the Distinctive audit

It has begun … the next wave
Further examples of reporting practice

Following on from our survey of September year-end reports, 'It has begun… Early examples of reporting practice', this survey continues to look at how companies have implemented the new requirements for a strategic report and the 2012 UK Corporate Governance Code (the Code). This survey is based on a sample of 50 FTSE 350 companies' annual reports with year-ends after September 2013 and up to 31 December 2013, 21 of which were FTSE 100 companies and 29 were FTSE 250 companies.

We not only looked at how well companies complied with the new regulations, we also looked at the way in which companies approached these changes – whether they took a fresh look at the front half of their annual report or just shuffled existing content into a different order. We examined the level of innovation and quality of reporting style, looking for linkages between the business model, strategy and the back half of the reports and ultimately the degree of coherent information provided to the users. Throughout this survey we provide insight in this regard plus best practice examples.

The strategic report – a fresh approach?

The level of innovation that we have seen is encouraging. Business model disclosures, quality of risk reporting and the level of linkage between different sections of the annual report are just a few of the areas in which noticeable improvements can be seen. However, not all companies have innovated to the same degree – inevitably, there are a few that have made only limited changes this year.

Good examples: Elementis plc and ITV plc

Legally speaking

What is the requirement?	How many of the 50 companies clearly complied?
Prepare a separate strategic report	49
Evidence approval of the strategic report by the Board	44 38 included this approval separately from that for the directors' report, while six combined the two approvals (all outside the FTSE 100).

As discussed in *It has begun*, there was initially some uncertainty as to whether or not the strategic report and directors' report should be separate documents. For listed companies, at least, it seems that a clear trend is emerging – all but one of the companies we looked at correctly presented a clearly distinct strategic report. IMI plc is a good example of how to approach the approval of the strategic report.

Changing emphasis

The new strategic report contains much of the interesting content that used to be in the directors' report. This has prompted a change in how the directors' report itself is being presented. In many of the reports it is buried somewhere at the back of the narrative, or even in an appendix, sometimes within a section called 'statutory information', or presented as part of the governance report.

With the new regulations drawing some quite arbitrary lines between directors' report content and strategic report content, it is not a surprise that all but two of the companies we looked at chose to take advantage of the option to promote material to the strategic report.

> Promoting the discussion of future developments in the business to sit alongside the review of current year activities in the strategic report (46 reports) was a common theme.

> Promotion of the new Greenhouse Gas Emissions disclosure was also popular – see below.

> Other potential areas of promotion (research and development activities, post balance sheet events, employee involvement and policies on disabled employment) were less popular, although the vast majority of companies which had significant research activities chose to discuss them in the strategic report.

Legally speaking

What is the requirement?	How many of the 50 companies clearly complied?
State in the directors' report which information has been 'promoted' from the directors' report to the strategic report	15

Human rights or human wrongs?

The new requirement for a company to provide information about the impact of human rights issues on their business is an area of emerging practice. Companies with December year-ends seem to be getting to grips with this a bit more than the first wave of reporters in September.

A company looking to give comprehensive human rights disclosures might wish to consider not only the group's own direct operations but also those of their suppliers. A discussion of human rights issues was often incorporated into a company's wider discussion of corporate social responsibility.

> Almost half of the companies surveyed (23) gave a detailed description of the impact of human rights issues on their business, including for example how they manage human rights in their supply chain.

> 8 companies gave no information at all on human rights issues (only two of these were in the FTSE 100). Of these, two companies noted that a discussion of human rights issues was not relevant for an understanding of the business.

Good examples: British American Tobacco p.l.c. Ferrexpo plc and Computacenter plc

The gender gap

All but one of the reports reviewed included information on employee gender diversity, as required by the new regulations. The requirements of the law insist on a very specific format for these disclosures, something which a few companies seem to have overlooked.

Legally speaking

What is the requirement?	How many of the 50 companies clearly complied?
Disclose gender diversity figures as absolute numbers, not percentages	39
Provide gender diversity disclosures for three levels – directors of the parent, senior management and employees	40 Of the ten companies not doing this, eight overlapped with those providing percentages rather than absolute figures.

Good examples: Lloyds Banking Group plc

The definition of 'senior management' in the regulations has attracted some criticism. The intention of the disclosure seems to be to capture the 'movers and shakers' within the company, demonstrating the depth of diversity at decision-making level. However, the requirement to include all directors of all undertakings included in the group (other than the parent) within this figure can distort this picture. Several companies chose to sub-divide this category to make this distinction clear, with many also including a discussion of how they had identified 'senior managers' within the group.

Carbon reporting

43 companies chose to 'promote' their discussion of carbon emissions from the directors' report to the strategic report, probably because such information fits neatly into the wider disclosure of information about environmental matters in the strategic report. As well as providing the details of emissions from operations (known as "scope 1" emissions) and from energy usage ("scope 2") required by law, 14 companies voluntarily provided information on their "scope 3" emissions (emissions from employee travel).

Good examples: Domino Printing Sciences plc, Interserve Plc and Meggit PLC

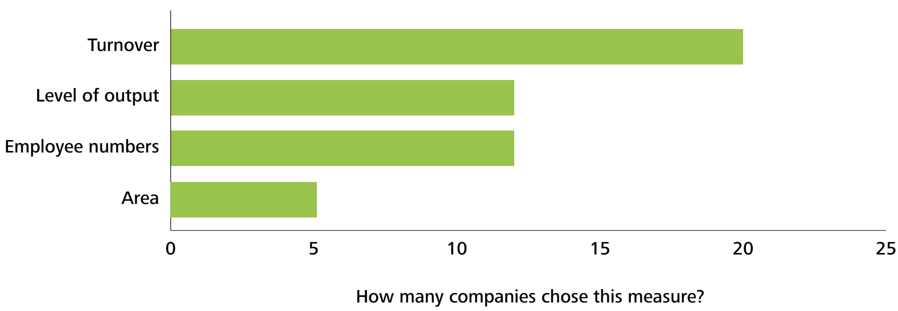
Legally speaking

What is the requirement?	How many of the 50 companies clearly complied?
Disclose 'scope 1' and 'scope 2' emissions	44
Disclose an intensity ratio relating emissions to a quantifiable factor associated with the company's activities	46

Interestingly, none of the reports took advantage of the clause in the regulations allowing companies not to disclose this information on the grounds that obtaining it was impractical.

In the absence of specific guidance in the law, a few intensity measures are proving particularly popular with companies.

Most popular intensity measures
Operational measure in relation to which emissions are quantified



As one would expect, the intensity ratios chosen by companies are reflective of the different natures of their businesses. One example of this is that service businesses are more likely to choose an employee-based metric whereas manufacturing businesses are more likely to use a production-based metric. For example, five real-estate companies used operational area.

Many companies included a cross-reference to more detailed information included in a separate sustainability report when discussing environmental issues.

Developments in going concern

With the amendments to the Code in light of the Sharman report on going concern still being finalised, it is unsurprising that most reports did not reflect the detail of the proposed changes. However, it is evident that the majority of companies now recognise that their assessment of going concern needs to encompass the health of the business as a whole, rather than just a narrow assessment of its ability to meet its debts over the next twelve months. Going concern disclosures now tend to include a cross-reference to broad sections of the rest of the annual report, covering among other things the company's strategy, objectives and business model, as well as of course its financial position.

Good example:
Of principal risk disclosures which reflect the latest thinking from the FRC is that of SEGRO plc

Only four of the companies surveyed included a mention of solvency or going concern within their discussion of principal risks, within the spirit of the FRC's November 2013 draft amendments to the Code. Interestingly, three of these companies were outside the FTSE 100. However, risk disclosures in general are becoming more dynamic, with 5 companies providing an indication of the likelihood of occurrence of their principal risks and 19 (38%) giving details of the change in risks compared to the prior year – a big increase compared to the 15% of reports surveyed in our publication *A new beginning*, which looked at reports for periods up to March 2013

The Code – 'Fair, balanced and understandable'

As required by the Code all companies in our sample included a statement from the board that the annual report was fair, balanced and understandable. 38 of the 50 companies surveyed included the statement in the directors' responsibilities statement, with the remainder including it in either the directors' report or the corporate governance statement.

Good example:
Anglo American plc, Cobham plc and Intu Properties plc

The audit committee was asked to provide advice to the board on making the statement in 39 of the reports. 14 of the companies (36%: FTSE 100, 21%: FTSE 250) in our sample chose to provide a description of the process undertaken by the company in confirming that the annual report was fair, balanced and understandable. Interestingly a fuller description was only provided by companies where the audit committee had been asked to advise the board. This additional commentary was usually provided in either the audit committee report or the corporate governance statement. The commentary generally focused on steps taken in the annual report process, some of which may be new this year, enabling the board to gain confidence regarding the ownership, balance and appropriate verification of the report.

The Code – significant issues considered by the audit committee

Audit committees now need to describe the significant issues they considered in relation to the financial statements and how they were addressed. As identified in *It has begun*, the audit committee's list of significant issues was often close to the list of risks reported by the auditor.

Number of issues discussed	• The number of issues presented ranged between one and ten significant issues, with an average of four (FTSE 100: five, FTSE 250: four). • Similarly, the auditor discussed between one and eight risks in their audit report, with an average of four. • The level of detail provided on each issue varies, both in audit committee reports and audit reports. • The majority of audit committees gave some detail on how they satisfied themselves regarding the significant issues. Examples include Tullow Oil plc and ITV plc.
Picking up recommendations from the Financial Reporting Lab	• Just over half of the audit committees cross-referred to other relevant disclosures within the financial statements. • ITV plc was the only company in our sample to split their disclosures between "complex discrete transactions" and "recurring transactions".
Reference to the work of the auditor	• The majority of companies made reference to the work of the auditors during their discussion of the issues considered. • In a step further than that, the audit committee from Pearson plc chose to provide a full commentary on their discussions with the external auditors on the significant issues. • There is an increasing trend to discuss misstatements, including those misstatements identified by the auditor, in audit committee reports. Three audit committees in our sample included this discussion. Admiral Group plc included additional information about their decision to accept management's position in not recording an immaterial adjustment relating to intra-group trading.
Links to the auditor's report	• The risks most commonly discussed by the auditor, each of which were included in at least half of audit reports, were revenue recognition, taxation (covering both direct and indirect tax risks) and carrying value of goodwill and/or intangible assets. • Around half of the audit committees omitted at least one of the risks discussed by the auditor – typically being those significant risks auditors are presumed to have (risk of fraud in revenue recognition) or must have (management override of internal control). Some risks omitted were more company-specific, for instance the audit committee of Ferrexpo plc did not include the risk relating to political disturbance in Ukraine that was discussed by the auditor. • Around half of the audit committees included an issue (or issues) not included in the auditor's report, with an average of two additional issues.The most common were going concern, treatment of underlying or exceptional items, taxation, defined benefit pension schemes and introduction of new accounting policies. Balfour Beatty plc discussed six issues over and above the three identified by the auditor.

The Code – external audit tendering

With the position in the EU only recently settled and some way to go before we know the final position on UK implementation and the Competition Commission's Orders, it was not surprising that audit tendering was discussed in some detail:

- 44% clearly indicated when they planned to undertake an audit tender, typically coinciding with rotation of the current engagement partner – Meggitt plc and Hunting plc are examples.

- 22% had undertaken a tender process since 2010 (12% ran a tender in 2013 or are undertaking one in 2014).

- 16% explained why it was not convenient for a tender process to be undertaken at the present time. Some of the reasons given were:
  – board changes, including the composition of the audit committee;
  – significant organisational, systems and process changes currently being undertaken; and
  – continuing regulatory uncertainty and the need to properly plan a tender process.

The Code – effectiveness of the external audit process

Just over half the disclosures in this area (56% of our sample) were relatively short with the majority focusing on the effectiveness of the external auditors alone as opposed to the audit process as a whole. It is appropriate to assess the audit process as a whole, putting the work of the auditor in context, since the auditor's work is only one component of an effective audit process. For example, 12% of the companies in our sample made explicit reference to the wider audit process and management's role within it, including Smith & Nephew plc.

Fuller disclosures were provided by 44% of our sample, with 20% noting that they had referred to the FRC's Audit Quality Review Team's report on their auditors. One SEC registered company also referred to the PCAOB report on their auditors and two companies referred to the auditor's Transparency Report.

Only one company from our sample, Lloyds Banking Group plc, explained that they had used an external party to carry out an assessment of the external audit process.

The Code – Diversity

Not to be confused with the Strategic Report disclosures on gender diversity, when looking at board diversity the Code is looking at diversity in its broadest sense. This is not something that is reflected in the disclosures we have seen within our sample, where just 18% referred to broader aspects of diversity than just gender. These were all FTSE 100 companies and some of the broader considerations included were industry experience, background, expertise, ethnicity and nationality.

In response to the Lord Davies recommendation that FTSE 100 companies should have a target of 25% women on the board by 2015, 30% of our sample included disclosures of a target. The majority of these targets were the target suggested by Lord Davies but others included their own, with a mix of more or less stretching targets than the Lord Davies target. One company explained that it was not going to be able to meet 25% by 2015 largely due to the nature of their industry.

Rexam plc made reference to the fact that they only use recruitment consultants who adhere to a Voluntary Code of Conduct which ensures that when seeking new candidates for the board at least 30% of the initial list of candidates are women.

Conclusion

The majority of companies in the survey have addressed or have made an attempt to address the key changes in reporting requirements, with an improvement in compliance compared to the very first reporters. There was an encouraging level of innovation and only a few instances of companies having limited changes in their annual reports. Deloitte's comprehensive survey of listed companies' reports will provide further insight later in the year.

To find out more

If you would like 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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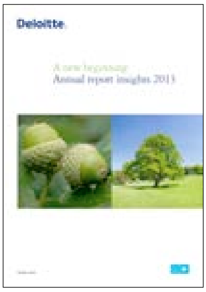

A new beginning – Annual report insights is available on www.ukaccountingplus.co.uk, your one stop shop for news and resources on UK accounting, reporting and corporate governance.

Other related Deloitte publications available on UK Accounting Plus include:

- Our Practical guide on preparing a strategic report
- Our newsletter Governance in focus – the 2013 audit committee reporting season: New rules or a new regime?
- Our newsletter Governance in focus: Describing your strategy and business model
- The Deloitte UK Carbon Reporting Survey
- The new remuneration report: First impressions

Useful external publications include:

- The draft FRC Guidance on the Strategic Report, available at http://frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Exposure-Draft-Guidance-on-theStrategic-Report.aspx
- The 2012 UK Corporate Governance Code, available at http://frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.aspx

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