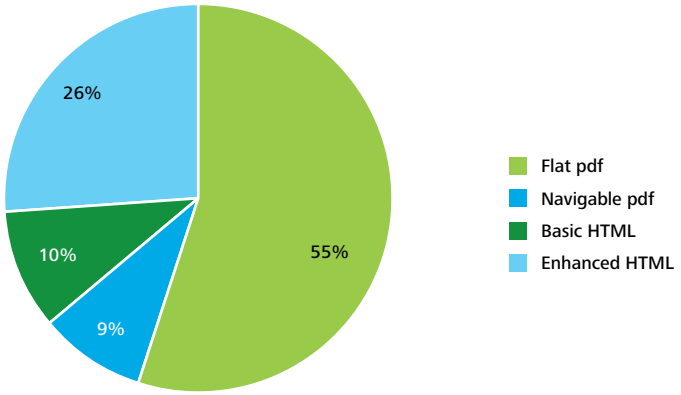
Presentation of report

The way in which an annual report is presented provides an interesting insight into the mind-set of the company behind it. While some companies go to great lengths to make their report accessible and interesting, others clearly feel that stakeholders are capable of finding the information of interest to them without the company expending a lot of effort in signposting it. 24% of the companies surveyed were judged to have visually dull reports, with little use of graphs, pictures or other elements to break up the flow of text. A number of these were from the top 350 group, showing that it is not just those small companies with fewer resources that do not produce an interesting report.

Another illuminating statistic is that only 71% of companies provide photos of the board in their report. While this may seem like a trivial point, pictures really help to give the impression that the board take ownership of the report and the statements attributed to them. Again, while the majority of companies that do not provide these tend to be smaller companies they are by no means all.

With the pace of technological change showing no signs of slowing, producing reports which are easy to view electronically is another area where we have seen significant development in recent years. As shown by figure 5.5 below, a significant number of companies now produce a report which is optimised in some way for electronic viewing. However, more than half of our sample did not produce anything beyond a basic pdf – useful for those who wish to download and print out the report but potentially frustrating for those viewing online.

Figure 5.5. What percentage of companies produce interactive reports?



2 See http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2013.n12.1

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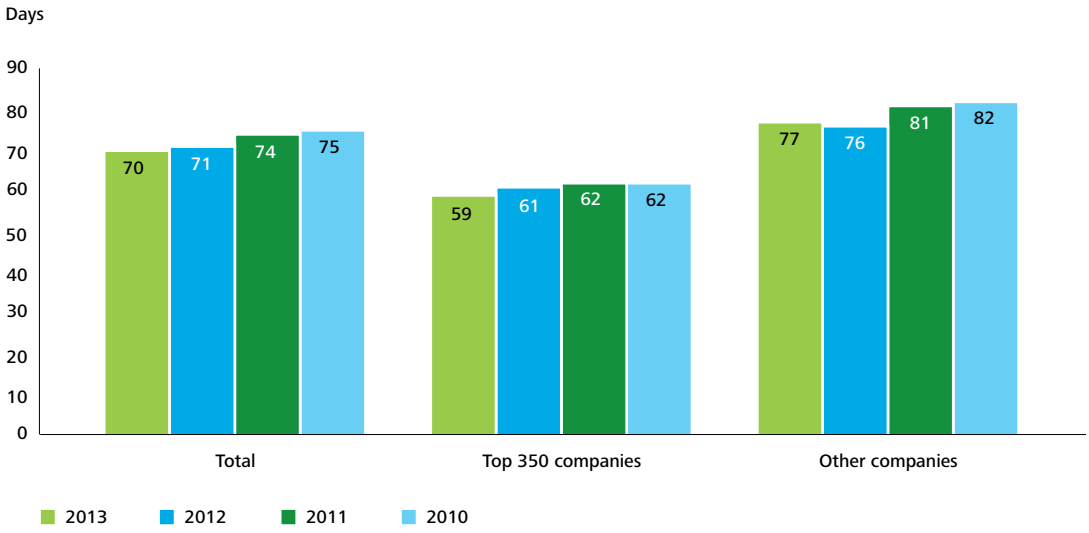
A 'navigable pdf' is a pdf including clickable navigation links. A 'basic HTML' document is an html including basic navigation elements, while an 'enhanced HTML' includes other elements such as videos or interactive content.

A recent innovation shown by a handful of companies is the inclusion of downloadable financial statements in excel format, very helpful for anyone wishing to do their own numerical analysis of a company's financial position and performance.

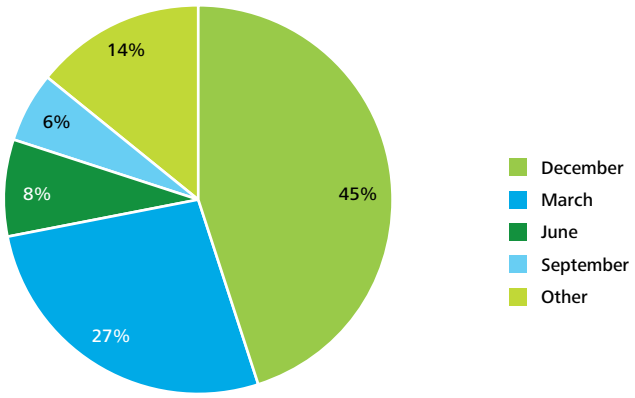
Reporting timetable

Figure 5.6. How quickly was the annual report approved?



While annual reports are getting longer, as discussed above, there is a similar trend for reporting timetables to get shorter each year, as illustrated by figure 5.6. Companies are investing more and more time in getting their annual report template set up pre year-end, so that it is ready to go as soon as the finance department have prepared the numbers and the auditors have signed them off. This is something that may create issues for some companies this year, with the new narrative and remuneration regulations only having been approved in August but affecting years ending on or after 30 September. September year-end reporters in particular may have been waiting with bated breath for the finalisation of these so that they can swing into action! Figure 5.7 shows the distribution of year-ends in our sample.

Figure 5.7. What is the distribution of company year-ends?



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Companies are investing more and more time in getting their annual report template set up pre year-end, so that it is ready to go as soon as the finance department have prepared the numbers and the auditors have signed them off.

Preliminary announcements

Whilst a preliminary announcement is in theory no longer required by the Listing Rules, companies still need to be mindful of their obligations under DTR 2.2 (disclosure of price sensitive information) and Listing Rule 9.7A.2 (announcement of dividend and distribution decisions). What this means in practice is that a company will frequently report its results to the market before the full annual report is ready. Where a listed company opts to prepare a preliminary announcement it should still comply with the requirements of Listing Rule 9.7A (preliminary statement of annual results). Once the full annual report is ready, a subsequent announcement must be made to notify the market of the website on which it is available.

90 of the 100 companies surveyed made an announcement of their results before their full annual report was ready. For a number of these 90 companies no subsequent announcement was made to indicate when their annual report was available on their website, instead its future availability was merely indicated in their results announcement. Such an approach appears open to challenge in light of DTR 6.3.5's dissemination requirements, which include indicating on which website the annual report is available. 77 of the aforementioned 90 announcements were based on audited results, ten were based on unaudited results and three were unclear as to whether the audit was complete. Three companies disseminated their annual report in full unedited text and for the seven remaining companies it was unclear whether their results announcements preceded their full annual report being made available. For the top 350 group the announcements came on average 59 days after the year-end, and for the other group the average time was 76 days.

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Highlights

- 93% (2012: 91%) of companies present a summary information section in their annual report.
- Of these, 89% (2012: 78%) present narrative information in addition to financial highlights.
- Of the companies presenting summary financial information, 19% (2012: 19%) do not present any of their KPIs in that summary information.

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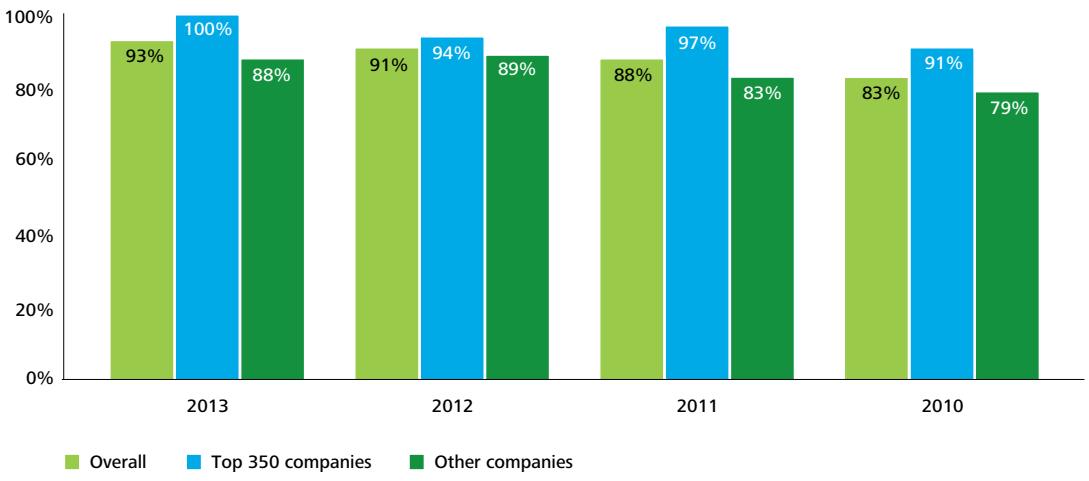
Traditionally, a company's annual report has been introduced with scene-setting statements from the chairman and the CEO. While in the past companies may have prefaced this with a brief numerical summary of key highlights, increasingly companies are including a more detailed narrative summary section which prefaces these formal introductions with some key details about the business – 89% of those surveyed in 2013 did so (2012: 78%). There are no requirements for such a summary section to be included in an annual report or for the content where it is provided. What this means is that preparers have the luxury of a blank canvas on which to design whatever they think works best. Key information highlighted may include a description of a company's business model, details of its geographical sphere of operations or a timeline of key events from the year.

Regardless of the precise content, the purpose of the summary section is to introduce the company and what it does. While one would hope that an existing investor knows about the business they have invested in, for a potential new investor, being made to feel that they understand the business quickly is vital. Indeed, three companies specifically included an 'investment proposition' section in their summary, recognising the usefulness of the annual report to communicate with prospective as well as current investors. These sections set out the reasons why the company in question represents good value for investors and how it will create value for them.

Figure 6.1 shows the percentage of companies that present summary information in their accounts.

Figure 6.1. How many annual reports in each category include a summary information section?



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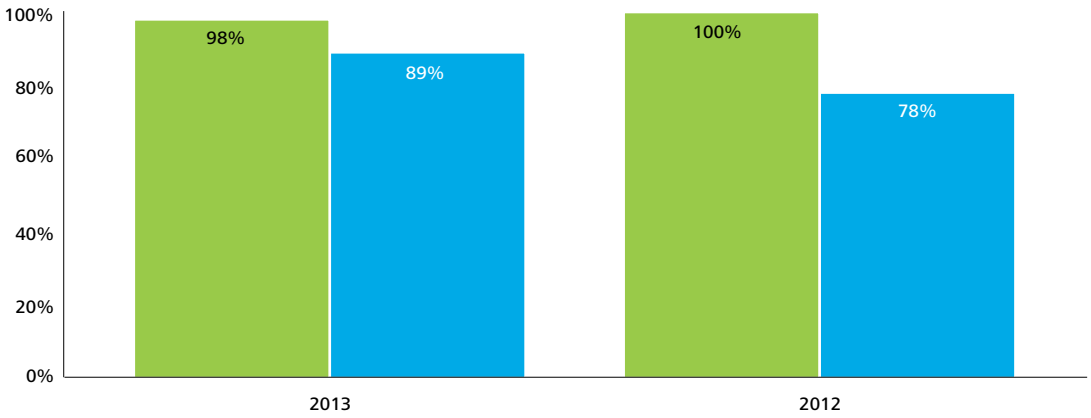
Information contained in summary sections

The structure of a summary section can vary from a single page of 'key financial highlights' to a detailed overview of the company, its products, markets and customers. The most useful summaries also include cross-references to where the information they are summarising is discussed in more detail, helping users to identify the sections that are of most interest to them.

As shown by figure 6.2, almost all companies presenting a summary section include financial information in it. However the proportion which also include narrative information is rapidly catching up – with 89% of companies presenting this in 2013 compared to 78% in 2012.

Figure 6.2. What kind of information is presented in the summary pages?



The type of narrative information which is included in the summary section can be seen from figure 6.3 – this shows the type of information included as a percentage of those companies presenting some narrative information in their summary. 94% of companies presented a description of what the company does, typically something that does not take more than a few sentences. While this may seem like something that a user of the report should really already know, it provides valuable context for anyone who does not. Often this description was linked into the company's strategy and differentiating factors, starting to paint the picture of how it creates value for shareholders. However, a significant proportion (38%) of companies did not develop the discussion in this way.

A discussion of the company's products and/or services was also presented by 78% of businesses. The form of this information varies between industries – for example professional services firms might discuss the different services they offer clients, while a consumer products business gives a summary of its key brands, or a business-to-business supplier lists some of the end uses of its products. While most businesses discussed their products, the majority (58%) did not provide a corresponding discussion of the customers that they are selling those products to. Developing the discussion of a company's products to include its target markets is a good example of the linkage between what a company does and its strategy discussed above – showing not just what it is doing but why.

Details of the geographical locations that a company operates in were provided by 66% of companies. In general, those companies with a wider geographical spread tended understandably to discuss this in greater detail – a typical presentation shows a map of the world with details of the business' operations in each location. This information is likely to be of significant interest to those investors looking to assess their geographical diversification and understand the exposures to different economies underlying their investment.

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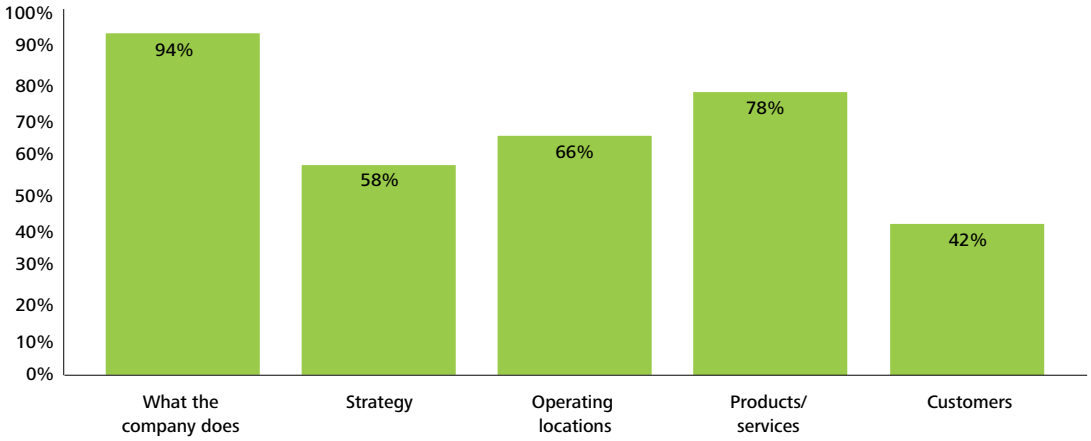
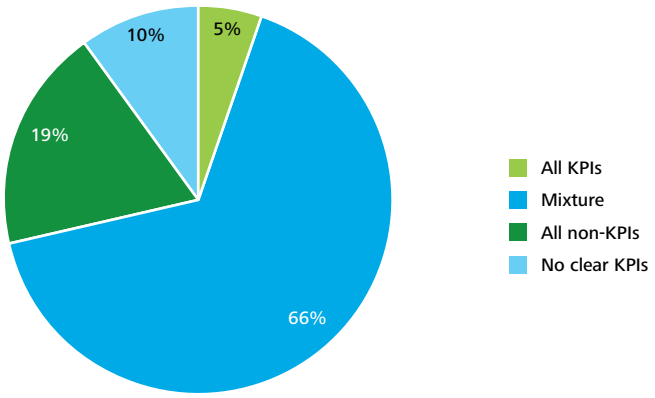
Figure 6.3. What kind of narrative information is given in the summary?



The linkage between the numerical information presented in a company's opening summary and the information identified later in the report as its Key Performance Indicators (KPIs) is interesting. Figure 6.4 shows the level of correlation between these measures. We would not go so far as to suggest that a company should only present measures identified as KPIs in its summary section – some numbers, such as revenue, profit for the year or net assets are likely to be of sufficient interest to users that it is reasonable to present them even if they are not identified internally as key measures. However, at 19%, the proportion of companies not discussing any of their KPIs in their summary information is worryingly high.

Figure 6.4. Are measures presented in the summary section the same as KPIs?



Of the companies which include some of their KPIs in their summary section, it is encouraging to see that 20% are discussing non-financial indicators as well as financial ones.

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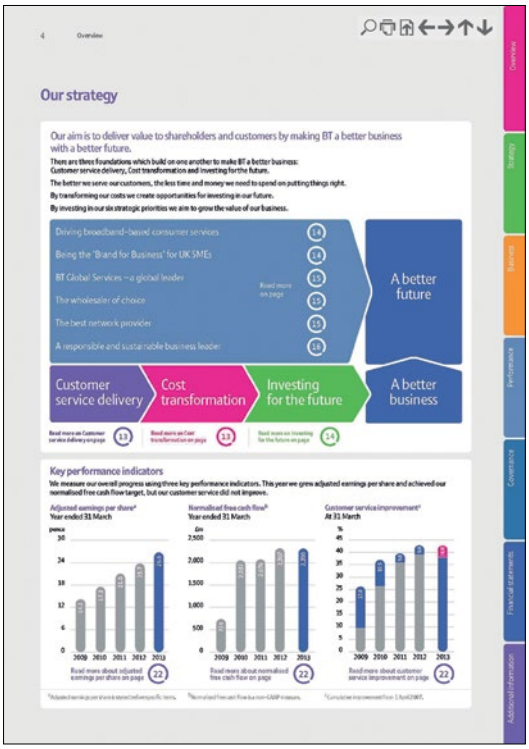
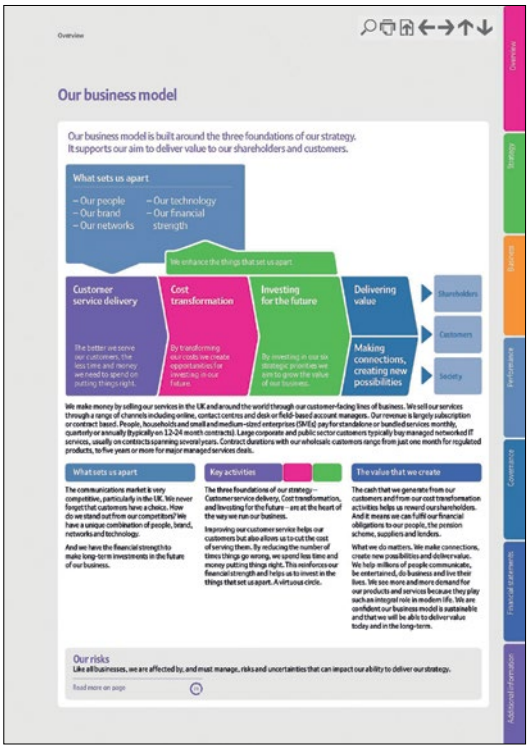
Of the companies which include some of their KPIs in their summary section, it is encouraging to see that 20% are discussing non-financial indicators as well as financial ones. Of the remainder, 37% do not identify any non-financial KPIs at all – this is a theme which will be picked up again in chapter 9.

Of those presenting financial information in their summary, the vast majority of companies (86%) include some non-GAAP measures, mostly (but not always) alongside related GAAP measures. Of these non-GAAP measures, a noticeably low percentage (55%) are consistent with the measures presented in the company's IFRS 8 *Operating Segments* note in the financial statements. This is surprising, since the latter should reflect the measures used by the chief operating decision maker (CODM) to manage the business[3]. The reason why so many companies choose to introduce the discussion of their performance to shareholders based on a measure that is neither clearly defined by accounting standards nor the primary measure used to run the business is, to us, unclear. The best reporters will present measures in a summary section that are consistent with their KPIs and those reported to the chief operating decision maker, which are disclosed in their IFRS 8 note.

Some good examples of how to present an effective summary information section are provided by BT Group plc and Howden Joinery Group Plc (extracts shown below). Both companies present a concise overall summary with links to where the key elements are discussed elsewhere in the report. However, the contrast between BT's clean, corporate style and Howden's eye-catching artwork illustrates that when it comes to summary sections there is definitely more than one way to communicate the message. A company needs to identify a presentation style that fits with its brand image, rather than trying to shoehorn itself into a one-size-fits-all model.





BT Group plc Annual Report & Form 20-F 2013

3 Where a company has only identified a single reportable segment, non-GAAP measures presented on the face of the income statement have been assumed to represent those measures reported to the CODM.

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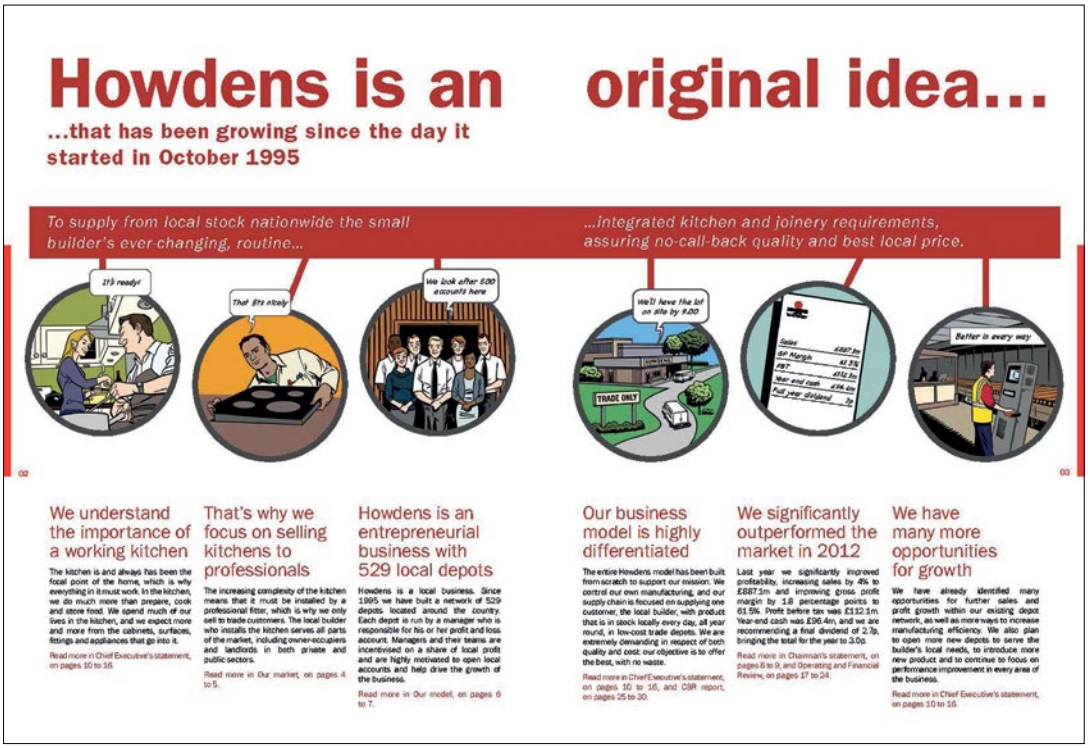

Howden Joinery Group Plc Annual Report and Accounts 2012

Howden's eye-catching artwork illustrates that when it comes to summary sections there is definitely more than one way to communicate the message. A company needs to identify a presentation style that fits with its brand image, rather than trying to shoehorn itself into a one-size-fits-all model.

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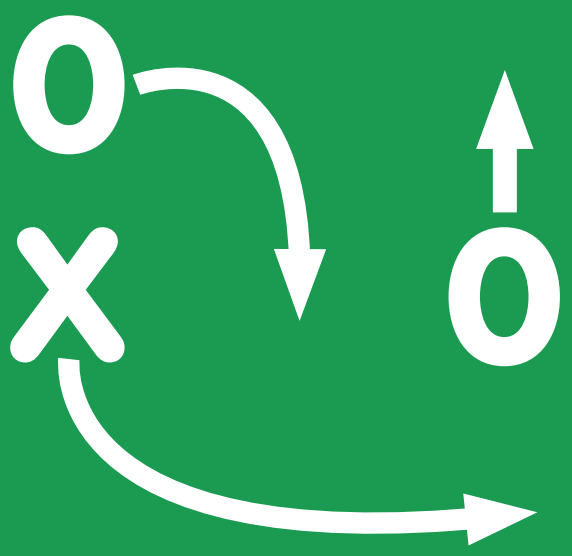
7. Towards a Strategic Report …

Highlights

- The proportion of companies clearly discussing their business model continues to grow, with 44% (2012: 37%) of those surveyed doing so. However, given that discussion of the business model is a requirement of the Code, it is surprisingly low.
- 86% (2012: 82%) of companies clearly identify the objectives of their business. Of these, 41% discussed long-term objectives.
- Of the companies which discussed their objectives, 90% provided a link between these and the strategies being pursued to achieve them.
- Of the companies discussing their strategy, 43% provided a link to the measures used to assess the success of its implementation.
- 39% (2012: 28%) of companies provided extensive commentary on their environmental impact and 32% (2012: 30%) provided this level of detail regarding employee matters.
- 72% (2012: 63%) of companies included some discussion of their greenhouse gas emissions, with 42% (2012: 42%) providing supporting numerical information.
- 21 companies provided some information on the gender diversity of the organisation as a whole.



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With the introduction of the Government's new narrative reporting regulations, outlined in chapter 3 and which become effective for years ending on or after 30 September 2013, we expect that the coming year will see some significant changes in the structure of what was, for the period covered by our survey, still the business review section of the directors' report.

Currently the law requires companies to include in their directors' report 'a fair review of the company's business', including the development and performance of the business during the year and its position at the year-end. The review is required to contain a discussion of principal risks and uncertainties (see chapter 8) and key performance indicators (see chapter 9). For a quoted company (as all of those in our survey are), the business review also needs to contain information about trends and factors affecting the business' future development, as well as information about environmental matters, employee matters and social and community issues. For periods ending on or after 30 September 2013, these requirements will become part of the content of the new 'strategic report', along with further requirements to discuss human rights issues, the company's business model and strategy and a new requirement to disclose gender diversity figures.

However, in most areas those companies which are at the forefront of reporting are already doing a lot of what will be required by these new regulations. Therefore it seems likely that the primary impact will be to spur on other companies to emulate these examples of how best to present what will become mandatory information. The FRC's Guidance on the Strategic Report (in exposure draft form at the time of writing)[4] will also prove an invaluable aid. Deloitte will also be producing a practical guide for those companies grappling with the new requirements. While only one of the companies in our sample has made an effort to already identify part of its report as a 'strategic report', this does not indicate a lack of progress on the part of others towards a more holistic strategic review.

Another key development in this area is the launch of the first consultation draft of the International Integrated Reporting Council's (IIRC) Integrated Reporting Framework. The framework suggests that companies would produce a standalone document, separate to the annual report, which will combine some of the elements of traditional financial reporting with environmental, social and governance information into a single report which acknowledges all of the factors or resources and relationships on which a company's performance depends in the short, medium and long term. The IIRC has captured these factors in the form of six definitions of "capital": financial, manufactured, intellectual, human, social and relationship, and natural capitals.

In the UK, many of the elements of the framework are currently required by law or encouraged by the draft FRC Guidance on the Strategic Report. Two of the companies in our sample described their annual reports as an 'integrated report', demonstrating the traction that these guidelines are already gaining.

This chapter discusses the overall content of the business review. Two specific areas, identification of principal risks and uncertainties and discussion of key performance indicators, are considered by us to be of sufficient importance to warrant their own separate chapters. Therefore, for consideration of the identification and presentation of principal risks and uncertainties please refer to chapter 8. For an analysis of the use of key performance indicators please see chapter 9. These are both areas where disclosure continues to be required under the new legislation.

4 See http://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Exposure-Draft-Guidance-on-the-Strategic-Report.aspx

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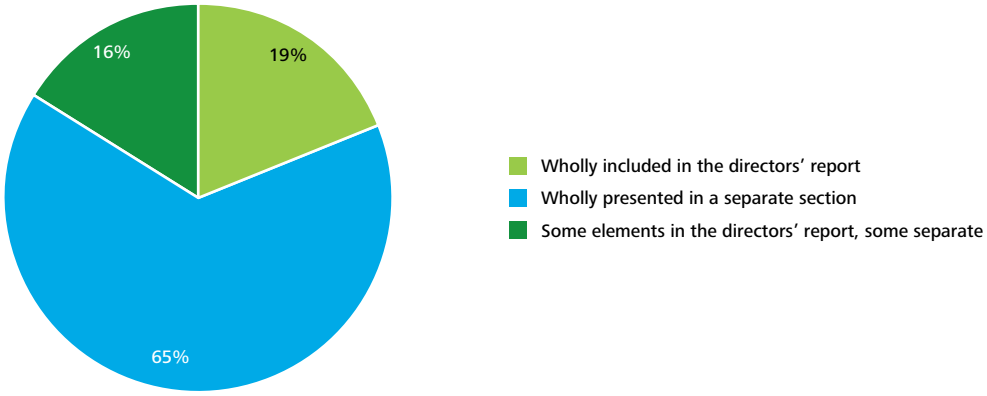
Presentation of the business review

While the new regulations identify the strategic report as a separate element of the annual report, clearly distinct from the directors' report and separately approved by the board, under the existing regulations there is some variety of practice in how companies meet the requirement to include a business review in the directors' report. Figure 7.1 shows how companies currently choose to present this information.

Figure 7.1. How is the business review structured?



As can be seen, many companies already choose to present this information in a separate section, with a simple cross-reference from the formal directors' report to clarify which sections cover the statutory requirements. While this cross-reference may seem like a minor thing, it is important from a legal point of view as it brings this information within the scope of the 'safe harbour' provisions of the Companies Act (s463), which restrict directors' liability for statements made in the directors' report. The new regulations amend these provisions to also include any information presented in a company's strategic report. Indeed, 46% of companies (2012: 43%) choose to go further than this and include a specific 'cautionary statement' warning users not to rely on any forward-looking statements included in the report. As companies continue to present more detailed and subjective information in their annual reports, ensuring that they do not unintentionally expose themselves to liability is likely to continue to be an important consideration.

Another impact of the new narrative reporting regulations is that instead of providing summary financial statements to shareholders who choose to receive them, companies will be able to provide a copy of the strategic report (along with some supplementary information). For any companies planning to do this, it will be important to ensure that the strategic report makes sense as a standalone document. A potentially significant element of this is how the strategic report presents summary financial information, since the supplementary information to be provided does not include the financial statements. While all companies discuss their financial results to some extent, providing a summary income statement or balance sheet is likely to be significantly helpful to a shareholder who is receiving only the strategic report without the full financial statements to support it. In our 2013 survey, 34 companies presented a summary income statement in their business review, with 9 of these also providing a summary balance sheet. One further company presented just a summary balance sheet.

One area which may cause some issues going forward is the presentation of information which is currently included in the business review but which is not necessarily of 'strategic importance'. This might, for example, include details of the performance and operations of individual divisions of the business which, while interesting, may not necessarily be strategically important to the group as a whole. Potentially the strategically important information which needs to be included in the strategic report could be distilled from this, leaving the supporting detail in a separate 'further information' section of the report.

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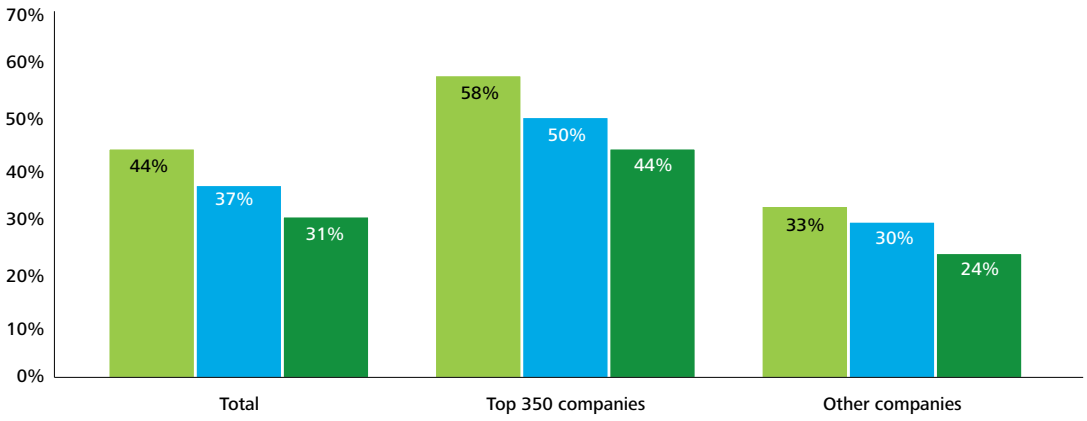
The business model

One area of development this year has been the discussion by companies of their business model. The new narrative regulations include a specific requirement for companies to discuss their business model in the strategic report, something that was not previously included in the Companies Act regulations, but which has been in the UK Corporate Governance Code since 2010 (and should therefore be provided on a comply or explain basis).

As described in the draft FRC Guidance on the Strategic Report, a description of the business model is of fundamental importance in providing context for the annual report as a cohesive document. At the highest level, the business model is a description of what the business does and why and how it does it. It should provide shareholders with an understanding of how the entity is structured, the market in which it operates, and how the entity engages with that market (e.g. what part of the value chain it operates in, its main products, services, customers and its distribution methods). It should also describe the nature of the relationships, resources and other inputs that are necessary for the successful continuation of the business.

Figure 7.2. What proportion of companies clearly identify and discuss their business model?



As shown by figure 7.2, the proportion of companies clearly identifying the discussion of their business model has improved year on year across the board. Furthermore, although only 44% of companies clearly identify their business model, another 23% discuss their business model without clearly identifying it. For the remaining 33% of companies, this is an area that will need to be carefully considered in advance of the new regulations coming into force.

A discussion of how the business creates value for shareholders was included in the business model by 70% of these companies. The level of detail in this discussion varied from company to company, with a small proportion also expanding the analysis to include the creation of value for other stakeholders such as employees and governments as well. One way in which this was done was by including a pie chart showing the value created for various stakeholder groups.

One helpful way to illustrate what the company does and how it creates value is to include a visual representation of the business model. Of those companies presenting a business model, 61% included a visual representation in their discussion. However, the usefulness of these visual representations was varied – in our view a company-specific diagrammatic representation of the business provides much more interesting information than an abstract diagram punctuated with management-speak buzzwords.

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Some good examples of effective business model presentation are provided by Intermediate Capital Group plc, Mondi Group, Rexam PLC (shown below and overleaf) and Vislink plc. ICG clearly demonstrate how they operate and create value for their customers, while Mondi and Rexam illustrate their production cycles and how these create a competitive advantage. Vislink provide a useful diagrammatic representation of how their technological expertise translates into a comprehensive service for their customers.

Intermediate Capital Group plc Annual Report & Accounts 2013

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Integrated value chain and products

Mondi manufactures a full range of packaging and paper products to meet customer demands. Our customer focus, experience and ongoing research deliver proactive, high-quality and cost-competitive solutions to meet our customers' requirements.

For more details of our product certifications, as well as additional product information please see: www.mondigroup.com/products

Packaging Paper

Inputs: Paper for recycling; Wood

Pulp mill → Paper mill

Products: Recycled containerboard; Virgin containerboard; Kraft paper

To Fibre Packaging value chain; To market

Consumption*: 6.9 million m³ softwood; 0.9 million m³ hardwood; 3.4 million tonnes of paper for recycling

Production: Sites: 11; Elé capacity: 3.2 million tonnes; MSRO capacity: 0.3 million tonnes

2012 production: Containerboard: 2.4 million tonnes; Kraft paper: 1.6 million tonnes

Group revenue contribution: €1,383 million; Packaging Paper 24%

* Wood volumes are reported in m³ across our reports, with figures reflecting Solid Cubic Metres (SCM).

Products

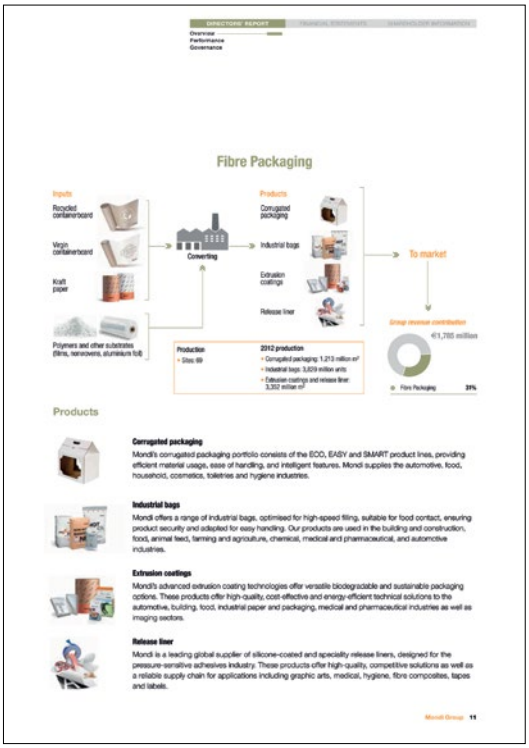
Containerboard

Mondi is an international supplier of virgin and recycled containerboard. Our ProVantage range includes lightweight recycled containerboard, high-performance semi-chemical fluting and 'Appearance', our white-top kraftliner and brown kraftliner. Our paper grades meet stringent health and safety standards for food packaging and are used in the food, automotive, household, cosmetics, industrial paper and packaging industries.

Kraft paper

Mondi's Advantage range consists of high-quality sack kraft paper, speciality kraft paper as well as speciality pulp. We combine customer requirements with extensive research and development to produce innovative, tailor-made packaging solutions.

10 Integrated report and financial statements 2012



DIRECTORS' REPORT | FINANCIAL STATEMENTS | SHAREHOLDER INFORMATION

Overview
Performance
Governance

Fibre Packaging

Inputs: Recycled containerboard; Virgin containerboard; Kraft paper; Polymers and other substrates (films, nonwovens, aluminium foil)

Converting

Products: Corrugated packaging; Industrial bags; Extrusion coatings; Release liner

To market

Production: Sites: 69

2012 production: Corrugated packaging: 1,213 million m²; Industrial bags: 3,839 million units; Extrusion coatings and release liner: 3,352 million m²

Group revenue contribution: €1,785 million; Fibre Packaging 31%

Products

Corrugated packaging

Mondi's corrugated packaging portfolio consists of the ECO, EASY and SMART product lines, providing efficient material usage, ease of handling, and intelligent features. Mondi supplies the automotive, food, household, cosmetics, toiletries and hygiene industries.

Industrial bags

Mondi offers a range of industrial bags, optimised for high-speed filling, suitable for food contact, ensuring product security and adapted for easy handling. Our products are used in the building and construction, food, animal feed, farming and agriculture, chemical, medical and pharmaceutical, and automotive industries.

Extrusion coatings

Mondi's advanced extrusion coating technologies offer versatile biodegradable and sustainable packaging options. These products offer high-quality, cost-effective and energy-efficient technical solutions to the automotive, building, food, industrial paper and packaging, medical and pharmaceutical industries as well as imaging sectors.

Release liner

Mondi is a leading global supplier of silicone-coated and speciality release liners, designed for the pressure-sensitive adhesives industry. These products offer high-quality, competitive solutions as well as a reliable supply chain for applications including graphic arts, medical, hygiene, fibre composites, tapes and labels.

Mondi Group 11

Integrated value chain and products continued

Consumer Packaging

Inputs: Films, paper, aluminium foil; Resins

Resins are generally sourced externally. Where the film requires specific characteristics, the resins are compounded inhouse using unique recipes.

Converting; Film extrusion

Products: Consumer goods packaging; Advanced films and components

To market

Production: Sites: 19

2012 production: Consumer packaging: 121,127 tonnes

Group revenue contribution: €498 million; Consumer Packaging 8%

Products

Consumer goods packaging

Our consumer packaging product portfolio comprises attractive and convenient solutions for pet food, food, personal and home care as well as other industrial applications. This range of plastic- and paper-based materials and converted consumer packaging include stand-up pouches, pre-made plastic and paper-based bags, laminates and printed films, all of which meet stringent health and safety standards for food packaging.

Advanced films and components

Mondi develops and produces films and film-based solutions for a variety of industries, including innovative hygiene product components such as elastic laminates, elastic films and frontal tapes for diapers and siliconised films for femcare packaging, label films, laminating films for flexible packaging applications, high barrier films and surface protection films.

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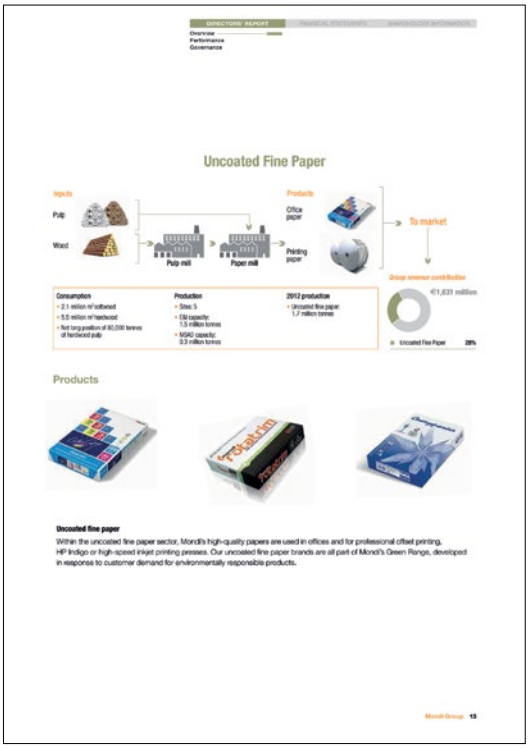

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Uncoated Fine Paper

Inputs: Pulp; Wood

Pulp mill → Paper mill

Products: Office paper; Printing paper

To market

Consumption: 2.1 million m³ softwood; 5.5 million m³ hardwood; Not long-position of 60,000 tonnes of hardwood pulp

Production: Sites: 5; Elé capacity: 1.5 million tonnes; MSRO capacity: 0.3 million tonnes

2012 production: Uncoated fine paper: 1.7 million tonnes

Group revenue contribution: €1,631 million; Uncoated Fine Paper 28%

Products

Uncoated fine paper

Within the uncoated fine paper sector, Mondi's high-quality papers are used in offices and for professional offset printing, HP Indigo or high-speed inkjet printing presses. Our uncoated fine paper brands are all part of Mondi's Green Range, developed in response to customer demand for environmentally responsible products.

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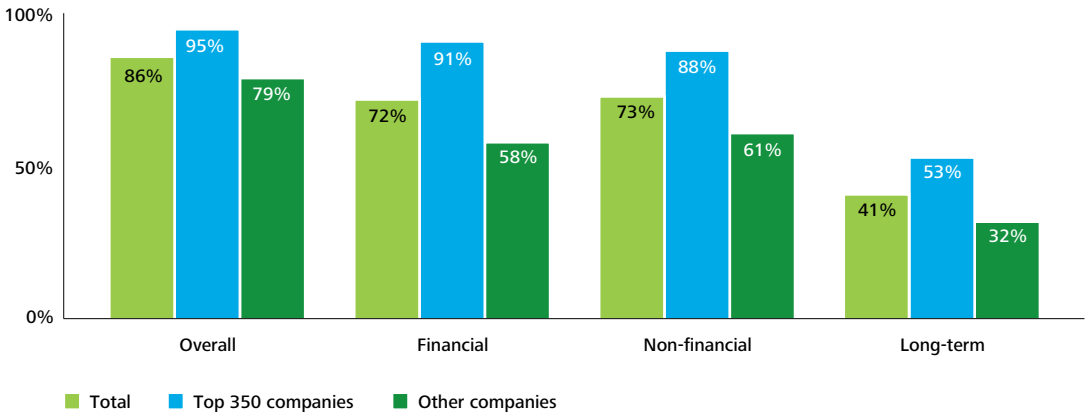
Rexam PLC annual report 2012

Objectives and strategy

Once a company has set the stage by outlining its business model, the next step is to develop this by discussing the company's objectives and its strategies for achieving these. Figure 7.3 shows how many companies clearly identify their objectives, along with the proportion clearly identifying financial or non-financial objectives. It also shows the proportion of companies for which these objectives are specifically linked to the long-term performance of the company. Although the new and existing regulations do not explicitly require objectives to be disclosed, the draft FRC Guidance suggests that they should be included in discussing a company's strategy (disclosure of which is required). Indeed, describing a strategy without the objectives that it is trying to achieve seems an odd proposition. The UK Corporate Governance Code does however note that the annual report should contain an explanation of 'the strategy for delivering the objectives of the company' (Provision C.1.2).

Figure 7.3. What type of objectives are identified by companies?



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It is encouraging to see that most companies identify some clear objectives for the business in their annual report, and the balance between those identifying financial and non-financial objectives is also good to see. Both financial and non-financial objectives are useful for stakeholders, with the latter taking on increased significance nowadays, as recommended by the draft FRC Guidance and the IIRC's Integrated Reporting Framework. Overall, 95% of companies in our top 350 group disclosed objectives, compared to 79% of smaller entities.

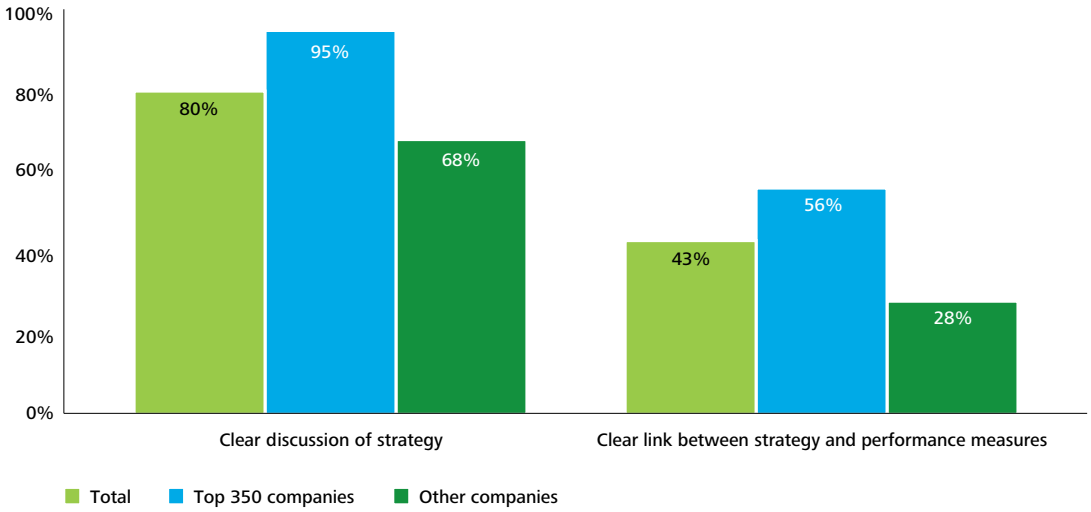
Understanding the company's financial strategy in terms of whether the directors' main priority is to return cash to shareholders in the short term through dividends or retain it in the business to invest for long term capital growth may well have an effect on the decisions of investors. Similarly, understanding how the business intends to generate future value, for example by developing new markets for existing products or new products for existing markets, will provide useful insight into the direction the business is travelling in and allow them to decide whether they agree with it.

The percentage of companies clearly linking their objectives to the long-term performance of the business is less encouraging. With the focus of the Sharman enquiry on the long-term health of businesses, this is an area in which we expect further development in the future (see chapter 10 for further discussion on going concern). Setting out clear long-term objectives is also likely to be helpful in illustrating the link between executive remuneration and long-term performance, another key theme of recent reporting developments.

The linking of discussion of objectives to the strategy being followed to deliver them is also important. 80 of the companies surveyed clearly set out their discussion of strategy, with 90% of those clearly setting out their objectives also discussing their strategy to achieve them. Interestingly, 3 companies set out their strategic priorities but with no clear indication of the objectives that these were working towards. Perhaps it was felt that the aims of these strategies were sufficiently obvious that a further discussion of objectives was unnecessary.

A particularly good example of the link between a company's values and objectives is provided by Dairy Crest Group plc. They also provide a further link to the key performance indicators that measure the success of the company in achieving its goals. Only 43% of those companies which discussed their strategic priorities included a clear link to the way in which the success of these is measured, something which is very important in helping shareholders to see whether the company is successfully achieving what it sets out to do. The draft FRC Guidance also recommends such linkage. Figure 7.4 shows how well companies are creating a link between their strategy and the measures used to assess its success. It is clear that this is an area that larger companies are significantly better at than the smaller ones in our sample.

Figure 7.4. How clear is the link between strategy and performance measures?



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A particularly good example of the link between a company's values and objectives is provided by Dairy Crest Group plc. They also provide a further link to the key performance indicators that measure the success of the company in achieving its goals.

Report of the Directors

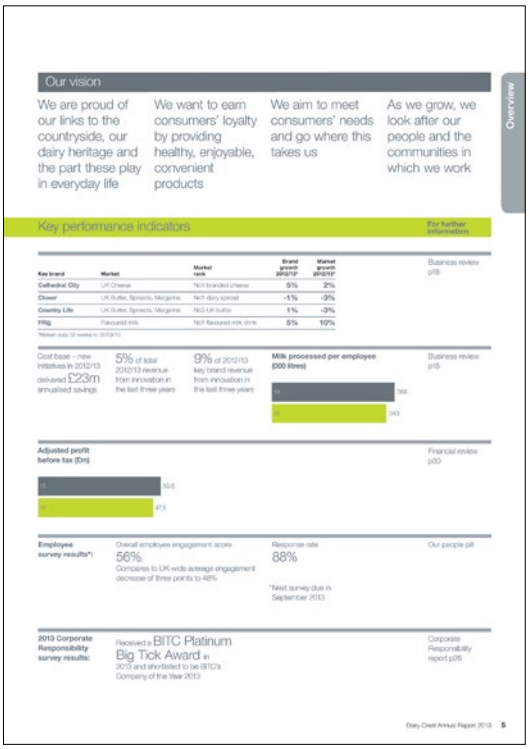
Our vision, values and measures

We have created a strong vision and robust values for the business. We have value measures supported by key performance indicators that give a clear indication of progress

We do not expect to achieve every value measure every year, but by making it clear what our targets are we believe that we have set a framework that will help us deliver continuous improvements in performance

Our values	Value measures
WE LISTEN Consumers are at the heart of our business	Grow share of our consumers' purse and be Number 1 or 2 in the markets we serve
WE CREATE We constantly look for new and better ways of doing things	10% of our annual turnover will come from consumer innovation. Internal innovation will reduce our cost base every year
WE LEAD We value success and strive to be the best	Our profit will grow every year
WE RESPECT We value our people and are stronger together	Improve our employee survey results
WE CARE We act responsibly with a passion to do the right thing	Improve our Corporate Responsibility survey results

4 Dairy Crest Annual Report 2013



Overview

Our vision

We are proud of our links to the countryside, our dairy heritage and the part these play in everyday life

We want to earn consumers' loyalty by providing healthy, enjoyable, convenient products

We aim to meet consumers' needs and go where this takes us

As we grow, we look after our people and the communities in which we work

Key performance indicators

For further information

Key brand	Market	Market rank	Brand growth 2012/13	Market growth 2012/13
Cathedral City	UK Cheese	No1 branded cheese	5%	2%
Clover	UK Butter, Spreads, Margarine	No1 dairy spread	-1%	-3%
Country Life	UK Butter, Spreads, Margarine	No3 UK butter	1%	-3%
Frijj	Flavoured milk	No1 flavoured milk drink	5%	10%

*Brand data 52 weeks to 30/03/13

Business review p18

Cost base – new initiatives in 2012/13 delivered £23m annualised savings

5% of total 2012/13 revenue from innovation in the last three years

9% of 2012/13 key brand revenue from innovation in the last three years

Milk processed per employee (000 litres)

Business review p18

Adjusted profit before tax (£m)

Financial review p30

Employee survey results*:

Overall employee engagement score 56%

Compares to UK-wide average engagement decrease of three points to 48%

Response rate 88%

*Next survey due in September 2013

Our people p8

2013 Corporate Responsibility survey results:

Received a BITC Platinum Big Tick Award in 2013 and shortlisted to be BITC's Company of the Year 2013

Corporate Responsibility report p28

Dairy Crest Annual Report 2013 5

Dairy Crest Group plc Annual Report 2013

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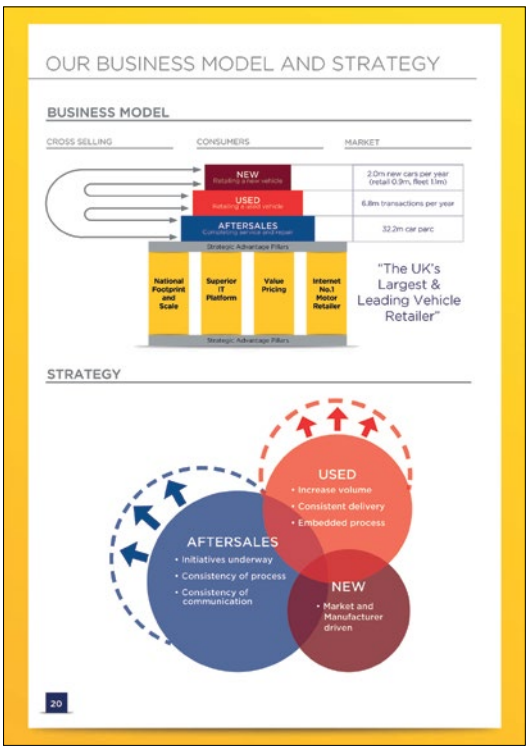
Another important area of linkage is between the company's strategy and its business model – Pendragon PLC shows a good example of this. A link between strategy and the markets a business operates in can also be useful for users – a clear overview of the markets they operate in was provided by 70% of the companies surveyed. Marks and Spencer Group plc provide a good example of a market overview with links to the strategic impacts of market developments. On a similar theme, Cobham plc present a useful visual illustration of their positioning in key markets.



Pendragon PLC 2012 Annual Report

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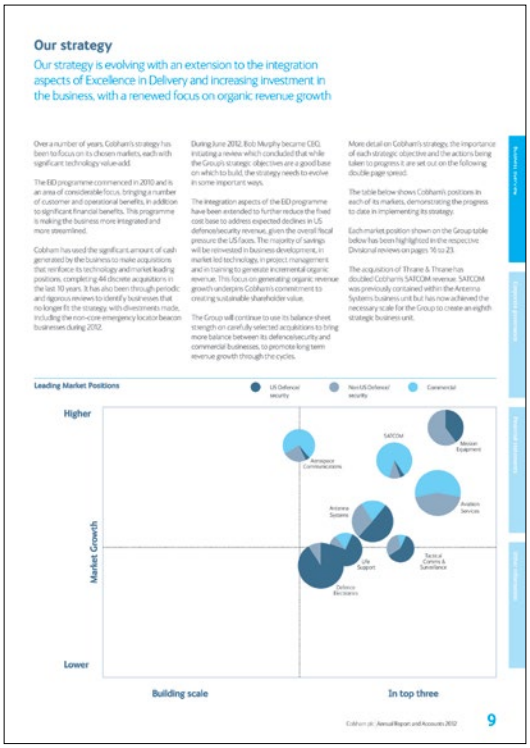
Marks & Spencer Group plc Annual report and financial statements 2013



Cobham plc Annual Report and Accounts 2012

Corporate social responsibility

Corporate social responsibility (CSR) is an area of continued focus for the business community at large and it is no surprise that practice continues to develop in this area regarding the level of disclosure given by companies. This is also an area of regulatory development, particularly for quoted companies – while the business review is currently required to discuss environmental matters, the company's employees and social and community issues, the new narrative regulations extend this to include human rights issues and also include specific new disclosure requirements regarding gender diversity that go beyond the UK Corporate Governance Code's requirements for disclosures around boardroom diversity policies. The new regulations also introduce specific requirements for numerical disclosure of greenhouse gas emissions into quoted companies' directors' reports, although in practice companies may combine this requirement with the discussion of environmental matters in the strategic report, something which is allowed by the new regulations where a matter required to be included in the directors' report is deemed to be of strategic importance to the company (as long as this approach is made clear in the directors' report) and in line with current practice.

The consideration of a business' wider impact is also a theme of the IIRC's Integrated Reporting Framework. This framework encourages companies to consider their wider impact on society through a discussion of the "six capitals" – financial, manufactured, social and relationship, human, intellectual and natural. Given that the draft framework was only released in June 2013 the impact on our current year survey is limited, however it will be interesting to follow the impact that this has on company reports in future years.

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Figure 7.5. How much detail have companies given about their corporate social responsibility?

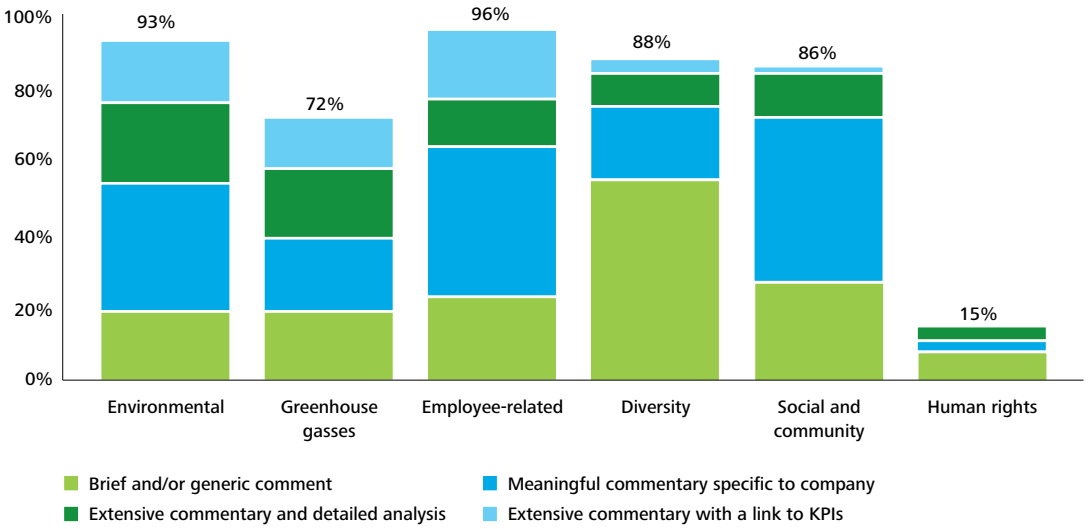
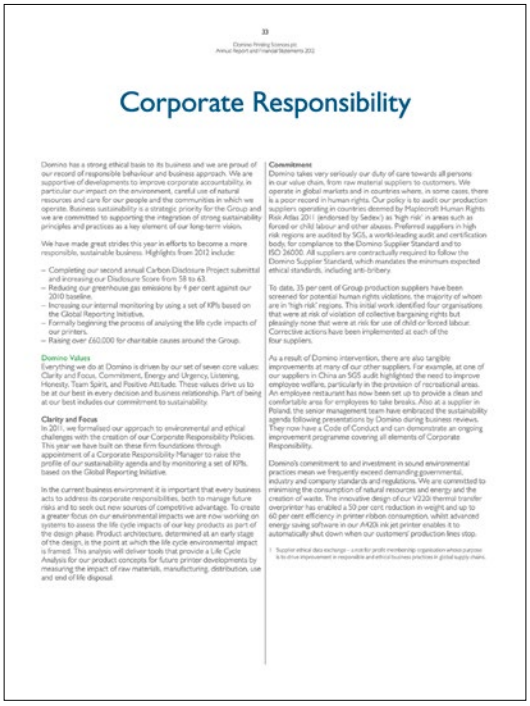


Figure 7.5 shows the level of detail that companies have given regarding corporate social responsibility. Understandably, given that these are not yet required, the level of disclosure regarding company-wide diversity and human rights is noticeably less extensive than for environmental, employee-related and social and community issues. Although the overall level of human rights disclosures was low at only 15%, the companies for which this is a more significant issue, such as mining companies or manufacturing firms with significant operations in Africa and South-East Asia generally did provide a more detailed level of disclosure in this area. Domino Printing Sciences plc provide an example of good disclosure in this area.



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Domino Printing Sciences plc
Annual Report and Financial Statements 2012

Corporate Responsibility

Domino has a strong ethical basis to its business and we are proud of our record of responsible behaviour and business approach. We are supportive of developments to improve corporate accountability, in particular our impact on the environment, careful use of natural resources and care for our people and the communities in which we operate. Business sustainability is a strategic priority for the Group and we are committed to supporting the integration of strong sustainability principles and practices as a key element of our long-term vision.

We have made great strides this year in efforts to become a more responsible, sustainable business. Highlights from 2012 include:

- Completing our second annual Carbon Disclosure Project submittal and increasing our Disclosure Score from 58 to 63.
- Reducing our greenhouse gas emissions by 4 per cent against our 2010 baseline.
- Increasing our internal monitoring by using a set of KPIs based on the Global Reporting Initiative.
- Formally beginning the process of analysing the life cycle impacts of our printers.
- Raising over £60,000 for charitable causes around the Group.

Domino Values

Everything we do at Domino is driven by our set of seven core values: Clarity and Focus, Commitment, Energy and Urgency, Listening, Honesty, Team Spirit, and Positive Attitude. These values drive us to be at our best in every decision and business relationship. Part of being at our best includes our commitment to sustainability.

Clarity and Focus

In 2011, we formalised our approach to environmental and ethical challenges with the creation of our Corporate Responsibility Policies. This year we have built on these firm foundations through appointment of a Corporate Responsibility Manager to raise the profile of our sustainability agenda and by monitoring a set of KPIs, based on the Global Reporting Initiative.

In the current business environment it is important that every business acts to address its corporate responsibilities, both to manage future risks and to seek out new sources of competitive advantage. To create a greater focus on our environmental impacts we are now working on systems to assess the life cycle impacts of our key products as part of the design phase. Product architectures, determined at an early stage of the design, is the point at which the life cycle environmental impact is framed. This analysis will deliver tools that provide a Life Cycle Analysis for our product concepts for future printer developments by measuring the impact of raw materials, manufacturing, distribution, use and end of life disposal.

Commitment

Domino takes very seriously our duty of care towards all persons in our value chain, from raw material suppliers to customers. We operate in global markets and in countries where, in some cases, there is a poor record in human rights. Our policy is to audit our production suppliers operating in countries deemed by Maplecroft Human Rights Risk Atlas 2011 (endorsed by Sedex) as 'high risk' in areas such as forced or child labour and other abuses. Preferred suppliers in high risk regions are audited by SGS, a world-leading audit and certification body, for compliance to the Domino Supplier Standard and to ISO 26000. All suppliers are contractually required to follow the Domino Supplier Standard, which mandates the minimum expected ethical standards, including anti-bribery.

To date, 35 per cent of Group production suppliers have been screened for potential human rights violations, the majority of whom are in 'high risk' regions. This initial work identified four organisations that were at risk of violation of collective bargaining rights but pleasingly none that were at risk for use of child or forced labour. Corrective actions have been implemented at each of the four suppliers.

As a result of Domino intervention, there are also tangible improvements at many of our other suppliers. For example, at one of our suppliers in China an SGS audit highlighted the need to improve employee welfare, particularly in the provision of recreational areas. An employee restaurant has now been set up to provide a clean and comfortable area for employees to take breaks. Also at a supplier in Poland, the senior management team have embraced the sustainability agenda following presentations by Domino during business reviews. They now have a Code of Conduct and can demonstrate an ongoing improvement programme covering all elements of Corporate Responsibility.

Domino's commitment to and investment in sound environmental practices mean we frequently exceed demanding governmental, industry and company standards and regulations. We are committed to minimising the consumption of natural resources and energy and the creation of waste. The innovative design of our V220i thermal transfer overprinter has enabled a 50 per cent reduction in weight and up to 60 per cent efficiency in printer ribbon consumption, whilst advanced energy saving software in our A420i ink jet printer enables it to automatically shut down when our customers' production lines stop.

1 Supplier ethical data exchange – a not-for-profit membership organisation whose purpose is to drive improvement in responsible and ethical business practices in global supply chains.

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The number of companies giving extensive information in relation to environmental issues (39%, 2012: 28%) and employee-related issues (32%, 2012: 30%) is encouraging, particularly the number that identify key performance indicators in these areas. In terms of environmental measures, greenhouse gas emission-related KPIs are particularly popular and these will dovetail nicely with the new regulations (see below). For employee-related information, KPIs in relation to employee engagement and satisfaction are particularly popular. Commentary on diversity tends to form a part of the discussion of employee-related issues, although for many companies this discussion does not go much further than the policy regarding employment of disabled persons which is required by the Companies Act.

Galliford Try plc, Kier Group plc and MITIE Group PLC provide some good examples of how to present an effective CSR report, balancing narrative and numbers. In particular, MITIE provide good disclosure of future targets for their sustainability measures, while Kier provide an example of a company which has obtained external assurance over its sustainability measures.


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Business review: **Sustainability**

Constructing a sustainable future

ENVIRONMENT & CLIMATE CHANGE

We aim to protect the environment and plan for its improvement where we can.

HEALTH & SAFETY

We place the highest priority on health and safety.

OUR PEOPLE

We are committed to the training and development of our staff.

SUPPLY CHAIN

We actively engage in ethical supply chain practices.

COMMUNITY

Our objective is to make a positive contribution to the communities in which we operate.

We will give total commitment and high standards to all our customers.

CUSTOMERS

The six fundamentals of our sustainable business

The six fundamentals help us to manage sustainability issues and to communicate our approach throughout the Group.

Our vision is to be leaders in the construction of a sustainable future. We therefore follow a sustainability strategy which requires us to consider, prioritise and manage sustainability issues. We have identified six fundamentals of sustainable business, as shown in the diagram above.

The Group policy statement defines our objectives in each area and communicates them across the business. We share and adopt best practice and look for initiatives that add value and help us to build partnerships with our stakeholders.

Governance of sustainability

The Group board delegates authority for sustainability to the chief executive, who is responsible for the Group policy statement. The executive board has overall responsibility for sustainability, with a board director accountable for each element. This ensures we implement our policies and make sufficient resources available.

Each month, our corporate responsibility (CR) manager updates the executive board on our progress. There are also regular presentations to, and interactions with, the divisional boards. This ensures divisions prioritise sustainability and create plans in line with the Group's approach.

The Group CR steering committee is chaired by the company secretary and legal director and includes representatives from across the business. It meets quarterly to review progress, discuss sustainability developments and best practice, and advise on sustainability across the Group. We include sustainability risks in the Group risk register, which the audit committee reviews on a regular basis.

We also have a carbon task force, which implements our carbon reduction and energy efficiency strategy, reviews training initiatives and engages with supply chain partners. Our CR manager chairs the task force. Attendees include the chief executive, key divisional representatives and procurement.

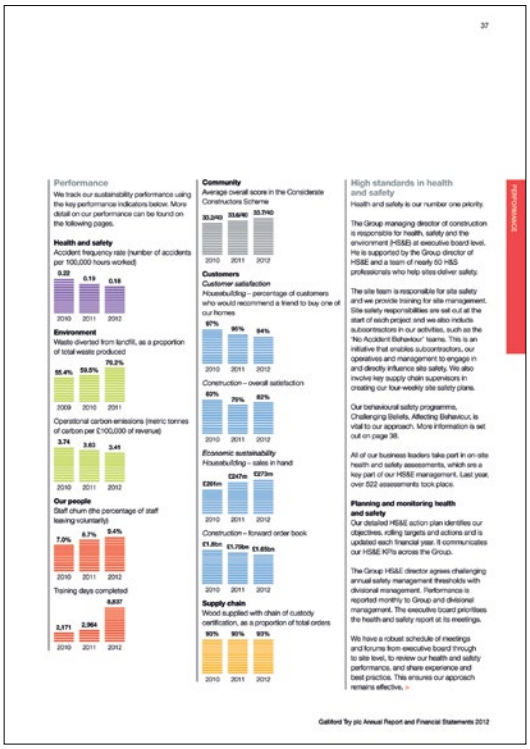
Engaging our stakeholders

Our stakeholders include communities, employees, shareholders, customers, supply chain, regulators, Government and industry bodies.

We aim to raise awareness of sustainable solutions and services, to influence our stakeholders and address sustainability in their dealings with us. We want to learn from and consult with others, share ideas and help deliver a sustainable economy.

We are active in industry working and policy groups, including: 'Doing Business Responsibly', which was set up by the UK Contractors Group (UKCG) to improve perceptions of the construction industry; the UKCG's Carbon Group; the Zero Carbon Hub, a public-private partnership that co-ordinates delivery of low and zero carbon new homes; and NextGeneration, which drives sustainability best practice in the UK's residential development sector.

Galliford Try plc Annual Report and Financial Statements 2012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Performance

We track our sustainability performance using the key performance indicators below. More detail on our performance can be found on the following pages.

Health and safety

Accident frequency rate (number of accidents per 100,000 hours worked)

0.22 | 0.19 | 0.18
2010 | 2011 | 2012

Environment

Waste diverted from landfill, as a proportion of total waste produced

55.4% | 59.5% | 70.2%
2009 | 2010 | 2011

Operational carbon emissions (metric tonnes of carbon per £100,000 of revenue)

3.74 | 3.63 | 3.45
2010 | 2011 | 2012

Our people

Staff churn (the percentage of staff leaving voluntarily)

7.0% | 8.7% | 9.4%
2010 | 2011 | 2012

Training days completed

2,171 | 2,964 | 8,837
2010 | 2011 | 2012

Community

Average overall score in the Considerate Constructors Scheme

30.2/40 | 33.6/40 | 33.7/40
2010 | 2011 | 2012

Customers

Customer satisfaction

Housebuilding – percentage of customers who would recommend a friend to buy one of our homes

97% | 96% | 94%
2010 | 2011 | 2012

Construction – overall satisfaction

60% | 79% | 82%
2010 | 2011 | 2012

Economic sustainability

Housebuilding – sales in hand

£269m | £247m | £273m
2010 | 2011 | 2012

Construction – forward order book

£1.8bn | £1.75bn | £1.65bn
2010 | 2011 | 2012

Supply chain

Wood supplied with chain of custody certification, as a proportion of total orders

90% | 91% | 93%
2010 | 2011 | 2012

High standards in health and safety

Health and safety is our number one priority.

The Group managing director of construction is responsible for health, safety and the environment (HSE) at executive board level. He is supported by the Group director of HS&E and a team of nearly 50 H&S professionals who help sites deliver safety.

The site team is responsible for site safety and we provide training for site management. Site safety responsibilities are set out at the start of each project and we also include subcontractors in our activities, such as the 'No Accident Behaviour' teams. This is an initiative that enables subcontractors, our operatives and management to engage in and directly influence site safety. We also involve key supply chain supervisors in creating our four-weekly site safety plans.

Our behavioural safety programme, Challenging Beliefs, Affecting Behaviour, is vital to our approach. More information is set out on page 38.

All of our business leaders take part in on-site health and safety assessments, which are a key part of our HS&E management. Last year, over 522 assessments took place.

Planning and monitoring health and safety

Our detailed HS&E action plan identifies our objectives, rolling targets and actions and is updated each financial year. It communicates our HS&E KPIs across the Group.

The Group HS&E director agrees challenging annual safety management thresholds with divisional management. Performance is reported monthly to Group and divisional management. The executive board prioritises the health and safety report at its meetings.

We have a robust schedule of meetings and forums from executive board through to site level, to review our health and safety performance, and share experience and best practice. This ensures our approach remains effective. >

PERFORMANCE

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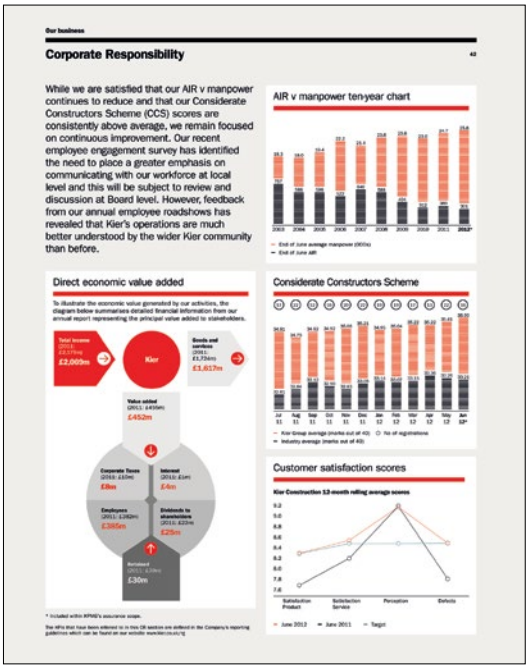
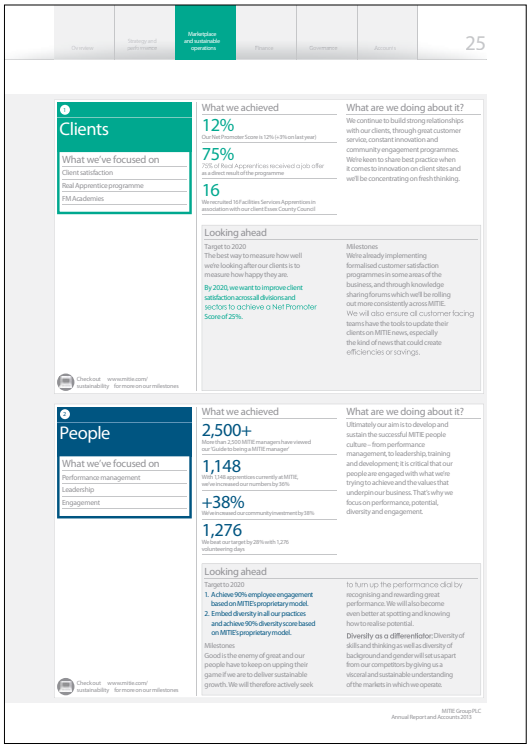


Kier Group plc Annual Report and Accounts 2012



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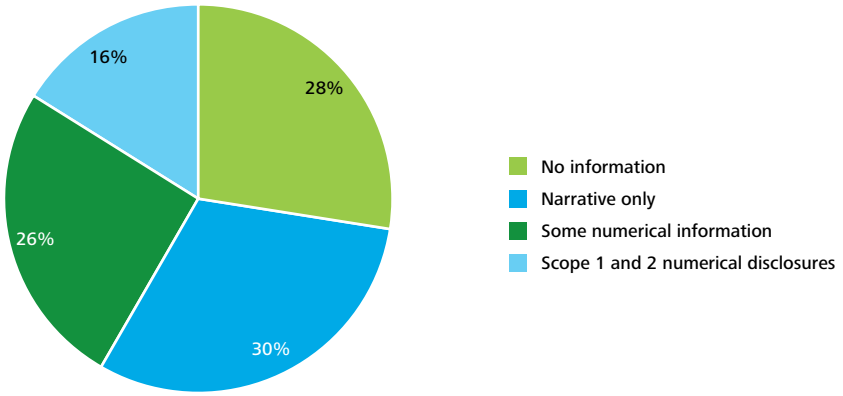
In addition to the information included in the annual report, 23 companies (2012: 10) refer to a separate standalone corporate social responsibility report in their annual report. This is further encouraging evidence of the rising priority of CSR for companies. Of these 23, 20 were from the largest 350 group in our sample, indicating that this is another area in which the largest companies (who one would expect to have a larger communications budget) are leading the way. A note of caution however (and one that has been picked up by the European Commission in their latest proposed amendments to the accounting directives) – it is important for companies to ensure that sufficient detail in this area is still included in the annual report itself, rather than just the separate CSR report.

Greenhouse gas reporting

With the new narrative reporting regulations including specific requirements for reporting on greenhouse gas emissions in the directors' report, it is interesting to see how practice is developing in this area. The new regulations require companies to provide disclosure of the amount of emissions produced directly by the business from combustion of fuel or the operation of its facilities, as well as indirect emissions from the purchase of electricity, heat, steam or cooling. These measures correspond to the existing "Scope 1" and "Scope 2" emissions disclosures as defined by Defra in its 2009 guidance on this subject[5]. Although there is no existing requirement to present this information, as shown by figure 7.6 a number of companies are already disclosing some limited numerical information about greenhouse gas emissions in addition to narrative information. However, with the new regulations requiring this information to be presented, the majority of companies have work to do. Deloitte's publication 'Lip service of Leadership'[6] gives more detail in this area.

Figure 7.6. How much numerical detail have companies given regarding greenhouse gases?



A significant number of companies are already disclosing numerical information about greenhouse gas emissions in addition to narrative information.

5 See https://www.gov.uk/government/publications/guidance-on-how-to-measure-and-report-your-greenhouse-gas-emissions
6 See http://www.iasplus.com/en/publications/uk/other/carbon-survey

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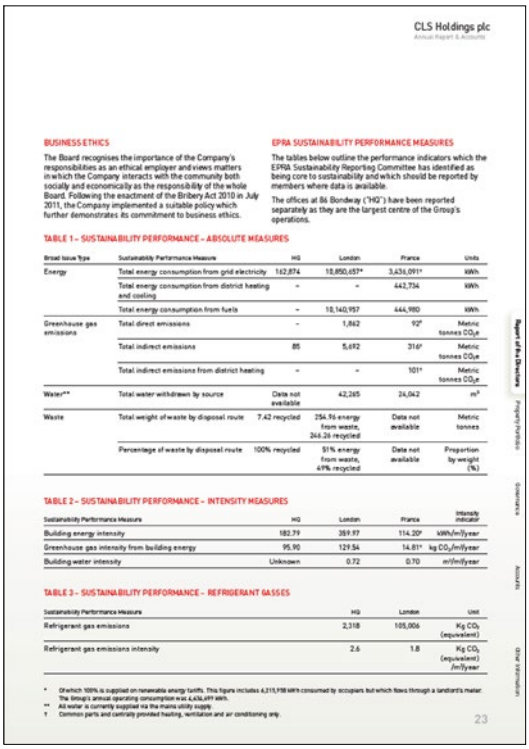
The new regulations also include a requirement to disclose the methodology used to calculate the figures disclosed, as well as "at least one ratio which expresses the company's annual emissions in relation to a quantifiable factor associated with the company's activities."

A good example of overall environmental (and in particular greenhouse gas emissions) disclosure is provided by CLS Holdings plc. Another example of relating carbon emissions to an operational measure is provided by British Polythene Industries PLC.



CLS Holdings plc

Annual Report & Accounts

BUSINESS ETHICS

The Board recognises the importance of the Company's responsibilities as an ethical employer and views matters in which the Company interacts with the community both socially and economically as the responsibility of the whole Board. Following the enactment of the Bribery Act 2010 in July 2011, the Company implemented a suitable policy which further demonstrates its commitment to business ethics.

EPRA SUSTAINABILITY PERFORMANCE MEASURES

The tables below outline the performance indicators which the EPRA Sustainability Reporting Committee has identified as being core to sustainability and which should be reported by members where data is available.

The offices at 86 Bondway ('HQ') have been reported separately as they are the largest centre of the Group's operations.

TABLE 1 – SUSTAINABILITY PERFORMANCE – ABSOLUTE MEASURES

Broad Issue Type	Sustainability Performance Measure	HQ	London	France	Units
Energy	Total energy consumption from grid electricity	162,874	10,890,657*	3,436,091†	kWh
	Total energy consumption from district heating and cooling	–	–	443,734	kWh
	Total energy consumption from fuels	–	10,140,957	444,980	kWh
Greenhouse gas emissions	Total direct emissions	–	1,862	92†	Metric tonnes CO_2e
	Total indirect emissions	85	5,692	316†	Metric tonnes CO_2e
	Total indirect emissions from district heating	–	–	101†	Metric tonnes CO_2e
Water**	Total water withdrawn by source	Data not available	42,265	24,042	m^3
Waste	Total weight of waste by disposal route	7.42 recycled	254.96 energy from waste, 264.26 recycled	Data not available	Metric tonnes
	Percentage of waste by disposal route	100% recycled	51% energy from waste, 49% recycled	Data not available	Proportion by weight (%)

TABLE 2 – SUSTAINABILITY PERFORMANCE – INTENSITY MEASURES

Sustainability Performance Measure	HQ	London	France	Intensity indicator
Building energy intensity	182.79	359.97	114.20*	kWh/m²/year
Greenhouse gas intensity from building energy	95.90	129.54	14.81*	kg CO_2/m²/year
Building water intensity	Unknown	0.72	0.70	m³/m²/year

TABLE 3 – SUSTAINABILITY PERFORMANCE – REFRIGERANT GASSES

Sustainability Performance Measure	HQ	London	Unit
Refrigerant gas emissions	2,318	105,006	Kg CO_2 (equivalent)
Refrigerant gas emissions intensity	2.6	1.8	Kg CO_2 (equivalent) /m²/year

* Of which 100% is supplied on renewable energy tariffs. This figure includes 4,215,958 kWh consumed by occupiers but which flows through a landlord's meter. The Group's annual operating consumption was 4,436,691 kWh.

** All water is currently supplied via the mains utility supply

† Common parts and centrally provided heating, ventilation and air conditioning only.

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Review of the Year

Corporate Social Responsibility Review (continued)

"Through close contact with national governments and industry regulators, we are at the forefront of legislative developments. We continue to develop our processes and working practices to meet, as a minimum standard, both our legal and social obligations."

Environment

Policy

As a leading manufacturer and supplier of polythene film and other products, we recognise our responsibility to operate with due concern for the environment in which we live and work and to minimise the impact of our activities on that environment. Through close contact with national governments and industry regulators, we are at the forefront of legislative developments. We continue to develop our processes and working practices to meet, as a minimum standard, both our legal and social obligations. We seek continually to improve our environmental performance by setting objectives and targets combined with clear management programmes and initiatives to minimise our impact on the environment. Specifically we are committed to:

- manufacture our products to meet the relevant legislative standards in the countries and regions in which we operate;
- minimise the use of resources and work with our customers to minimise their use of resources through environmentally responsible packaging systems;
- promote the re-use, recycling and recovery of our materials and assist in this recovery wherever it is practical and environmentally beneficial to do so;
- improve the environmental performance of our processes by reducing emissions and energy use, minimising waste and controlling noise;
- be a responsible employer and a good neighbour;
- provide suitable and unambiguous environmental information for our employees, customers and the local community; and
- maintain leadership in the development of new products and processes using recycled materials and support initiatives which benefit the environment.

The Group Environmental Director, Andrew Green, is a member of the Group Management Board and reports to the Chief Executive. With the increasing focus on environmental issues and the enhanced interest in packaging and recycling, it is important that the Group has an experienced representative and spokesman on these topics. Andrew is also on the Board of Valpak, the UK's largest compliance scheme for packaging waste regulations, and is a member of the UK Government Advisory Committee on Packaging.

Energy

	2012	2011	2010	2009	2008
CO_2 output (kg/tonne)	338	342	358	362	356
CO_2 output (kg/1,000 square metres)	13.9	14.2	14.7	15.3	15.7
Electricity (kWh/tonne)	696	694	693	697	679
Electricity (kWh/1,000 square metres)	28.3	28.8	29.4	30.5	30.6

The UK Government require that instead of using actual CO_2 data, standard conversion factors for each country are used for energy consumption.

We have included measures of CO_2 and energy usage per square metre to reflect the continuing trend to produce thinner stronger films. As the average weight of products has reduced, our energy usage and CO_2 output per square metre has reduced whilst energy usage per tonne has remained relatively constant. For more information on the impact of thinner stronger films, please see page 3.

CO_2 output per tonne has reduced compared with 2011. This is due to reduced gas and oil usage especially for background space heating by re-using exhaust heat from our processes and also continuing efficiencies from our investment in newer more efficient print machines.

There is a long established improvement programme in place to purchase more efficient equipment and fit energy saving devices, especially to motors, compressors and lighting schemes. There is also an established and ongoing programme of energy audits and improvement programmes.

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Employee diversity

Employee diversity at different levels within a company, specifically in relation to gender, is another area in which the new narrative reporting regulations introduce additional requirements. Previously the government was promoting voluntary disclosure around gender equality rather than implementing the mandatory disclosure requirements in the 2010 Equality Act, which focused on disclosure of gender pay gap information. The new regulations have moved away from this to require more basic numerical information about the number of employees of each gender in a company. However, as well as employees overall, the regulations also require that the gender split of the board and 'senior management' is disclosed, to give an idea of how equal opportunities are at the top of the company, not just the bottom. Diversity at board level and the implementation of Lord Davies' report "Women on boards" is discussed in more detail in chapter 11.

Of the companies surveyed, 17 provided gender diversity information broadly in line with the requirements of the new regulations and a further four provided some gender diversity information. Of these 21 companies, the majority (15) came from the top 350 companies group. A particularly good example of diversity disclosures, encompassing not just gender but age, ethnic background and disability status, is provided by PayPoint plc.

CORPORATE SOCIAL RESPONSIBILITY *continued*

business ethics - we set out clear standards for ethical relationships and conduct to be maintained by employees and sub-contractors and conduct our business in accordance with the highest ethical standards. We do not offer or accept any bribes; and

training and development - all employees meet twice a year with their line manager to discuss performance and any development needs. Training is provided either in-house or externally. We also sponsor employees through further professional and technical qualifications. We promote internally, where appropriate.

PayPoint's employees

	UK		Rest of the world[2]	
	53 weeks ended 31 March 2013	52 weeks ended 25 March 2012	53 weeks ended 31 March 2013	52 weeks ended 25 March 2012
General[1]				
Average number of staff employed during the period	464	432	156	148
Average length of service	5 years	4 years	2 years	3 years
Average staff turnover during the period	23%	26%	17%	28%
Sickness absence rate	1.5%	1.3%	1.1%	2.0%
% working part-time	9%	10%	2%	2%
Women[1]				
Number of women employed	198	200	59	54
% of all employees	43%	43%	38%	37%
% of management grades	20%	13%	26%	14%
Ethnic minorities[1]				
% of all employees	24%	16%	8%	4%
% of management grades	3%	3%	6%	1%
Disabled employees[1]				
% of all employees	0%	1%	0%	1%
Age profile[1]				
employees under 25	54	46	12	12
employees 25 to 29	90	103	36	31
employees 30 to 49	262	224	107	101
employees 50 and over	66	63	3	4

1. Numbers based on employees employed at the end of the relevant period
2. Rest of the world includes Ireland, Romania, Canada and France

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8. Risks and uncertainties – what's keeping you awake?

Highlights

- 83% (2012: 83%) of companies clearly identify their principal risks and uncertainties.
- The average number of risks identified is 10 (2012: 9).
- 57% of companies gave clear descriptions of all of their risks, with these companies on average having fewer risks than those for whom the descriptions were less clear.
- Encouragingly, only 5% of companies (2012: 11%) presented an entirely generic list of risks, with the rest ensuring that at least some were company-specific.
- 91% (2012: 83%) of companies clearly discuss the mitigating actions taken in response to the risks identified.

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8. Risks and uncertainties – what's keeping you awake?

This chapter looks in more detail at the types of principal risks and uncertainties identified by companies and the way in which they are presented. Both company law, in the Companies Act 2006 requirements for a business review, and the FCA's Disclosure and Transparency Rules, require listed companies to give a description of the principal risks and uncertainties facing the company. The use of the word 'principal' here is not accidental – the idea is for companies to give a detailed summary of relevant information on the risks which are really key to their business, rather than a 'brain dump' of any and all risks that could possibly be relevant.

Risk reporting is a sensitive area and it is just as important to communicate risks effectively as it is to identify them properly in the first place. Understandably, risk management disclosures continue to be an area of focus for stakeholders and regulators and, while companies are making progress in this area, for many there are still improvements that can be made. A recent survey of FTSE 350 risk reporting by the Association of Insurance and Risk Managers in Industry and Commerce (AIRMIC) found that "the standards of risk reporting vary considerably between individual companies and, very noticeably, between the different business sectors" and this is a finding which is borne out by our results.

The most commonly levelled criticism of companies is not that they identify too few risks but that they identify too many. In the words of Stephen Haddrill, Chief Executive of the FRC, risk reporting should be about "directors explaining clearly how they identify and manage risk and what keeps them awake at night." A detailed assessment of the handful of risks which are really key to a specific company is of much more use than a long list of generic risks with just a couple of sentences to explain their potential impact.

One idea which is very effective in demonstrating the relative significance of various risks is to show a 'heat-map' which illustrates the likelihood and potential impact of a 'risk event' in relation to the various risks identified. Although many companies use such a heat-map for internal management purposes, the number that present it in their annual report is very small – only two from our sample. A good example of this is shown by Premier Oil plc, who not only illustrate the current status of various risks but also the factors causing changes in them. An alternative approach is demonstrated by Domino Printing Sciences plc, who show similar information but in a tabular form. The best reports also show a clear link between this discussion of principal risks and the information on risk management and internal controls which is required by the UK Corporate Governance Code (see chapter 11).

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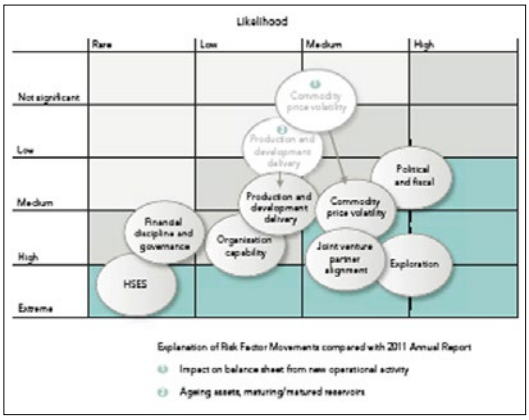
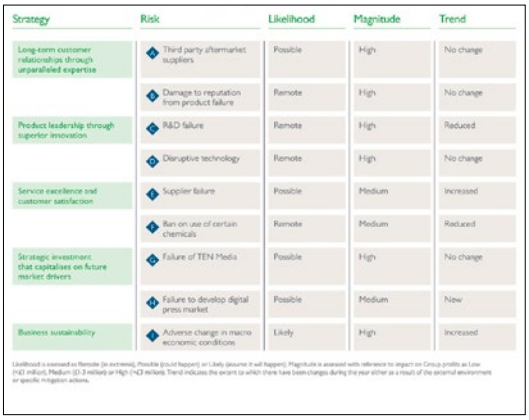


Premier Oil plc 2012 Annual Report and Financial Statements



Strategy	Risk	Likelihood	Magnitude	Trend
Long-term customer relationships through unparalleled expertise	Third party aftermarket suppliers	Possible	High	No change
	Damage to reputation from product failure	Remote	High	No change
Product leadership through superior innovation	R&D failure	Remote	High	Reduced
	Disruptive technology	Remote	High	No change
Service excellence and customer satisfaction	Supplier failure	Possible	Medium	Increased
	Ban on use of certain chemicals	Remote	Medium	Reduced
Strategic investment that capitalises on future market drivers	Failure of TEN Media	Possible	High	No change
	Failure to develop digital press market	Possible	Medium	New
Business sustainability	Adverse change in macro economic conditions	Likely	High	Increased

Likelihood is assessed as Remote (ie extreme), Possible (could happen), or Likely (assume it will happen). Magnitude is assessed with reference to impact on Group profits as Low (<£2 million), Medium (£2-3 million) or High (>£3 million). Trend indicates the extent to which there have been changes during the year either as a result of the external environment or specific mitigation actions.

Domino Printing Sciences plc Annual Report & Financial Statements 2012

Overall, just 15% of the companies surveyed gave a clear indication of how their risks had changed from last year. This information is not difficult to present and would demonstrate active risk management to a reader, so it is quite surprising that so few do so. A simple way of doing this is to include trend arrows showing how management's perception of the risk has changed, such as those used by Halma plc.

PRINCIPAL RISKS AND UNCERTAINTIES

Risk description	Trend*	Potential impact	Mitigation
Operational Risk **Remoteness of operations and globalisation** A key operational risk arises from remoteness of operations from Head Office and the increasing global spread of our businesses.	▲	• Weakening of financial control and divergence from overall Group strategy in remote operations, leading to unexpected financial outcomes • Failure to comply with local laws and regulations in unfamiliar territories, leading to legal or regulatory disputes	• Control is exercised locally in accordance with the Group's policy of autonomous management. We seek to employ local high quality experts. • The Group's acquisition model ensures retention of management and staff in acquired businesses meaning that local expertise is maintained. • Divisional Chief Executives (DCEs) ensure that overall Group strategy is fulfilled through on-going review of the businesses. The right balance between autonomy and adherence to the overall objectives of the Group is a key function of the DCEs and Divisional Finance Directors. • Regular visits by senior management, finance staff and Internal Audit support local control. **Key KPIs: International expansion; Values alignment; Development programmes**
Operational Risk **Staff quality** The actions and quality of our employees affect the growth of, and level of innovation in, the business.	▼	• Failure to retain key staff could lead to reduced innovation and progress in the business • Unethical actions of staff could cause reputational damage to the Group	• Group Development Programmes enhance the skills of executives and middle managers needed in their current and future roles. • Comprehensive recruitment and ongoing evaluation processes assist high quality hiring and development. • The Group regularly surveys staff to assess the alignment of individuals with Group values. **Key KPIs: Development programmes; R&D investment; Values alignment; Organic revenue growth**
Operational Risk **Competition** The Group faces competition in the form of pricing, service, reliability and substitution.	▲	• Loss of market share due to price pressure and changing markets • Reduced financial performance arising from competitive threats	• By empowering and resourcing innovation in local operations to respond to changing market needs, the potential adverse impact of downward price pressure and competition can be mitigated and growth maintained. • We recognise the competitive threat coming from emerging economies and by operating within these economies, typically using local staff, we are better placed to make fast progress ourselves. • The Group operates in specialised global niche markets offering high barriers to entry. **Key KPIs: R&D investment; Return on Sales; Organic revenue growth; Development programmes**
Operational Risk **Pressure-point Exposures** including **Large customer risk** – individual operating companies are at some risk of over-reliance on larger customers. **Key supplier risk** – we rely on high quality services from our supply partners.	▼	• Loss of market share and reduced financial performance due to loss or failure of a major customer • Disruption of service to customers through supply chain interruption	• We do not place undue reliance on any one Group company nor does the Group rely heavily on one customer, supplier or transaction. • We address customer concentration at Company level through active diversification of the customer base. No customer represents more than 2% of Group revenue. • We aim to manage the risk of timing and quality of component supply by dual sourcing and through long-standing working relationships. **Key KPIs: Organic revenue growth**
Operational Risk **Research & Development** New products are critical to our organic growth and underpin our ability to earn high margins and high returns over the long term.	▶	• Loss of market share resulting from product obsolescence and failure to innovate to meet customer needs	• By devolving control of product development into the autonomous operating businesses, we both spread risk and ensure that the people best placed to service the customer's needs are driving innovation. • New product development 'best practice' is shared between Group companies and return on investment of past and future innovation projects is tracked monthly. This ensures that the collective experience and expertise of the Group can be utilised to maximum effect. • Large R&D projects, especially those which are capitalised, require Head Office approval, ensuring that the Group's significant projects are aligned to overall strategy. **Key KPIs: R&D investment; Development programmes**

* Trend indicates management's perception of how the pre-mitigation risk has moved year on year.

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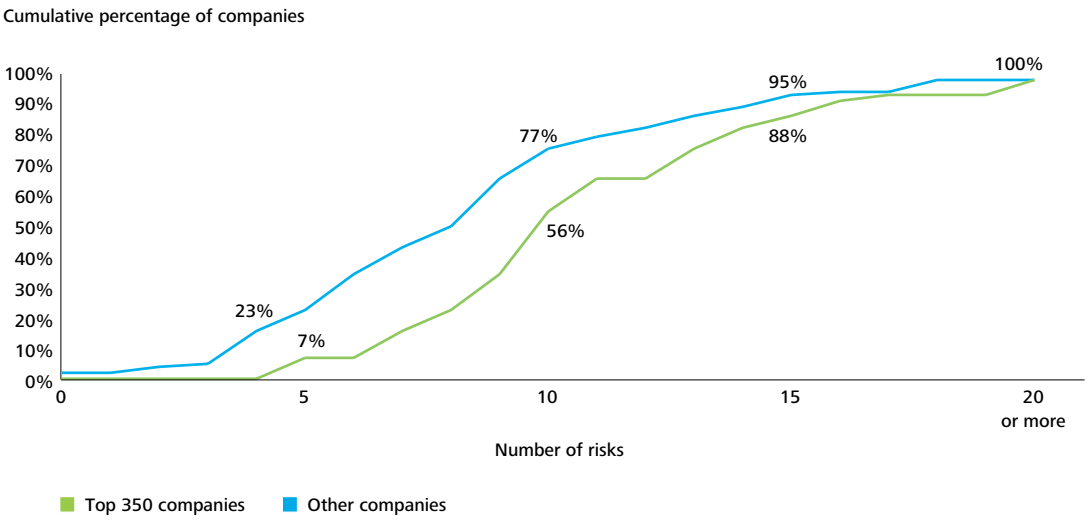
Number of risks identified

All of the companies in our sample discussed risk management in some way in the directors' report. 83% (2012: 83%) clearly identified that the risks discussed were the principal risks to the company – either by using the word 'principal' itself or a similar description such as 'key' or 'most significant'. Those companies failing to identify that the risks discussed were principal did not identify noticeably more risks, suggesting that this is just a failure to label the discussion properly. Figure 8.1 shows the number of risks identified by different companies, displayed as a cumulative figure. For example we can see that while 77% of smaller companies identify 10 risks or fewer, only 56% of top 350 companies identify 10 or fewer. As one might expect, the overall trend shows smaller companies identifying fewer risks than larger ones, probably reflective of the fact that larger companies tend to have more complex operations and a greater geographical spread. Nevertheless, those companies identifying a number of risks in the high teens or even twenties may wish to consider whether all of the risks are really principal.

Figure 8.1. How many risks are identified by companies in 2013?



Some companies choose to categorise their risks into groups, such as 'operational' or 'general economic'. While this can give helpful definition to users, in some cases companies seem to put pressure on themselves to identify several risks in each category by doing this, meaning that some of the individual risks can start to become rather generic.

The overall trend shows smaller companies identifying fewer risks than larger ones, probably reflective of the fact that larger companies tend to have more complex operations and a greater geographical spread.

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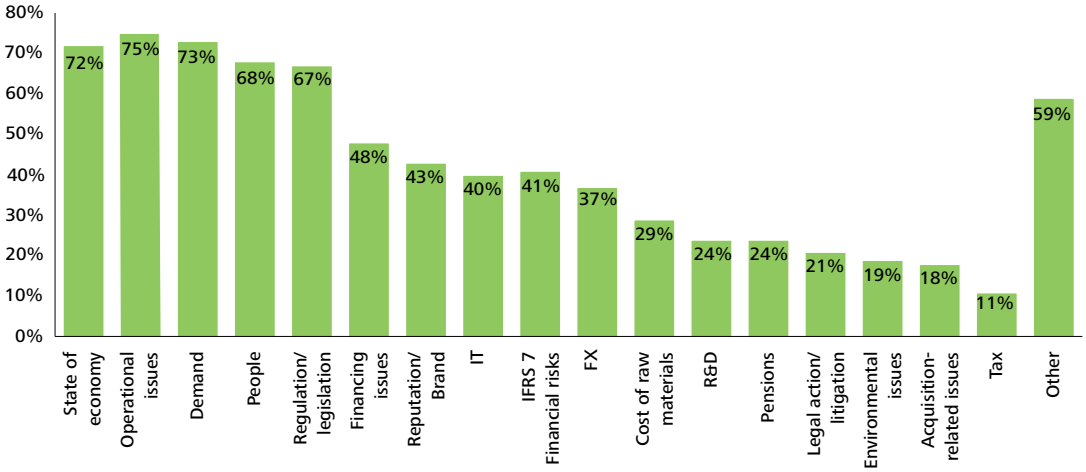
Types of risks and uncertainties identified

Figure 8.2. What are the main categories of risk disclosed in 2013?



As shown by figure 8.2, there is a good spread of risks across the various categories we have specifically identified. The most popular risks continue to be those arising from the state of the economy, operational issues, company-specific demand factors, people and regulation/legislation. However, it is also encouraging to see the high percentage of companies identifying risks which do not fit into any of our predetermined categories. This shows that companies are putting a commendable level of effort into identifying really company-specific issues that do not fit neatly into a pigeon-hole.

With the UK economy (or, for those international businesses, the global economy) still struggling to recover from the 2008 financial crisis, it is understandable that the majority of companies identify this as a risk to their business. However, it is also excellent to see that almost as high a proportion go beyond this to identify specific factors affecting demand in the markets that they operate in rather than just the global economy in general.

'Operational issues' covers a broad sweep of issues that could lead to a business' operations being interrupted. This includes issues such as supply chain failures or business continuity planning.

People related issues cover areas such as retention of key personnel and recruitment of new staff, as well as more general employee engagement and the possibility of a loss of staff goodwill due to a failure to prevent workplace accidents.

Regulation and legislation are particularly important for those businesses operating in highly regulated industries, such as construction or pharmaceuticals. However, changes in government attitudes and policies either at home or abroad can also have a significant impact on a business' operations.

Description of risks and mitigating actions

As well as identifying the right risks, it is important to clearly describe their potential impact on the company and how this impact is managed. As indicated by the FRC's FRRP (now part of the Conduct Committee) in its 2012 annual report, risk disclosures should include "descriptions [which are] sufficiently specific that the reader can understand why they are important to the company," as well as a description of the mitigating actions taken by the board and clear links to the accounting estimates and judgements arising from them. This is reiterated in the draft FRC's Guidance on the Strategic Report.

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The percentage of companies judged to provide comprehensive descriptions of all their risks (57%) has improved significantly from 33% last year, while the percentage of companies providing purely generic risks has reduced from 11% in 2012 to 5% in 2013.

Figure 8.3. How well do companies describe their risks?

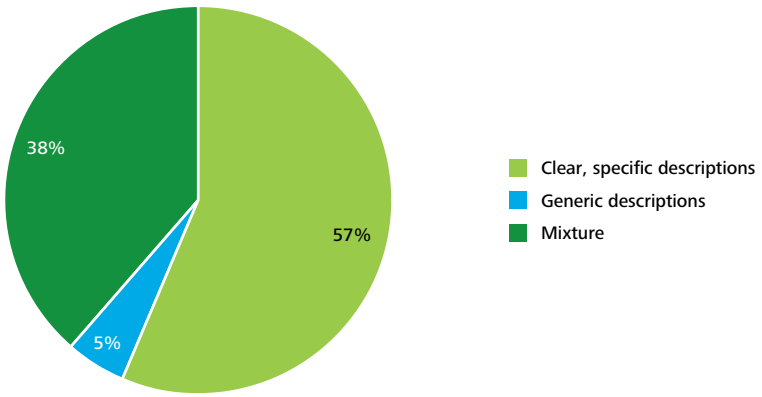

Figure 8.3 shows how well companies describe their risks. The percentage of companies judged to provide comprehensive descriptions of all their risks has improved significantly from 33% last year, while the percentage of companies providing purely generic risks has reduced from 11% in 2012.

As one might expect, there appears to be an inverse link between the number of risks disclosed and the comprehensiveness of the descriptions given. Companies giving clear descriptions of all risks had on average nine risks, while those for which some of the descriptions were rather generic averaged eleven. This again highlights the importance of identifying risks carefully, as this avoids the potential problem of a risk section that needs to run on for pages and pages to discuss all the risks fully.

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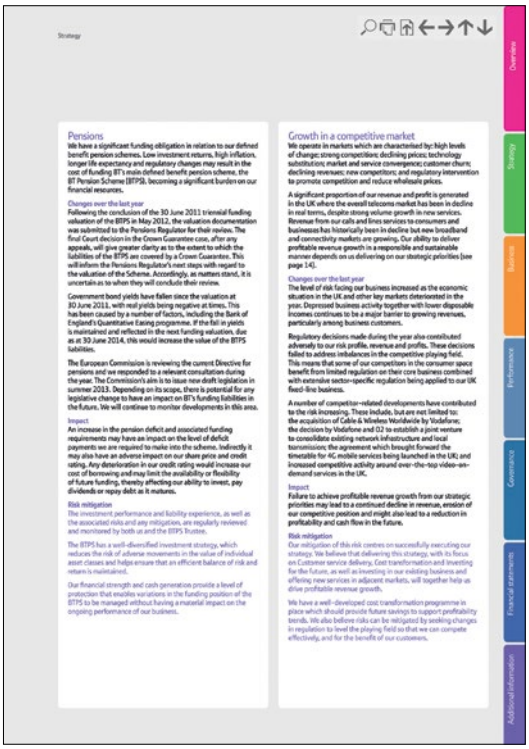
A good example of a company providing detailed narrative descriptions of its risks is BT Group plc. Despite the size of the company they only identify seven principal risks, giving them scope to dedicate plenty of space to describing each one properly.

Our principal risks

Security and resilience

Major contracts



Pensions

Growth in a competitive market

BT Group plc Annual Report & Form 20-F 2013

In our 2013 sample, 89% (2012: 83%) of companies clearly discussed the way in which they mitigate the potential business consequences of their principal risks. One helpful way to make this discussion clear is to present risks in a tabular format, with mitigating actions clearly identified in a separate column from the descriptions of the risks themselves. This approach is noticeably more popular amongst larger companies, with 81% of those companies in the top 350 category doing this compared to just 53% of the other companies surveyed.

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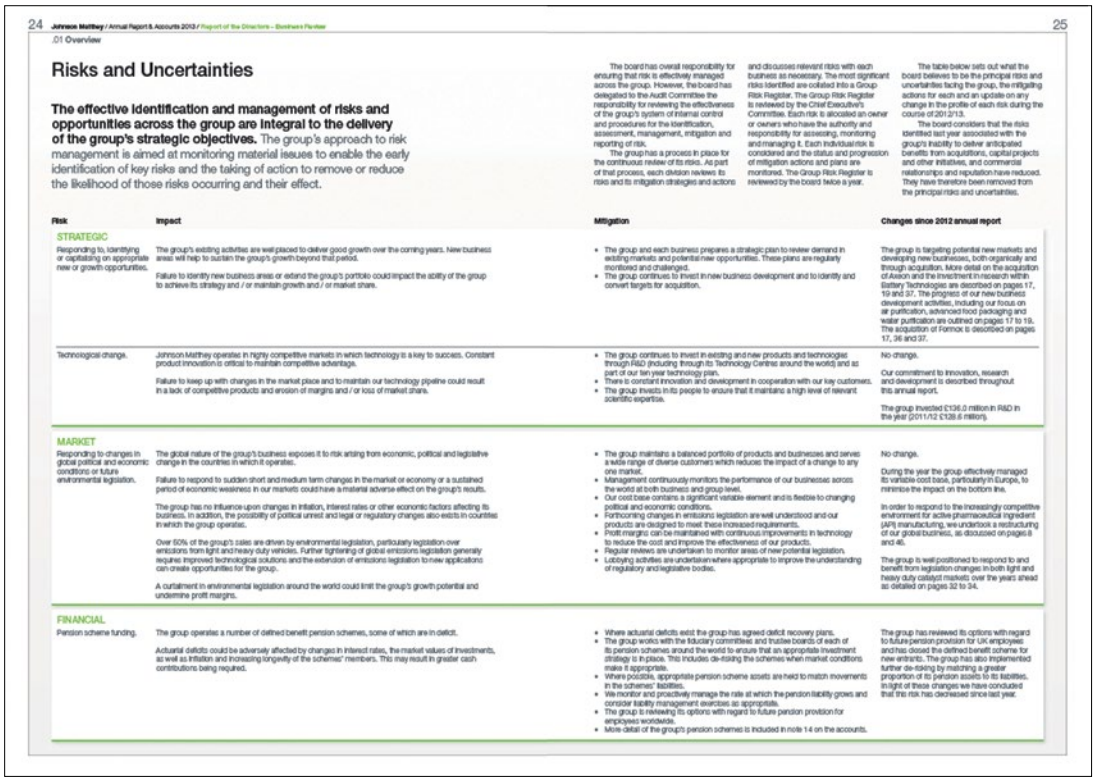
Johnson Matthey provide a good example of clear separation between the discussion of the risks themselves and the related mitigating actions.



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.01 Overview

Risks and Uncertainties

The effective identification and management of risks and opportunities across the group are integral to the delivery of the group's strategic objectives. The group's approach to risk management is aimed at monitoring material issues to enable the early identification of key risks and the taking of action to remove or reduce the likelihood of those risks occurring and their effect.

The board has overall responsibility for ensuring that risk is effectively managed across the group. However, the board has delegated to the Audit Committee the responsibility for reviewing the effectiveness of the group's system of internal control and procedures for the identification, assessment, management, mitigation and reporting of risk.

The group has a process in place for the continuous review of its risks. As part of that process, each division reviews its risks and its mitigation strategies and actions and discusses relevant risks with each business as necessary. The most significant risks identified are collated into a Group Risk Register. The Group Risk Register is reviewed by the Chief Executive's Committee. Each risk is allocated an owner or owners who have the authority and responsibility for assessing, monitoring and managing it. Each individual risk is considered and the status and progression of mitigation actions and plans are monitored. The Group Risk Register is reviewed by the board twice a year.

The table below sets out what the board believes to be the principal risks and uncertainties facing the group, the mitigating actions for each and an update on any change in the profile of each risk during the course of 2012/13.

The board considers that the risks identified last year associated with the group's inability to deliver anticipated benefits from acquisitions, capital projects and other initiatives, and commercial relationships and reputation have reduced. They have therefore been removed from the principal risks and uncertainties.

Risk	Impact	Mitigation	Changes since 2012 annual report
STRATEGIC			
Responding to, identifying or capitalising on appropriate new or growth opportunities.	The group's existing activities are well placed to deliver good growth over the coming years. New business areas will help to sustain the group's growth beyond that period. Failure to identify new business areas or extend the group's portfolio could impact the ability of the group to achieve its strategy and / or maintain growth and / or market share.	• The group and each business prepares a strategic plan to review demand in existing markets and potential new opportunities. These plans are regularly monitored and challenged. • The group continues to invest in new business development and to identify and convert targets for acquisition.	The group is targeting potential new markets and developing new businesses, both organically and through acquisition. More detail on the acquisition of Axeon and the investment in research within Battery Technologies are described on pages 17, 19 and 37. The progress of our new business development activities, including our focus on air purification, advanced food packaging and water purification are outlined on pages 17 to 19. The acquisition of Formox is described on pages 17, 36 and 37.
Technological change.	Johnson Matthey operates in highly competitive markets in which technology is a key to success. Constant product innovation is critical to maintain competitive advantage. Failure to keep up with changes in the market place and to maintain our technology pipeline could result in a lack of competitive products and erosion of margins and / or loss of market share.	• The group continues to invest in existing and new products and technologies through R&D (including through its Technology Centres around the world) and as part of our ten-year technology plan. • There is constant innovation and development in cooperation with our key customers. • The group invests in its people to ensure that it maintains a high level of relevant scientific expertise.	No change. Our commitment to innovation, research and development is described throughout this annual report. The group invested £136.0 million in R&D in the year (2011/12 £128.6 million).
MARKET			
Responding to changes in global political and economic conditions or future environmental legislation.	The global nature of the group's business exposes it to risk arising from economic, political and legislative change in the countries in which it operates. Failure to respond to sudden short and medium term changes in the market or economy or a sustained period of economic weakness in our markets could have a material adverse effect on the group's results. The group has no influence upon changes in inflation, interest rates or other economic factors affecting its business. In addition, the possibility of political unrest and legal or regulatory changes also exists in countries in which the group operates. Over 50% of the group's sales are driven by environmental legislation, particularly legislation over emissions from light and heavy duty vehicles. Further tightening of global emissions legislation generally requires improved technological solutions and the extension of emissions legislation to new applications can create opportunities for the group. A curtailment in environmental legislation around the world could limit the group's growth potential and undermine profit margins.	• The group maintains a balanced portfolio of products and businesses and serves a wide range of diverse customers which reduces the impact of a change to any one market. • Management continuously monitors the performance of our businesses across the world at both business and group level. • Our cost base contains a significant variable element and is flexible to changing political and economic conditions. • Forthcoming changes in emissions legislation are well understood and our products are designed to meet these increased requirements. • Profit margins can be maintained with continuous improvements in technology to reduce the cost and improve the effectiveness of our products. • Regular reviews are undertaken to monitor areas of new potential legislation. • Lobbying activities are undertaken where appropriate to improve the understanding of regulatory and legislative bodies.	No change. During the year the group effectively managed its variable cost base, particularly in Europe, to minimise the impact on the bottom line. In order to respond to the increasingly competitive environment for active pharmaceutical ingredient (API) manufacturing, we undertook a restructuring of our global business, as discussed on pages 8 and 46. The group is well positioned to respond to and benefit from legislation changes in both light and heavy duty catalyst markets over the years ahead as detailed on pages 32 to 34.
FINANCIAL			
Pension scheme funding.	The group operates a number of defined benefit pension schemes, some of which are in deficit. Actuarial deficits could be adversely affected by changes in interest rates, the market values of investments, as well as inflation and increasing longevity of the schemes' members. This may result in greater cash contributions being required.	• Where actuarial deficits exist the group has agreed deficit recovery plans. • The group works with the fiduciary committees and trustee boards of each of its pension schemes around the world to ensure that an appropriate investment strategy is in place. This includes de-risking the schemes when market conditions make it appropriate. • Where possible, appropriate pension scheme assets are held to match movements in the schemes' liabilities. • We monitor and proactively manage the rate at which the pension liability grows and consider liability management exercises as appropriate. • The group is reviewing its options with regard to future pension provision for employees worldwide. • More detail of the group's pension schemes is included in note 14 on the accounts.	The group has reviewed its options with regard to future pension provision for UK employees and has closed the defined benefit scheme for new entrants. The group has also implemented further de-risking by matching a greater proportion of its pension assets to its liabilities. In light of these changes we have concluded that this risk has decreased since last year.

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Linkage

Linking the discussion of principal risks and uncertainties to the other sections of the annual report is another area in which some companies are innovating to make their reports more cohesive. A good example of linking principal risks and uncertainties back to the company's strategic priorities is provided by Optos plc. An example of clearly making the link between risks and KPIs is given by Halma plc (see extract earlier in this chapter). While the companies doing this are still in the minority, we expect to see further development in this area going forward. Indeed, the draft FRC Guidance on the Strategic Report suggests ways in which principal risks and uncertainties can be linked to the business model (what could threaten the entity's viability), the corporate governance report and the discussion around accounting estimates and judgements in the audit committee report and the financial statements.

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Optos plc

Principal risks and uncertainties

Our principal risks and uncertainties are outlined below. These are the most significant risks that may adversely affect our business strategy, financial position or future performance. It is not possible to identify every risk that could affect our business, and the actions taken to mitigate the risks described below cannot provide absolute assurance that a risk will not materialise.

Certain risks have been identified as having a possible impact on the implementation of our strategic priorities. These are indicated by the symbols below:

Products Segments Geographies

Business risks

PRINCIPAL RISK		MITIGATING FACTORS
Market success of new products	The Group has recently launched a new device branded "Daytona". Success and uptake of this device (and future derivatives of it) in our key markets is critical to the long term growth of the Group.	The Daytona device has been developed to deliver practitioner and patient benefit, including: images of an equal or better quality to the current P200C device; the same widefield view of the retina; auto-fluorescent imaging; new software; robust and smaller size allows use regardless of practice size or physical/ climatic environment.
Product portfolio risk	The Group derives the majority of its revenue from its P200 and P200C medical devices. There is a risk that success of Daytona could result in significantly reduced demand for these products.	The Group derives an increasing share of revenue from other products, including Daytona, the 200Tx for the ophthalmology market, OCT devices and various other precision optometric and ophthalmic instruments. The Group has taken specialist marketing advice on how best to position Daytona to reduce the risk of P200/C cannibalisation. Pricing programmes have been established in the market place.
Geographic dependency	The Group currently generates most of its revenue in the optometry sector within North America.	The Group is investing in direct sales and distributor relationships outside North America, as well as building sales capability for ophthalmology and other specialist markets.

Supply risks

PRINCIPAL RISK		MITIGATING FACTORS
Complex nature of products	The Group's devices are complex, expensive to build and rely on a number of specialist components and parts. The growth of the Group's business is dependent on it being able to manufacture and service its devices in a cost-effective and repeatable way.	The Group's development team runs projects to reduce the cost of building devices. The Daytona design is modular, relies on readily available components and technologies and is therefore easier to manufacture than existing products. To improve security of supply, the Group is able to manufacture, repair and refurbish its devices at both its manufacturing sites and will hold supplies of parts at dual locations. Where a product is single-sourced, the Group seeks to hold sufficient inventories to manage expected demand.
Technology and competition	If a third party produces a more advanced device with improved functionality, or a similar device with significantly lower build costs, this could have a material adverse effect on the Group's business.	The Group continually develops the quality and functionality of its products, as well as investing approximately 5% of revenue per annum in R&D to bring new products to market. The Group has also invested in demonstrating the clinical efficacy and superiority of its devices.

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Optos plc

Regulatory and legal risks

PRINCIPAL RISK		MITIGATING FACTORS
Regulation	The Group operates in a highly regulated industry. The Group's medical devices are subject to strict US Federal Food and Drug Administration (FDA) regulations and the requirements of similar regulatory bodies outside the USA. Although the Group's devices are currently FDA cleared to market, if the Group or its third party manufacturers fail to satisfy regulatory requirements or regulations change, this could result in the imposition of sanctions, cause the Group to be unable to sell its product in certain markets or face adverse publicity.	The Group operates to relevant ISO guidelines and monitors and anticipates developments in regulatory thinking.
Intellectual property suits or litigation	Intellectual property suits that are brought against the Group may significantly harm the business, as could significant litigation. Technology-based companies are frequently subject to litigation with respect to patent and other intellectual property rights. Any litigation to determine the validity of third-party infringement claims or defend the Group's Intellectual Property could at a minimum be costly.	The Group believes the core patent protection around its product is strong and is not aware of any significant actual or pending suits. The Group's business exposes it to the risk of certain litigation, for example, a patient suffering harm during the image process or the Group's retinal imaging system not identifying an underlying medical problem. The Group does not offer diagnostic or treatment services and its customers are all qualified eyecare clinicians who are fully trained in the use and interpretation of the optomap product. The Group maintains product liability insurance although there can be no certainty the insurance coverage would be sufficient to meet the cost of any claims.

Pricing and financial risk

PRINCIPAL RISK		MITIGATING FACTORS
Pricing pressures	In common with other consumer businesses, the Group is subject to pricing pressures and relies in part on reimbursement agreements with insurers and government health authorities. There is no guarantee that the Group can deliver continued increases in revenue, nor can there be any certainty that the optomap image or any other procedure will continue to qualify under health reimbursement schemes or that the reimbursement rates will not decrease. The Group may also be subject to healthcare-related taxes imposed by government agencies.	The near-term success of the Group's business depends on consumers understanding the benefit of regular optomap examinations at the price offered by the Group and healthcare professionals. The Group seeks to drive adoption and awareness of its product through strong educational programmes and compelling evidence from clinical studies. The Group continues to work with regulatory agencies to demonstrate the clinical effectiveness of the device and so seek to maintain reimbursement rates.
Macroeconomic pressures	The Group's operating results and financing capacity could be adversely affected by the current world economic outlook. Continued stagnation and any further downturn in world markets could adversely impact on a practitioner's desire or ability to enter into a device contract with the Group. In addition, a reduction in patient disposable income may result in reduced demand for the Group's products at optometrists' offices.	The Group offers customers alternative ways to access its technology, including pay-per-patient rental, fixed rental, rent-to-own and outright purchase. Customers have responded well to these alternative business models and this contributes to the low de-install rate for devices. The Group benefits from good visibility of secured forward revenues and cash through service and rental contracts, the latter typically having a term of around three years. The Group has financing in place and it closely monitors its covenant compliance.
Currency and exchange rates	The Group operates in several countries and currencies and its results are impacted by changes in currency exchange rates. The Group reports its results in US$, the currency in which the majority of its revenues and costs arise.	The Group monitors its non-US$ foreign currency exposure and, when deemed necessary by the Board, seeks to minimise its transaction exposure by using forward foreign currency contracts to eliminate exposures on any committed significant transactions. Wherever possible the majority of cash balances are maintained in US$ to mitigate the impact of currency fluctuations.

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9. Unlocking performance

Highlights

- 87% (2012: 86%) of companies clearly identify their key performance indicators (KPIs). 56% (2012: 56%) identify non-financial KPIs.
- However, only 42% (2012: 34%) gave reasons why they had selected those particular measures.
- On average, companies presented 8 KPIs (2012: 7).
- As in 2012, profit measures were the most popular KPI in 2013, with 79% (2012: 77%) of companies including such a measure.
- 31% of companies demonstrated a clear link between KPIs and directors' remuneration.

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9. Unlocking performance

The Companies Act requires that a company's business review (or from next year, the strategic report) includes an analysis of the business using financial key performance indicators (KPIs) and, where appropriate, other key performance indicators (which might include environmental or employee-related measures). While a simple list of measures may be sufficient to meet the legal requirement, the identification of KPIs is an area where creating links to other areas of the annual report is very important, and this is an area where many companies show a good level of innovative thinking. A significant proportion have now recognised that simply listing out a dozen financial measures that show the financial success of a company during the year is not what stakeholders are looking for. As discussed in chapter 7, a discussion of strategy is not complete without a link to KPIs and the reverse is also true. Without understanding how a company's KPIs demonstrate the progress (or lack of it) towards strategic goals, it is hard to interpret their meaning and why those particular measures have been selected. One assumes that companies don't just draw a selection of measures out of a hat, but in many cases the reasons for a particular measure being used could be made a lot clearer. In our 2013 survey, only 42% (2012: 34%) of companies gave reasons why they had selected the particular KPIs presented, although the improvement on last year is encouraging.

As well as a clear link to strategy, an indication of how a company views the performance of its KPIs against internal targets is something that can help stakeholders to develop their understanding of the business' performance. Discussion of future goals can also provide helpful insight into the direction of travel. However, only 22% (2012: 16%) of companies surveyed gave information on targets for their KPIs and performance against these. Perhaps they were reluctant to provide this information due to commercial sensitivity, particularly if performance was below target.

The new remuneration regulations focus on the link between executive remuneration and the company's strategy and performance as it is expected that the measures that are key to assessing the performance of the business should be very similar to the measures of success used to reward directors. In our 2013 survey sample, 31% of companies demonstrated a clear link between KPIs and performance-related pay (although two companies surveyed do not have any performance-related pay for directors). This is a number that we would expect to see increasing in next year's survey results.

How well do companies identify their KPIs?

As shown by figure 9.1, the percentage of companies that clearly identify their KPIs has remained pretty static over the past few years. Although the majority do clearly identify their KPIs, a significant minority continue not to do so. This is surprising given the statutory requirement to identify at least financial KPIs for all companies, not even just listed companies. One assumes that the companies not providing this disclosure believe that they already provide sufficient numerical information and highlights, and that the identification of specific numbers as KPIs is unnecessary. Two of the companies which did not clearly identify KPIs mentioned in their directors' report that the business review included analysis using KPIs (in a nod to the legal requirement) but gave no indication of which measures were considered to be KPIs.

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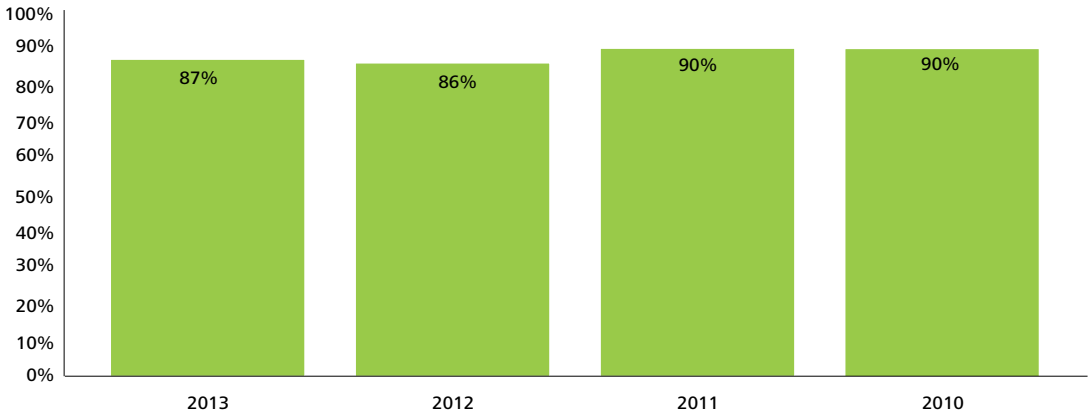
Figure 9.1. How many companies clearly identify their KPIs?

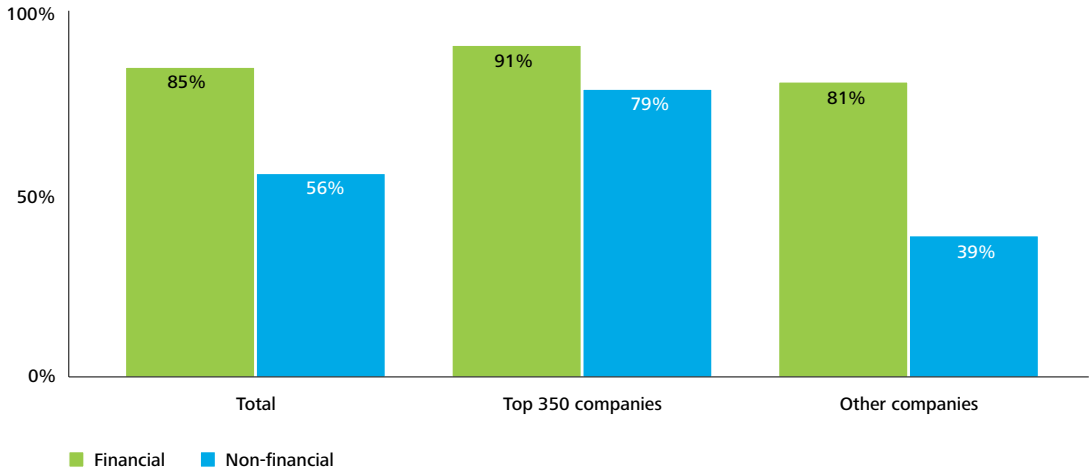


Although the failure to clearly identify KPIs is more prevalent amongst the smaller companies in our sample, with 18% (2012: 17%) failing to do so, it is surprising that even amongst our top 350 group 7% (2012: 9%) do not do this.

Of those companies clearly identifying their KPIs, it is perhaps surprising that only 90% (2012: 88%) go on to clearly present the numerical values of these measures. It is hard to see how a disclosure that lists a selection of KPIs but then gives no further information about them is of value to users of the annual report – this appears to be merely paying lip service to the company's compliance obligations.

In the modern world, the importance of non-financial information should not be underestimated – a recent ACCA survey of investors and analysts[7] found that 78% of respondents felt the level of non-financial reporting by European companies was inadequate. To what extent such information is included in an annual report, a separate CSR report or a combined 'integrated report' is a different matter. The proportion of companies identifying non-financial KPIs in their annual reports seems to have plateaued somewhat – 56% of companies clearly identified at least one non-financial indicator this year, in line with last year. This is an area in which the larger companies in our survey are definitely leading the way, as shown by Figure 9.2.

Figure 9.2. How many companies identified financial and non-financial KPIs?



7 http://www.accaglobal.co.uk/en/research-insights/environmental-accountability/investors-expect.html

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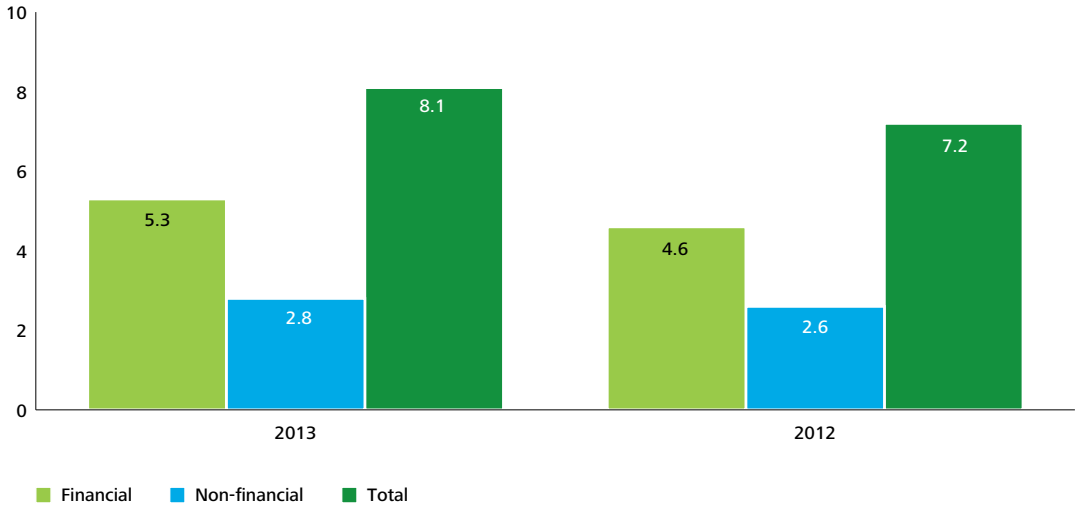
What KPIs do companies present?

As well as an increase in the number of companies clearly identifying their KPIs, the average number of KPIs being presented by companies has also increased from 7.2 to 8.1. Figure 9.3 shows the average number of KPIs presented by companies which clearly identify their financial or non-financial KPIs.

Figure 9.3. How many KPIs are identified by companies?



The nature of KPIs identified by the companies in our survey can be seen in figure 9.4. Unsurprisingly, measures of profitability (presented by 79% of companies) and revenue (67%) are the most popular indicators selected, with shareholder return measures such as earnings per share also increasing in popularity slightly. A measure of cash generation has been presented by more companies this year than in 2012, although it is interesting to note that gearing has seen a noticeable decline.

The most popular type of non-financial indicator continues to be employee satisfaction, although the rising priority of environmental issues has led to a noticeable increase in the number of companies presenting such a measure as a KPI. Impending legislation requiring disclosure of greenhouse gas emissions may also have served as a wake-up call for some in this area (see chapter 7).

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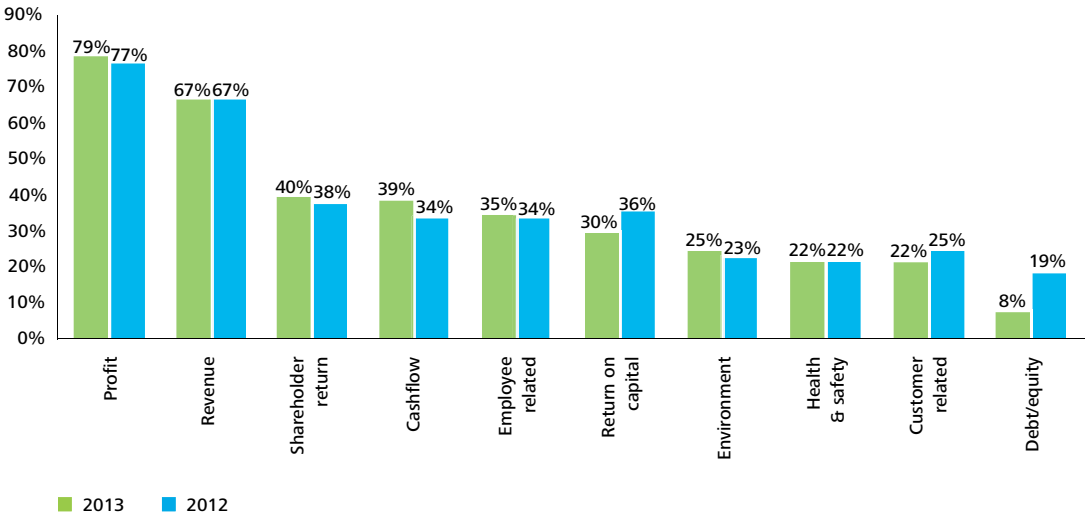
Figure 9.4. What type of KPIs are included within the annual report?



A significant number of companies also present other KPIs that do not fit into the categories listed above. This is good to see and shows that companies are really thinking about the measures that are relevant to their business and the strategy they are pursuing. An example of a financial indicator not captured in the data above is net debt to EBITDA ratio (presented by five companies), which gives an idea of a company's ability to pay back its borrowings. Some examples of other non-financial indicators include measures of reliance on key customers or geographical locations and measures of market share in key markets.

Understandability of KPIs

As well as ensuring that appropriate KPIs are identified, clear discussion of the relevance of the measures identified to the business is important to ensure that shareholders understand the meaning behind the numbers. The draft FRC Guidance on the Strategic Report sets out a number of pieces of information that should be provided for each KPI, where relevant:

- its definition and calculation method;
- its purpose;
- the source of underlying data;
- any significant assumptions made; and
- any changes in the calculation method used compared to previous financial years.

50% of the companies which discussed their KPIs gave clear definitions of them, with 62% of the top 350 group doing this but only 40% of the smaller companies. This may be linked to the fact that smaller companies tend to present simpler KPIs which have less need of definition. Another example of this is that only 31% of all companies presenting solely financial KPIs gave definitions for them, whereas 57% of companies presenting non-financial KPIs defined them. The more complex and bespoke nature of non-financial KPIs means that ensuring they are clearly defined is particularly important.

While some companies present the definitions of their KPIs directly with the measures themselves, others choose to present them in a separate glossary, along with other key definitions. A good example of this is shown by Vodafone plc in their Annual Report for the year ended 31 March 2013.

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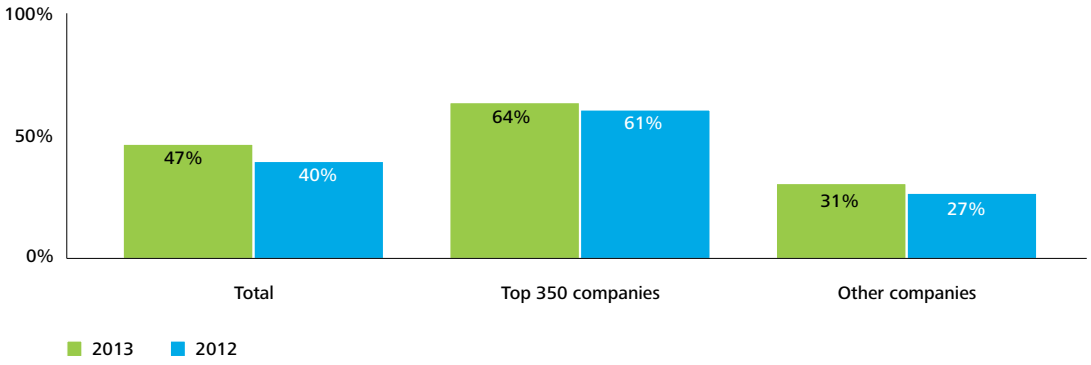
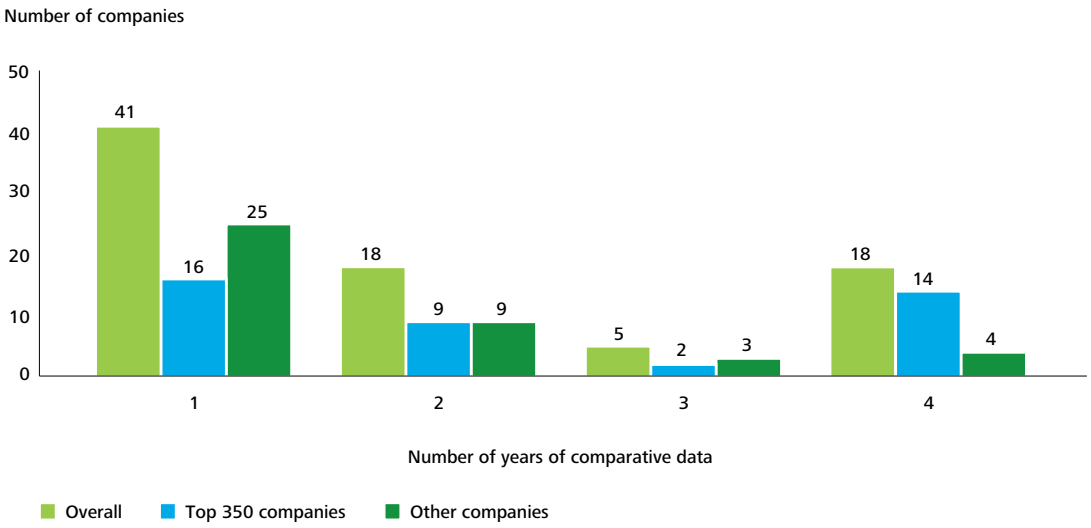
Once KPIs have been clearly defined, the next step is to clearly explain the purpose of each KPI i.e. why it is an important measure of the business' performance. For example, the percentage of revenue from significant customers may have been identified as a KPI because reliance on key customers has been identified as a principal risk to the business. Figure 9.5 shows the proportion of companies providing a clear explanation of the purpose of each of their KPIs. It is encouraging to see a year-on-year improvement in this area across the board.

Figure 9.5. How many companies provide a clear indication of the purpose of each KPI?



Finally, the company should give an indication of how its performance against its KPIs has developed recently. As discussed in the introduction to this chapter, only 23% (2012: 16%) of companies surveyed gave information on targets for their KPIs and performance against these. Provision of prior year comparative information is much more consistent, with only seven companies failing to do so. Of those presenting comparative information, figure 9.6 shows the number of comparatives presented.

Figure 9.6. How many years' worth of comparatives do companies present for KPIs?



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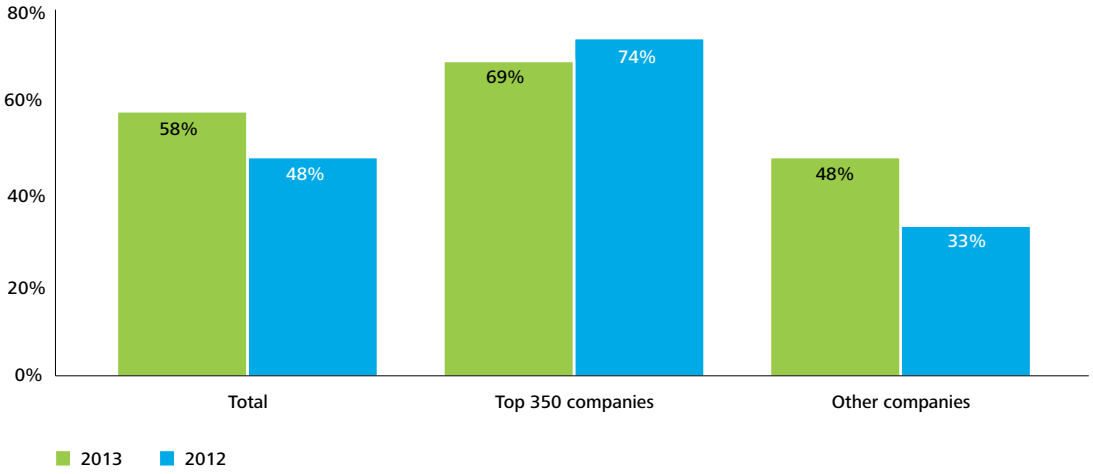
As expected, most companies present just a single year's worth of comparatives, although a sizeable proportion do present more. Four years' worth of comparatives is popular, particularly with larger companies – perhaps because this ties in with the five years' worth of historical financial information that many companies like to present.

Overall presentation of KPIs

The most effective method of presenting KPIs is a subject of continuing debate, with some people arguing that using a clear separate section (which helps to bring the KPIs together as a cohesive group) is more effective, while others believe that integrating the KPIs within the discussion of strategy (helping to demonstrate the linkage between strategy and KPIs is preferable). Figure 9.7 shows that overall a separate section is marginally more popular, particularly amongst the top 350 companies.

Figure 9.7. How many companies present their KPIs in a separate section?



Some good examples of KPI presentation in a separate table are given by Hill & Smith Holdings PLC in their Annual Report for the year ended 31 December 2012 and British Polythene Industries PLC (extract shown below). DRS Data and Research Services plc give a subtly different alternative, with a table of figures supported by separate narrative commentary on each KPI (extract shown below).

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Key Performance Indicators – The Group utilises the following indicators of performance to assess its development against its strategic, financial and operational objectives.

Financial Key Performance Indicators

Operating profit per tonne (£/tonne) 86

Diluted Earnings Per Share (pence) 43.62

Return on capital employed (%) 16.8

Dividend cover (times) 3.30

Operational Key Performance Indicators

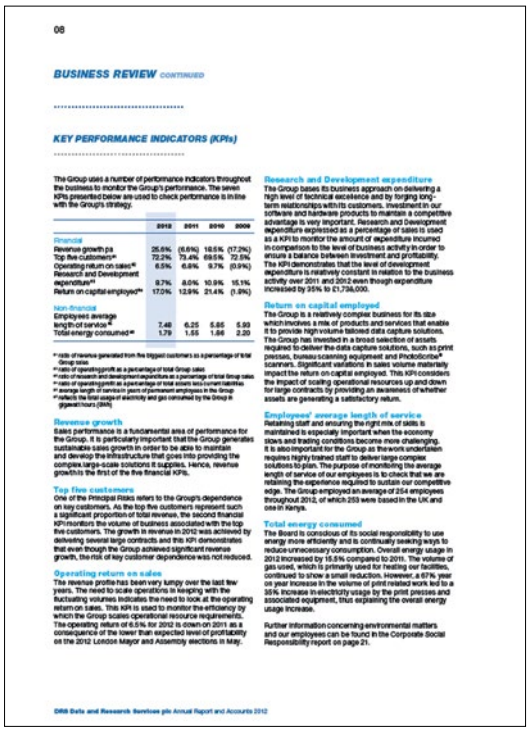
Electricity usage (kWh/tonne) 696

Electricity usage (kWh/^000 Square Metres) 28.3

Absenteeism (%) 3.0

Lost time accidents (accidents/100k hours) 0.5

British Polythene Industries PLC Annual Report and Accounts 2012



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BUSINESS REVIEW CONTINUED

KEY PERFORMANCE INDICATORS (KPIs)

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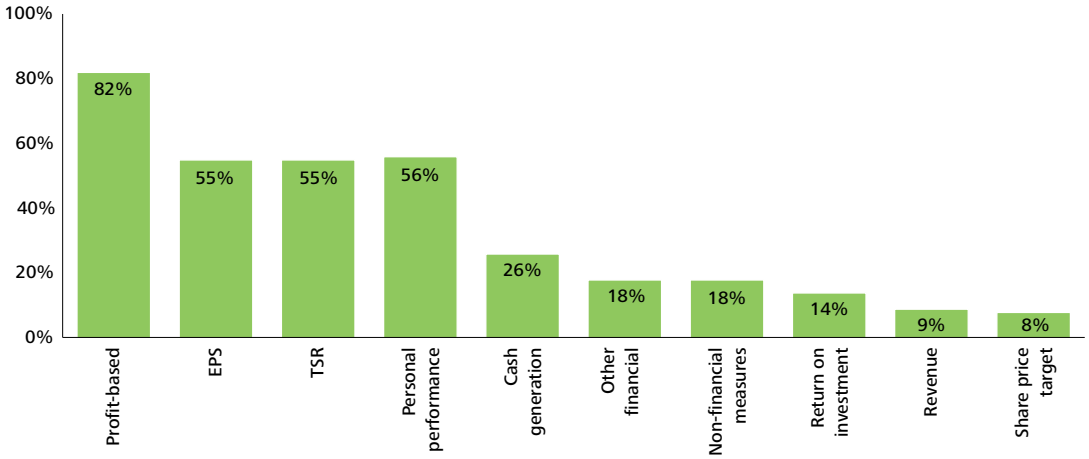
Linkage between KPIs and remuneration

As mentioned previously, making more of a link between KPIs and remuneration is a current hot topic. Indeed, several of the companies in our survey discussed in their remuneration report the fact that, going forward, they would be changing the measures used to assess executive pay to be more in line with their KPIs – probably in response to the requirements of the new directors' remuneration regulations. Figure 9.8 shows the measures used by companies to assess performance for pay purposes.

Figure 9.8. What performance measures are used to determine executive pay?



Unsurprisingly, profit based measures are the most commonly used, with 82% of companies linking remuneration to company profits (usually an 'underlying' measure, designed to eliminate one-off effects, rather than statutory profit). Earnings per share and total shareholder return are both very popular measures for the assessment of share-based payment awards, although a small number of companies choose to express their 'share performance' condition as an absolute price target rather than a TSR target.

The popularity of personal performance measures, including both those that are assessed against pre-set targets and those that are purely discretionary, shows that remuneration committees like to maintain the ability to make their own assessment of an executive's performance with the benefit of hindsight, rather than just relying on a pre-set formula. Indeed, a significant number of companies mention that performance-related remuneration is subject to an overriding determination by the remuneration committee that the company's overall performance has been satisfactory, regardless of individual conditions. Another condition, either existing or mentioned as being introduced, is the ability for performance-related pay to be clawed back in the event of subsequently determined irregularities. In the light of recent media scrutiny over so-called 'rewards for failure', it is unsurprising that companies are putting in place more discretionary protocols in this area. The new directors' remuneration report legislation introduces new disclosure requirements in this respect. Additionally, the FRC is consulting on amendments to the code in this area.

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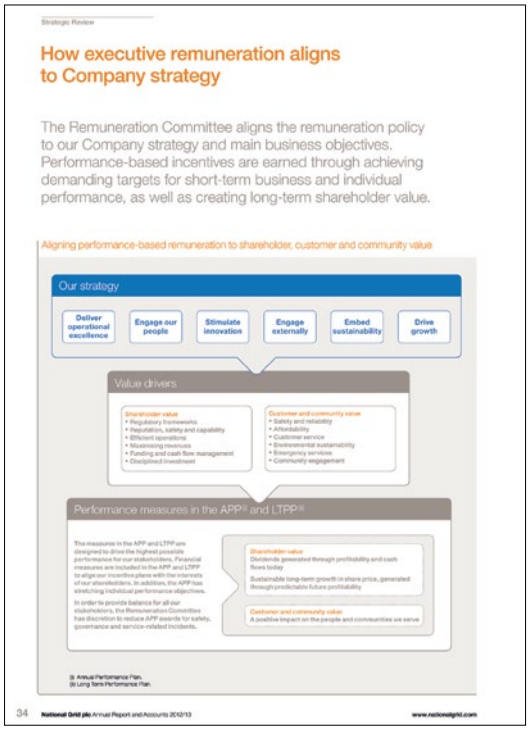
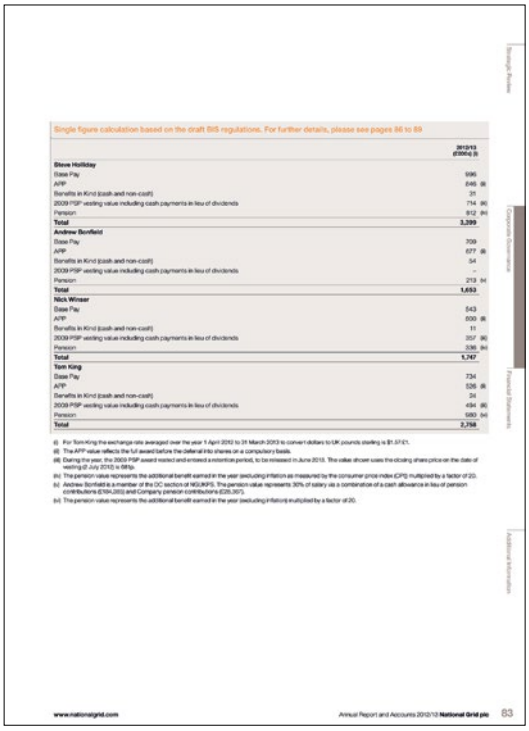
A particularly good example of linking KPIs to the performance measures assessed under remuneration schemes was given by National Grid plc (below left).





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Another area where companies have been looking forward to the new remuneration regulations has been the much-touted 'single figure' for directors' remuneration. This is intended to place a value on all elements of a director's pay package each year, including cash payments as well as pension contributions and share-based payments, to ensure that shareholders have complete visibility over the amount of their reward. In response to the new regulations, detailed guidance on determining this figure has been issued by the GC100 and Investor Group[8]. Further guidance is also available from the FRC's Financial Reporting Lab, developed in response to the draft proposals[9]. 24% of the companies in our survey presented a single figure, looking towards the implementation of this new legislation next year. Unsurprisingly, the majority of these were in the top 350 size bracket, with 44% of those companies giving this information.

National Grid plc also give a good example of how this disclosure might be expected to look (above right) – however it is important to note that this table is based on the draft and not the final regulations.

8 See http://www.iasplus.com/en-gb/news/2013/09/gc100-directors-remuneration-guidance
9 See http://www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/A-single-figure-for-remuneration.aspx

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10. Concerned about going concern?

Highlights

- Companies are giving more prominence to going concern disclosures, with 53% (2012: 49%) presenting the discussion of going concern as part of the business review or corporate governance disclosures rather than just in the directors' report.
- 78% (2012: 73%) of companies demonstrated clear compliance with the FRC's 2009 recommendations on going concern assessment.
- 16 (2012: 17) companies discussed an uncertainty regarding going concern in their financial statements, although in most cases these were minor issues. Only 2 (2012: 3) had sufficiently serious uncertainties for there to be an emphasis of matter in the audit report.
- No companies mentioned the Sharman report specifically in their going concern disclosures, although there was evidence that a small minority of companies had taken some of its recommendations into consideration.

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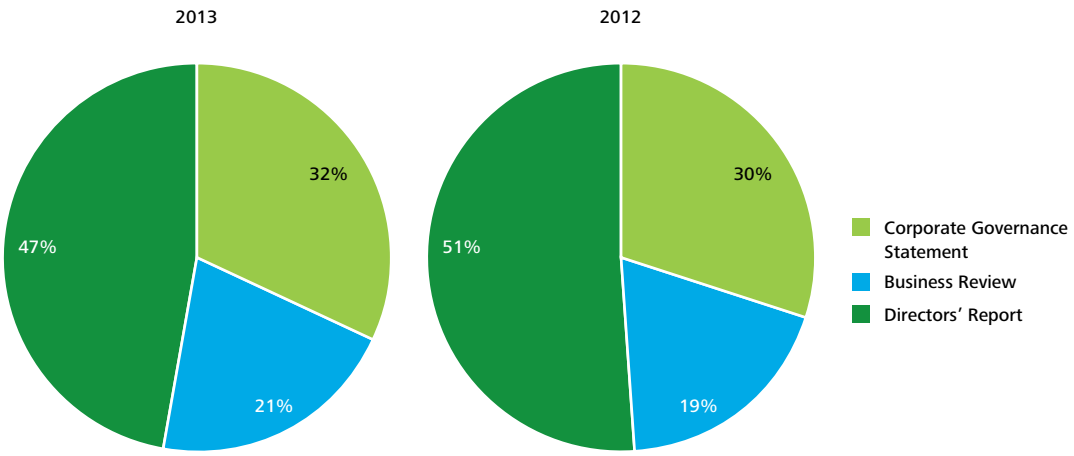
The Companies Act, Listing Rules and IFRSs all include requirements in relation to going concern assessment. In response to this the FRC issued guidance in 2009 suggesting that companies should bring their going concern disclosures together in a single place in the annual report, providing cross-references to/from this as necessary. While IAS 1 requires going concern to be considered for at least twelve months from the balance sheet date, auditing standards require it to be considered for at least a year from the date of approval of the annual report, so the FRC guidance refers to twelve months from the date of approval (as this will be longer). There is no requirement to disclose the exact period considered, unless it is less than 12 months, however it may be helpful to users to present this information.

The assessment by a company of its ability to operate as a going concern is something that has been the subject of a lot of public comment over the past year. With the publication of the Sharman report (see chapter 3) in June 2012 and the FRC's consultation paper on its implementation in January 2013[10], regulatory interest in the area has also been high. Although the responses to the paper have led to the FRC deciding to re-think how this implementation will work and postpone making any changes to the UK Corporate Governance Code, it is nevertheless something that companies should be thinking carefully about now and in the future.

One of the main concerns about the FRC paper was the use of the term 'going concern' both as a concept of overall business model sustainability and as a basis for preparing financial statements. While there is general agreement that more disclosure about how a company ensures its future viability is needed, clearly more discussion about the best approach to these disclosures is needed.

Figure 10.1. Where is the going concern statement positioned?



10 See http://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Sharman-Implementation-Consultation-Paper-File.pdf

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Positioning of the assessment of going concern

As shown by figure 10.1, where companies are presenting their assessment of going concern is changing. The increased percentage presenting it as an integral part of the business review is a welcome development, showing that these companies are recognising that an ongoing assessment of 'business health' is an essential part of a discussion of business strategy. Presentation as part of the corporate governance report is also on the rise, demonstrating that clear ownership of the going concern assessment by the directors is also a rising priority.

However, the fact that 47% of companies still present their going concern assessment only as part of the 'boiler plate' directors' report disclosures is disappointing. Although the fact that it is presented here does not necessarily mean that the disclosure itself lacks information, it suggests that these companies see it more as a statutory requirement than as an important piece of information which is of relevance to shareholders. The fact that when a company fails, its going concern disclosure is one of the first areas that comes under scrutiny shows that users do not necessarily agree with this assessment. For a company which is suffering some difficulties, clear up-front discussion of these creates a much better impression than a small footnote towards the back of the narrative section of the annual report.

Quality of going concern disclosures

In the absence of updated Sharman-based guidance, the most up to date formal guidance on going concern is still the FRC's October 2009 guidance "Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009", although the FRC has encouraged companies to have regard to the Sharman report going forward in the absence of formal guidance on its implementation. In practical terms this may, amongst other things, mean directors undertaking a robust assessment of the significant risks facing the company's ability to deliver its strategy, which includes significant solvency and liquidity risks, and looking beyond the next twelve months.

In our survey sample, no companies made a specific reference to the Sharman report in their going concern disclosures, although one company that appeared to have made a significant effort to embrace its principles, by defining what they consider to be the foreseeable future and discussing solvency as well as liquidity, was National Grid plc.

Going concern

Having made enquiries, the Directors consider that the Company and its subsidiary undertakings have adequate resources to continue in business for the foreseeable future, and that it is therefore appropriate to adopt the going concern basis in preparing the consolidated and individual financial statements of the Company. The Directors consider that a robust going concern assessment process was undertaken and the results were discussed and challenged formally at the Audit Committee in May 2013, who recommended the Board's approval at the meeting in May 2013 prior to approving the Annual Report and Accounts.

The process undertaken involved consideration of the forecasts produced for the UK and US businesses for a period to March 2015. This period is considered to be the 'foreseeable future' as required for this going concern assessment only, and is in accordance with company law, accounting standards and the Listing Rules. The forecasts include the impact of the RIIO price control framework on our UK regulated businesses and the impact of agreed and ongoing rate plan filings with the relevant US state and federal bodies for our US businesses. While we have forecasts that extend to the end of each of our current rate plans (for example until 2021 for the UK regulated businesses), we have not considered going concern formally for these periods, due to the increased forecasting risk and uncertainty involved.

This assessment also considered the significant solvency and liquidity risks involved in delivering our forecasts for the foreseeable future. These are wider than the current global economic uncertainty and include recognising the risks around the continued significant investment programme that the Group has committed to and the potential risk that the credit ratings on some of our issued debt are changed. Any change would increase the cost of servicing this debt, therefore reducing the overall profitability of the Group. The assessment also considered the Group's ability to obtain additional funding across a number of scenarios reflecting the current economic uncertainty, especially in Europe. This analysis also noted the fact that the debt markets remained a viable source of funding for the Group even at the height of the credit crunch in 2007 and 2008. Given the significance of maintaining our overall credit rating, the Group has policies and procedures in place to help mitigate this risk as far as possible, as described on page 33. Additional oversight is also provided by the Finance Committee (see page 66).

More detail on our financial risks, including liquidity and solvency, is provided in note 30 to the consolidated financial statements. There have been no major changes to the Group's significant liquidity and solvency risks in the year.

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Figure 10.2. How many companies are clearly applying the 2009 FRC guidance?

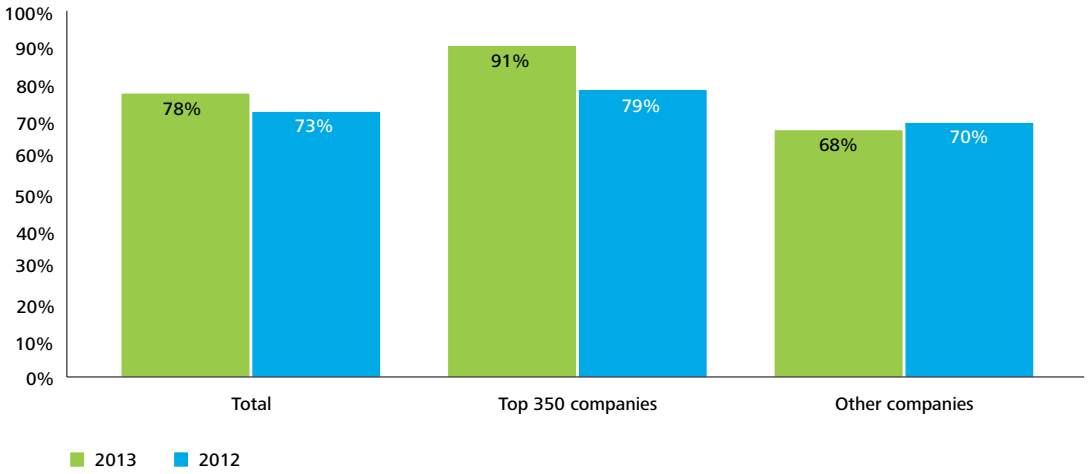
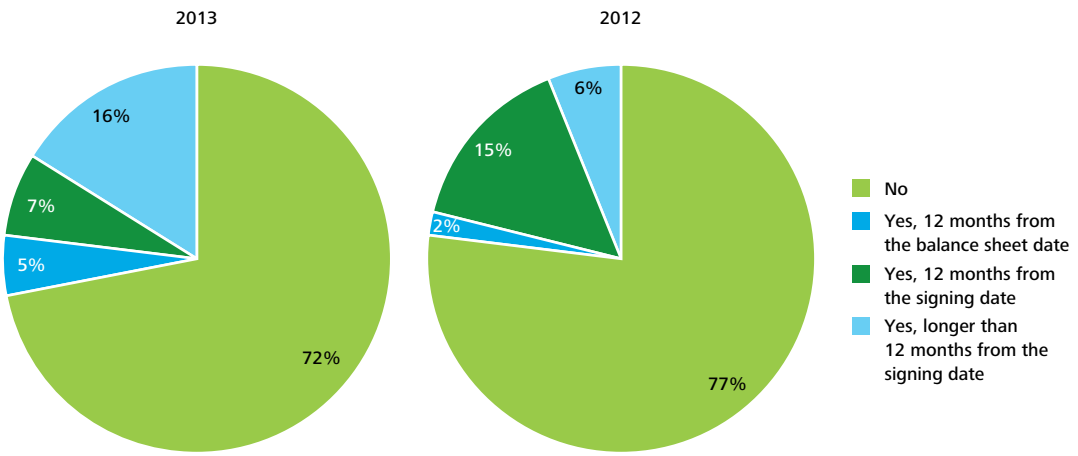


Figure 10.2 shows how many companies have clearly applied the FRC's 2009 guidance on going concern when making their disclosures. Gradual improvements are still being made, particularly amongst the larger companies in our sample. However, the fact that 22% of companies are still not making clear disclosures around going concern – in some cases just a very brief 'boiler-plate' statement – despite the current focus in this area is disappointing.

Two key elements of the best going concern disclosures (although not specifically required by law unless they are shorter than 12 months) are a clear discussion of the timeframe covered by the company's forecasts and a discussion of the time period considered by the company for going concern purposes. These will not necessarily be the same – although a company may prepare forecasts looking quite a long way into the future, the length of the business cycle and the inherent uncertainty of the forecasting process may mean that it is neither necessary nor appropriate to consider going concern over the full forecast period.

Figure 10.3 shows the length of forecasts or budgets prepared for going concern purposes by the companies in our survey. While the majority of companies still do not disclose the length of the budgets prepared, it is interesting to note the significant increase in the percentage of companies using forecasts for longer than 12 months for going concern purposes. If this increase is replicated across the companies who do not disclose their forecast period, it would suggest that companies are thinking harder about their process for the assessment of going concern and the period for which they make that assessment, rather than just defaulting to a 12 month timescale.

Figure 10.3. Is the period of forecasts or budgets disclosed?



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The number of companies clearly disclosing the period for which they have assessed going concern is even lower than the number disclosing budget length, with only 8% clearly explaining the period that they consider to be the 'foreseeable future' for this purpose. Of the remainder, 85% of the companies surveyed simply disclosed that they considered the business a going concern for the foreseeable future but without explaining what they consider this to be, while the remaining 7% did not even go this far. What time period constitutes the 'foreseeable future' and how this differs by company were key questions raised in the Sharman report.

Going concern uncertainties

With the effects of the 2008 financial crisis still being felt in a number of sectors of the UK economy, and the continued wait for the 'green shoots of recovery' to fully materialise, it is perhaps unsurprising that the proportion of companies discussing uncertainties in their going concern statements has remained reasonably consistent over the past three years, with 16 in 2013 (2012: 17, 2011: 18). However, only two companies specifically mentioned going concern risk as one of their principal risks and uncertainties, with a further two referring more generally to the health of the business.

12 companies (2012: 12) highlighted concerns about external financing, including potential covenant compliance issues. Nine (2012: 11) indicated a significant uncertainty in relation to trading volumes, showing that for some companies adapting to the changing consumer environment is an on-going problem. Various companies also highlighted other issues, with several noting issues specifically in relation to cash generation and working capital management, thus demonstrating the importance of capital management disclosures (see chapter 14).

Most of these were not considered to be material uncertainties, however they show that the on-going uncertainty in the wider economy is still being assessed very closely by some companies. Having said this, the number of companies for which the auditors felt it necessary to include an emphasis of matter around going concern has reduced from three in 2012 to two in 2013. It is interesting to note that all three of the companies with an emphasis of matter last year have fallen out of our survey sample, whether through de-listing, takeover or share suspension. No company had a qualified audit opinion.

The number of companies clearly disclosing the period for which they have assessed going concern is even lower than the number disclosing budget length, with only 8% clearly explaining the period that they consider to be the 'foreseeable future' for this purpose.

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11. The governance debate

Highlights

- 52% (2012: 54%) of companies fully complied with the UK Corporate Governance Code 2010 (the "Code").
- The most common areas of non-compliance with the Code are in relation the division of responsibilities between Chairman and Chief Executive (14 instances) and board independence (13 instances).
- 16% of companies whose reports were issued after the publication of the September 2012 revisions to the UK Corporate Governance Code (the "2012 Code") also reported compliance against this revised Code.
- 14 companies included a statement that the annual report, taken as a whole, was 'fair, balanced and understandable', in line with the provisions of the 2012 Code.
- The proportion of companies with female directors has increased, with 16% (2012: 15%) having at least one female executive and 49% (2012: 41%) at least one female non-executive.

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11. The governance debate

Alongside narrative reporting and remuneration, corporate governance (and the related disclosures) is another area in which the coming year will see significant changes. With the FRC's September 2012 revisions to the UK Corporate Governance Code (the "2012 Code") coming into force for years ending on or after 30 September 2013, most companies by now should have a pretty clear picture of the impact that it will have on them. Of the annual reports issued since the publication of the 2012 Code, just under one-third have made reference to it, indicating that this is a topic that companies are taking seriously. Indeed, even one of the reports published before the 2012 Code was issued made reference to the expected updates and their potential implications!

Of the companies making reference to the 2012 Code, 52% indicated that they had considered it in preparing their report and incorporated some of the additional provisions, as encouraged by the FRC. One or two even went so far as to fully adopt the 2012 Code and report compliance against it.

One of the provisions of the 2012 Code which has prompted a significant amount of comment and debate is provision C.1.1 that requires the directors to make a statement that "the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy." 14 of the companies in our survey made such a statement, attributed either to the full board or (in five cases) specifically to the audit committee. Interestingly, a further 17 made a specific statement that the accounts were 'balanced and understandable', reflecting the requirement of C.1 of the 2010 Code that "The board should present a balanced and understandable assessment of the company's position and prospects" – although there is currently no requirement to make a statement to this effect.

Compliance with the Code

The number of companies reporting full compliance with the 2010 Code has fallen slightly year-on-year from 54% to 52%. As in the prior year, full compliance is more prevalent among the larger companies in our sample, with 65% (2012: 65%) of these complying fully, compared to 42% (2012: 48%) of smaller companies.

However, since the Code operates on a 'comply or explain' basis rather than a full compliance model, it is more interesting to consider the data presented by figure 11.1, which shows not just those companies which comply with all of the provisions of the Code but also those which do not comply but provide a clear explanation for their non-compliance. One can see that while full compliance is less common amongst smaller companies, the majority do present a clear explanation for this non-compliance.

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Figure 11.1. How well are companies complying with the Code?

Of the companies not fully complying with the Code, 73% gave a clear list of the provisions that they did not comply with. This can be a useful aid to users interested in the significance of the areas of non-compliance – it is easier to assess than where discussion of areas of non-compliance is scattered throughout the report. An example of such a statement is given by Thomas Cook Group plc.

> **Compliance with the UK Corporate Governance Code**
> This report sets out how the Company applied the principles of the UK Corporate Governance Code ('the Code') and the extent to which the Company complied with the provisions of the Code in the year to 30 September 2012. During the year, the Company fully complied with the provisions of the Code, except for Provision B.3.3, in relation to executive directors taking on more than one non-executive directorship in a FTSE 100 company, and Provision D.1.5, in relation to Directors' notice or contract periods being set at one year or less. These are explained in the relevant sections within the Remuneration Report on pages 53 to 64.

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The 2012 Code incorporates additional guidance from the FRC (in its section describing the 'Comply or Explain' approach) on what should be contained in a good explanation for Code non-compliance. It should set out the background to the non-compliance, provide a clear rationale for it and describe any mitigating actions taken by the company to address any additional risk arising from the non-compliance. In addition, for temporary non-compliance an indication of when the company expects compliance to be achieved should be given. While the Code does not specifically mention this, some companies choose to include in their explanation a clear indication that the non-compliance has been discussed with shareholders – four did so in 2013.

Of some concern is the assessment that only 54% of those companies indicating non-compliance gave a real justification for it. Most companies who did not comply fully with the Code applied the majority of the provisions but some smaller companies seem to consider that some of its provisions are less relevant to their business, particularly those which still have a high level of ownership and directorial involvement from the founder(s). However, the justification as to why it is not necessary for a business to have independent non-executive directors, as in one case surveyed, is hard to see.

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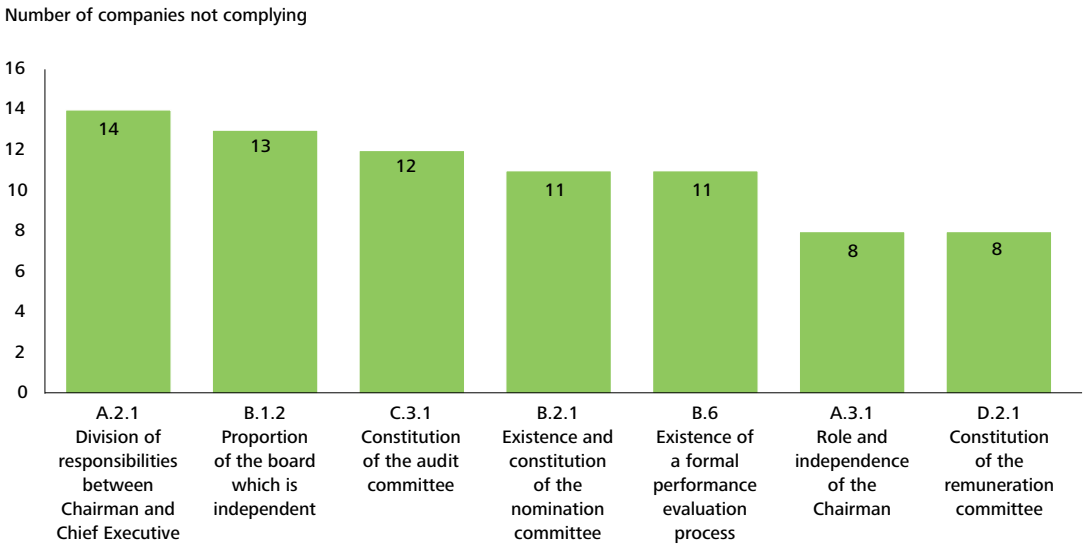
16 companies indicated that their non-compliance was temporary, either because it only occurred for a limited time during the year or because plans were in place to resolve the issue. 15 of these companies indicated when compliance had or would be achieved.

Figure 11.2 shows the most common areas of non-compliance with the Code amongst the companies surveyed, showing all provisions with more than six instances of non-compliance reported. Although these were the most common areas identified, overall there were 42 Code provisions with at least one instance of non-compliance noted.

Figure 11.2. What are the most common non-compliances with the Code?



A quick scan of figure 11.2 indicates that the majority of these non-compliance issues arise from the provisions in relation to the constitution of the board and its committees, rather than the operational processes in place. This is understandable – after all it is easier and quicker to implement new processes than change the composition of the board, particularly in the case of smaller companies for which hiring new directors is potentially time consuming and costly. For example, 13 of the 14 companies which at some point during the year did not comply with provision A.2.1 were from the group of smaller companies in our survey. For four of these companies the non-compliance was identified as temporary, while one did not have any executive directors. The remaining nine have a permanent Executive Chairman.

Ownership of corporate governance

As the leader of the board (as opposed to the chief executive who is responsible for running the business) the chairman is responsible for ensuring that it fulfils its responsibilities effectively. The preface to the Code encourages chairmen to report personally on how the principles relating to the role and effectiveness of the board have been applied. It is becoming more and more common for the chairman to clearly demonstrate their responsibility for leading the board, for example by discussing corporate governance issues and the implementation of the Code in their 'Chairman's statement' at the beginning of the narrative report or by providing a formal introduction to the corporate governance disclosures. 57% of chairmen clearly took ownership of the corporate governance disclosures, with 36% including some discussion of corporate governance in their chairman's statement at the beginning of the annual report. Another common way of doing this was to include an opening statement from him or her to the governance disclosures, providing an overview of the key issues dealt with during the year. A good example of this sort of introduction is provided by Thomas Cook Group plc.

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Corporate governance report

Strengthening our governance

Dear Shareholder

At the end of my first year as Chairman, I am pleased to report on the progress we have made to strengthen our governance arrangements.

One of my main priorities was to strengthen our Board. In July, Harriet Green became our new Group Chief Executive Officer and Michael Healy joined as our Group Chief Financial Officer. Both have a highly successful track record. Harriet brings a wealth of experience of successful corporate transformations, and Michael likewise, with highly leveraged companies.

At our 2012 AGM, three of our long-serving Non-Executive Directors stepped down to give me the opportunity to seek Non-Executive Directors with more recent operational experience. I am pleased to report that Emre Berkin, with a wealth of skills and experience in the technological sector and international markets as well as experience of airlines, joined our Board as a Non-Executive Director on 1 November 2012. We continue to work with an international search and selection firm and expect to make further appointments in due course.

In making these appointments, the Board has strengthened its diversity across a range of measures, including skills, experience, nationality and gender, which will help bring different perspectives to our deliberations and decision making as we face the challenges of rebuilding our business.

"Harriet brings a wealth of experience of successful corporate transformations, and Michael likewise, with highly leveraged companies"

We have also strengthened our Board Committees with the appointment of Marlene Verluyden as Chair of the Audit Committee, Roger Burnell as Chair of the Remuneration Committee and Peter Marks as Chair of the Health, Safety & Environmental Committee. Each Committee has made real progress under its new leadership as detailed further in this Report.

In the spring of 2012, we conducted a review of Board effectiveness, with the assistance of external facilitators. One of the key areas of focus was to evaluate the breadth of skills and experience on the Board. The output from that evaluation has helped shape the candidate profile for our search for additional Board members. There were a number of other outputs, ranging from the need for the Board to have greater visibility and connection with the organisation; the need for improved financial information and forecasting; and an increase in the time allocated for the Board to review strategy, succession planning and risk management. There is an action plan in respect of each of those outputs (see page 45) and progress is monitored by me and reported regularly to the Board.

Whilst improved cash forecasting has been a priority of management and the Board in the past year, we are also taking significant steps under the leadership of the new Group CEO and Group CFO to strengthen risk management, internal and financial control, and the management and direction of internal audit. In view of the importance and urgency in these areas, a number of senior appointments have been made in recent months, including a new Group Treasurer, a new Head of Financial Control & Planning, and a new Director of Enterprise Risk and Audit. A number of other senior appointments have been made, as detailed in the Group CEO Q&A on page 9.

Throughout the year, Roger Burnell and I engaged with our major shareholders on a number of occasions across a range of issues, including Board appointments and remuneration, and will continue to do so. We are grateful for the feedback given, which has been supportive and constructive.

Under my leadership, we have made considerable progress towards achieving the highest standards of corporate governance and we will strive to build upon this during the course of the year ahead.

Frank Meysman
Chairman

27 November 2012

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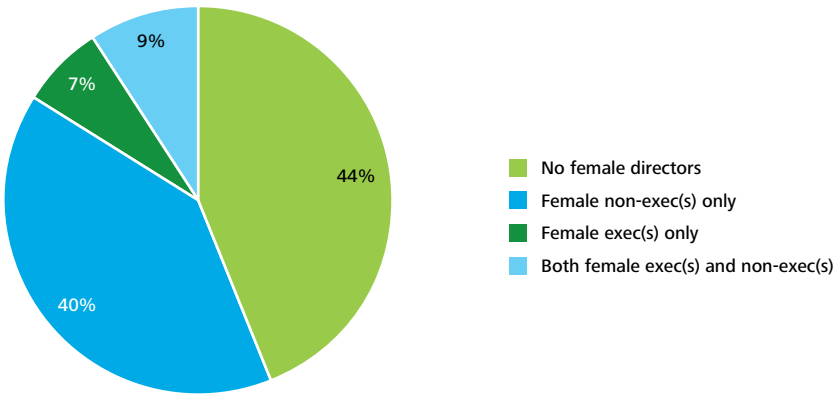
Structure of the board and its committees

The median number of directors on the boards of the companies surveyed has increased slightly from seven last year to eight. However, the smallest board in our survey this year consisted of three members, compared to only two in 2012. The largest board was made up of 16 people (2012: 17).

The median number of executive directors has also remained the same as last year at three. The largest number of executives was six (2012: six), while interestingly one company indicated that none of its directors were executives.

Diversity continues to be a hot topic, in the context of board composition as well as the wider company (as discussed in chapter 7). Figure 11.3 shows the distribution of companies which have female directors – encouragingly, the overall percentage of companies with female directors has risen from 48% last year to 56% in 2013. Larger companies in particular are gaining the value of a female perspective, with 77% of the companies surveyed from our top 350 group having at least one woman on the board, compared to 40% of smaller companies. The highest proportion of women on a single board was 38% (2012: 33%).

Figure 11.3. How many companies have female directors?



The overall percentage of female directors across our sample companies has also risen from 10% to 12%. The most progressive companies, particularly those which operate internationally, are now looking beyond just gender diversity to ensure that their boards also have sufficient geographic and ethnic diversity. A good example of this disclosure is given by Marks and Spencer Group plc. Cobham plc gives a useful table showing the relevant skills and experience brought to the table by each of its directors.

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Board diversity

This year we continued to make progress in shaping our Board for the future, ensuring that diversity, in its broadest definition, is at its heart. From a practical perspective, our focus on diversity means we look hard at our mix of skills and experience. New Board appointments will always seek to complement these as well as ensuring that a good balance of skill set, international experience and gender is maintained.

Our policy on page 54 summarises our views and sets out our ambitions with regard to diversity and what this means for our business, customers and stakeholders.

Board experience

Retail 93%

Consumer 100%

Finance 36%

E-commerce & technology 29%

International

Women on the board*

21%

Executive 17%

Non-executive 25%

Executive recruitment

Internally 33%

Externally 67%

Non-executive Board tenure

0–1 years 12%

1–3 years 38%

3–6 years 25%

6–9 years 25%

*Women on the Board will increase to 23% following Jeremy Darroch's departure on 19 June 2013.

Amanda Mellor
Group Secretary and Head of Corporate Governance
Appointed: July 2009
Other roles: Non-executive director of Kier Group plc.

Marks & Spencer Group plc Annual report and financial statements 2013

The overall percentage of female directors across our sample companies has also risen from 10% to 12%. The most progressive companies, particularly those which operate internationally, are now looking beyond just gender diversity to ensure that their boards also have sufficient geographic and ethnic diversity.

	Independence	Years with Cobham	Skills			Experience						
			Leadership	Strategy	UK Corporate Governance	Corporate	Engineering	Defence	Finance	US market	UK listings	HR
John Devaney		2	•	•	•	•	•	•	•		•	
Bob Murphy		0	•	•	•	•		•	•	•		•
Warren Tucker		10	•	•	•	•		•	•		•	•
Marcus Beresford	✓	9	•	•	•	•	•	•		•	•	
John Patterson	✓	7	•	•	•	•					•	•
Michael Wareing	✓	2	•		•	•		•	•		•	
Mark Ronald	✓	6	•	•		•	•	•		•	•	
Mike Hagee	✓	4	•	•				•		•		
Alison Wood	✓	1	•	•	•	•		•		•	•	•

Cobham plc Annual Report and Accounts 2012

The priority given to diversity when recruiting new directors has also risen, with 56% of companies now discussing the importance of a diverse board compared to 38% last year. Indeed, 28% of companies mention a specific policy on board diversity, although for the majority of these this does not give specific targets in relation to diversity. Where any objectives have been set to assess the implementation of policies in this area, these should be disclosed under the 2012 Code together with progress in achieving those objectives.

The provision of targets and quotas around diversity is a divisive issue, with some arguing that they are necessary to achieve the desired objective of an increase in diversity, while others contend that merit should be the overriding determinant of who gets a role and that appointing someone to fill a quota is demeaning for the individual involved. This is an area where larger companies are more open about their policies, with 84% of our top 350 sample talking about this compared to just 35% of the smaller companies.

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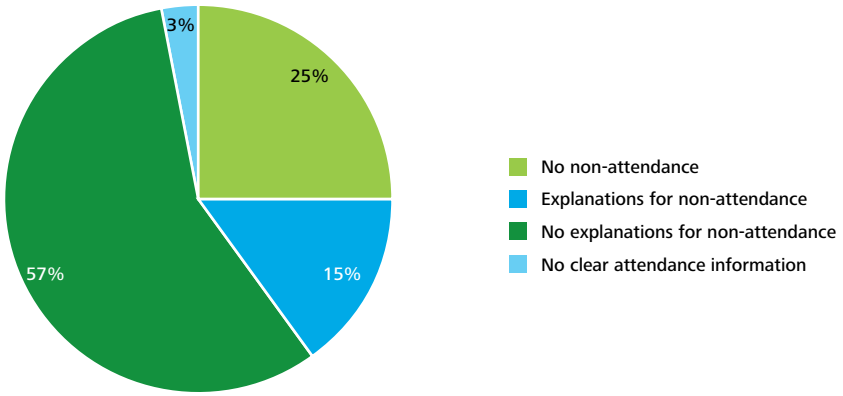
Another area of differing practice is the use of external search consultants when recruiting non-executive directors. This is something that is recommended by the Code and which can undoubtedly be beneficial, however companies often see it as another unnecessary cost. While 47% of the companies surveyed indicate that they use consultants or external advertising when recruiting non-executives, 6% specifically stated that this was not a preferred method of recruitment due to the cost implications. Some companies remained silent in this area, perhaps because of a lack of appointments during the year.

Operation of the board

Although the Code does provide specific requirements for the disclosures that companies should make in their annual reports, its primary purpose is to set out guidance on how the board should function in its day to day operations. One element that is of significant importance to shareholders is the attendance of directors at board meetings – after all, they want to know that the people entrusted with running their company are dedicating sufficient time to it! It is encouraging to note that only three of the companies surveyed failed to provide attendance information for board and committee meetings. Indeed, the most progressive companies are not only presenting information on how many meetings have been attended but, where certain directors have been absent from some meetings, providing explanations for these absences. Figure 11.4 shows the level of attendance information given by the companies surveyed.

Figure 11.4. How many companies give explanations for non-attendance?



Some companies have also started to include specific information about what the board has spent its time discussing – an example of this is given by Barclays PLC. Again, this gives shareholders more clarity around whether the board is spending its time on the areas that shareholders feel are important.

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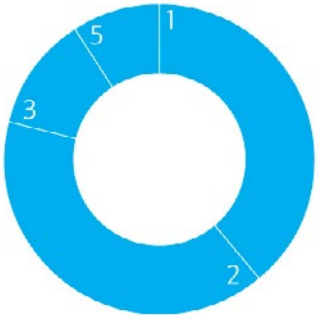
Board allocation of time %



		2012	2011
1	Strategy formulation and implementation monitoring	39	39
2	Governance and Risk (including regulatory issues)	40	35
3	Finance (including capital and liquidity)	12	16
4	Corporate Finance	0	1
5	Other (including compensation)	9	9

Board activity in 2012

The Board's agenda in 2012 was dominated by the changing regulatory environment and, in the latter half of 2012, by consideration of the future direction and shape of the business and its culture and values in light of both the external environment and in the aftermath of the LIBOR announcement. Key activities for the Board during the year included:

- reviewing strategic options open to the Group in its different business areas in light of the regulatory and economic environment.
- receiving updates from each of Barclays principal businesses and discussing their progress against agreed strategy.
- discussing the implications of a statement by HMRC concerning the repurchase of debt by Barclays.
- considering and approving the sale of Barclays interest in BlackRock, Inc.
- discussing and agreeing Barclays 'One Africa' strategy, involving the combination of the majority of Barclays operations in Africa with Absa.
- considering the announcement of penalties relating to the industry-wide investigation into the setting of interbank offered rates and the subsequent events.
- discussing changes in the composition of the Board, including approving the appointment of a new Chairman and a new Chief Executive.
- reviewing a report on compliance and internal audit lessons learned from the LIBOR incident.
- discussing and reviewing progress of the work implemented by Antony Jenkins as part of the Transform Programme, including a review of business performance, costs, funding and liquidity matters and a discussion of Barclays purpose, values and behaviours.
- considering and approving Barclays risk appetite, liquidity risk appetite and the Group's capital plan.
- receiving regular updates on global economic conditions and regulatory developments and the outlook for the industry.

During 2012, the Board held two informal meetings with representatives from the FSA to ensure that all Directors had the opportunity to hear first-hand from Barclays principal regulator and exchange views. The chart on page 50 illustrates how the Board allocated its time during 2012.

Barclays PLC Annual Report 2012

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Another area in which disclosure is improving is the robustness of the process used by the companies in our survey to appraise the performance of their boards. The Code recommends that companies in the FTSE 350 should have board performance evaluations externally facilitated at least once every three years, but this is an idea that is also gaining credence amongst smaller listed companies. While in the prior year 12% of the companies surveyed indicated that they had undertaken an external performance evaluation, in 2013 42% of companies indicated that either an external facilitator had been involved in the current year or would be in one of the next two years. This is much more prevalent in the top 350 companies, with 79% (2012: 29%) of them doing so (note that this segment of our population includes a few companies which are not in the FTSE 350, so we would not expect this figure to be 100%). However, 14% of smaller companies (2012: 3%) also do so. A good example of disclosures around the performance evaluation process is given by National Grid plc.

Corporate Governance

Continued

Board evaluation and effectiveness

The Board agreed this year it would be beneficial and timely, given the changes in Board composition, to undertake an external evaluation of Board and committee performance to provide fresh insight and objectivity to the process. Schneider Ross was appointed to conduct an evaluation of the Board and its committees, having previously provided inclusive leadership training to the Company in 2009. The Board agreed this previous relationship would not impact in any way the independence of the review.

The Board recognises the value of inclusive leadership and a diverse Board. In considering the review process this year, it noted the anticipated benefits to be gained by undertaking an external review from an inclusion & diversity perspective.

Board and committee evaluation process

Schneider Ross held confidential one-to-one interviews with 24 people comprising Directors and members of the leadership team. Mark Williamson and Jonathan Dawson did not participate due to the timing of their appointments. The focus for these discussions was on the behavioural aspects of Board effectiveness such as:

- how the Board works together as a unit;
- the quality of inputs, discussions and decision-making;
- the leadership demonstrated both individually and collectively; and
- specific themes, for example differences in perspectives between male and female Board members and more recently appointed Non-executive Directors were asked about their integration and induction to the Board.

Questionnaires were designed to gather views and feedback on the overall effectiveness, performance and processes of the Board and each of the committees including the Executive Committee. Additionally this year, regular attendees of the Board and committee meetings were surveyed to gain a different perspective and a more holistic picture of performance.

In total 47 people, including regular attendees and two external advisors, were invited to complete questionnaires anonymously online.

Schneider Ross presented the key conclusions of the evaluation at a meeting of the Nominations Committee with the Executive Directors present. Findings, which were debated openly, had been grouped into three themes:

- Mechanics: for example the role, composition and processes of the Board and its committees.
- Dynamics: such as teamwork, quality of discussions, debate and decision-making.
- Specifics: including leadership, succession planning, risk appetite and reporting, and inclusion & diversity.

As a result of their evaluation, Schneider Ross commented:

"With the Board in the later stages of its transition, the boardroom dynamic continues to evolve. We have made a set of recommendations which, taken together, we believe should drive progress towards a truly high performing, inclusive Board – where constructive challenge from a diverse group of Non-executive Directors makes its full contribution to excellent decision-making."

Each committee chairman was requested to prepare an action plan for their respective committee for presentation to the April Board meeting. Noting the suggestions, the Board agreed areas of improvement and actions for further enhancements. Progress against all action plans will be monitored throughout the year: see table opposite for examples.

In addition to the review by Schneider Ross and on receipt of its findings, Sir Peter met with each Board member to discuss their individual performance, with the exception of Ken Harvey and George Ross as they will not be standing for re-election at this year's AGM.

Progress against the examples from the combined action plan reported last year, which includes items identified from the performance evaluation process together with Sir Peter's complementary review, is set out opposite.

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Smaller companies are also adopting another Code provision aimed mainly at the FTSE 350 as an example of 'best practice' in relation to the re-election of directors. The Code indicates that all directors of FTSE 350 companies should be subject to annual re-election, however not only do 86% (2012: 88%) of the top 350 companies do this, 32% (2012: 26%) of the smaller companies surveyed have also implemented annual re-election.

Internal controls

Code provision C.2.1 requires that the board should, at least annually, conduct a review of the effectiveness of the company's risk management and internal control systems and should report to shareholders that they have done so. Currently the FRC's "Internal Control: Guidance to Directors" (formerly known as the Turnbull Guidance) gives companies more detail on how to comply with this Code requirement. However, this is another area of potential change in the near future, with the FRC set to consult on revisions to the Turnbull Guidance before the end of 2014.

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All companies in 2013 included a statement on internal control in their corporate governance statement. This was frequently located in or near the section or sub-section on the audit committee. 88% (2012: 89%) also included a more detailed description of the internal control processes in place. However, only 74% (2012: 81%) were judged to have provided a summary of the actual process applied by the board in reviewing the company's systems of internal control and risk management, rather than just confirmation that such a process exists. This figure rose to 86% (2012: 97%) in the top 350 companies and fell to 65% (2012: 73%) among the other companies.

12 (2012: six) companies highlighted instances of breakdowns in internal control during the year. All of these provided a confirmation that necessary action had been or was being taken to remedy the weakness highlighted. A further 27 (2012: 23) companies confirmed that no breakdowns in internal control had occurred; all other companies in the sample did not confirm one way or the other.

Other board committees

89% (2012: 94%) of companies included a section in their corporate governance statement describing the work of the nomination committee, but only 68 (2012: 55) companies included a discussion of the process followed for board appointments within that section – this may reflect the fact that the issue is less important in years in which there are no new appointments. In many cases the discussion of the process for board appointments came in the context of actual appointments which took place in the year. Of the remaining 11 companies, 9 did not have a nomination committee, and one of the others had no nomination committee meetings during the year. The proportion of committees referring specifically to succession planning, an area of rising priority with investors and regulators, has risen from 62% in 2012 to 76% in 2013.

Another area of continued development in practice is the creation of a separate risk committee with responsibility for risk oversight. The FCA requires financial institutions to consider whether they need to establish a board risk committee and cites FTSE 100 banks and insurers as firms that should do so. The FRC has noted that most market participants do not think it is appropriate to require risk committees outside the financial sector.

All companies in the survey sample were reviewed to see if they had a separate risk committee. In 2013, 14 (2012: eight) companies disclosed that they had a separate risk committee, of which 11 (2012: six) were in the top 350 sample – three banks and eight other companies. Some also provided details on the availability of the terms of reference, the names of the members of the committee and the number of meetings held in the year.

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12. Auditing by committee

Highlights

- 36% (2012: 26%) of companies present a clear, separate audit committee report within their annual report.
- 57% of audit committee reports give specific detail of the way the committee has discharged its responsibilities, including the issues dealt with.
- 33% already give specific detail of the key financial reporting judgements discussed by the committee, with almost half of these also disclosing information about discussions held with the auditor around these issues.
- 24 companies gave an indication of when they might put the audit out to tender in the future, anticipating the new requirements around this in the 2012 Code.

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12. Auditing by committee

Of the areas of corporate governance which have been revisited and 'beefed up' in the 2012 Code, one which has been under significant scrutiny is the role of the audit committee and the reporting of its activities. Where the 2010 Code focusses largely on what the responsibilities of the committee should be, the revised 2012 Code places more emphasis on presenting details in the annual report of what the committee has done during the year under review to fulfil its responsibilities. This level of transparency gives shareholders a much clearer picture of what the key issues considered by the committee are and also helps to illuminate the relationship between the audit committee and the external auditor, in terms of the issues discussed.

The 2010 Code requires that there is a separate section of the report which describes the work of the audit committee in discharging its responsibilities. The FRC's guidance expands on what this should contain, recommending that there is a summary of the role of the committee, the names and qualifications of its members and the number of meetings. It also suggests that the report should discuss the activities carried out to monitor the integrity of the financial statements and the integrity of internal controls, the procedures adopted to review the independence of the external auditors and confirmation that an assessment of the effectiveness of the external audit has been made, and a review of the plans and work of the internal audit department.

As well as the requirements of the Code itself, the FRC has also published updated "Guidance on Audit Committees" documents which give examples of best practice around how a company should apply the Code requirements and report on the committee's activities.[11] This guidance was updated when the 2012 Code was issued, expanding various sections including the 'communication with shareholders' guidance. Certain material previously located in the guidance has now been 'upgraded' into the Code itself, thus requiring the Code's 'comply or explain' approach to be adopted in relation to this.

It is also worthy of note that the 2013 revisions to audit reporting, which come into force for periods ending on or after 30 September 2013 (i.e. at the same time as the 2012 Code) include a requirement for the auditor to state in the audit report if the audit committee report does not appropriately address the matters communicated by the auditor to the audit committee. These revisions introduce a large number of fundamental changes to the audit report, moving away from a largely boilerplate statement of compliance to include much more information on the level of audit materiality and the risks addressed, among other things.

The 2013 revisions to audit reporting, which come into force for periods ending on or after 30 September 2013 (i.e. at the same time as the 2012 Code) include a requirement for the auditor to state in the audit report if the audit committee report does not appropriately address the matters communicated by the auditor to the audit committee.

11 See http://www.frc.org.uk/our-Work/Publications/Corporate-Governance/Guidance-on-Audit Committees-September-2012.aspx

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Vodafone Group Plc has anticipated the revision of ISA (UK and Ireland) 700 and included an audit report based on the draft revised standard. Although this was not exactly the same as the final standard, it gives a good indication of what audit reports will look like in future.

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Audit report on the consolidated financial statements

Independent auditor's report to the members of Vodafone Group Plc

Opinion

In our opinion the consolidated financial statements of Vodafone Group Plc:

- give a true and fair view of the state of the Group's affairs as at 31 March 2013 and of its profit for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006 and Article 4 of the IAS Regulation.

The consolidated financial statements comprise the consolidated statement of financial position, the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of changes in equity, the consolidated statement of cash flows, and the related notes 1 to 26 and A1 to A9. The financial reporting framework that has been applied in their preparation is applicable law and IFRSs as adopted by the European Union.

Separate opinion in relation to IFRSs as issued by the IASB

As explained in note 1 to the consolidated financial statements, the Group in addition to applying IFRSs as adopted by the European Union, has also applied IFRSs as issued by the International Accounting Standards Board (IASB).

In our opinion the consolidated financial statements comply with IFRSs as issued by the IASB.

Basis for opinions

We have audited the consolidated financial statements in accordance with applicable law and International Standards on Auditing (USA) (UK and Ireland). Our responsibilities under those standards are further described below under Respective Responsibilities of Directors and Auditor. In performing our audit, as required by those standards, we complied with the Financial Reporting Council's Ethical Standards for Auditors including those requiring us to be independent and objective.

Going concern

As required by the Listing Rules we have reviewed the directors' statement on page 84 that the business is a going concern. We confirm that

- we have not identified material uncertainties related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern which we believe would need to be disclosed in accordance with IFRSs as adopted by the European Union; and
- we have concluded that management's use of the going concern basis of accounting in the preparation of the financial statements to be appropriate.

However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Company's ability to continue as a going concern.

Auditor commentary

Without modifying our opinion, we highlight the following matters that are, in our judgment, likely to be most important to users' understanding of our audit. Our audit procedures relating to these matters were designed in the context of our audit of the financial statements as a whole, and not to express an opinion on individual accounts or disclosures.

Our assessment of risks significant to our audit

We identified the following risks that we believe to have had the greatest impact on our audit strategy and scope:

- the assessment of the carrying value of goodwill and intangible assets;
- the accounting for the legal claim in respect of withholding tax on the acquisition of Hutchison Essar Limited;
- the recognition and measurement of deferred tax assets in Germany and Luxembourg;
- revenue recognition, including the timing of revenue recognition, the recognition of revenue on a gross or net basis, the treatment of discounts, incentives and commissions and the accounting for multiple element arrangements; and
- the risk of management override of internal control. International Standards on Auditing (UK and Ireland) state that this risk must always be treated as significant.

Our assessment of materiality

We apply the concept of materiality both in planning and performing our audit, and in evaluating the effect of misstatements on our audit and on the financial statements. For the purposes of determining whether the financial statements are free from material misstatement we define materiality as the magnitude of misstatement that makes it probable that the economic decisions of a reasonably knowledgeable person, relying on the financial statements, would be changed or influenced. We also determine a level of performance materiality which we use to determine the extent of testing needed to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

When establishing our overall audit strategy, we determined a magnitude of uncorrected misstatements that we judged would be material for the financial statements as a whole. We determined planning materiality for the Group to be €500 million, which is approximately 5% of adjusted pre-tax profit, and below 1% of equity. We use adjusted pre-tax profit to exclude the effect of volatility (for example, separately disclosed adjusting items) from our determination. On the basis of our risk assessments, together with our assessment of the Group's overall control environment, our judgement is that overall performance materiality for the Group should be 70% of planning materiality, namely €350 million. Our objective in adopting this approach is to ensure that total detected and undetected audit differences do not exceed our planning materiality of €500 million for the financial statements as a whole.

We agreed with the Audit and Risk Committee that we would report to the Committee all audit differences in excess of €10 million, as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds.

The scope of our audit

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Our Group audit scope focused on seven operating locations, of which six were subsidiaries or joint ventures subject to a full scope audit for the year ended 31 March 2013. The remaining operating location was Verizon Wireless, a material associate which is not controlled by the Group, which was subject to a full scope audit for the year ended 31 December 2012 and review procedures for the quarters ended 31 March 2012 and 2013. Together with the Group Functions, which were also subject to a full scope audit for the year ended 31 March 2013, these locations represent the principal business units of the Group and account for 83% of the Group's total assets, 70% of the Group's revenue and 78% of the Group's operating profit. Audits of these locations are performed at a materiality level calculated by reference to a proportion of Group materiality appropriate to the relative scale of the business concerned. In addition, audits are performed for local statutory purposes at a further 18 locations, which represent a further 12% of the Group's total assets, 29% of the Group's revenue and 21% of the Group's operating profit. Audits of these locations are performed at a local materiality level calculated by reference to the scale of the business concerned.

The Group audit team follows a programme of planned site visits that is designed to ensure that the Senior Statutory Auditor or his designate visits each of the seven full scope locations at least once a year. This year the Group audit team visited all seven of the full scope locations.

The way in which we scoped our response to the significant risks identified above was as follows:

- we challenged management's assumptions used in the impairment model for goodwill and intangible assets, described in note 12 to the financial statements, including specifically the cash flow projections, discount rates, perpetuity rates and sensitivities used, particularly in respect of the Group's interests in southern Europe;
- we considered the legal advice in connection with management's disclosure in note 21 of contingent liabilities, including the impact of the introduction by the Indian government of legislation which amends Indian tax law with retrospective effect to overturn a judgement in the Group's favour;
- we considered the appropriateness of management's assumptions and estimates in relation to the likelihood of generating suitable future taxable profits to support the recognition of deferred tax assets described in note 7, challenging those assumptions and considering supporting forecasts and estimates;
- we carried out testing relating to controls over revenue recognition, including the timing of revenue recognition, the recognition of revenue on a gross or net basis, the treatment of discounts, incentives and commissions and the accounting for multiple element arrangements, as well as substantive testing, analytical procedures and assessing whether the revenue recognition policies adopted complied with IFRS; and
- we carried out analytical procedures and journal entry testing in order to identify and test the risk of fraud arising from management override of controls.

The Audit and Risk Committee's consideration of these judgements is set out on page 62.

Opinions on matters prescribed by the Companies Act 2006

In our opinion:

- the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006.

Other matters on which we are required to report by exception

Adequacy of explanations received

Under the Companies Act 2006 we are required to report to you if in our opinion, we have not received all the information and explanations we require for our audit. We have nothing to report in respect of this matter.

Directors' remuneration

Under the Companies Act 2006 we are also required to report if in our opinion certain disclosures of directors' remuneration have not been made or the part of the Directors' Remuneration Report to be audited is not in agreement with the accounting records and returns. Under the Listing Rules we are required to review certain elements of the Directors' Remuneration Report. We have nothing to report arising from these matters or our review.

Corporate Governance Statement

Under the Listing Rules we are also required to review the part of the Corporate Governance Statement relating to the company's compliance with nine provisions of the UK Corporate Governance Code. We have nothing to report arising from our review.

Our duty to read other information in the Annual Report

We have been asked by the Board to report the results of our having read the entire annual report, for the purposes of identifying any material inconsistencies with the audited financial statements or information that is apparently incorrect based on, or materially inconsistent with, the knowledge of the Group we acquired in the course of performing the audit. Such inconsistencies would include any that we may have identified in relation to the directors' statement that the annual report is fair, balanced and understandable and provides the information necessary for users to assess the entity's performance, business model and strategy and any that we may have identified because the section of the annual report describing the work of the Audit and Risk Committee does not, in our judgment, appropriately disclose matters that we communicated to the Audit and Risk Committee.

We confirm that we have not identified information in the annual report that is materially inconsistent with the audited financial statements or that is apparently incorrect based on, or materially inconsistent with, the knowledge of the Group we acquired in the course of performing the audit. However, we have not audited this other information and accordingly do not express an audit opinion on it.

Respective responsibilities of directors and auditor

Responsibility of directors for the financial statements

As explained more fully in the Directors' statement of responsibility set out on page 84 the directors are responsible for the adequacy of the accounting records, the preparation of the financial statements from those records and for being satisfied that the financial statements give a true and fair view.

Auditor's responsibility

Our responsibility is to audit and express an opinion on the financial statements, and to provide other reports and communications arising from our audit, in accordance with applicable law and International Standards on Auditing (UK and Ireland).

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are either required to state to them in an auditor's report and for those further matters we have expressly agreed to report to them on in our engagement letter and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Other matter

We have reported separately on the parent company financial statements of Vodafone Group Plc for the year ended 31 March 2013.

Panos Kakoullis FCA (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
London
United Kingdom
21 May 2013

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Vodafone Group Plc Annual Report for the year ended 31 March 2013

Presentation of the audit committee report

With the exception of two companies which did not have a separate audit committee, all of the companies in our survey presented an audit committee report in accordance with the Code. Although the Code specifies that information on the work of the audit committee should be included in a 'separate section of the annual report', this is taken to include a subsection within the overall corporate governance report. However, the number of companies presenting a fully separate audit committee report continues to increase, with 36 companies (2012: 26 companies) presenting such a report. This separation is useful as it provides clear definition between the work of the audit committee and the work of the board as a whole, which does overlap in areas such as reviewing internal controls.

In line with this rise, there is also an increase in the number of companies where the audit committee chairman takes clear ownership of the audit committee report, from 27 in 2012 to 34 in 2013. This is usually done either by the committee chairman signing the report or presenting an introductory summary.

The Code also indicates that the terms of reference of the committee should be made available. 79% (2012: 90%) of companies gave a clear indication of how a user of the report could obtain a copy of these terms of reference, either by including them in the report directly, referring to the company's website or indicating that they are available on request.

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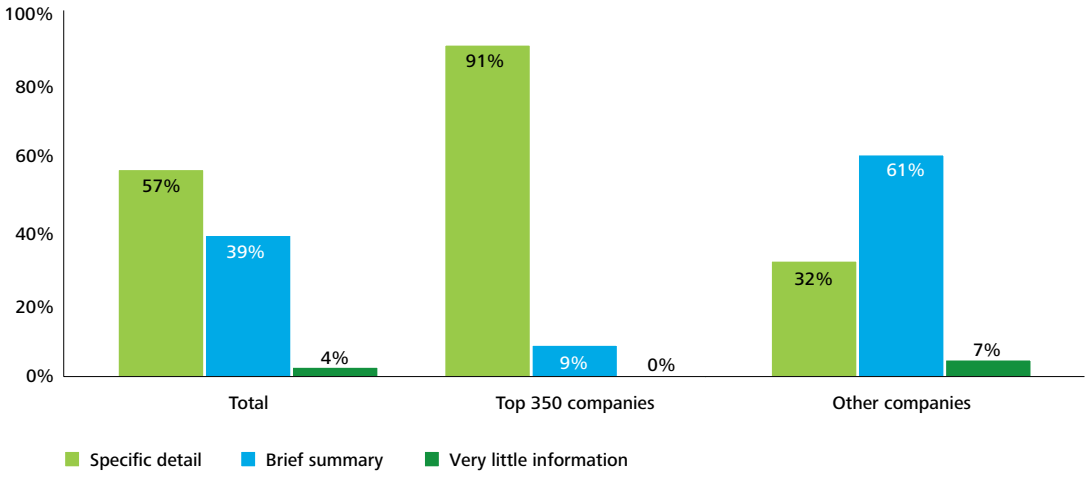
Content of the report

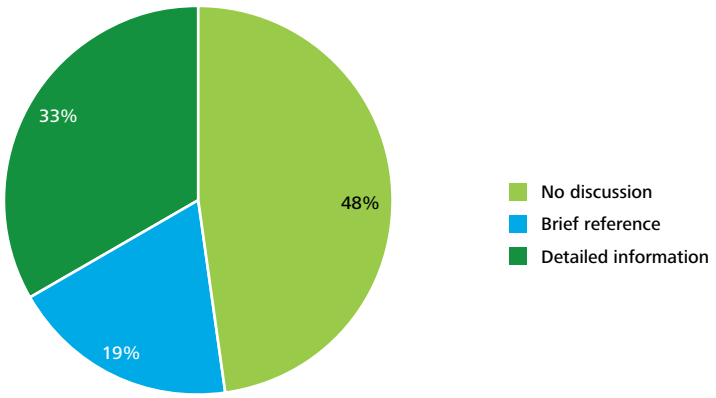
As discussed above, going forward companies will be required to put more specific detail in their audit committee reports. However, those which have been applying the best practice recommendations in the FRC's guidance have already been doing this to a greater or lesser extent. Figure 12.1 illustrates the level of detail given by companies in their reports.

Figure 12.1. How well have companies explained the activities of the audit committee?



32% of the audit committee reports reviewed gave specific details of the activities that the committee had carried out to monitor the integrity of the financial statements, while a further 46% gave some limited information about these activities. Figure 12.2 shows a breakdown of the level of detail given about the specific financial reporting issues (assumptions, estimates, judgements etc.) considered by the committee during the year. This is something that will be required under the 2012 Code and so we would expect to see a lot more detail next year from those companies providing only brief information in this area.

Figure 12.2. How much detail is given about estimates and judgements considered by the committee?



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It can be seen from this that 33% of companies are already giving some detail of the specific estimates and judgements considered by the audit committee in a year. Encouragingly, in 91% of these cases the issues discussed in the audit committee report were consistent to some degree with the areas identified as critical judgements and key sources of estimation uncertainty in the notes to the accounts, with 41% of them showing an almost direct correlation between the two. This shows that there is a good level of joined up thinking going on between the issues focussed on by the audit committee and those which significantly impact the accounts.

It is also interesting that 47% of companies are talking about the discussions held with their auditors around these issues. Under the current regulations the audit committee report is the only place which really gives any scope to lift the lid on the audit black box, so it is encouraging to see some companies starting to do this. However, this is something that will become a lot more transparent with the new style audit reports next year – as part of the new audit report, the auditor will be required to state if the audit committee report does not appropriately address matters communicated by the auditor to the audit committee.

A particularly good illustration of the interaction between the audit committee and auditor is given by BT Group plc.

Reports of the Board Committees

Audit & Risk Committee Chairman's report

"Over the past year we have paid particular attention to increasing our understanding beyond group level risks. We have attended line of business audit & risk committees, received deep-dive risk presentations from the line of business CEOs, and undertaken in depth reviews of specific markets such as Italy. All of this has served to enhance our understanding of BT's overall control environment."

Nick Rose

What we have done

Allocation of time

Internal controls and risk management

Financial reporting

Independence of the external auditors

Internal audit

Governance

Nick Rose
Chairman of the Audit & Risk Committee
9 May 2013

BT Group plc Annual Report & Form 20-F 2013

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In general the level of communication in audit committee reports seems to be improving – as shown by figure 12.3, in most areas the percentage of committees reporting what they have done to discharge their responsibilities (rather than just indicating that they have a responsibility in that area) has increased from 2012. Johnson Matthey gives an excellent summary of the work of the audit committee by listing the matters discussed at each committee meeting.

Another emerging area is that the audit committee may be asked to advise the board on whether the annual report is 'fair, balanced and understandable'. A good example of the disclosure that could be made in relation to this process is given by BAE Systems plc in their Annual Report 2012.

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Audit Committee Report

"The Audit Committee has a key role to play in ensuring the integrity of Johnson Matthey's reported financial results and its internal financial controls."

Alan Ferguson
Chairman of the Audit Committee

Role

The terms of reference of the Audit Committee are summarised on pages 99 and 100. They can be found in full in the Investor Relations / Corporate Governance section of our website or may be obtained from the Company Secretary.

Composition

The Audit Committee comprises all the independent non-executive directors. The Committee is chaired by Alan Ferguson. Details of Alan's experience and qualifications are set out on page 93.

The group Chairman, the Chief Executive, the Group Finance Director, the Head of Internal Audit and Risk and the external auditor attend Audit Committee meetings by invitation. The Committee also meets separately with the Head of Internal Audit and Risk and with the external auditor without management being present.

The Company Secretary is secretary to the Audit Committee.

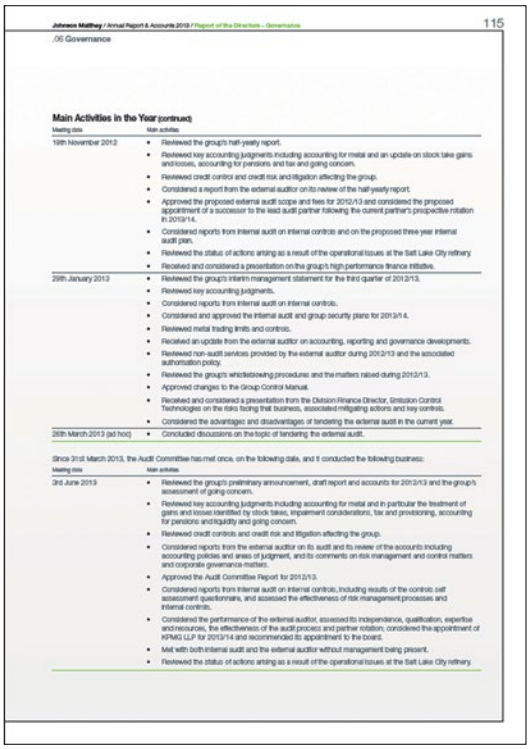
Meeting Frequency

Meetings are held at least four times per year at appropriate times in the reporting and audit cycle and otherwise as required.

Main Activities in the Year

The Audit Committee met five times during the year ended 31st March 2013, on the following dates, and it conducted the following business:

Meeting date	Main activities
31st May 2012	• Reviewed the group's preliminary announcement, draft report and accounts for 2011/12. • Reviewed key accounting judgments including accounting for metal and in particular the treatment of gains and losses identified by stock takes, impairment considerations, tax and provisioning, accounting for pensions and liquidity and going concern. • Reviewed credit controls and credit risk and litigation affecting the group. • Considered reports from the external auditor on its audit and its review of the 2011/12 accounts including accounting policies and areas of judgment, and its comments on risk management and control matters and corporate governance matters. • Approved the Audit Committee Report for 2011/12. • Considered reports from internal audit on internal controls. • Reviewed the performance of the external auditor, considered the reappointment of KPMG Audit Plc (KPMG) as auditor for 2012/13 and recommended its appointment to the board. • Met with both internal audit and the external auditor without management being present.
24th July 2012	• Reviewed the group's interim management statement for the first quarter of 2012/13. • Reviewed key accounting judgments. • Considered reports from internal audit on internal controls. • Reviewed the performance of internal audit. • Approved a draft specification for the appointment of a new external lead audit partner in view of the current partner's prospective rotation in 2013/14. • Reviewed the effectiveness of risk management processes and internal controls. • Considered finance systems and process improvements and the group's high performance finance initiative. • Received and considered a presentation from the Group Tax Director on the group's management of global duty. • Received and considered a presentation from the Division Finance Director, Fine Chemicals on the division's key financial risks and key performance indicators.



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Main Activities in the Year (continued)

Meeting date	Main activities
19th November 2012	• Reviewed the group's half-yearly report. • Reviewed key accounting judgments including accounting for metal and an update on stock take gains and losses, accounting for pensions and tax and going concern. • Reviewed credit control and credit risk and litigation affecting the group. • Considered a report from the external auditor on its review of the half-yearly report. • Approved the proposed external audit scope and fees for 2012/13 and considered the proposed appointment of a successor to the lead audit partner following the current partner's prospective rotation in 2013/14. • Considered reports from internal audit on internal controls and on the proposed three-year internal audit plan. • Reviewed the status of actions arising as a result of the operational issues at the Salt Lake City refinery. • Received and considered a presentation on the group's high performance finance initiative.
29th January 2013	• Reviewed the group's interim management statement for the third quarter of 2012/13. • Reviewed key accounting judgments. • Considered reports from internal audit on internal controls. • Considered and approved the internal audit and group security plans for 2013/14. • Reviewed metal trading limits and controls. • Received an update from the external auditor on accounting, reporting and governance developments. • Reviewed non-audit services provided by the external auditor during 2012/13 and the associated authorisation policy. • Reviewed the group's whistleblowing procedures and the matters raised during 2012/13. • Approved changes to the Group Control Manual. • Received and considered a presentation from the Division Finance Director, Emission Control Technologies on the risks facing that business, associated mitigating actions and key controls. • Considered the advantages and disadvantages of tendering the external audit in the current year.
26th March 2013 (ad hoc)	• Concluded discussions on the topic of tendering the external audit.

Since 31st March 2013, the Audit Committee has met once, on the following date, and it conducted the following business:

Meeting date	Main activities
3rd June 2013	• Reviewed the group's preliminary announcement, draft report and accounts for 2012/13 and the group's assessment of going concern. • Reviewed key accounting judgments including accounting for metal and in particular the treatment of gains and losses identified by stock takes, impairment considerations, tax and provisioning, accounting for pensions and liquidity and going concern. • Reviewed credit controls and credit risk and litigation affecting the group. • Considered reports from the external auditor on its audit and its review of the accounts including accounting policies and areas of judgment, and its comments on risk management and control matters and corporate governance matters. • Approved the Audit Committee Report for 2012/13. • Considered reports from internal audit on internal controls, including results of the controls self assessment questionnaire, and assessed the effectiveness of risk management processes and internal controls. • Considered the performance of the external auditor, assessed its independence, qualification, expertise and resources, the effectiveness of the audit process and partner rotation, considered the appointment of KPMG LLP for 2013/14 and recommended its appointment to the board. • Met with both internal audit and the external auditor without management being present. • Reviewed the status of actions arising as a result of the operational issues at the Salt Lake City refinery.

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Audit Committee Report (continued)

Independence of the External Auditor

Both the board and the external auditor have for many years had safeguards in place to avoid the possibility that the auditor's objectivity and independence could be compromised. The issue of auditor independence is taken very seriously and is reviewed annually.

Our policy in respect of services provided by the external auditor is as follows:

- Audit related services – the external auditor is invited to provide services which, in its position as auditor, it must or is best placed to undertake. This includes formalities relating to borrowings, shareholder and other circulars, various other regulatory reports and work in respect of acquisitions and disposals.
- Tax compliance and advice – the auditor may provide such services where it is best suited, but otherwise such work is put out to tender.
- Other services – these may not be provided where precluded by ethical standards or where we believe it would compromise audit independence and objectivity.

To the extent consistent with the above policy, services likely to cost less than £25,000 may be approved by the Group Finance Director. Services above this amount must be approved by the Chairman of the Audit Committee, unless they are likely to be in excess of £100,000, when they must be approved by the Audit Committee.

During the year ended 31st March 2013 the Chairman of the Audit Committee authorised the use of KPMG to support the group in its due diligence prior to the acquisition of Axeon and, following a competitive tendering process, to advise the group on the establishment of a special purpose vehicle which holds certain corporate bonds used to fund the group's UK pension scheme.

The split between audit and non-audit fees for the year ended 31st March 2013 and information on the nature of non-audit fees appear in note 5 on the accounts.

External Audit Quality and Tendering

The board is committed to maintaining the highest standards of audit quality. Management receives regular feedback from the businesses on the audit process. When assessing the effectiveness of the external audit process, the Committee combines formal and informal processes. As part of the formal processes the Committee considers feedback on the auditor provided by management and by external parties. Informal processes are centred around how the audit team, and the lead partner in particular, interact with management and the Committee. A constructive, open and challenging approach supported by knowledge of the business and sound judgment are important criteria in making this assessment.

KPMG (and its predecessor entities) have been the external auditor of the company since 1986. The last full tendering process was conducted in 1985 although annual performance reviews have been carried out as well as a more substantial review in 2003. The current lead audit partner at KPMG rotates after finalisation of the current year's audit and earlier in the year the Committee worked closely with KPMG to identify his successor. In light of the changes introduced in the 2012 Code, which requires the external audit contract to be put out to tender at least every ten years (and which apply to Johnson Matthey for its year commencing 1st April 2012), and the FRC's transitional guidance, the Committee spent some time considering the merits of putting the audit out to tender in 2013/14. The Committee decided against this for a number of reasons including the fact that it is very comfortable with the performance of KPMG and is looking forward to working with the newly appointed lead audit partner, who will bring new perspectives to the audit. In addition there is the possibility of further changes in the relevant governance frameworks pending the conclusion of the Competition Commission's market investigation into the supply of statutory audit services to large companies in the UK, and best practice around the tendering process is also developing. Whilst the Committee does not propose that a tendering process should be undertaken in 2013/14 it is committed to tendering the audit sometime during the new lead audit partner's five year tenure, at a time which is right for Johnson Matthey.

Internal Audit

Internal audit independently reviews the risks and control processes operated by management. It carries out independent audits in accordance with an internal audit plan which is agreed with the Audit Committee before the start of the financial year. As part of this process the Committee looks at the resources devoted to the function to ensure they are adequate to deliver the plan.

The plan provides a high degree of financial and geographical coverage and devotes significant effort to the review of the risk management framework surrounding the major business risks.

Internal audit reports include recommendations to improve internal controls together with agreed management action plans to resolve the issues raised. Internal audit follows up the implementation of recommendations and reports progress to senior management and the Audit Committee.

The Audit Committee reviews the findings of the internal audits completed during the year.

The effectiveness of the internal audit function is reviewed and discussed on an annual basis.

The major focus of internal audit in the year was a review of the audit planning and reporting processes following the arrival of the new Head of Internal Audit and Risk in April 2012. This resulted in changes to the audit plan to focus on core processes, testing of key controls and the introduction of group wide themed audits together with a revised self assessment exercise and refreshed approach to risk assessment and management.

On behalf of the Audit Committee

Alan Ferguson
Chairman of the Audit Committee

Johnson Matthey Annual Report & Accounts 2013

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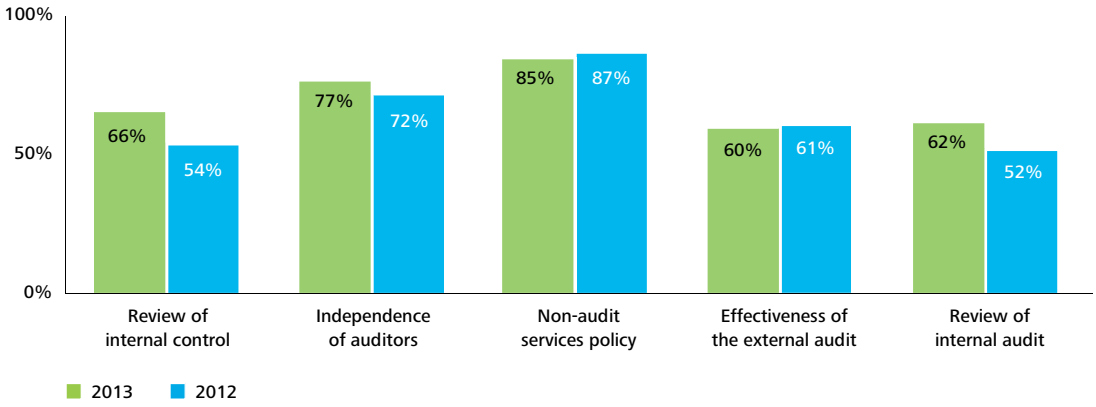
Figure 12.3. Which other audit committee activities are discussed in the annual report?



Audit tendering

The frequency of audit tendering and the relationships between auditors and the companies they are auditing has been one of the key areas of regulatory focus following the 2008 financial crisis. The first changes in this area will come into force next year, with the 2012 Code introducing a recommendation that FTSE 350 companies put their audit out to tender every ten years (subject to transitional provisions). However, the Competition Commission report on audit market concentration, which resulted from the House of Lords inquiry into this area, and the European Commission proposals for reform of the audit market, may also introduce further changes when their proposals are finalised.

In spite of this focus, the number of companies giving information on the tenure of the incumbent auditor (38%) and the date of the last audit tender (20%) is disappointingly low, although it is welcome to see that this is a significant improvement on last year, when only 24% of companies gave information on tenure and just 6% gave tendering information. Of those companies disclosing auditor tenure, the median figure is 11 years, roughly in line with the new proposals. However, the longest relationship disclosed has lasted for a full 117 years.

The number of companies giving an indication of when they might put the audit out to tender in the future was 24, of which 22 were from the largest 350 companies – the majority being FTSE 350 companies discussing the implementation of the 2012 Code requirements next year. Regardless of the cause, it is clear that the number of companies considering the implications of the length of the audit relationship on auditor independence is on the rise.

Another of the recommendations of the FRC's Guidance on Audit Committees is that the committee's report should include information about how the committee reached its recommendation on re-appointment (or not) of the company's auditors. With the current regulatory scrutiny on this area, it is not surprising that the percentage of companies giving this detail has increased to 43% (2012: 37%), with 72% (2012: 59%) of the largest 350 companies giving this information. Again, this is an area where we would expect to see an increase in disclosure next year with the adoption of the 2012 Code and guidance.

Another area of responsibility for audit committees is oversight of the provision of non-audit services by the company's auditor. This is discussed in Chapter 14 along with the broader topic of auditor remuneration and independence.

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Highlights:

- 65% of companies presented non-GAAP measures on the face of the income statement (2012: 61%). The use of such measures and the associated disclosures remain an area of focus for regulators.
- 45 companies are voluntarily disclosing either a net debt reconciliation, a reconciliation of cash flows to movement in debt or both. The IASB are considering introducing a requirement for such information.
- Classifying operating expenses using a functional presentation continues to be most popular with 51 companies (2012: 58) doing so.
- 20% of companies with joint ventures account for them using proportional consolidation, an accounting technique which will need to be revisited with the advent of IFRS 11 *Joint Arrangements*.
- Six companies included a statement on taxation governance, with three of these disclosing corporation tax charges or payments to tax authorities that went beyond the requirements of IAS 12 *Income Taxes*.

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Income statements

All companies seemed to meet the requirements of IAS 1 *Presentation of Financial Statements* with regards the minimum line items that must be shown on the face of the income statement. It was noted that there were four companies with interests in associates and joint ventures which were applying the equity method of accounting which did not present the share of the associates' or joint ventures' profit or loss on the face of the income statement (as required by IAS 1). Two companies confirmed that the net income in both the current and prior years was nil. One company explicitly stated that this was due to materiality, while it was assumed – taking into account the rest of the disclosures around the interest in joint ventures – that the second company had also taken this decision on materiality grounds.

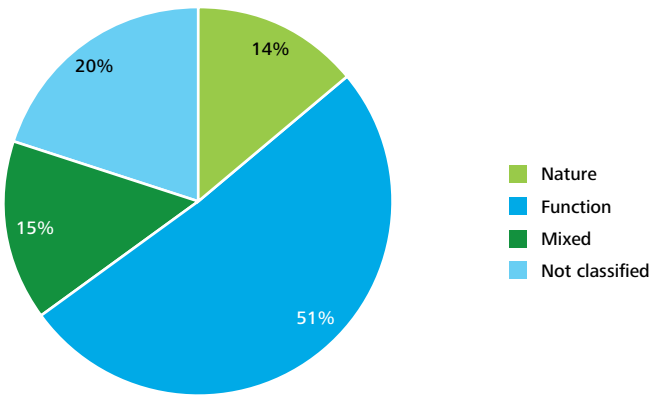
Only 14 companies (2012: 14) presented a combined statement of total comprehensive income, with all others favouring a separate income statement and statement of other comprehensive income. One company stated that there were no items of other comprehensive income and so presented only an income statement. Of those choosing the combined approach, three were in the top 350 group, and the remaining 11 in the other group. Unusually, one IFRS reporter appeared to include a statement of comprehensive income, but labelled it as a consolidated statement of recognised income and expense (SORIE), a term eliminated from IFRSs several years ago.

Many companies continue to make use of IAS 1's flexibility for presenting additional line items, headings and subtotals when such presentation is relevant to an understanding of an entity's performance. The length of the income statement (taking into account all line items down to profit after tax) has remained stable since the prior year, with the shortest being a mere 7 lines, and the longest income statement being 33 lines in length. On average the length was 15 lines. The range of length was similar across both the top 350 and the other group.

IAS 1 requires companies to present an analysis of expenses recognised in profit or loss using a classification based on either their nature or their function within the company; IAS 1 encourages companies to present this analysis in the statement presenting profit or loss and other comprehensive income (rather than in the notes). Consistent with previous years, the most popular presentation of expenses is classification by function (where line items such as cost of sales are disclosed), with 51% of companies (2012: 58%) choosing this presentation, as shown in figure 13.1.

While presentation of expenses by function (classification as cost of sales, administrative expenses etc.) continues to be popular, 15% of companies (2012: 19%) expand on this basic presentation by splitting out some items by their nature, such as amortisation or impairments – this is the 'mixed' classification below. A 'mixed' classification could be challenged on the grounds that IAS 1 requires presentation by nature or function.

Figure 13.1. How are operating expenses presented on the face of the income statement?



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While presentation by function was a clear preference by the smaller companies (with 65% of the other group adopting it), the presentation chosen by top 350 companies was more varied, with a third choosing function and nearly a third opting not to classify their expenses, instead often presenting just a single line for all operating expenses. The remaining top 350 companies were split fairly evenly between presenting expenses by nature or a mix of nature and function.

Where expenses were not classified on the face of the income statement, most companies included extended presentation of expenses in the notes to the financial statements by nature.

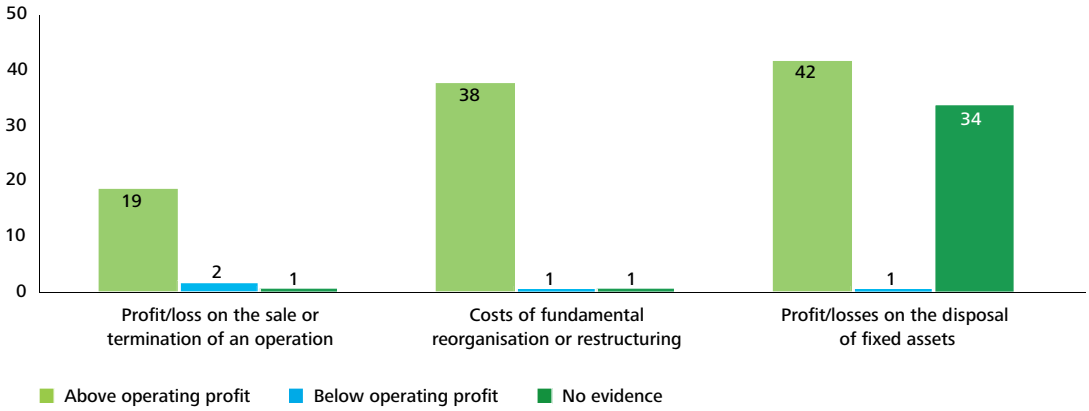
Where the classification of expenses is by function (and, for the purpose of our survey, a mixed classification), companies are obliged under IAS 1 to disclose further information on the nature of expenses in the notes, such as depreciation and staff costs. There were 77 companies to which this applied; all but four of them provided further information on the nature of expenses. One outlier provided a note with select expenses disclosed (such as auditor remuneration and operating lease rentals) but these disclosures are driven by other requirements within IFRSs and UK company law and so it was considered that they had not clearly met this IAS 1 disclosure requirement. Another outlier possibly excluded further analysis on materiality grounds, given the value of expenses was so small and most of the charges to profit or loss were in relation to movement in investment property.

Operating profit

Under UK GAAP a company must include a subtotal for operating profit, and bearing in mind IAS 1's flexibility around presenting additional line items, this has remained a popular subtotal for inclusion within the consolidated IFRS financial statements sampled. 93% of companies (2012: 94%) presented some form of operating profit line, and of these, 8% (2012: 14%) used a different name, such as trading income. Of those companies not disclosing an operating profit line, four were from the top 350 group and three from the other group. In both groups, these companies were from a variety of industries.

Another hang-over from UK GAAP reporting is the presentation of specified items (defined under UK GAAP as "exceptional items") below operating profit. These are: profit or loss on the sale or termination of an operation (which do not qualify as a discontinued operation); costs of fundamental reorganisation or restructuring; and profit or losses on the disposal of fixed assets. Figure 13.2 shows how these items were presented, highlighting that, on the whole, companies are choosing to classify these within operating profit, rather than retain the former UK GAAP approach. This is encouraging since the Basis for Conclusions accompanying IAS 1 indicates that if such a measure is presented it would be misleading to exclude items 'of an operating nature' such as inventory write-downs, restructuring and relocation expenses.

Figure 13.2. Where are the following items presented?



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Non-GAAP performance measures

IAS 1 only has a few minimum line items required to be shown on the face of the income statement. As such, companies have a relative amount of freedom in how they present the profit or loss from their operations and the components that comprise it. Non-GAAP measures are those which are shown on the face of the income statement yet not defined as a particular reporting measure under IFRSs and for the purposes of this survey exclude operating profit (discussed above). These measures could therefore be open to manipulation, to an extent, by the preparers of financial statements to present a more positive view of an entity's results, even though the bottom line profit or loss after tax will remain the same.

Presentation of non-GAAP measures remains a hot topic for the FRC's Conduct Committee, which is looking both at those measures which are disclosed in the narrative reporting and those which are disclosed in the financial statements. It is understood that the European Securities and Markets Authority (ESMA) also plan to update their guidance from 2005 on the presentation of alternative performance measures and preparers would do well to keep their eyes peeled for this in light of the scrutiny such measures are attracting from regulators.

One challenge that arises is where non-GAAP measures presented are different to how information is reported internally to management (as disclosed in the IFRS 8 *Operating Segments* note – see chapter 14) – this raises questions over why information is presented to investors in a different way to how it is presented to management. Companies should ensure that non-GAAP measures presented in the financial statements are in line with not only those non-GAAP measures included in the narrative reporting (discussed in chapter 6), but also in line with any disclosure of adjusted measures within the IFRS 8 note. This kind of joined up thinking is what helps produce the best annual reports.

The Conduct Committee also consider the consistent application of non-GAAP measures year on year. For example, it would not be considered appropriate to strip out from underlying results an impairment charge in one year, thus improving the underlying results, yet include within underlying results the corresponding credit to the income statement if the charge were to be reversed in a future period.

65% of companies (2012: 61%) presented non-GAAP measures on the face of their income statement. An equal proportion of companies within the top 350 and the other group presented such measures.

The majority of companies presenting non-GAAP measures (85%) defined the measure used (or, at least, the items stripped out from the measure), usually within the accounting policies note. Definitions commonly indicated that the items stripped out required separate presentation from the remaining results of the group due to their one-off nature and that this this would allow users of the financial statements to better understand the elements of financial performance in the period and enable comparison with prior periods.

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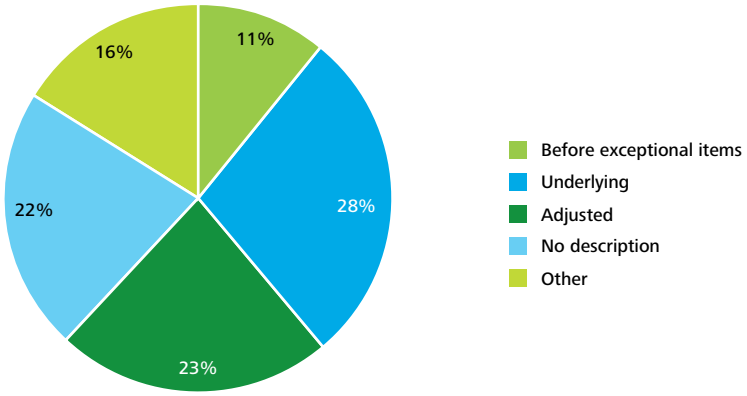
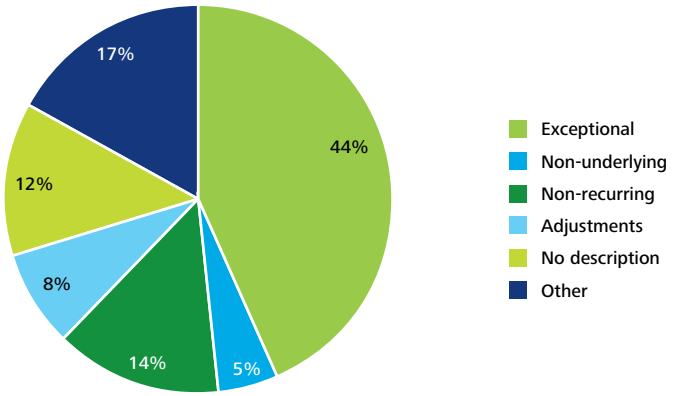
The labelling of the non-GAAP measures was fairly mixed (see figure 13.3), with "Underlying" earnings being the most common description of the measure.

Figure 13.3. How are the non-GAAP performance measures broadly described?



The items that were stripped out to calculate the non-GAAP measures, however, were described slightly differently. The most common description of items being stripped out was "Exceptional", as shown in figure 13.4.

Figure 13.4. How are the excluded items broadly described?



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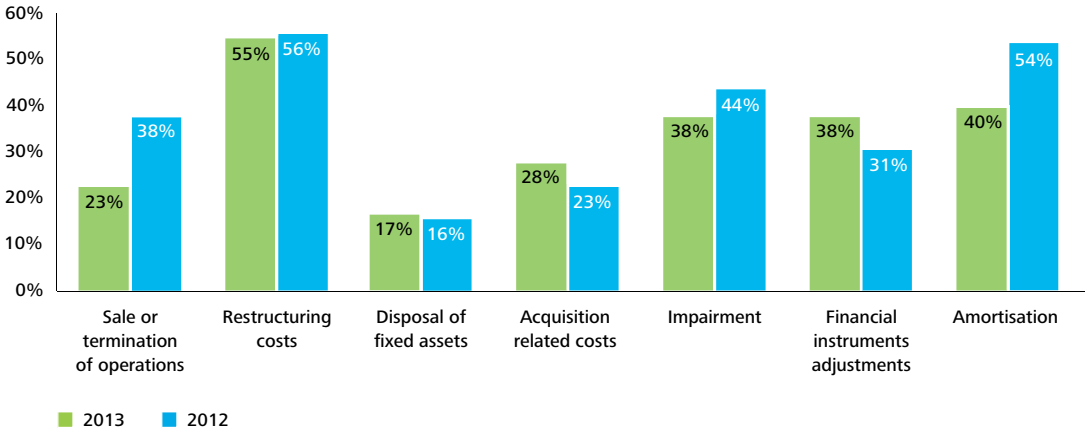
Common presentation of the non-GAAP measures include the use of an additional column (39% of companies chose this), inclusion of a removable box on the face of the income statement (25% adopting this presentation) or simply inserting additional lines (19%). Where companies presented more than one non-GAAP measure, a combination of these presentation styles was often adopted, with 13% of companies presenting non-GAAP measures doing so.

As noted above, companies chose to strip out items that were often considered to be one-off in nature, or those which were not directly related to the daily operations of the group per se. As in prior years, the most popular items being stripped out were costs relating to restructuring or fundamental re-organisation, with 55% (2012: 56%) of companies presenting non-GAAP measures excluding such costs.

Figure 13.5. What do non-GAAP measures strip out?



In 2013 it was also noted that many companies (29%) presenting non-GAAP measures stripped out one-off provisions, or releases of provisions, often in relation to onerous leases.

Where non-GAAP measures were presented in a separate column, it was common for entities also to include the tax impact of the excluded items within the tax expense line; this tax effect has been excluded from the analysis above as those entities presenting the measures as additional line items or in a removable box did not include the tax impact on the face of the income statement.

One company presented an additional disclosure entitled "Reconciliation of adjusted financial measures" and gave this equal prominence to the other primary statements although did state that it was not a primary statement. While it is important to ensure that any non-GAAP measures referred to in either the narrative reporting or else within the financial statements are appropriately reconciled to the statutory information, it is questionable whether giving such prominence to adjusted measures is appropriate or provides a fair and balanced view. On the other hand, the fact that all adjusted measures were presented separately from the income statement could be said to add clarity and transparency.

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Share of results of associates and joint ventures

46 companies within the survey had interests in associates and joint ventures which were accounted for using the equity method. IAS 1 requires that the share of the profit or loss of these associates and joint ventures be presented on the face of the income statement in a separate line, although there is no specific requirement as to where above 'profit for the period' this should be presented. All of these companies except for four presented such a line. Of the outliers, two disclosed in the notes that the net profit was nil in the current and prior years and one confirmed that no disclosure was made in relation to the relevant associate's results as they are highly immaterial. The fourth entity did not explicitly provide a reason for not presenting a separate line on the face of the income statement, but disclosed in a note the profit from its jointly controlled entities and that it was presented within operating profit; we assume that the value of this was considered to be immaterial.

A new accounting standard, IFRS 11 *Joint Arrangements*, replaces the existing accounting standards for joint ventures and for those reporting under EU-endorsed IFRSs is effective for periods beginning on or after 1 January 2014. The two main changes brought in by IFRS 11 are:

- joint arrangements are now categorised by focusing on the rights and obligations of the parties to the joint arrangement, whereas previous accounting was driven by the structure of the joint arrangement; and
- the choice of accounting method for jointly controlled entities is removed under IFRS 11 – the equity method is required for all joint ventures, and proportionate consolidation is not permitted.

41 companies had evidence of interests in joint arrangements within the financial statements. Of these, eight chose to account for them using proportionate consolidation, albeit one described their investment as being in a joint operation (rather than joint venture). Four of the eight had also identified that the forthcoming adoption of IFRS 11 (which none had adopted early) would have a significant impact on the financial statements (see chapter 14 for more detail).

Another two companies had evidence of interests in joint ventures yet it was not clear what their accounting policy was as there was no clear policy disclosed. The remaining entities chose to equity account for their interests in joint arrangements.

Tax

The matter of companies' tax charges – particularly large companies with international operations – and the jurisdictions in which the company actually makes corporation tax payments has become a hot topic within the UK press recently. Perhaps in response to this, of the companies surveyed, six provided a statement on tax strategy, or a summary of the company's principles with regards taxation. An example of this is from BT Group plc's Annual Report & Form 20-F 2013. All of these six companies were in the top 350 group and all of these disclosures were located in the front half of the annual report.

Three of these six companies went on to provide an explanation of corporation tax charges or payments to UK or global tax authorities that went beyond the requirements of IAS 12 *Income Taxes*, and also quantified the total tax payments they make on their own account or on behalf of others to UK or global tax authorities. An example of the latter is taken from Greene King plc's Annual report 2013 where they quantified tax payments above those solely relating to corporation tax.

Tax strategy

Our aim is to comply with relevant regulations. We try to structure our affairs in a tax efficient manner where this is a consequence of our operating activities and has underlying commercial substance, with the aim of supporting our capital or operational expenditure programmes and customer service initiatives. The Board sets the parameters which govern our approach and regularly reviews our tax strategy.

We operate in more than 170 countries and this comes with additional complexities in the taxation arena. The majority of our tax liabilities arise in the UK. In terms of our UK corporation tax position, all years up to 2010 are substantially agreed.

We have an open, honest and positive working relationship with HMRC and are committed to prompt full disclosure and transparency in all tax matters. We recognise that there may be areas of differing legal interpretations between ourselves and tax authorities. Where this occurs we will engage in proactive discussion to bring matters to as rapid a conclusion as possible.

BT Group plc Annual Report & Form 20-F 2013

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One other company provided an explanation of their effective corporation tax rate that went beyond the requirements of IAS 12 as their effective tax rate was nearly 196%, so significant detail was included.

Tax

The effective rate of corporation tax (before exceptional items) was 24% compared to 25% in the previous year, resulting in a charge to operating profits (before exceptional items) of £38.9m. This is in line with the standard UK corporation tax rate and is expected to remain in line.

However, our full year contribution to HM Treasury was much higher with a total of £375m in total taxes paid or generated (including beer duty, VAT, PAYE etc.). This is equivalent to 31% of our turnover and is seven times the dividends we paid out to our shareholders.

The group's tax policy, which has been approved by the board, is aligned with the business strategy. It seeks to protect shareholder value by structuring operations in a tax efficient manner, while complying with all relevant tax laws and legislation, and fulfilling our obligations as a responsible UK tax payer.

Greene King plc Annual report 2013

Discontinued operations

IAS 1 requires that if there are discontinued operations in the period, the total profit or loss from these discontinued operations must be shown as a single line item on the face of the income statement. The order of the items required to be disclosed on the face of the income statement (as listed in IAS 1:82) suggests that the results from discontinued operations should come below the tax expense line, although this is not an explicit requirement of the standard.

14% of companies (2012: 20%) had clearly identified discontinued operations in the year, and all of these companies complied with the requirement to show the total profit or loss from the discontinued operation as a single line item. Half of these companies were in the top 350 group and half in the other group.

Of the remaining companies, 59% included a clear statement (most commonly on the face of the income statement, but occasionally within the notes) that the results of the group were entirely from continuing operations. The remaining 41% did not clearly state that all operations were continuing, but there were no instances where disclosure in the remainder of the annual report hinted that perhaps there were discontinued operations in the year.

Earnings per share

Companies often present earnings per share (EPS) figures other than those basic and diluted EPS figures required to be presented under IAS 33 *Earnings per Share*. Such figures may be calculated based on a reported component of the statement of comprehensive income, such as the non-GAAP measures disclosed (as discussed above). 62% of companies (2012: 57%) presented an EPS measure based upon an additional measure other than statutory profit after tax. This appeared to be more popular among the larger companies, where 74% of the top 350 presented an adjusted EPS, compared to only 53% of the other group.

IAS 33 specifies that where additional EPS figures are provided, both the adjusted basic and adjusted diluted EPS figures are required to be presented with equal prominence and included in the notes to the financial statements. No reference is made to presentation on the face of the statement of comprehensive income, and it is not clear whether presentation both in the notes and on the face of the statement of comprehensive income is permitted. Of the companies presenting additional EPS figures, 52% presented them on the face of the income statement while the remaining 48% presented them only in the notes to the financial statements.

85% of companies (2012: 82%) presenting an additional EPS measure also presented an additional diluted measure, in line with the requirements of the standard.

IAS 33 requires basic and diluted EPS to be presented for profit/loss for continuing operations, and for the total profit/loss attributable to shareholders. Of those 14 entities with discontinued operations in the year, eight complied with this requirement. Of the remaining companies, five presented a reconciliation on the face of the income statement of EPS from continued and discontinued operations to total EPS and one company did not meet the IAS 33 requirements as it did not disclose a separate EPS from continuing operations only.

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Balance sheet

IAS 1 refers to the "Statement of Financial Position" but allows companies to use alternative terminology and also to determine the order and format of items presented as they see fit. Most companies (77%) continue to refer to a "Balance Sheet", and 80% of companies present net assets followed by total equity (rather than total assets followed by total equity and liabilities). One company presented the information as total assets less current liabilities followed by total non-current liabilities and equity, although they did not disclose why this presentation was adopted. Historically a small number of companies has adopted such an approach and sometimes described such a total of long-term liabilities and equity as 'capital employed'. This company chose not to do so, potentially because items such as retirement benefit obligations were included in their non-current liabilities.

The length of companies' balance sheets has remained stable on prior year, with overall length ranging from 21 to 51 lines (2012: 21 to 51) and an average of 32 lines (2012: 32). The larger the company, the longer the balance sheet, with the top 350 companies averaging 36 lines (2012: 36) and the other group averaging 29 lines (2012: 30).

Nearly all companies presented two balance sheets, with only 1% (2012: 3%) presenting three periods of information due to a prior year restatement that materially impacted the balance sheet in each year. A change to IAS 1, made as part of the 2009-11 *Annual Improvements to IFRSs* and effective for periods commencing on or after 1 January 2013, clarified that a third balance sheet need only be presented if retrospective application, restatement or reclassification has a material impact on that balance sheet. The requirement for related notes to accompany such a third balance sheet was also removed. Whilst many will welcome this change it appears that a lot of companies had already been applying the concept of materiality. Prior year restatements are discussed further in chapter 14.

Cash flow statement

IAS 7 *Statement of Cash Flows* provides guidance and explicit definitions around the classification of cash flows, requiring the cash flows of a company to be classified into operating, investing and financing activities. The FRC's Conduct Committee has indicated that it continues to find possible errors in the classification of cash flows and that this remains an area of focus of their reviews. Certainly, one company surveyed noted that it had made a prior year restatement to reflect the reclassification of cash flows from investing activities to operating activities (see chapter 14 for further discussion on prior year restatements).

IAS 7 gives companies the option of presenting their cash flows from operating activities using either the direct method (whereby major classes of gross cash receipts and gross cash payments are disclosed) or the indirect method (whereby profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows). The direct method is encouraged as it provides information which may be useful in estimating future cash flows and which is not available under the indirect method.

The direct method is encouraged as it provides information which may be useful in estimating future cash flows and which is not available under the indirect method.

Despite this, the indirect method continues to be a clear favourite, with 96% of companies (2012: 98%) choosing this method.

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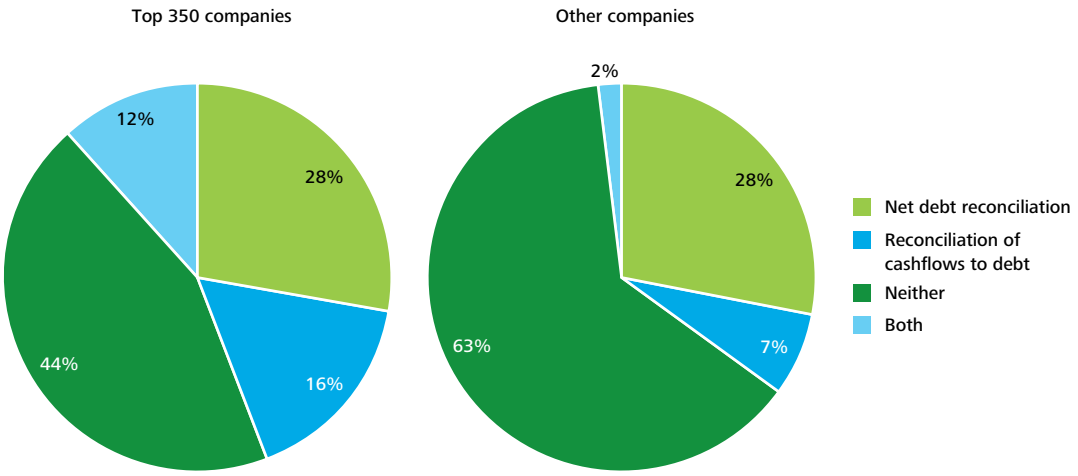
Despite this, the indirect method continues to be a clear favourite, with 96% of companies (2012: 98%) choosing this method. Of these companies, 44% presented the reconciliation of cash flows using the indirect method in a note to the financial statements, rather than directly on the face of the cash flow statement. A likely explanation for the preference for using the indirect method is that its preparation is generally easier than that of the direct method, as non-cash and other relevant items are able to be extracted from the consolidation workings more easily than identifying which cash flows recorded by multiple subsidiaries related to which category of cash flow.

In May 2013, the IASB acknowledged[10] that investors place great reliance upon the disclosure of net debt reconciliations, and as such the IASB will consider including such a reconciliation to be mandatory within IFRS disclosure requirements. The FRC's Financial Reporting Lab also produced a report in September 2012[11] which showed that those companies defining net debt and disclosing various cash and non-cash movements in net debt gives investors confidence that they have understood issues related to the development of financial obligations that must be met, and issues relating to the capital structure and the enterprise value attributable to net debt versus shares.

Of the companies surveyed, 45 are already disclosing either a net debt reconciliation (which reconciles opening to closing debt), a reconciliation of cash flows (which reconciles cash flows to movement in debt) or both. A split between the top 350 and the other group is shown in figure 13.6 which indicates that disclosure of such information is more common among the larger companies.

Figure 13.6 Has the company disclosed further information around debt?



10 This was disclosed in the IASB's Feedback Statement to their Discussion Forum-Financial Reporting Disclosure which can be found at: http://www.ifrs.org/Alerts/PressRelease/Documents/2013/Feedback-Statement-Discussion-Forum-Financial-Reporting-Disclosure-May-2013.pdf

11 The Lab's report can be found at:

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Parent company reporting

Listed companies are required by UK company law to present IFRS consolidated financial statements, but they have a choice as to whether to present the parent's separate financial statements using IFRSs or UK GAAP. Of the companies surveyed, 55 (2012: 60) chose IFRSs to prepare the separate financial statements and the remaining 45 (2012: 37) used UK GAAP. In 2012, of the remaining three companies, one had no subsidiaries so just presented single entity IFRS financial statements, while the other two were incorporated in Jersey and did not include separate financial statements in their group's annual report. This slight change in statistics is due to the underlying sample population changing slightly year on year (see chapter 4 for detail). Those parent entities preparing separate financial statements under UK GAAP will want to consider carefully their options for reporting frameworks going forward, with new UK GAAP (FRSs 100-102) becoming effective for periods commencing on or after 1 January 2015. FRS 101, the reduced disclosure framework, may prove a popular choice for such entities given that it is based upon IFRSs, but with exemptions offered for certain disclosures.

UK company law also provides an exemption from publishing a parent's company-only income statement/profit and loss account; 96 companies (2012: 92) took advantage of this exemption. The legal exemption is not clear as to whether it extends to the statement of other comprehensive income (for IFRS reporters) or the statement of total recognised gains and losses (for UK GAAP reporters). Of those companies taking advantage of the exemption, seven (2012: nine) presented a separate company-only statement of other comprehensive income/statement of total recognised gains and losses. Unusually, one IFRS reporter taking advantage of the exemption and not presenting a parent company-only income statement presented a parent statement of comprehensive income, yet labelled it a "statement of recognised income and expense", a term eliminated from IFRSs several years ago.

It was most common for companies to present the consolidated group financial statements and the parent company-only financial statements separately from one another, with 53 companies choosing to do so (2012: 54). Of those companies choosing to present the consolidated group financial statements and the parent company-only financial statements together, 57% combined the primary statements of each on the same page, whereas 43% presented the primary statements on adjacent pages.

Pro forma information

'Pro forma information' is usually a label applied to financial information which reflects a proposed change (such as a merger or acquisition) or else which is prepared in order to emphasise certain figures or results.

Seven companies included pro forma information within the annual report. Of these, three companies presented the pro forma information in the front half of the report within the narrative reporting. One bank calculated a pro forma post-tax profit number to aid its comparison of profits to dividends and variable pay; a second bank used a pro forma capital position to show compliance with new EU requirements for managing capital; the third company (not a bank) produced pro forma information to enable more meaningful comparison year on year without the impact of a significant acquisition.

Of the remaining four companies presenting pro forma information in the back half of the annual report (either as part of or straight after the financial statements), two sets of information had been audited. In one case this was an adjusted EPS measure which had been reported in the prior year to show the EPS value without a particular entity which was subsequently demerged. In the other instance this information consisted of certain primary statements for a consolidation of certain group entities which guarantee some of the group's listed debt.

Of the other two companies disclosing unaudited pro forma information, one produced "normalised results" excluding revenue and costs from activities closed or divested in the period while the other produced 12-month comparatives, as the comparative statutory period had actually been 14 months in length.

Seven companies included pro forma information within the annual report.

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Auditors' reports

In June 2013 the FRC issued revisions to ISA (UK and Ireland) 700 "The Independent Auditor's Report on Financial statements." The revisions require auditors reporting on companies which comply with the UK Corporate Governance Code to provide significantly increased disclosure around the work that they have performed on the audit and are a move away from the traditional binary pass/fail model of the past, and are effective for the audits of financial statements for periods commencing on or after 1 October 2012. This move towards more transparency requires auditors to disclose more information around key audit risks, the application of materiality and the scope of the audit.

Of the 55 IFRS parent company reporters, the scope of the auditors' reports covered both the consolidated group and parent company-only financial statements for 95% of companies (2012: 88%). Interestingly, 31% of companies (2012: 24%) where parent company-only financial statements were prepared under UK GAAP also had combined auditors' reports which covered both the consolidated group and parent company-only financial statements even though they were prepared under different financial reporting standards.

Out of the entire sample there were no qualified audit opinions, although two companies had an emphasis of matter paragraph included by the auditors which highlighted potential issues around the use of the going concern assumption (2012: three) which is discussed further in chapter 10.

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Highlights:

- 90% of companies continue to present accounting policies straight after the primary statements, but 4% have adopted innovative placement techniques for accounting policies, such as relegating them to an appendix, or else including them throughout the notes.
- No companies disclosed that they had adopted any IFRSs early, but of those noting material impacts of future standards, IAS 19 (2011) Employee Benefits was the most common standard.
- 72% of companies (2012: 75%) still do not differentiate between critical judgements and key sources of estimation uncertainty, simply presenting a combined list of the two.
- The combined number of critical judgements and key sources of estimation uncertainty disclosed has remained static on prior year, with the largest number being 13 and the average being five.
- An average of three operating segments was disclosed with 13 companies (2012: 11) only identifying one reportable segment.
- 81% of companies (2012: 74%) with goodwill disclosed the allocation of goodwill to the underlying cash-generating units (CGUs); the average number of CGUs identified to which goodwill had been allocated was four.
- 80 companies (2012: 82) recognised an impairment loss in the year, with financial assets (including trade receivables) being the most common items.
- 93 companies included disclosure around capital management, or capital risk management, within the financial statements.

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The notes to the financial statements provide the detail required to give a complete picture of the company's performance in the year and its position at the year end. Since 2009 there has been significant discussion of how financial statements appear to be getting longer each year, how disclosure requirements are in many people's eyes becoming more onerous and overall the financial statements are becoming more difficult for the lay reader to digest. The debate quickly became known as the 'cutting clutter' debate, as its primary focus has been on trying to identify not only the drivers of increasing disclosure, but also ways in which 'clutter' can be removed from the financial statements. Despite this, some investors[12] have said that in fact they already have the tools they need to cut through the clutter and that the presentation and transparency of financial statements is more of a problem than the volume of disclosures. Regardless, a shared goal is to make financial statements more user-friendly and for the most important information within to be readily identifiable and understandable.

One key conclusion emerging from the cutting clutter debate is that too often immaterial disclosures are included within the financial statements, thus 'cluttering up' the financial statements and making it more difficult for users to identify the information that really matters. The IASB have acknowledged this[13] and intend to provide extra guidance around the application of materiality, as well as considering whether to clarify the requirements of IAS 1 to provide disclosures only where information is material. Equally, the FRC and their Conduct Committee are keen to promote the message that they do not expect companies to disclose immaterial information. These aims are in direct alignment with the goals of the new strategic report, discussed in chapter 7.

Despite the understandable caution from preparers and perhaps their auditors it is good to see that some companies are being bold in this area and – presumably – identifying those items which are immaterial to the financial statements and not including reams of disclosures around these. For example, one company held investments in associates and joint ventures on their balance sheet totalling £28m, yet there was not a supporting accounting policy or note providing further information. Given that non-current assets alone totalled £20.2bn, in all likelihood it is appropriate to assume that these disclosures were not considered to be material. Similarly, one company held goodwill of £1.5m on its balance sheet yet had no further disclosure around this; given the company had total assets of £875m, again it can be assumed that the goodwill balance was considered to be immaterial.

Some companies are explicitly stating that immaterial items have not been disclosed in the current year, such as BT Group plc in their Annual Report & Form 20-F 2013:

> In addition, following the Financial Reporting Council's objective of cutting clutter from financial statements, separate non-controlling interests disclosures have been removed from the group's consolidated financial statements and the related notes because they are immaterial; non-controlling interests represent profit for the year of £2m (2011/12: £1m, 2010/11: £2m); total comprehensive income for the year of £3m (2011/12: £2m, 2010/11: £2m); and total equity in the balance sheet of £14m (2011/12: £11m equity).

BT Group plc Annual Report & Form 20-F 2013

12 CFA Institute survey – http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2013.n12.1
13 This was disclosed in the IASB's Feedback Statement to their Discussion Forum-Financial Reporting Disclosure which can be found at: http://www.ifrs.org/Alerts/PressRelease/Documents/2013/Feedback-Statement-Discussion-Forum-Financial-Reporting-Disclosure-May-2013.pdf

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Order of notes

While there are certain set rules around presentation of the primary statements (see chapter 13), a company has more freedom in presenting the notes to the financial statements, with only a few IFRSs dictating presentation of information (such as IFRS 7 *Financial Instruments: Disclosures'* requirements for some information to be shown in tabular format). IAS 1 simply requires companies to present notes in a systematic manner and to cross-reference them to the relevant item on the primary statements.

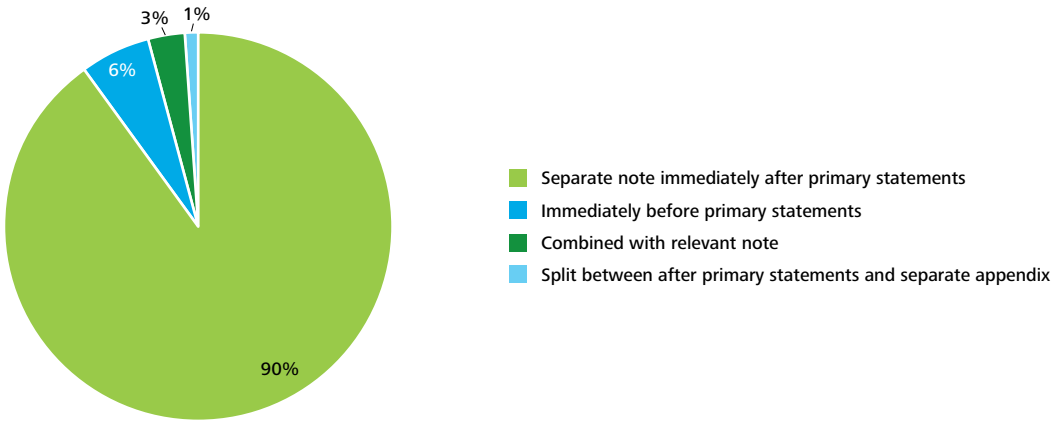
The ordering of notes is also an important consideration. While historically most companies have followed the order that the relevant balance appears on the face of the income statement or balance sheet, now some companies are becoming more innovative in their approach. An example of this is Barclays PLC which identified different categories of financial information (Performance, Assets and liabilities held at fair value, Financial instruments held at amortised cost, Employee benefits, Accruals, provisions, legal proceedings and contingent liabilities etc.) and groups its notes within these categories. Pendragon PLC provide another example of notes being divided into different sections (being Results and trading, Operating assets and liabilities, Financing activities and capital structure, Pension schemes and Other notes), facilitating navigation through the financial statements and making the information more easy to digest.

A slightly different, innovative approach to ordering was adopted by BAE Systems plc's Annual Report 2012 whereby the notes were placed in between the primary statements themselves, depending on which primary statement the note related to. Splitting up the primary statements and placing them throughout the financial statements is unusual as traditionally the primary statements are presented together. It will be interesting to see if users find that this approach improves their ability to navigate through the financial statements.

Accounting policies

Presenting the accounting policies in a separate note immediately after the primary statements remains the most popular choice by companies, with 90% choosing to do so.

Figure 14.1. How are the accounting policies presented?



It is the larger companies who are leading the way in beginning to challenge the presentation of accounting policies by adopting innovative presentations, such as presenting the accounting policy with the relevant note, or presenting key accounting policies up front and then relegating the others to an appendix at the end of the financial statements. Only one company from the other group presented their accounting policies somewhere other than immediately after the primary statements in a separate note. The FRC's Financial Reporting Lab has also undertaken a project aimed at providing insight on effective approaches to disclosing accounting policy information, the ordering of footnotes within financial statements, and the linking or integrating of related information on policies and their application. The Lab's report is due out before the end of 2013.

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ITV plc were particularly innovative in their Annual Report and Accounts 2012 by grouping their notes in a manner similar to Pendragon PLC (see above), placing the accounting policy within the relevant note, and then including an explanatory "Keeping it simple" box which provided an explanation in layman's terms of what the item of the note was.

Where accounting policies are presented in a separate note, the length of the policies was similar to last year, varying from two and a half to 19 pages (2012: two to 18) and averaging six. The longest accounting policies are presented by one bank in the top 350 group and skews the overall results somewhat. Excluding this bank, page length ranged from two and a half to twelve pages, and averaged six; there was no noticeable difference in lengths between the top 350 and the other group.

3.6 Provisions

Keeping it simple . . .

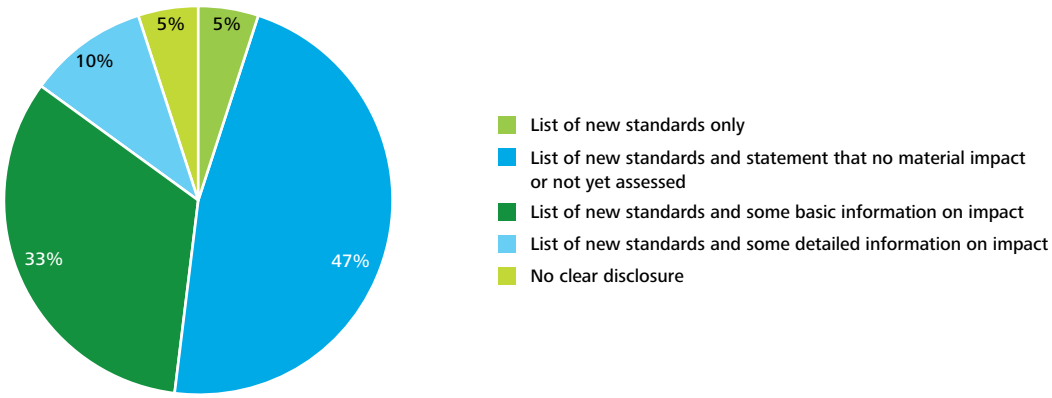
A provision is recognised by the Group where an obligation exists, relating to events in the past and it is probable that cash will be paid to settle it.

A provision is made where the Group is not certain how much cash will be required to settle a liability, so an estimate is required. The main estimates relate to the cost of holding properties that are no longer in use by the Group, the likelihood of settling legal claims and contracts the Group has entered into that are now unprofitable.

ITV plc Annual Report and Accounts 2012

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires companies to disclose whether there have been any changes in accounting policy during the year, such as adopting a new reporting standard. Compared to companies' narrative reporting, it seems that there is less appetite to look to the future when it comes to financial reporting: no companies at all disclosed that they had adopted any new standards earlier than necessary during the year (although the largest suite of new IFRSs was not endorsed for adoption in the EU until December 2012, so some companies in our sample could not have adopted them early). However, when a company has not applied a new IFRS that has been issued but is not yet mandatorily effective, this must be disclosed along with any known or reasonably estimable information relevant to assessing the possible impact that application will have on the company's financial statements. Figure 14.2 shows the level of compliance with this disclosure requirement.

Figure 14.2. How detailed are the disclosures regarding standards in issue but not yet effective?



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Although only 10% of companies provided some detailed information on the impending standards' impacts, there appears to have been some improvement on last year: 43% of companies (2012: 21%) provided a list of new standards with some basic or detailed information on their impact. This is likely to be due to the increase in number of standards which were endorsed for use in the EU in the year. Of those companies identifying significant impacts upon future adoption of particular standards, the most common was IAS 19 (2011) *Employee Benefits* (see below). Four companies identified IFRS 9 *Financial Instruments*, four companies identified IFRS 11 *Joint Arrangements*, and another four identified IFRS 10 *Consolidated Financial Statements* as being likely to have a significant impact on the financial statements. As the various instalments of IFRS 9 continue to be published by the IASB one would expect the number of companies identifying this as a standard with a significant impact to increase.

Although only 10% of companies provided some detailed information on the impending standards' impacts, there appears to have been some improvement on last year: 43% of companies (2012: 21%) provided a list of new standards with some basic or detailed information on their impact.

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One of the more useful disclosures in this area was in Vodafone Group Plc's Annual Report for the year ended 31 March 2013. Not only was a comprehensive list of standards in issue but not yet effective provided, the impact of these standards was then provided in significant detail, as the extract below demonstrates.

For periods commencing on or after 1 April 2013, the Group's financial reporting will be presented in accordance with the new standards above. Except for IFRS 11 and the amendments to IAS 19, these pronouncements are not expected to have a material impact on the consolidated results, financial position or cash flows of the Group. The impact of restating key financial information for the impact of IFRS 11 and the amendments to IAS 19 for the year to 31 March 2013 is described below:

Consolidated income statement and statement of comprehensive income for the years ended:

	2013			2012		
	As reported £m	Adjustments £m	New basis £m	As reported £m	Adjustments £m	New basis £m
Revenue	44,445	(6,404)	38,041	46,417	(7,596)	38,821
Gross profit	13,940	(2,466)	11,474	14,871	(3,251)	11,620
Share of results of equity accounted associates and joint ventures	6,477	520	6,997	4,963	1,033	5,996
Operating profit	4,728	(508)	4,220	11,187	(702)	10,485
Profit before tax	3,255	(372)	2,883	9,549	(561)	8,988
Profit for the financial year	673	(16)	657	7,003	(9)	6,994
Other comprehensive income	76	16	92	(4,653)	9	(4,644)
Total comprehensive income	749	–	749	2,350	–	2,350

Consolidated statement of financial position at:

	2013			2012		
	As reported £m	Adjustments £m	New basis £m	As reported £m	Adjustments £m	New basis £m
Non-current assets	119,411	(2,736)	116,675	119,551	(3,132)	116,419
Current assets	23,287	(1,672)	21,615	20,025	(994)	19,031
Total assets	**142,698**	**(4,408)**	**138,290**	**139,576**	**(4,126)**	**135,450**
Total equity	72,488	–	72,488	78,202	–	78,202
Non-current liabilities	38,986	(1,519)	37,467	37,349	(1,724)	35,625
Current liabilities	31,224	(2,889)	28,335	24,025	(2,402)	21,623
Total equity and liabilities	**142,698**	**(4,408)**	**138,290**	**139,576**	**(4,126)**	**135,450**

Consolidated statement of cash flows for the year ended:

	2013			2012		
	As reported £m	Adjustments £m	New basis £m	As reported £m	Adjustments £m	New basis £m
Net cash flow from operating activities	10,694	(1,870)	8,824	12,755	(2,458)	10,297
Net cash flow from investing activities	(7,398)	1,652	(5,746)	3,843	2,738	6,581
Net cash flow from financing activities	(2,956)	213	(2,743)	(15,369)	(300)	(15,669)
Net cash flow	**340**	**(5)**	**335**	**1,229**	**(20)**	**1,209**

Vodafone Group Plc Annual Report for the year ended 31 March 2013

Critical judgements and key sources of estimation uncertainty

The preparation of financial statements inherently requires significant judgement and a number of assumptions to be made, even for entities with relatively simple business models. IAS 1 requires companies to disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

These judgements and estimates are of considerable interest to many stakeholders, including regulators, given that they can have significant impacts on a company's financial statements and, by their very nature, the risk of manipulation attached to them. The attention these disclosures are likely to attract will only increase going forward given that similar matters will now be discussed in audit committee reports (see chapter 12) and auditor's reports for periods commencing on or after 1 October 2012. It will be important for preparers to tell a consistent story in this regard, linking in with the principal risks and uncertainties where appropriate.

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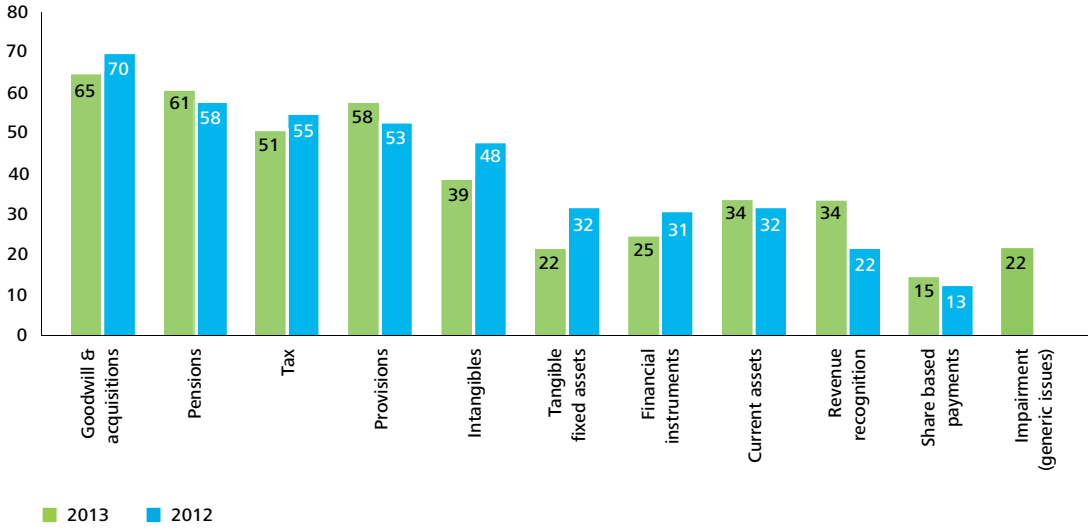
Although usually considered by companies to form part of the accounting policies, a number of companies presented their critical judgements and key sources of estimation uncertainty within a separate note at the end of the financial statements. This is a slightly unusual placement given their importance and the fact that by that stage a user of the financial statements may only find this note having already reviewed the other information. One company presented its consideration of critical judgements and key sources of estimation uncertainty within their Financial Risk Management disclosures – usually made in relation to financial instruments – which was considered also to be unusual.

72% of companies (2012: 75%) did not differentiate between critical judgements and key sources of estimation uncertainty, but simply presented a combined list of the two. For some the distinction between these two disclosures may not be clear: an example of a critical judgement could be the timing of revenue recognition, whereas forecasting future cash flows as part of a goodwill impairment test could be a key source of estimation uncertainty. 2% of companies disclosed information only about either critical judgements or key sources of estimation uncertainty but without mentioning the other.

The combined number of critical judgements and key sources of estimation uncertainty disclosed has remained static on prior year, with the largest number being 13 and the average being five. The average for the top 350 group was six and for the other group was five, thus implying that the size of a company does not necessarily dictate the level of judgements and uncertainty that may be seen as being the most important.

Six companies (three from the top 350 and three from the other group) stated that there were no critical judgements applied by the directors in preparing the financial statements; one of these companies also, perhaps boldly, indicated that there were no key sources of estimation uncertainty either. Another company also referred specifically to sources of estimation uncertainty, but disclosed none in particular, instead stating merely that these form the basis of judgements applied.

Figure 14.3. How many companies include the following items as critical judgements or key sources of estimation uncertainty?



The underlying pattern of areas common to a majority of companies remains the same as last year, with goodwill and acquisitions, pensions, tax and provisions being the most common areas of judgement and estimation uncertainty. In this year's survey, the number of companies identifying generic issues around impairment has been identified separately and accounts in part for the seeming fall in number of companies identifying items such as goodwill, intangibles and fixed assets as problem areas.

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A lot of the commonly identified areas of judgement and estimation involve the use of fair value techniques and discounted cash flow calculations, thus indicating that these are top of the list of preparers' concerns.

In 2012, three companies identified the application of the going concern basis of accounting as being a critical judgement or key source of estimation uncertainty; in 2013 this has fallen to only two. Unexpectedly, perhaps, neither of these two companies were those that had received an auditor's report containing an emphasis of matter paragraph relating to going concern.

43 companies identified issues other than those noted in figure 14.3 as being critical judgements and key sources of estimation uncertainty. Common themes emerging include the valuation of investment property, the measurement of contingent consideration and impairment of carrying values in investments in group entities (in the parent company-only accounts).

Preparers of financial information have a good opportunity to tailor these disclosures directly to the company's circumstances, rather than merely repeat a boiler-plate list of items. It was curious, therefore, as to why one company disclosed that impairment of CGUs containing goodwill is a key judgement when there was no disclosure of goodwill being held at either the current or prior year ends.

A lot of the commonly identified areas of judgement and estimation involve the use of fair value techniques and discounted cash flow calculations, thus indicating that these are top of the list of preparers' concerns. This is perhaps unsurprising given the significant changes in the economic environment over recent years that would directly impact inputs into such models (for example, discount rates). For reporting periods commencing on or after 1 January 2013, IFRS 13 *Fair Value Measurement* will be the new standard that governs many such fair value techniques and may bring new challenges and increased disclosures for preparers to consider.

Revenue recognition

Revenue is arguably one of the most important balances within the financial statements for investors; certainly it commonly attracts a lot of attention and discussion. The IASB continues its work on a new Revenue standard, with the new standard expected in the second half of 2013. The FRC's Conduct Committee has also indicated that revenue recognition continues to be an area of focus for its review, particularly where there has been a change in the company's business model (in which case it is not unreasonable to assume that the revenue recognition policy may need to be revised). Despite this importance, the revenue balance has surprisingly little disclosure within the financial statements, often only being disclosed as one number on the face of the income statement and then split out by segment in the IFRS 8 note.

The length of the revenue recognition policy is not a direct measure of its quality, but it is less than encouraging to see that the number of companies with policies less than 50 words in length has increased on last year, with nine companies identified this year (2012: eight). Perhaps unusually, given the size of a company may suggest more complex processes and policies, six of these entities were within the top 350 group.

Those entities with lengthier policies (defined as being over 250 words) were split evenly between the top 350 group and the other group.

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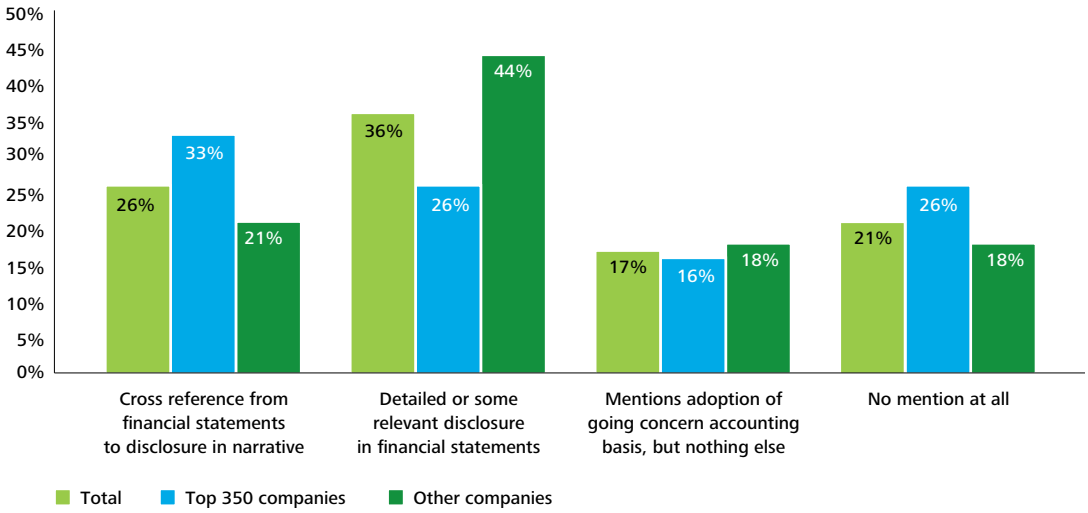
Going concern

The requirements for disclosure around going concern within the annual report are discussed in detail in chapter 10.

Figure 14.4. How detailed are the going concern disclosures in the financial statements?



The majority of companies (62%) included either some detailed or relevant disclosure around going concern within the financial statements or else a clear cross-reference to relevant disclosure in the narrative reporting. 17% stated that the financial statements were prepared on a going concern basis, yet did not expand on this, while the remaining 21% had no mention of going concern at all within the financial statements, contrary to the FRC's 2009 Guidance on Going Concern.

These are surprising statistics, given that 65% of companies surveyed in the 2010 Deloitte survey *Drowning by numbers* that were caught by the 2009 FRC Guidance on Going Concern when it was first published made reference to going concern in their financial statements and one might have expected that this number would have continued to increase year on year, particularly following the Sharman review and the publicity that has surrounded it.

Operating segments

IFRS 8 *Operating Segments* became mandatorily effective in 2009 and brought with it a fundamentally different approach to identifying the components of an entity that are reported in segmental disclosures. Disclosure is driven by the information reported to management, rather than by business or geography.

In July 2013 the IASB published their Post-implementation Review on the standard. This confirmed that the use of the management perspective did make communication by management with investors easier and the incremental costs of the implementation of IFRS 8 were low. The IASB found that there is support for IFRS 8 from preparers, accounting firms, standard setters and regulators. Investors have provided a mixed response, with some preferring to have information about how management views the business (as IFRS 8 requires) but others considering that a segmentation process that is based on management's perspective may be more easily open to manipulation, such as obscuring the entity's true management structure (often as a result of concerns about commercial sensitivity) or by masking loss-making activities within individual segments.

All companies included disclosure around operating segments. IFRS 8 allows entities, subject to certain criteria, to aggregate their identified operating segments to form reportable segments (which are disclosed in the financial statements). 21% of companies (2012: 11%) made reference to aggregation, while 45% of companies indicated that their operating segments directly matched their reportable segments. Seven companies were noted to have changed their operating segments since the prior year and hence provided restated comparative information.

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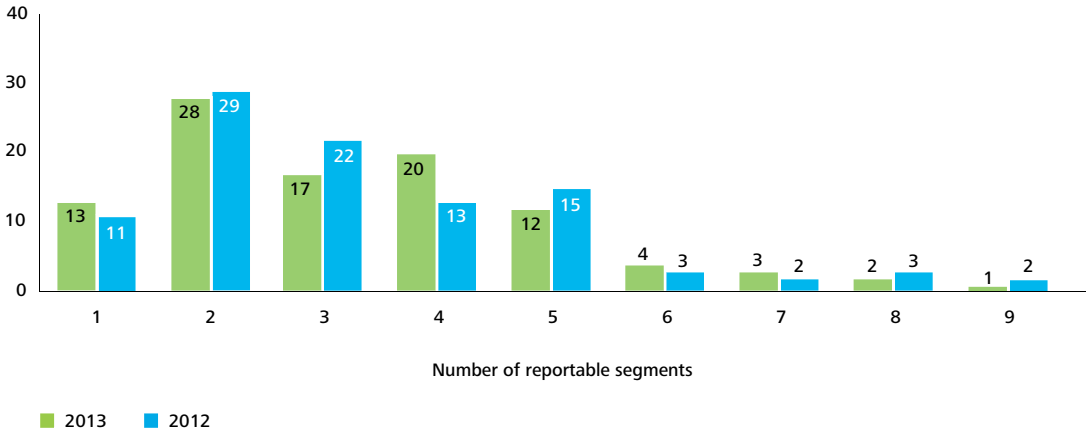
The number of operating segments identified ranged from one to nine (2012: one to nine) with an average of three. Perhaps unsurprisingly, given the larger the company the more complex its operating structure may be, the top 350 group had a higher average number of segments (four) than the other group (three).

Figure 14.5. How many reportable segments were disclosed?



13 companies (2012: 11) only identified one reportable segment, a position that regulators may be tempted to challenge in some circumstances. These companies were concise in explaining why this was so, justifying the decision in an average of 38 words (2012: 47). An example of such concise explanation is taken from Howden Joinery Group Plc's Annual Report and Accounts 2012:

> **5 SEGMENTAL REPORTING**
>
> **(a) Basis of segmentation, and other general information**
>
> Information reported to the Group's Executive Committee is focused on one operating segment, Howden Joinery. Thus, the information required in respect of profit or loss, assets and liabilities, can all be found in the relevant primary statements and notes of these consolidated financial statements.
>
> The Howden Joinery business derives its revenue from the sale of kitchens and joinery products, along with the associated procurement, manufacture and distribution of these products.

Howden Joinery Group Plc Annual Report and Accounts 2012

IFRS 8's description of an operating segment includes the requirement for the component to engage in business activities from which it may earn revenues and incur expenses (including those revenues and expenses relating to transactions with other components of the same entity). However, a corporate headquarters or some functional departments may not earn revenues or may earn revenues that are only incidental to the activities of the entity and so under IFRS 8 would not be operating segments. Despite this, of the companies identifying more than one segment, 13% included an "Other" operating segment (2012: 13%). The lack of clear description of these 'other' segments by some of these companies (for example as a separate operating division which may warrant separate discussion in the narrative reporting) calls into question whether the strict definition of IFRS 8 has been met. If amounts disclosed under such a segment are just there to reconcile to the primary statements, then labelling or describing them as such may be helpful.

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Given IFRS 8's focus on disclosing information that is as reported to the chief operating decision maker, it would not be unreasonable to assume, therefore, that the identification of reportable segments within the financial statements would be the same as how the company and its operations are described in the narrative reporting (aside from any aggregation of operating segments, as noted above). Consistency between the narrative and financial reporting is valuable to ensure that a full picture of a company, its operations and its performance are communicated to shareholders.

The reportable segments disclosed by 24% of companies (2012: 15%) in their financial statements appeared to be inconsistent with how the company analysed their operations in the narrative reporting in the front half of the annual report. A further six companies did not provide any segmental analysis in the front half at all, but did disclose more than one reportable segment in the financial statements.

Defined benefit pension schemes

A revised version of IAS 19 *Employee Benefits* (IAS 19(2011)) is effective for periods beginning on or after 1 January 2013 and its most significant impact is on the accounting for defined benefit schemes. The most significant amendment will require an entity to recognise net interest on the net defined benefit liability (or asset) in its income statement, rather than interest on the obligation and an expected return on plan assets. Because the net interest rate is determined by reference to high quality corporate bonds and the expected rate of return on plan assets would typically have been higher, this change may lead to a negative impact on a company's profit, albeit actuarial gains and losses in other comprehensive income could end up compensating for this. For a smaller number of companies, at least in the UK, other significant changes could include the removal of the 'corridor' approach, which permitted deferral of some actuarial gains and losses, and the removal of an option to present actuarial gains and losses in profit or loss. More extensive disclosure requirements are unsurprisingly included, too.

Of the companies surveyed, 62 had defined benefit schemes. No companies disclosed that they had adopted IAS 19(2011) early, yet two were noted to have adopted "IAS 19 (revised)" which is somewhat unusual as the previous revisions to IAS 19 were effective a number of years ago.

36 companies had identified the impending adoption of IAS 19(2011) as having a significant impact on the financial statements. Two companies were identified as currently using the 'corridor' approach, and both had appropriately considered that the adoption of IAS 19(2011) will have a significant impact on their financial statements.

Defined benefit obligations and other long-term employee benefits should be discounted using a discount rate determined with reference to market yields on high quality corporate bonds. If there is no deep market in such high quality corporate bonds, the market yields on government bonds should be used instead. Of those companies with defined benefit schemes or other long-term employee benefits, 6% provided a description of the discount rate used beyond that which would be obtained on high quality bonds, as shown in the examples below from Howden Joinery Group Plc's Annual Report and Accounts 2012 and HSBC Holdings plc's Annual Report and Accounts 2012. At the time of writing IFRSIC had issued a tentative decision rejecting a request for further guidance on discount rates to be added to their agenda.

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The discount rate used is selected so as to closely approximate the yield at the balance sheet date on AA rated bonds that have maturity dates approximating to the terms of the Group's obligations. Because there are no AA rated bonds with maturity dates which are as long as those of the Group's retirement benefit obligations, the discount rate is derived using the rate of return of zero-coupon Gilts which have the same maturity as the Group's obligations, to which is added a premium which is calculated to account for the difference in risk between Gilts and AA rated bonds. The calculation is performed by a qualified actuary using the projected unit method. Scheme assets are valued at bid price.

Howden Joinery Group Plc Annual Report and Accounts 2012

HSBC determines the discount rates to be applied to its obligations in consultation with the plans' local actuaries, on the basis of current average yields of high quality (AA rated or equivalent) debt instruments, with maturities consistent with those of the defined benefit obligations. In countries where there is not a deep market in corporate bonds, government bond yields have been used. The yield curve has been extrapolated where the term of the liabilities is longer than the duration of available bonds and the discount rate used then takes into account the term of the liabilities and the shape of the yield curve. When determining the discount rate with reference to a bond index, an appropriate index for the specific region has been used.

HSBC Holdings plc's Annual Report and Accounts 2012

The discount rates applied by those companies with defined benefit schemes ranged from 1.8% to 6.3%; the average rate used was 4.3%. Of those defined benefit schemes located within the UK, 97% of companies had used discount rates between 4% and 5%.

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Goodwill and business combinations

As noted above, many companies consider that there are critical judgements to be made around business combination accounting and the initial recognition (and subsequent on-going recognition) of goodwill, and that the related accounting in its nature includes key sources of estimation uncertainty.

39 companies (2012: 31) had business combinations in the year. Of these, 24 were in the top 350 group (2012: 14) and the remaining 15 from the other group (2012: 17). IFRS 3 *Business Combinations* has extensive disclosure requirements where companies have acquired a business during the period. Of those entities with a business combination in the period, 79% (2012: 84%) provided disclosures which were considered to meet all, or nearly all, of the IFRS 3 disclosure requirements. Two companies were determined to have had business combinations during the year, as indicated by snippets of information scattered about the notes to the financial statements, but did not have a separate business combinations note or any clear disclosure confirming such an event or meeting any of the IFRS 3 disclosure requirements.

Given the extensive nature of the disclosure requirements, a good example of a company presenting information in a helpful manner where multiple business combinations have been made is in Pearson plc's Annual report and accounts 2012. By combining the information for multiple acquisitions into one table, the user of the accounts can see at a glance the key financial information:

30. Business combinations continued

Provisional values for the assets and liabilities arising from these and other acquisitions completed in the year together with adjustments to prior year acquisitions are as follows:

							2012	2011
All figures in £ millions	Notes	Certiport fair value	Author Solutions fair value	Global English fair value	Embanet Compass fair value	Other fair value	Total fair value	Total fair value
Property, plant and equipment	10	–	1	–	3	6	10	21
Intangible assets	11	49	35	36	74	86	280	375
Intangible assets – Pre-publication	20	5	–	1	–	–	6	8
Inventories		–	–	–	–	1	1	2
Trade and other receivables		5	8	8	13	–	34	58
Cash and cash equivalents (excluding overdrafts)		2	–	8	18	6	34	151
Financial liabilities – Borrowings		–	–	–	–	–	–	(9)
Net deferred income tax liabilities	13	(20)	(3)	(13)	(21)	(10)	(67)	(96)
Retirement benefit obligations		–	–	–	–	(2)	(2)	(4)
Provisions for other liabilities and charges	23	–	–	–	–	(1)	(1)	(78)
Trade and other liabilities		(11)	(28)	(22)	(26)	(24)	(111)	(115)
Current income tax liabilities		–	–	(1)	–	–	(1)	(2)
Non-controlling interest		–	–	–	–	–	–	(1)
Net assets acquired at fair value		30	13	17	61	62	183	310
Goodwill	11	58	56	46	350	(5)	505	620
Fair value of previously held interest arising on stepped acquisition		–	–	–	–	–	–	(15)
Total		88	69	63	411	57	688	915
Satisfied by:								
Cash		(88)	(69)	(63)	(411)	(51)	(682)	(913)
Deferred consideration		–	–	–	–	(6)	(6)	–
Net prior year adjustments		–	–	–	–	–	–	(2)
Total consideration		(88)	(69)	(63)	(411)	(57)	(688)	(915)

Pearson plc's Annual report and accounts 2012

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The disclosure requirements under IFRS 3 include explaining the primary reasons for the business combination and a qualitative description of the factors that make up any goodwill recognised. A good example of clear explanation of both of these items is from Mondi plc's Integrated report and financial statements 2012:

> **Acquisition of Nordenia**
> On 1 October 2012 Mondi acquired 99.93% of the outstanding share capital of Nordenia from Oaktree Capital Management L.P. and certain other minority shareholders for a cash consideration of €259 million. The acquisition enables the Group to create a leading consumer packaging business.
>
> Nordenia generated operating profits prior to its acquisition by Mondi, but was highly geared and as a result had an equity deficit. The premium of €268 million paid over the fair values of Nordenia's identifiable net assets was recognised as goodwill on acquisition and can be attributed to significant synergies to be realised from combining Nordenia's existing consumer packaging activities with those of Mondi, the ability to leverage Nordenia's existing competencies in high-growth emerging markets, exposure to Nordenia's proven innovation and product development processes and access to Nordenia's long-term relationships with a broad blue chip customer base. It is not expected that any portion of the goodwill will be deductible for tax purposes.

> **Other acquisitions**
> On 2 May 2012, following completion of a number of suspensive conditions, including a ruling from the Arbitration Court of the National Chamber of Commerce in Poland, Mondi Świecie S.A. acquired the entire share capital of Saturn Management Sp. Z o.o. from Polish Energy Partners S.A. for a net cash consideration of €31 million and the assumption of debt of €57 million. The premium of €4 million paid over the acquisition date fair values of the net assets acquired is attributable to expected cost saving synergies. Transaction costs of approximately €1 million were expensed. Saturn Energy is the owner of the power and heat generating plant that provides Mondi Świecie S.A. with most of its electricity requirements and all of its heat and steam needs.
>
> In line with Mondi's existing strategy to strengthen its leading market position in corrugated packaging in central and eastern Europe, Mondi acquired two corrugated box plants in Germany and the Czech Republic, consuming 130,000 tonnes of containerboard per annum, and a 105,000 tonne recycled containerboard mill in the Czech Republic from Duropack GmbH (Duropack) for a cash consideration of €133 million on 5 November 2012. On 19 November 2012 the Group announced its intention to close the recycled containerboard mill. Closure costs of €3 million were recognised in the combined and consolidated income statement.
>
> The premium of the purchase price over the acquisition date fair values of the net assets acquired from Duropack amounted to €84 million and is mainly attributable to synergies expected to be realised from combining the converting activities of the two box plants with the Group's existing operations.

Mondi Group Integrated report and financial statements 2012

On-going recognition of goodwill

IAS 36 *Impairment* requires goodwill to be tested for impairment annually and as part of this has a number of disclosure requirements, as noted below.

Disclosure around impairment continues to be a hot topic for the FRC's Conduct Committee and companies continue to be challenged in this area. Of particular interest to the Conduct Committee is where a value in use model has a 'hockey stick' approach i.e. in the first year (or two) of forecasts, the growth rate is steep, and after this time the growth rate levels down. Arguably this will be due to management basing the value in use model upon their detailed budgets for the first year or so and then simply applying a more modest growth rate, possibly to reflect the fact that detailed strategic decisions that will directly influence growth on a granular level have yet to be determined. Companies should expect to be challenged regarding this.

81 companies surveyed recognised goodwill on their balance sheets at the end of the current reporting period (2012: 81), which under IAS 36 needs testing for impairment annually. Of these, only 81% of companies (2012: 74%) disclosed the allocation of goodwill to the underlying cash-generating units (CGUs), which is a disclosure requirement of IAS 36. Those companies not complying with this disclosure requirement were split evenly between the top 350 and the other group, and most provided a breakdown of goodwill by segment instead (without specifically indicating that perhaps the segments represented the CGUs). The number of CGUs identified to which goodwill had been allocated ranged from one to twelve (2012: one to thirteen).

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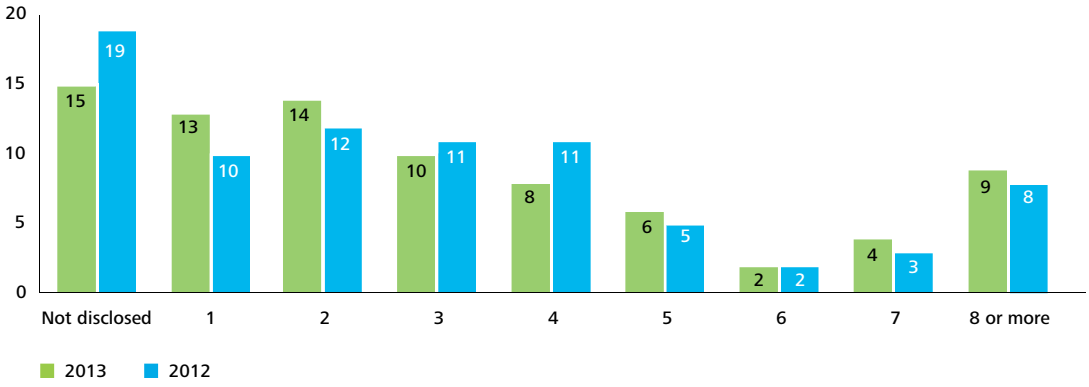
Figure 14.6. How many CGUs has goodwill been allocated to?



An example of clear disclosure of goodwill allocation to CGUs, including an explanation of how goodwill arising in the year has been allocated, is taken from Domino Printing Sciences plc's Annual Report and Financial Statements 2012.

Goodwill acquired in a business combination is allocated upon acquisition to the cash generating units ('CGUs') that are expected to benefit from that business combination. Following the acquisition of PostJet Systems Limited in 2012, an additional CGU has been created, since the cash inflows associated with this business are largely independent of the cash inflows of the Group's other CGUs. A separate CGU has not been created following the acquisition of Graph-Tech AG ('Graph-Tech') since Graph-Tech's product offering is consistent with that of the Group's core product offering. It has therefore been amalgamated into the Domino core CGU during the year. The customer database that was acquired from Mikrojet Systems GmbH ('Mikrojet') and the associated intellectual property rights also form part of the Group's core CGU. Further details relating to these acquisitions, including the fair value of the assets and liabilities assumed, are given in note 17.

The carrying amount of goodwill has been allocated as follows:

	2012 £'000	2011 £'000
Domino core products	47,030	32,261
Citronix product range	9,975	9,956
Purex product range	4,859	4,864
PostJet product range	4,382	–
Print and Apply product range	6,766	7,088
Thermal Transfer Overprinting product range	5,864	6,397
Thermal Ink Jet product range	8,661	9,305
	87,537	69,871

Domino Printing Sciences plc's Annual Report and Financial Statements 2012

Assets are tested for impairment by comparing the asset's carrying amount to its recoverable amount; recoverable amount is calculated as the higher of an asset's value in use and its fair value less costs to sell. One company disclosed that their recoverable amount was based on the fair value less cost to sell method (2012: two), while all others used value in use.

For those entities where a CGU with significant goodwill has a recoverable amount based on value in use, IAS 36 requires disclosure of the period over which management has projected cash flows based on financial budgets/forecasts approved by management and, when a period greater than five years is used for a cash-generating unit (group of units), an explanation of why that longer period is justified. With regards to disclosure around goodwill impairment, 88% of relevant companies (2012: 89%) disclosed the period over which cash flows had been projected. Six of these companies (2012: two) indicated that the period was more than five years; four of these provided an explanation to justify the longer period while two did not.

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Companies are also required to disclose the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/forecasts, and the justification for using any growth rate that exceeds the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market to which the unit (group of units) is dedicated. 16% of companies (2012: 14%) basing their recoverable amount on value in use did not disclose the growth rate used beyond the forecast period. One other company stated that the total period of cash flows used for their value in use calculation was only five years in length (their forecasted period) and so no further growth rate was applicable.

Of those companies using the value in use method and which disclosed the growth rate applied, 56% of these disclosed one single growth rate, with an average of 5.3% being applied. Those companies disclosing ranges of growth ranges averaged from 1.3% – 4.2%.

33% of companies basing their recoverable amount on value in use explicitly stated that the growth rate applied did not exceed the long-term average growth rates for the relevant country or market; a further 14% implied that this was the case, but the description was not as explicit. The remaining companies did not provide evidence as to whether their long term growth rate exceeded the average. Of these, five companies had disclosed that the growth rate applied was nil, so it may be assumed that this is automatically lower than the long-term average, unless of course the industry was actually in decline.

93% of companies basing their recoverable amount on value in use (2012: 91%) disclosed the discount rate used. 15% of companies had identified and disclosed only one CGU; of the remaining companies, 49% indicated that they had used more than one discount rate, such as for different CGUs or groups of CGUs.

Figure 14.7. What are the discount rates used?

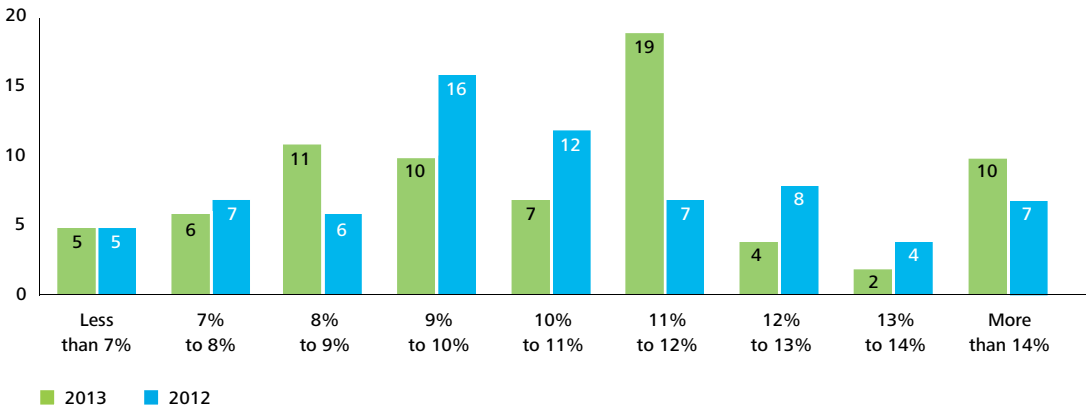

Figure 14.7 shows the discount rates used by those companies which disclosed them. Where a range was used, the average of this range has been calculated. Broadly, there appears to be a shift towards higher discount rates used in the calculation of recoverable amount. Those companies with a particularly high average discount rate had CGUs based in countries such as Greece and Egypt, where higher rates would be expected.

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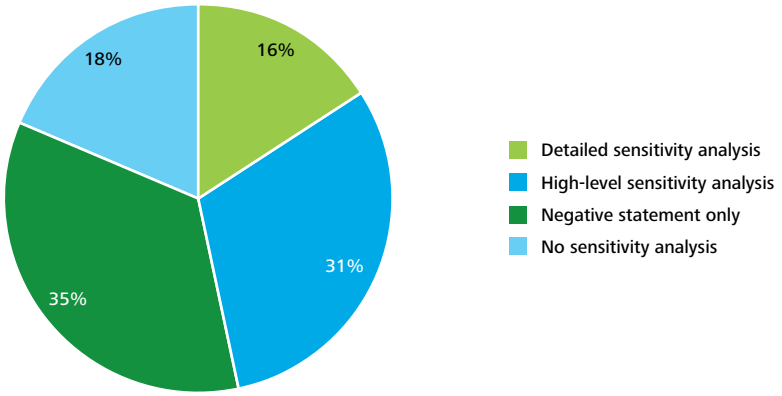
While there is no specific requirement under IAS 36 to explain how discount rates used were arrived at, two companies provided such disclosure – an example is taken from Latchways plc's Annual Report and Accounts 2013.

> The key assumptions used in the value in use calculations for all the cash generating units were as follows:
>
> - The forecast net profit margin. This was based on the achieved results for the cash generating units over the previous two years, and assuming a cautious uplift in business for the forthcoming year. Thereafter, net profit margins were assumed to be flat.
> - The risk adjusted discount rate. The discount rate is based on the risk free rate for 10 year UK Gilts, adjusted for a risk premium to reflect the increased risk of investing in equities. In making this adjustment, the required data are the equity market risk premium (that is, the increased return required over and above the risk free rate by an investor who is investing in a company of average risk) and the risk adjustment applied to reflect whether the specific segment is more or less risky than average.
> - The relative risk adjustment (or "beta") applied to discount rates to reflect the risk inherent in the group. This adjustment was as published by Bloomberg in April 2013.
>
> The above assumptions resulted in a discount rate of 4.1% (2012: 5.2%). This is an unusually low discount rate caused by historically low returns on 10 year UK Gilts and therefore impairment calculations were carried out using a pre-tax discount rate of 8.0% (2012: 8.0%).

Latchways plc Annual Report and Accounts 2013

Both the value in use method and the calculation of a CGU's fair value less costs to sell require the use of estimates and assumptions. For CGUs with significant goodwill, if a reasonably possible change in a key assumption on which management has based its determination of recoverable amount would prompt an impairment, IAS 36 requires the disclosure of further relevant sensitivity information.

Figure 14.8. Were additional sensitivity disclosures provided regarding goodwill impairment?



47% of companies (2012: 48%) provided either detailed or high-level sensitivity analysis. While this is broadly in line with the prior year, it is encouraging to see that of those companies not disclosing such information, there has been a shift from those who are silent (18% in 2013; 23% in 2012) to those making, at the very least, a negative statement that there are no possible changes in key assumptions that may indicate impairment.

One issue which may be slightly concerning is that over half of the companies (2012: two thirds) which did not provide a sensitivity analysis had nevertheless identified impairment of goodwill as a key source of estimation uncertainty or critical judgement. While this issue seems to be reducing year on year, it still indicates that there may be some disconnect between the assessment of key accounting issues and the level of disclosure subsequently provided in the financial statements.

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It is also worth noting that the Conduct Committee are keen to challenge descriptions of key assumptions, management's approach to determining the values assigned to each assumption and missing sensitivity disclosures.

An example of detailed sensitivity analysis is taken from TT electronics plc's Annual Report 2012.

Long-term growth rate

The budget and strategic review for these companies have been extrapolated in perpetuity using a long-term growth rate of 1.0% and discounted using the relevant entity discount rate. A key assumption in deriving the growth rate is that the businesses will grow in line with the underlying economic environment for the foreseeable future. Revenue growth would need to decrease annually by the following amounts for the carrying values to be impaired:

	2012	2011
BI Technologies	1.9%	3.6%
Optek Technology	3.4%	4.9%
TT electronics integrated manufacturing services, USA	1.4%	6.1%
New Chapel	2.4%	3.7%
Semelab	0.7%	0.2%

Discount rate

Sensitivity analysis has determined that the discount rate of 10.0% in the US and 7.6% in the UK is an influential assumption on the outcome of the recoverable amount calculation. For the carrying values to be impaired, the discount rate would need to increase to the following amounts:

	2012	2011
BI Technologies	11.3%	13.3%
Optek Technology	13.9%	15.9%
TT electronics integrated manufacturing services, USA	11.6%	16.6%
New Chapel	9.2%	9.9%
Semelab	8.2%	13.2%

Cash flows

Sensitivity analysis has also been performed on the operating cash flow projections. Cash flows can be impacted by changes to sales projections, sales prices, direct costs and replacement capital expenditure. In order for the carrying values to be impaired the expected cash flows for every year would need to reduce by the following:

	2012	2011
BI Technologies	13%	23%
Optek Technology	30%	36%
TT electronics integrated manufacturing services, USA	17%	41%
New Chapel	20%	22%
Semelab	11%	42%

The Directors have not identified any other likely changes in other significant assumptions that would cause the carrying value of recognised goodwill to exceed its recoverable amount.

TT electronics plc's Annual Report 2012

Other intangible assets

15 companies (2012: 14) surveyed had no intangible assets (excluding goodwill) recognised on their balance sheets at their reporting date. 13 of these were from the other group.

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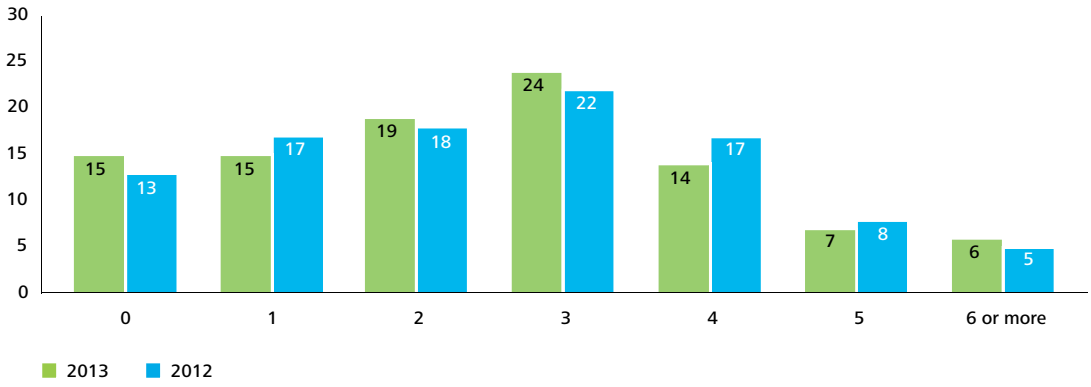
Figure 14.9. How many classes of intangibles (other than goodwill) are recognised?



The greatest number of classes of intangibles recognised by one company was seven (2012: seven), and figure 14.9 shows that the number of classes of intangibles was broadly in line with last year across the sample.

16% of companies with intangible assets (other than goodwill) disclosed that one or more classes of intangible assets had been assessed to have an indefinite life. IAS 38 *Intangible Assets* requires the reasons supporting the assessment of an indefinite useful life to be disclosed, including the factors that played a significant role in determining that the asset has an indefinite useful life. It is encouraging to see that 71% of companies with intangible assets assessed to have an indefinite life included the reasons supporting the judgement.

Impairments

80 companies (2012: 82) surveyed recognised an impairment loss in the year; this represented 91% of the top 350 group and 72% of the other group.

Figure 14.10. What has been impaired during the year?

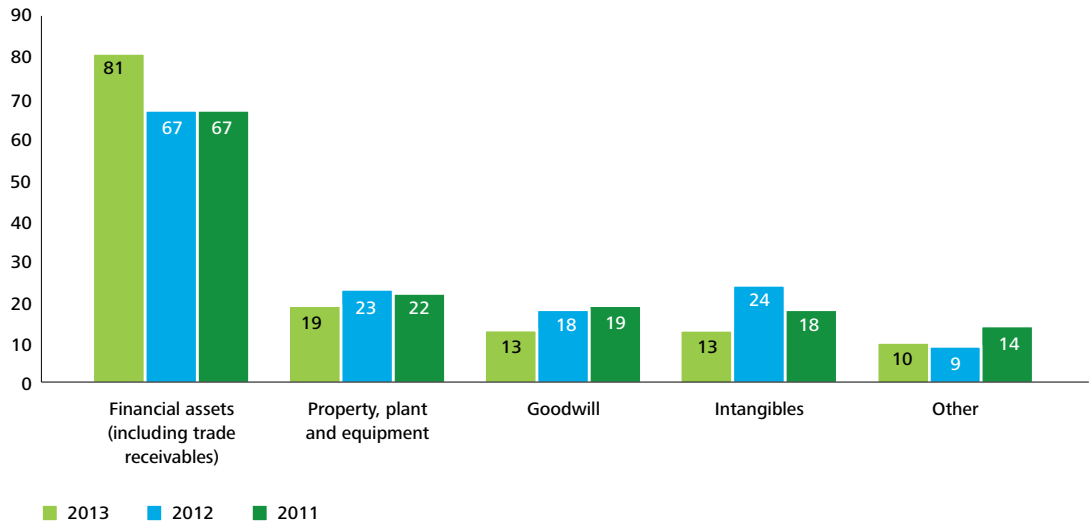


Figure 14.10 indicates what was impaired in the period. Of those financial assets impaired in 2013, 90% of these impairments relate solely to trade receivables.

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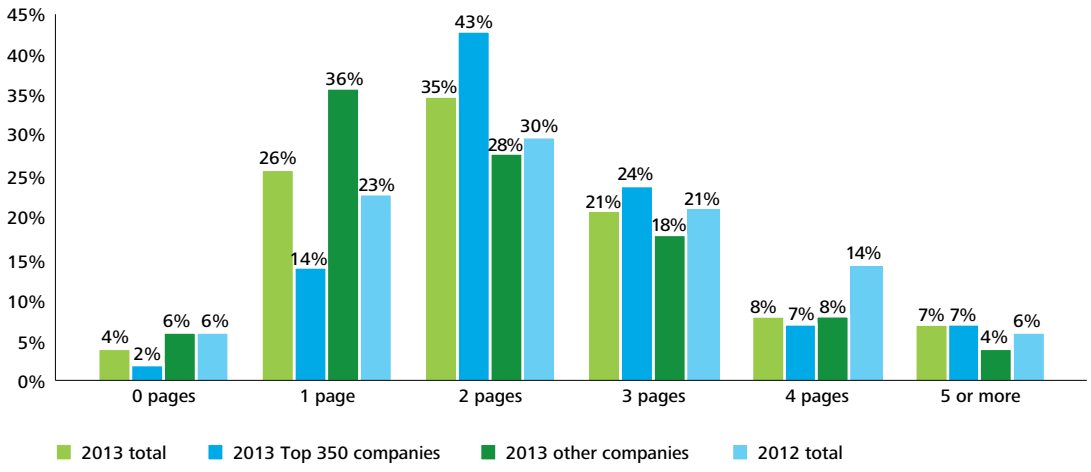
For all material impairments within scope of IAS 36 (which would exclude IAS 39 *Financial Instruments: Recognition and Measurement* impairments of financial assets such as trade receivables), the events and circumstances that led to the recognition of the impairment loss are required to be disclosed, as well as the location of the CGU which suffered an impairment and, if the impairment was identified using the value in use method to determine recoverable amount, the discount rate used in that calculation. Disappointingly, these disclosure requirements do not appear to be being made, with only 35% of companies with impairments within the scope of IAS 36 clearly disclosing the events and circumstances leading to the impairment. 46% of companies with impairments disclosed the location of the CGU which suffered the loss (a further 8% gave some relevant disclosure but it was not clear), while only 23% disclosed the discount rate used in the value in use calculation (although one company had clearly used a fair value less costs to sell model, so this disclosure was not applicable).

Share based payments

The disclosure requirements of IFRS 2 *Share Based Payments* are extensive, with numerous disclosures required for each different share scheme set up. Whilst IFRS 2 does permit some level of aggregation for substantially similar types of schemes, in practice this may not provide much relief.

92 companies surveyed (2012: 96) had share based payment schemes, with all but one of the top 350 having such schemes. The overall pattern of length of disclosures is the same as last year, with the average length being two pages, and the longest disclosure being six pages in length.

Figure 14.11. How long are the share based payment disclosures (to the nearest page)?



Financial instruments

The disclosure requirements relating to financial instruments are driven by IFRS 7 *Financial Instruments: Disclosures*. These disclosures require detail around individual classes of financial instruments, as well as the nature and extent of risks arising from financial instruments. While it is pleasing to see that all companies surveyed met some disclosure requirements of IFRS 7, the level of detail provided by companies varied significantly. Two companies (in the other group) managed to compact the disclosures into only one page, while six companies' disclosures spanned fifteen or more pages in length (all of these were in the top 350).

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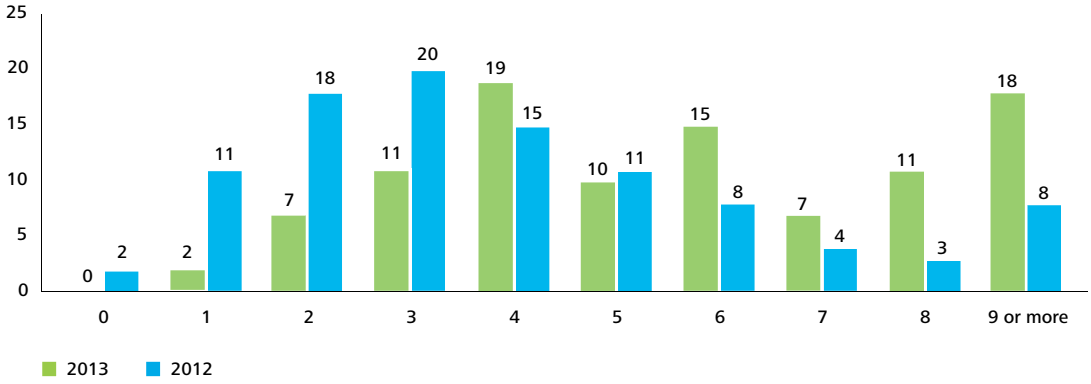
Figure 14.12 shows the comparison of length of clearly identified IFRS 7 disclosures with last year; overall there appears to be a trend for disclosures to be getting longer.

Figure 14.12. How long are the IFRS 7 disclosure notes (to the nearest page)?



IFRS 7 requires disclosure of the carrying amounts of each category of financial instruments (being financial assets or liabilities at fair value through profit or loss, held-to-maturity investments, loans and receivables, available-for-sale assets and financial liabilities held at amortised cost) held by a company. Where companies do not have complex financial instruments, this is often disclosed in a sentence or two. Where there are numerous categories or types of financial instrument, this disclosure is often presented in a table. Such a table would enable a reader to identify easily those financial instruments which are held at fair value. It was surprising how many companies – albeit usually the smaller ones – included items within their tables which were not financial instruments (such as prepayments, tax liabilities, provisions and pension obligations).

Similarly, preparers of financial statements appear to be unsure or confused about the different disclosure requirements of IFRS 7 and how they interrelate. For example, one company had a table categorising their financial instruments, with none being clearly categorised as held at fair value; yet, strangely, a further disclosure stated that all fair values of the group's financial instruments are categorised as Level 2 in the fair value hierarchy. Another company presented its preference shares within its fair value table (see below), determining that it falls within Level 2, despite the fact that several pages earlier it had confirmed that these instruments were held at amortised cost.

For all financial instruments measured at fair value, companies must elaborate on how that particular fair value was determined, using IFRS 7's hierarchy of inputs into valuation techniques:

- Level 1: inputs into valuation technique are quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2: inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and
- Level 3: inputs for the asset or liability that are not based on observable market data (unobservable inputs).

51 companies surveyed held financial assets at fair value. Of these, 43 (84%) clearly identified the level of the hierarchy that the inputs to the valuation technique used to measure these assets fell into. Of these 43 companies, 60% used inputs into valuation techniques for all assets within the same hierarchical level. Most commonly this was Level 2.

58 companies surveyed held financial liabilities at fair value. Of these, 49 (84%) clearly identified the level of the hierarchy that the inputs to the valuation technique used to measure these liabilities fell into. Of these 49 companies, 86% used valuation techniques for all liabilities using the same level. Most commonly this was Level 2.

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Currently, further information is required regarding valuation methods for financial instruments falling within Level 3, such as a reconciliation from opening to closing positions and information around the effect of changing one or more of the inputs to reasonably possible alternative assumptions that would change the instrument's fair value significantly. However under new requirements from IFRS 13 *Fair Value Measurement*, which come into effect for periods beginning on or after 1 January 2013, further detail around the unobservable input factors (including any quantitative factors) used in level 3 valuations will need to be disclosed. IFRS 13's scope is also broader than just financial instruments, which would previously have been captured by IFRS 7's fair value disclosure requirements.

21 companies had either assets or liabilities which were valued where inputs were unobservable and therefore fell into Level 3. For fair value measurements in Level 3, IFRS 7 requires companies to disclose the effect of changing one or more of the inputs to reasonably possible alternative assumptions in cases where such a change would change fair value significantly. Of the 21 companies, nine disclosed some information around the quantitative factors of inputs into the valuation model as part of this sensitivity analysis disclosure. This is encouraging, as it would appear that companies are already able to identify the relevant information which will be mandatory to disclose under IFRS 13 in the future.

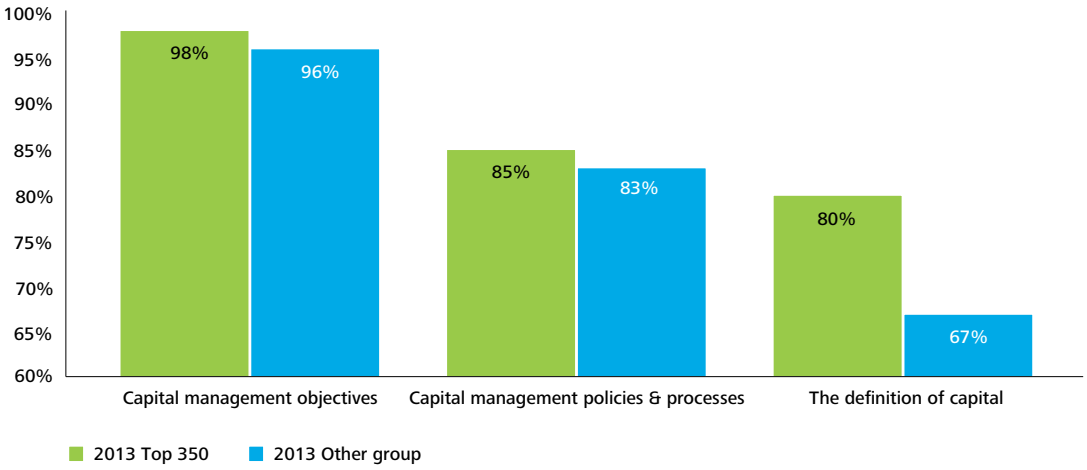
Capital risk management

IAS 1 includes the requirement to disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital. This includes a description of what it manages as capital, qualitative information about its objectives, policies and processes for managing capital, any externally imposed capital requirements (including whether it has complied with these during the period) and any changes to the aforementioned from the prior period.

In recent times this has been an area of focus for the FRC's Conduct Committee, who consider such information to always be material by virtue of its nature. As a result, requests for further information to assess compliance with these requirements are not uncommon. However, to help preparers, further insight in this area was offered by the Financial Reporting Lab's reports on net debt reconciliations, operating and investing cash flows and debt terms and maturity tables, all published towards the end of 2012.

93 companies included disclosure around capital management, or capital risk management, within the financial statements. Disclosure was usually made either in conjunction with the other IFRS 7 financial risks, or else in one of the equity or reserves notes. Of these, most companies included a description of their objectives, their policies and processes and also a definition of "capital", as shown in figure 14.13.

Figure 14.13. Of those companies referring to capital management in the financial statements, what detail has been clearly disclosed?



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While these statistics are encouraging in terms of compliance, a lot of the disclosures were noted to be boilerplate, such as the objective which was commonplace among many companies and was simply along the lines of "to ensure that entities in the Group are able to continue as going concerns whilst maximising the return to stakeholders". Similarly, policies and processes often merely referred briefly to board review and managing capital through the issue of new shares, returning capital to shareholders, or selling assets to reduce debt. The better disclosures contained more detail around the specific policies and processes in place. An example of such is from Mondi plc's Integrated report and financial statements 2012:

37 Capital management

The Group defines its total capital employed as equity, as presented in the combined and consolidated statement of financial position, plus net debt (see note 33), less financial asset investments.

€ million	**2012**	2011
Total borrowings and current financial asset investments (see note 33c)	1,827	948
Less: cash and cash equivalents (see note 33c)	37	(117)
Net debt (see note 33c)	**1,864**	831
Less: non-current financial asset investments		
Loans and receivables (see note 17)	(12)	(20)
Available-for-sale investments (see note 17)	(15)	(13)
Adjusted net debt	**1,837**	798
Equity	**2,876**	3,035
Total capital employed	**4,713**	3,833

Total capital employed is managed on a basis that enables the Group to continue trading as a going concern, while delivering acceptable returns to shareholders and benefits for other stakeholders. Additionally, the Group is also committed to reducing its cost of capital by maintaining an appropriate capital structure. In order to do so, the Group may adjust the future level of dividends paid to shareholders, repurchase shares from shareholders, issue new equity instruments or dispose of assets to reduce its net debt exposure.

The Group reviews its total capital employed on a regular basis and makes use of several indicative ratios which are appropriate to the nature of the Group's operations and are consistent with conventional industry measures. The principal ratios used in this review process are:

- gearing, defined as net debt divided by total equity plus net debt; and
- return on capital employed, defined as underlying operating profit, plus share of associates' net income, divided by average capital employed.

%	**2012**	2011
Gearing	**39.3**	21.5
Return on capital employed	**13.7**	15.0

The Group operates a DLC structure which has been agreed with the South African Ministry of Finance and is subject to certain exchange control conditions. The exchange control conditions do not infringe upon the Group's ability to optimally manage its capital structure. However, they do require that the capital supplied by, or made available to, the shareholders of Mondi Limited and Mondi plc, is constrained by the equality of treatment mechanism, which serves to maintain and protect the economic interests of both sets of shareholders. The Group has continually met the exchange control provisions in the past and management is committed to ensuring that the Group continues to meet these provisions in future.

The Group's trading and financing activities expose it to various financial risks that, if left unmanaged, could adversely impact on current or future earnings. Although not necessarily mutually exclusive, these financial risks are categorised separately according to their different generic risk characteristics and include market risk (foreign exchange risk and interest rate risk), credit risk and liquidity risk. The Group is actively engaged in the management of all of these financial risks in order to minimise their potential adverse impact on the Group's financial performance.

The principles, practices and procedures governing the Group-wide financial risk management process have been approved by the Boards and are overseen by the DLC executive committee. In turn, the DLC executive committee delegates authority to a central treasury function (Group treasury) for the practical implementation of the financial risk management process across the Group and for ensuring that the Group's entities adhere to specified financial risk management policies. Group treasury continually reassesses and reports on the financial risk environment, identifying, evaluating and hedging financial risks by entering into derivative contracts with counterparties where appropriate. The Group does not take speculative positions on derivative contracts and only enters into contractual arrangements with counterparties that have investment grade credit ratings.

Mondi Group Integrated report and financial statements 2012

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Prior year restatements

21 companies within the survey made restatements to their prior year reported figures of which seven restated their previously reported segmental analysis.

Of the remaining 14 companies restating comparatives, eight had a change in accounting policy (including changes made to presentation policies with no change to the underlying values), three restated the comparatives due to identifying errors, one had both a change in accounting policy and a prior year error, one restated the prior year balance sheet due to a change in the acquisition accounting fair values for a business combination, and one restated its analysis of staff costs within the notes with no clear explanation as to why. A further company identified a change in accounting policy, but made no restatement citing immaterial impact on prior year results and financial position. Not all of those companies restating their comparative primary statements clearly marked the comparative columns as "restated", instead leaving it to the user of the financial statements to discover the restatement through disclosure in the accounting policies.

Two of the companies restating their financial statements due to error did so following discussions with the FRC's Conduct Committee, and included disclosure around these circumstances.

Of the 14 companies restating information other than segmental analysis, only two presented a third balance sheet, in line with IAS 1 requirements. Three companies disclosed that the impact on the third balance sheet was immaterial, and so was not presented, while the other companies remained silent on the matter.

Further clarification on the requirement for a third balance sheet was included in the annual improvements to IFRSs published in May 2012, making it clear than the extra balance sheet need only be included where the impact of the restatement has a material effect on it. The requirement to present related notes for that third balance sheet was also removed. The amendments have effect for periods commencing on or after 1 January 2013.

Auditors' remuneration and independence

The detailed requirements for disclosure of the auditor's remuneration for both audit and non-audit services stem from regulations made under the UK Companies Act 2006. This requires the notes to the accounts to disclose any remuneration receivable by the company's auditor or their associates for auditing the accounts, and any remuneration for the supply of other services to the company or its associates. Separate disclosure is required in respect of auditing the accounts in question and of each of eight specified categories of other services.

All companies clearly disclosed the remuneration paid to their auditors within the financial statements. 91 companies presented these disclosures using different categories as required by the regulations.

45 companies provided a subtotal for total audit fees including audits of subsidiaries. While this is not a requirement of the regulations (since technically the audit of subsidiaries is regarded as a non-audit service), this is often viewed as helpful.

The auditors of 95 companies provided non-audit services in either the current or the prior years. For 67 companies, the total non-audit fees earned by their auditors in the current year were more than 20% of the value of the audit fees alone. Of these, only 42% provided a clear explanation as to why they had engaged their auditors to perform the services as called for by the FRC's Guidance on Audit Committees. In some cases the explanations were provided within the audit committee's report in the narrative reporting section of the annual report. One company disclosed non-audit fees earned by their auditors of £187,000, compared to fees for the audit of only £38,000 and did not provide a clear explanation of how they were satisfied with this balance of remuneration. Ever-increasing scrutiny in this area by a variety of stakeholders means that many would do well to increase their disclosure in this regard.

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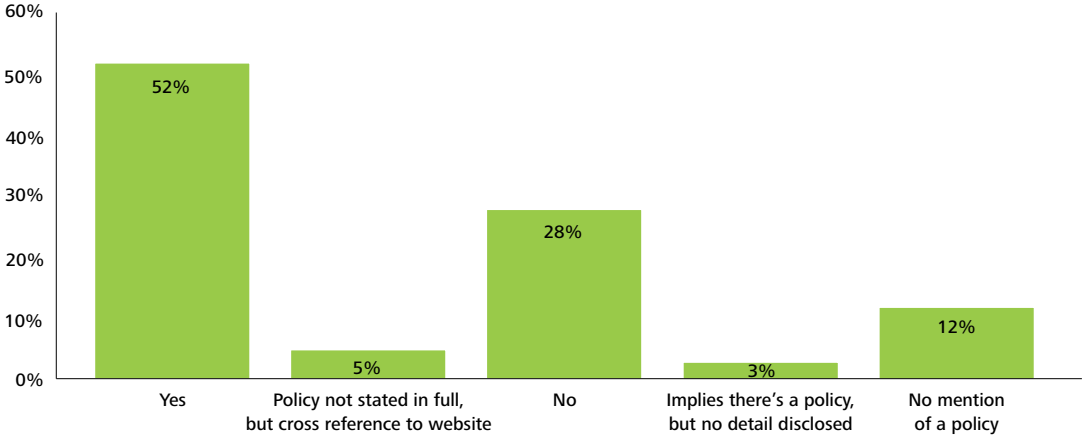
More than half of companies surveyed (52%) are disclosing their policy on the provision of non-audit services in a detailed and meaningful way, such as including detail around prohibited services, pre-approved services and those services for which specific approval is required.

70 companies disclosed remuneration payable to their auditors for "Other services", one of the eight specified categories. It was disappointing to see that only 37% provided a clear description – either in the notes to the financial statements where remuneration was disclosed, or else in the audit committee's report – as to what these services were, although this is not a mandatory disclosure. In some cases, however, the amounts paid for "Other services" were notably small in comparison to the rest of the remuneration, and therefore a description may have been omitted due to immateriality.

The FRC's Guidance on Audit Committees calls for audit committees to disclose their policy regarding the provision of non-audit services by their auditors, either in the annual report or by indicating where it can be found on the company's website. The policy should include those services which are prohibited, those which are pre-approved and those for which specific approval is required.

Figure 14.14. Does the policy on the provision of non-audit services describe those services which are prohibited, those which are pre-approved and those for which specific approval is required?



It is good to see that more than half of companies surveyed (52%) are disclosing their policy on the provision of non-audit services in a detailed and meaningful way, such as including detail around prohibited services, pre-approved services and those services for which specific approval is required. However, the level of detail provided within the audit committee reports with regards to this did vary considerably. Unusually, one company's audit committee disclosed that they always expect their auditor to be the provider of non-audit services, which appears to go against the underlying issue of auditor independence which has driven the requirement for audit committees to establish a set policy.

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A good example of disclosure by the audit committee describing the policy for non-audit services is taken from Halma plc's Annual Report and Accounts 2013:

Policy of auditor independence and services

Prohibited non-audit services
- appraisal or valuation services;
- financial Information systems design and implementation;
- bookkeeping services;
- management functions;
- executive recruiting and resource services;
- broker-dealer services; and
- legal services.

Audit-related services not subject to separate tender if fees <£100,000
- audits of businesses acquired or to be sold and due diligence services;
- opinions/audit reports on information provided by the company upon request from a third party;
- advice on accounting policies;
- electronic data processing audits; and
- tax services including local tax compliance.

Permitted non-audit services, subject to approval
- due diligence services relating to acquisitions with fees in excess of £100,000;
- public reporting on investment circulars;
- liquidation services in respect of redundant subsidiaries or associate companies; and
- tax-advisory fees in excess of £100,000 where the firm's existing knowledge of the Group structure is preferred.

Halma plc Annual Report and Accounts 2013

Of the 95 companies whose auditors provided non-audit services in either the current or the prior years, the disclosures were sufficient to confirm that for 47% of these companies the non-audit services were provided in line with their policy for non-audit services. However, for a few of these companies (eight), the policy was not clearly articulated or detailed in the audit committee's report, but the audit committee's report had implied or stated that all non-audit services were in line with their policy. A clear explanation of the non-audit services provided by the auditor and an explanation for why the auditor was engaged for the work is provided within National Grid plc's Annual Report and Accounts 2012/13.

Non-audit services provided by the external auditors

Non-audit services provided by the external auditors require approval by the committee. Approval is given on the basis the service will not compromise independence and is a natural extension of the audit or if there are overriding business or efficiency reasons making the external auditors most suited to provide the service. Certain services are prohibited from being performed by the external auditors, as required under the SOX Act.

Total non-audit services provided by PwC during the year ended 31 March 2013 were £2.3 million (2012: £3.8 million) which comprised 23% (2012: 44%) of total audit and audit related fees. Total audit and audit related fees include the statutory fee and fees paid to PwC for other services which the external auditors are required to perform, for example regulatory audits and SOX Act attestation. Non-audit fees represent all other services provided by PwC not included in the above.

Significant non-audit services provided by PwC in the year included quality assurance provided on the US financial controls improvement programme (£0.7 million) and tax compliance services in territories other than the US (£0.5 million).

PwC were engaged on the US financial controls improvement programme, as they were best placed to provide valuable insight on the programme, given their in depth knowledge of our control environment and relevant utilities experience. They were appointed in an advisory capacity only and were not involved in designing or implementing new controls and processes, thereby helping to safeguard independence and objectivity.

The committee considered that tax compliance services were most efficiently provided by the external auditors as much of the information used in preparing computations and returns is derived from audited financial information. In order to maintain the external auditors' independence and objectivity, management reviewed and considered PwC's findings and PwC did not make any decisions on behalf of management.

National Grid plc Annual Report and Accounts 2012/13

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Consistency with narrative

The annual report is meant to be read as a whole and, as such, should be telling 'one story' of what has happened in the year, the position the company is in at the year end and what the future prospects are. An important part of enabling an annual report to hang together well to achieve these objectives is ensuring that key financial information as presented in the financial statements is given suitable prominence within the narrative reporting in a way that gives a fair and balanced view of the company.

A number of companies, as seen by those presenting non-GAAP measures, for example, have incurred one-off items or significantly material items in their financial statements during the period. For example, 39 of the companies surveyed had material restructuring or reorganisation costs in the year, almost all of whom had stripped out these costs as part of a non-GAAP measure presented on the face of the income statement (discussed further in chapter 13). It was good to see that 90% of these companies made reference to these charges in their narrative discussions in the front half of the annual report, usually in the financial review discussion. However, a few of these companies made only brief reference to these costs, and a couple of companies did not make the value of the costs particularly prominent, but nevertheless their existence was discussed as part of the review.

Similarly, 37 of the companies surveyed incurred significant impairment charges (most impairment charges against trade debtors have not been considered to be particularly significant), although only 59% of these companies were considered to highlight these in their narrative to present a balanced review of the company's performance in the year.

In contrast, there were six companies identified within the survey which presented information within the financial statements that would often instead be found in the narrative reporting, or the front half of the annual report. Of these, three companies provided explanation or discussion in the financial statements as to what was driving the movement in balances year on year. Particularly innovative in this respect was the National Grid plc financial statements which also included a link back to the company's strategy. Two other companies provided lengthy disclosure around directors' remuneration, while the last company had a lengthy note specifically to reconcile non-GAAP measures to the statutory financial statements, even though these measures were only referred to in the narrative (and not presented in the financial statements).

10. Property, plant and equipment

The following note shows the physical assets controlled by us. The cost of these assets primarily represents the amount initially paid for them. A depreciation expense is charged to the income statement to reflect annual wear and tear and the reduced value of the asset over time. Depreciation is calculated by estimating the number of years we expect the asset to be used (useful economic life) and charging the cost of the asset to the income statement equally over this period.

Our strategy in action

We operate an energy networks business and therefore have a significant physical asset base. We continue to invest in our networks to maintain reliability, create new customer connections and ensure our networks have the flexibility and resilience necessary to meet future challenges. Our business plan envisages these additional investments will be funded through a mixture of cash generated from operations and the issue of new debt.

National Grid plc Annual Report and Accounts 2012/13

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Appendix 1 – A new beginning for your annual report

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Appendix 1 – A new beginning for your annual report

This appendix identifies various ways in which you can improve your annual report in 2013 based on our survey findings and areas that will be under scrutiny from regulators. In order to reflect the differing appetites as to how far preparers want to go in improving their reports our tips are split into four levels:

1. **The bare minimum – complying with new and existing requirements**
2. **Upping your game – looking at regulatory areas of focus**
3. **Clearer communication – considering the qualitative characteristics of effective communication**
4. **Going the extra mile**

We conclude with six ideas on how to cut clutter from an annual report, which can be applied by preparers anywhere on the above spectrum.

Level 1 – The bare minimum – complying with new and existing requirements

Producing a top quality annual report is no mean feat. Based on our survey findings we've picked out three easy wins, reflecting areas that many companies currently slip up on, but which with a bit of planning and thought could be rectified with relative ease. Following this we identify several newly effective requirements to be addressed.

Existing requirements – pitfalls to avoid

1. **Clearly identify the business model**
2. **Check IFRS 7 *Financial Instruments: Disclosures***
3. **Check IAS 36 *Impairment***

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1 Clearly identify the business model. Specific discussion of a company's business model will be a statutory requirement from next year and despite being a requirement of the UK Corporate Governance Code for the last couple of years (albeit on a "comply or explain" basis) only 44% of companies surveyed clearly identified their business model in their report. Better signposting of the disclosure, or more effort to identify this key information, will make a significant difference in this area.

2 Check that the disclosure table showing the categories of financial instruments the company holds, as required by paragraph 8 of IFRS 7 *Financial Instruments: Disclosures*, is consistent with those instruments covered by the accounting policy disclosures and that the table doesn't include items outside of IFRS 7's scope, such as pension liabilities. The number of companies making errors in this area is surprisingly high.

3 Check your disclosure of the allocation of goodwill to the underlying cash-generating units making up your business required by IAS 36 *Impairment*. 19% of companies in our survey with goodwill at the year-end were not clearly making this disclosure. Impairment disclosures are a continual area of regulatory focus.

New requirements

With a whole host of new legislation and some new IFRSs to watch out for too, below is a list of the major areas that you can't afford to miss in 2013/14.

These issues, and more, are discussed in the regulatory overview in chapter 3, together with links to further information and resources.

1 For periods ending on or after 30 September 2013, the new strategic report replaces the current business review. While many of the requirements regarding its contents are the same, quoted companies will need to present specific information on their strategy and business model, human rights issues and employee gender balance. The directors' report also needs to contain specific numerical information on greenhouse gas emissions. It is worth noting that the strategic report is separate to the directors' report and should be separately signed and approved.

2 At the same time, the new directors' remuneration report legislation also comes into force. As well as information on remuneration during the year, this includes a new requirement to disclose a separate remuneration policy report which shareholders will need to approve. Disclosure will also be required of the much discussed 'single figure for remuneration'.

3 The September 2012 revisions to the UK Corporate Governance Code have a come into force for periods commencing on or after 1 October 2012, along with the associated revised audit committee guidance. The audit committee report will need to be more detailed as a result of this change and the directors will need to be prepared to confirm that the annual report and accounts, taken as a whole, is fair, balanced and understandable.

4 Audit reports for those reporting under the UK Corporate Governance Code will be significantly expanded to give more detail about the audit process and issues identified as a result of ISA (UK and Ireland) 700 *The independent auditor's report on financial statements*. Early engagement with the auditor will ensure a company avoids unpleasant surprises in this regard.

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5 IAS 19 (2011) *Employee Benefits*. The revisions to IAS 19 mean that companies with defined benefit obligations will present a net interest expense in their income statement rather than the separate 'expected return on plan assets' and 'unwind of discount on plan liabilities'. This will reduce profits for the majority of companies (albeit compensated for in other comprehensive income), but there may not be a balance sheet impact. Application of the standard has been identified as an ESMA enforcement priority and accordingly the FRRP are expected to monitor this closely.

6 IFRS 13 *Fair Value Measurement* unifies the guidance on fair value measurement from various IFRSs, as well as standardising the disclosure requirements for almost any asset measured at fair value. There are some significant new disclosures needed for non-financial assets (such as investment property) measured at fair value.

7 Check consistency of disclosures around key financial reporting judgements throughout the report. With critical judgements already being disclosed in the financial statements and new requirements for significant financial reporting matters to be discussed in the audit committee report and matters of audit significance to be discussed in the audit report, ensuring consistency between these is an easy way to make the annual report tell a consistent story.

Level 2 – Upping your game – looking at regulatory areas of focus

Companies could also bear in mind the areas regulators are focusing on. These include:

1 **Impairment models,** particularly those 'value in use models' incorporating a 'hockey stick' growth forecast (high growth in the early years). Where companies have a model which has such a profile, they should be particularly prepared for regulatory scrutiny. Regulators will focus on value in use calculations they perceive to have a higher risk of impairment, challenging key assumptions and any applicable missing sensitivity disclosures.

2 **Non-GAAP measures,** specifically where measures used in the narrative reporting are different to those presented to management (as disclosed in the IFRS 8 note) and those presented on the face of the income statement. Year on year consistency in the items stripped out from statutory numbers is also expected.

3 **KPIs** should be clearly and consistently defined year on year, with reconciliations to statutory measures provided where appropriate. Linking them to the company's strategy, business model, objectives and remuneration policy are also current hot topics.

4 **Principal risks and uncertainties,** despite improvements in risk reporting in recent years. Companies should take care to make clear their 'principal' risks and uncertainties and to describe their mitigating activities, which the FRRP believes is necessary.

5 Disclosure around the assumptions used in **investment property valuations.** A statement that the valuation was carried out under the standards issued by the Royal Institution of Chartered Surveyors or under International Valuation Standards is not considered sufficient and such minimal disclosures will be open to challenge in the future.

6 **Cash flow statements** and compliance with IAS 7 Statement of Cash Flows classification requirements. It is tempting to assume that, since IAS 7 contains fewer headline categories than FRS 1 Cash flow statements, it is more flexible but in reality there is unlikely to be much of a grey area as to whether a transaction is operating, investing or financing in nature.

7 **Revenue recognition,** particularly in cases where there has been a change in business model. Aggressive revenue recognition can be tempting, particularly when a new line of business may be taking time to build inertia, but this is another area where regulators will be on the lookout for unusual policies.

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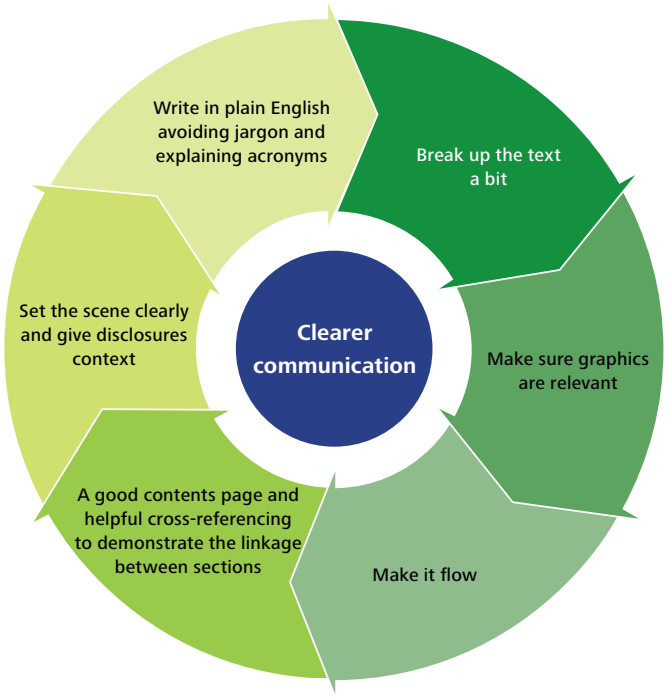
Level 3 – Clearer communication – considering the qualitative characteristics of effective communication

The first two levels focus on the content. This level considers how that content is communicated. Here are some broad-brush areas that may increase the impact of the information presented in the annual report.



1. Break up the text a bit. Long paragraphs of narrative are never easy to read – it's important to include some graphics or even just blank space to make those pages a bit less 'busy'. However, see (2) below!
2. Make sure graphics are relevant. Lots of snazzy graphs can make a report look more lively but be careful to ensure that they are complementing and not confusing the key messages.
3. Make it flow. Having the right information in your report is no good if it is not well structured and organised effectively. Weaving the common messages/themes throughout all elements of the report also helps.
4. A good contents page and helpful cross-referencing to demonstrate the linkage between sections. Clearly setting out what is where is great to enable users to quickly navigate to the information they are interested in. This includes cross-referencing to the back half where appropriate e.g. the notes to the accounts, as well as the narrative sections.
5. Set the scene clearly and give disclosures context. Launching straight into the detail of how successful 'Project X' has been is dangerous if the reader might not know the background behind what Project X was trying to achieve.
6. Write in plain English avoiding jargon and explaining acronyms. An understandable report written through the eyes of management is more engaging.
7. Ensure the key messages are clear to the user and not obstructed by immaterial, boilerplate clutter. (See ideas on cutting clutter at the end of this Appendix).

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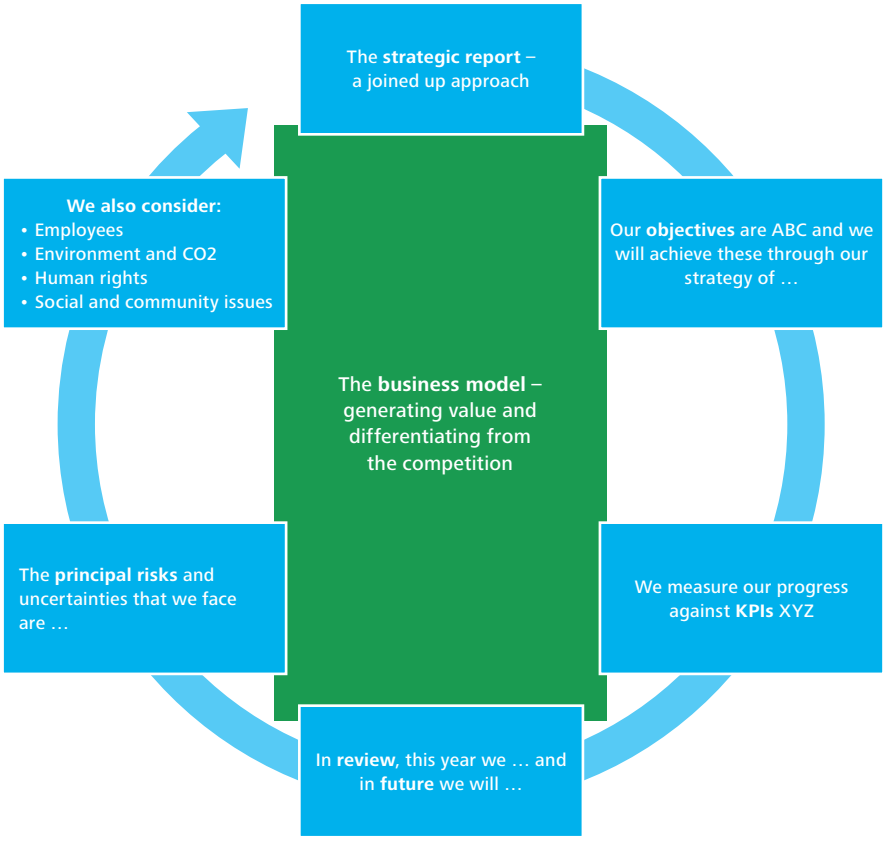
8 The draft FRC Guidance on the Strategic Report provides complementary principles to those outlined above which note that the strategic report should:

- be fair, balanced and understandable;
- be concise;
- have a forward looking orientation, where appropriate;
- provide information that is entity-specific;
- highlight relationships and interdependencies (linkages) between information presented in different parts of the annual report; and
- be reviewed annually to ensure that it continues to meet its objectives in an efficient and effective manner.

The following diagram illustrates how the elements of the strategic report should be woven together. Many of these elements, in turn, link through to various sections of the annual report.



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Level 4 – Going the extra mile

Whilst some preparers of annual reports will always lean towards providing the bare minimum and others will want to go above and beyond, stakeholders often value those reports that follow best practice guidance. Those companies that go the extra mile adopt new proposals early, take on board non-mandatory guidance and provide additional information that is thought to improve a user's understanding of the performance and strategy of the business. Below are some areas where preparers could choose to impress their readers in 2013/14 – some easier to achieve than others.

- Presenting a short **investment proposition** piece of narrative may provide helpful information for potential investors (see chapter 6).
- Setting out the **market context** in which the narrative report is being written can be useful background to the information it contains (see chapter 7).
- Illustrating **stakeholder value analysis**, showing the value created by the company for all its stakeholders, not just the shareholders, can really help to illustrate how it is being a responsible corporate citizen (see chapter 7).
- Integrating the **concepts embodied in the IIRC's Integrated Reporting Framework** into the narrative report to ensure that it is relevant to all of a business' stakeholders (see chapters 3 and 7).
- Communicating **risk priorities** by giving information on the relative importance of the principal risks and uncertainties identified (see chapter 8).
- Incorporating the **principles from the Sharman review** into disclosure around going concern (see chapters 3 and 10).
- Including a **net debt reconciliation** which is of interest to many investors (see chapter 13).

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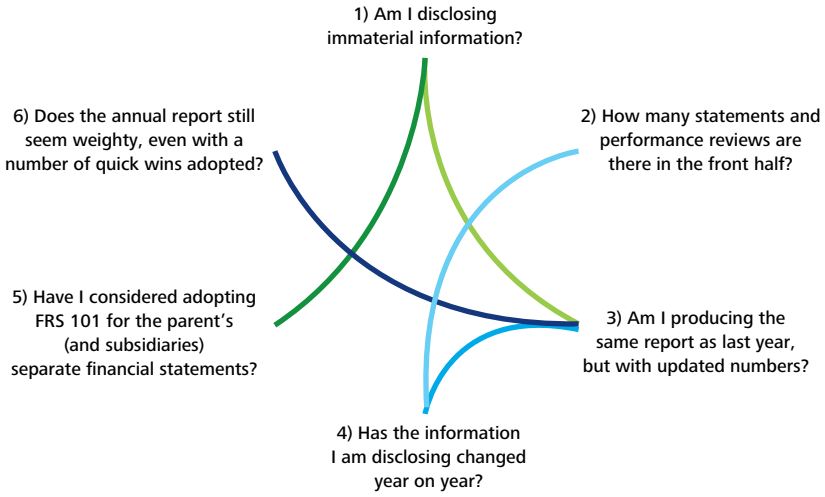
Cutting clutter

Whilst going the extra mile in an annual report is to be commended, a continual challenge in today's world is to avoid overloading readers with information and leaving them in a position where they struggle to see the wood for the trees. Here are six questions for preparers to consider when attempting to cut clutter from their annual reports.



1) Am I disclosing immaterial information?

As the IASB continues to work on their disclosure framework project they, along with the FRC and other regulators, are keen to remind preparers that IAS 1 clearly sets out that only material disclosures need be provided under IFRSs. A position held by many preparers is that it's better safe than sorry and that one is rarely penalised for putting in too many disclosures. However, regulators are genuinely keen for preparers to avoid prematurely leaping to this conclusion.

Materiality applies equally to the 'front half'. The FRC has made clear in their draft strategic report guidance that only material which is material to investors should be included in the annual report.

2) How many statements and performance reviews are there in the front half?

The new strategic report provides an opportunity to rationalise the number of different people providing a review of performance. For example, where a chairman, chief executive, finance director and heads of divisions have all provided statements in addition to the company's actual strategic report it may well be possible to reduce material that is being duplicated. Why not get the chief executive to introduce the strategic report?

3) Am I producing the same report as last year, but with updated numbers?

Don't just roll forward last year's report – there can be a tendency to disclose 'everything we disclosed last year plus some extra bits'. Be ruthless and cull information that was included last year but is no longer relevant or material this year.

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4) Has the information I am disclosing changed year on year?
If not, could this sort of 'standing data' be relegated to an appendix and cross-referred to as appropriate? The FRC are encouraging companies to adopt a 'core' and 'supplementary' approach where core information is included in the strategic report and supplementary information in a separate part of the annual report.

5) Have I considered adopting FRS 101 for the parent's (and subsidiaries) separate financial statements?
Subject to being a 'qualifying entity' and, amongst other things, having notified the shareholders in writing and having not received objections, a parent company within a group could apply FRS 101 *Reduced Disclosure Framework* for its separate financial statements (but not the consolidated financial statements). FRS 101 closely resembles IFRS accounting but provides a number of disclosure exemptions. Eligible parents may wish to use this year's annual report to provide shareholders with written notification of their intention to move to FRS 101 in future years (or indeed adopt FRS 101 in the current year, if the relevant criteria have been met).

6) Does the annual report still seem weighty, even with a number of quick wins adopted?
Instead of sending the complete annual report to shareholders, subject to certain criteria, the strategic report together with certain supplementary information (this replaces the summary financial statements) could be sent to shareholders if struggling to cut clutter from the full annual report.

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BIS The Department for Business, Innovation and Skills

BR Business Review
The Companies Act 2006 requires that directors' reports include a Business Review.

CEO Chief Executive Officer

CGU Cash generating unit

CODM Chief Operating Decision Maker

Competition Commission
An independent public body which helps to ensure healthy competition between companies in the UK for the ultimate benefit of consumers and the economy.

Conduct Committee
The Conduct Committee of the FRC have taken on the legal powers of the FRRP, following the FRC's restructuring.

CSR Corporate social responsibility
Corporate social responsibility is about how businesses take account of their economic, social and environmental impact. The Companies Act 2006 requires that companies disclose information, about environmental matters, their employees, and social and community issues, in their annual report.

DTR Disclosure and Transparency Rules
These rules of the FCA include requirements for periodic financial reporting to meet the requirements of the EU Transparency Directive.

EBITDA Earnings before interest, tax and amortisation

EC European Commission

EDTF Enhanced Disclosure Task Force
Established by the Financial Stability Board in May 2012, the Task Force aims to improve the risk disclosures of banks and other financial institutions.

EPS Earnings per share

ESMA European Securities and Markets Authority
An independent EU Authority that seeks to ensure the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection.

EU European Union

FCA Financial Conduct Authority
Originating from the former Financial Services Authority, the FCA acts as the Competent Authority for setting and enforcing the rules applicable to listed companies and those admitted to trading on a regulated market.

FRC's Financial Reporting Lab
Facilitated by a steering group and FRC staff, the Lab provides an environment where investors and companies can come together to develop pragmatic solutions to reporting needs.

FRC Financial Reporting Council
The UK's independent regulator responsible for promoting confidence in corporate reporting and governance and issuing accounting standards.

FRRP Financial Reporting Review Panel
The Panel's role, in order to fulfil the Conduct Committee's responsibilities, is to ensure that the annual accounts of public companies and large private companies comply with the Companies Act 2006 and applicable accounting standards.

FTSE 100/350 Financial Times Stock Exchange top 100/350 companies (share index)

GAAP Generally accepted accounting practice

IAS International Accounting Standard

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IASB International Accounting Standards Board
The IASB is an independent body that issues International Financial Reporting Standards.

IFRSIC International Financial Reporting Standards Interpretations Committee (formerly IFRIC)
IFRIC is the term given to describe Interpretations issued by the Committee which has been renamed the IFRS Interpretation Committee (IFRSIC). It develops interpretations of IFRSs and IASs, works on the annual improvements process and provides timely guidance on financial reporting issues not specifically addressed by the existing standards.

IFRS International Financial Reporting Standard(s)

IIRC International Integrated Reporting Council
Global body aiming to create a globally accepted framework for a process that results in communications by an organisation about value creation over time.

KPI Key performance indicator
A factor by reference to which the development, performance or position of the company's business can be measured effectively.

Listed company
A company, any class of whose securities is listed (i.e. admitted to the Official List of the UK Listing Authority).

Listing Rules
The Listing Rules made by the UK Listing Authority for the purposes of Part VI of the Financial Services and Markets Act 2000 and published in the manual entitled 'The Listing Rules' as from time to time amended.

Market capitalisation
A measure of company size calculated as share price multiplied by the number of shares in issue at a certain point in time.

PPE Property, plant and equipment

Quoted company
Section 385 of the Companies Act 2006 defines a quoted company as a company whose equity share capital:

a) has been included in the official list in accordance with the provisions of Part 6 of the Financial Services and Markets Act 2000; or

b) is officially listed in an EEA State; or

c) is admitted to dealing on either the New York Stock Exchange or the exchange known as Nasdaq.

Regulated market
Regulated market is defined in the Markets in Financial Instruments Directive. The European Commission website also includes a list of regulated markets at: http://ec.europa.eu/internal_market/securities/isd/index_en.htm

SEC U.S. Securities and Exchange Commission
Regulator of all securities commissions within the United States of America.

SOCIE Statement of Changes in Equity

SORIE Statement of Recognised Income and Expense

SORP Statement of Recommended Practice

STRGL Statement of total recognised gains and losses

UK Corporate Governance Code
The UK Corporate Governance Code sets out standards of good practice on issues such as board composition and development, remuneration, accountability and audit, and relations with shareholders. All companies with a previous listing are required under the Listing Rules to report in their annual report on how they have applied the UK Corporate Governance Code.

UKLA UK Listing Authority
The FCA acting in its capacity as the competent authority for the purposes of Part VI of the Financial Services and Markets Act 2000.

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Deloitte would be pleased to advise on specific application of the principles set out in this publication. Professional advice should be obtained as this general advice cannot be relied upon to cover specific situations; application will depend on the particular circumstances involved. If you would like further, more detailed information or advice, or would like to meet with us to discuss your reporting issues, please contact your local Deloitte partner or:

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UK Accounting Plus

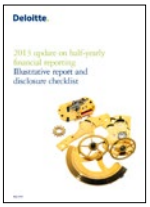
For the latest news and resources on UK Accounting, Reporting and Corporate Governance, go to www.ukaccountingplus.co.uk. UK Accounting Plus is the UK-focused version of Deloitte's hugely successful and long-established global accounting news and comment service, IAS Plus.

iGAAP 2014 – Annual report disclosures for UK listed groups (due to be published in early December 2013)

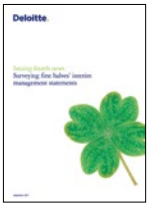
This Deloitte publication illustrates the disclosures in force for December 2013 year ends, including material encompassing all of the revised reporting requirements discussed in *A new beginning.* If you would like to obtain a copy of this publication, please speak to your Deloitte contact or alternatively visit the Lexis Nexis website for details on how to order.

Other Surveys

The following other Deloitte surveys are available at www.deloitte.co.uk/auditpublications.



2013 update on half-yearly financial reporting (May 2013)
This publication follows on from the 2012 Deloitte survey of half-yearly financial reports, Split and Polish. It provides an update on the key issues to consider in preparing half-yearly financial reports in 2013 and includes an illustrative report and disclosure checklist.



Issuing fourth news – Surveying first halves' interim management statements (September 2011)
The latest publication in the Firm's financial reporting series analysing the interim management statements made by 130 listed companies.

Designed and produced by The Creative Studio at Deloitte, London. 29790A