Rising to the challenge.

A review of narrative reporting
by UK listed companies

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The Accounting Standards Board

The Accounting Standards Board (ASB) is an operating body of the Financial Reporting Council (FRC). The FRC is the UK's independent regulator responsible for promoting confidence in corporate reporting and governance. For corporate reporting, the outcome we seek is this:

Corporate reports contain information which is relevant, reliable, understandable and comparable, and are useful for decision-making, including stewardship decisions.

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Why did we write this report?

The Accounting Standards Board (ASB), an operating body of the Financial Reporting Council (FRC), first undertook a review of narrative reporting in 2006. The review concluded that certain areas of reporting were a challenge for companies. Since then, further content requirements have come into force for quoted companies in the form of the enhanced business review requirements in the Companies Act 2006 (CA), prompting us to take another look.

> “Preparing a good quality annual report that communicates effectively all the important information is a major intellectual and logistical challenge.”

Preparing a good quality annual report that communicates effectively all the important information is a major intellectual and logistical challenge. Many companies continue to devote significant time and effort to improving their narrative reporting, but there are always opportunities for further enhancement as experience and best practice develop. We hope this report will be helpful to companies looking to rise to this challenge.

We also have some internal goals as well. As the ASB is responsible for the UK best practice narrative reporting guidance in its *Reporting Statement: Operating and Financial Review* (RS), it is useful to continue to monitor the effects of the statement on current practice. In addition, another operating body of the FRC, the Financial Reporting Review Panel (FRRP), is responsible for ensuring that the annual accounts of public companies and large private companies comply with the requirements of the CA and applicable accounting standards. We hope these findings will provide a useful contribution to the FRRP's work.

What was our research process?

The findings summarised in this report are based on our rigorous review of the annual reports of a sample of 50 UK listed companies.

The review focused on:

Content
How well companies were reporting the content areas set by the newly effective enhanced business review requirements

Communication
Communication of that content using the *Principles for Effective Communication* in the FRC's June 2009 discussion paper *Louder than Words*

Clutter
Identifying sources of immaterial clutter in narrative reporting

We scored each company in our sample against each of the requirements in the CA and best practice using a scale of 1–5.

For a more detailed description of our research process, our scoring scale and the scores awarded for each CA requirement, see *Our research process*, page 15.

What did we find?

We found that the best reporters have continued to evolve their narrative reporting – in terms of content and communication of that content. They also tended to report effectively across a number of content areas.

Most companies are providing a good standard of information in their financial reviews, the description of objectives and strategies, and the provision of financial key performance indicators (KPIs). However, there are significant opportunities for improvement in the reporting of principal risks, trends and factors, contractual and other arrangements and non-financial KPIs.

During our review, we found immaterial clutter detracting from important information most frequently in the corporate social responsibility (CSR) and risk reporting sections of the narrative.

It also appears that where companies are struggling to report, it could be due to a lack of clarity of the requirements. As such, we have included some discussion that may contribute to the regulatory process going forward. See *Better regulation – what to watch going forward*, page 10. This section includes a discussion of business models and a glimpse into the future of sustainability reporting along with a caution that further requirements may just add clutter to an already heavy annual report.

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For those looking to follow the example set by the best reporters, there are practical steps companies can take to improve their narrative reporting, which we have outlined in this section according to the CA content requirements.

Some key points have also been summarised into a list of *Do's and don'ts for companies* on the last two pages of this report.

What is going well?

Financial review: performance and position

Companies did well in this area. However, discussion of profit was stronger than cash flow and position. Companies looking to move to best practice in this area should also consider resources rarely captured by current balance sheets – intangible assets such as patents and brands are an important part of 'position'. For example, Reed Elsevier's 2008 annual report includes a discussion of its investment in brands.

Given the current economic environment, we were expecting greater discussion of liquidity risk, unless clearly not an issue for the company. Some companies were very effective at communicating liquidity information through the use of graphical illustrations of debt maturities. For an example of this type of graphical display, see Great Portland Estates' 2009 annual report.

76% of our sample provided discussion of performance and position to supplement the financial statements instead of just repeating them.

Two companies were not compliant with the law because they discussed performance but not position.

The FRRP has commented that it is paying particular attention to liquidity risk at present and has written to a number of companies about improvements to their debt maturity tables.

Financial KPIs

We observed that there has been improvement in this area. Those looking to advance further should think about how KPIs link to the rest of the report. Many reports still feature an isolated KPI table with no accompanying discussion or link to the remainder of the document. For a fresh approach to KPIs see Logica's 2008 annual report – KPIs are embedded in the discussion throughout the report and flagged as such using a special symbol.

94% of our sample provided some financial KPIs.

We found one company with 68 KPIs scattered throughout the report – too many to all be 'key'.

The best companies linked KPIs to strategy and provided an explanation of each measure along with some targets and reconciliations, where appropriate. See InterContinental Hotels Group's 2008 annual report, which links KPIs to strategy and plans for the future in an effective way.

Strategy

While not explicitly mentioned in the CA, the discussion of strategy is an important part of providing a 'fair review' of the business.

92% of our sample attempted to outline some objectives or strategies, or both.

The best reports describe both objectives and strategies – objectives tell us 'what' the company is aiming for and strategies tell us 'how' they will achieve this. For example, 'our goal is to grow sales' is an objective but without an additional statement such as 'by expanding the number of retail shops we have in China' it is not a strategy.

The best reports explained or illustrated how they measure the achievement of strategies – often by linking KPIs to strategy in a table. For example, Amlin's annual report for 2008 illustrates this.

Where do the challenges remain?

Principal risks

All companies in our sample provided some information on risks; however, companies looking to improve should take care to avoid the following pitfalls:

- Too many risks to all be principal
- Generic risks that could easily be cut and pasted into any report – for example, 'influenza outbreak' or 'terrorism'
- Too little detail to understand the risk – for example 'insurance risk' with no detailed discussion is not enough for an insurance company when this is its business
- Risk reporting only by reference to *IFRS 7: Financial Instruments Disclosures* in the notes to the financial statements.

A best practice report should also provide some context for the risk – is it increasing or decreasing – and some idea of the impact of a risk crystallising. This means the risk section will include some numbers, along with the narrative. Many reports do include this type of information, but it is dotted throughout the report, which makes it difficult to consider when reading through the risks. The answer here is referencing to help the reader.

66% of the sample were technically compliant because they listed some risks, but in our view needed to make improvements to meet the spirit of the requirements.

Only 6% of the sample had the content for a best practice score in risk reporting.

From a communication perspective, the most appealing risk sections use a table to link each risk to context, impact and risk mitigation. However, many companies that attempted this ended up with an excessively abbreviated list of risks that we could not understand. We still think tables are a good idea, but the table needs to grow to fit the content, as opposed to shrinking the content to fit the table.

"We think tables are a good idea, but the table needs to grow to fit the content, as opposed to shrinking the content to fit the table."

The FRRP has recently commented on its experience of reviewing risk disclosures. It has written to some companies to ask where their principal risks are and to others to ask which ones from a lengthy list are really 'principal'.

Trends and factors

Discussing the future has long been a struggle for companies, and never more so than in the current environment of uncertainty. Our review led us to conclude that there is some confusion regarding what 'trends and factors' means – is it the macro environment or company-specific factors or both? Although the RS provides only company-specific examples, we think it's both.

Only 38% of companies provided discussion of trends and factors that we considered compliant with the spirit of the regulations.

Looking to improve? Four words come to mind – 'relevant', 'future-oriented', 'quantified', and 'evidenced'. See Xstrata's 2008 annual report for an example of how these concepts can be applied to create an informative trends and factors discussion.

Contractual and other arrangements

There has been significant confusion over this requirement, prompting Lord Sainsbury to provide the following clarification during a session in the House of Lords in 2006:

'This is not a requirement on companies to list their suppliers and customers, or to provide detail about contracts. The provision is about reporting significant relationships, such as with major suppliers or key customers critical to the business, which are likely to influence, directly or indirectly, the performance of the business and its value. It is for the directors to exercise judgment on what is necessary to report. They need only include information to the extent necessary for an understanding of the development, performance or position of the business.'

It was unclear whether 52% of the sample specifically addressed the requirement to discuss contractual and other arrangements...for 12% it was clear they did not.

Only 8% of the sample provided a good level of detail on most important relationships, commonly as part of a business model disclosure.

Non-financial KPIs

Companies looking to improve should seek to measure the key drivers of their business. Possibly because the CA specifically mentions employee and environmental non-financial KPIs, many companies are choosing peripheral disclosures of KPIs in these areas over the more important key drivers of their business. For example, an insurance company disclosed number of employees as a measure when it may be that client retention is a more important driver of the business.

Marks & Spencer Group's 2009 annual report shows a number of non-financial measures, beyond just employees and environment, that are clearly relevant to the business.

32% of the sample did not disclose any non-financial KPIs, despite the CA requirement to do so where 'necessary' and 'appropriate'.

What areas are causing the most clutter?

CSR reporting

Companies are feeling their way in developing their CSR reporting and there is significant social pressure in this area. But some have fallen into the trap of delivering unnecessary clutter such as: 'football coaching' for an insurance company and 'donating chocolate gifts to the community at Easter' for a service company – these are worthwhile activities but in our view are not material to understanding a company's performance and position. There is potential for more companies to say, 'we have no material social issues' if they genuinely do not have material issues instead of adding clutter to the report.

Nine companies had a CSR section longer than their financial review.

Only 20% of the sample provided a convincing explanation of why CSR is important to their business.

Principal risks

Listing every conceivable risk adds to clutter. Many companies started strongly with 'principal' risks, but in an apparent preference for a long list of risks, allowed their good work to deteriorate to boilerplate. In an attempt to deter this practice, Addison came up with a list of 'ridiculous risks' in its report *Risky Business*, which includes 'changes in accounting standards', and 'global nature of our operations'. Without additional specifics, these are clearly boilerplate and adding to clutter.

One company had 33 risks and eight companies had 20 or more.

Some companies had risk sections that were 10 pages long.

Business models

A 'fair review' of the business is required in the CA and we interpreted this requirement to include a description of the business. As outlined in paragraph 31 of the RS, we think that describing the business should go beyond just products, services and geography to include business processes, distribution methods and structure of the business – in other words the disclosure of the business model.

The credit crisis has highlighted the importance of companies articulating business models in a clear and understandable way. Business models cannot be conveyed through numbers alone and it is up to the narrative report to tell the story of what a company does to generate cash.

For many companies, we understood what they sell, where they sell it and whom they sell it to but this generally fell short of describing the business model. Some of the best reports in the sample included a business model disclosure, which led to our conclusion that this can help drive better disclosures in other areas. For example, when describing a business model, it is difficult to avoid discussing important contractual or other arrangements.

Of course, describing the business model is difficult for companies with a complex business – but this is no excuse for not trying.

It is possible that explicit requirements for business model disclosure could drive better reporting overall as well as filling a gap in information brought to light by the credit crisis.

“One potential reason for this deluge of information is the regulations, which require discussion of all three of employees, environment and social and community or disclosure of the type of information that has been excluded.”

Sustainability reporting

We concluded that the CSR sections of annual reports contain significant immaterial clutter that is not necessarily essential for making resource allocation decisions. For example, it is a good thing that many companies are now using refillable glass bottles in meetings, but this is not a decision-changing piece of information. One potential reason for this deluge of information is the regulations, which require discussion of all three of employees, environment and social and community or disclosure of the type of information that has been excluded. Social pressures make it difficult for a company to flag up non-disclosure in any of these areas, with the result that companies disclose all three, regardless of the importance of each to the business.

This trend looks set to continue with what The Virtuous Circle describes as an ‘evolving plethora’ of sustainability reporting requirements in its publication entitled *Just how many greenhouse gas reporting (GHG) standards do we need?* The Virtuous Circle notes the evolving requirements are not well coordinated or ‘the same but different’ and the number of standards and the disparity could leave companies ‘wallowing in uncertainty’. See *Carbon reporting initiatives*, page 18.

Amongst the companies in our sample, 30% are already making some type of carbon emissions disclosures, albeit in varying degrees of detail. We must consider carefully whether the annual report is the appropriate place for more detailed carbon disclosures prepared by all companies, as proposed by the Climate Change Act 2008, which says:

The Secretary of State must, not later than 6th April 2012 –

(a) make regulations under section 416(4) of the Companies Act 2006 (c. 46) requiring the directors' report of a company to contain such information as may be specified in the regulations about emissions of greenhouse gases from activities for which the company is responsible, or

(b) lay before Parliament a report explaining why no such regulations have been made.

The ASB agrees that sustainability is an issue of vital importance. It is attracting a great deal of interest and attention, through initiatives such as the Prince of Wales' Accounting for Sustainability project and from accountancy bodies both in the UK and internationally. Ultimately, since the real issue is reducing carbon emissions rather than simply reporting them, we must consider whether further reporting requirements in the business review will succeed in changing company behaviour or just in adding clutter to an already lengthy annual report. To this end, we welcome the Government plan to carry out a review in 2010 of the contribution that reporting on GHG emissions is making to the achievement of climate change objectives. In our view, further work also needs to be undertaken to consider whether the focus should be on integrating all reporting into one place or having separate stand-alone sustainability reports.

“...we must consider whether further carbon reporting requirements in the business review will succeed in changing company behaviour or just in adding clutter to an already lengthy annual report.”

Where can I find more information?

The full report of our findings is available at: *www.frc.org.uk/asb/narrativereporting*.

This includes further detail on the scores awarded to companies for each of the CA requirements.

Reports of others

Our scoring methodology was inevitably subjective. To ensure that our findings were robust, we met with other organisations that champion high quality narrative reporting in order to compare observations and conclusions. This review also draws on discussions with and research completed by these other organisations. The following may be interesting and useful to those tasked with making substantial improvements to corporate reports:

Organisation	Publication title/web address
Addison	*Risky Business: An overview of European Risk Reporting* **Website:** www.addison.co.uk/riskybusiness
Black Sun	*100/08 Annual Analysis of FTSE 100 Corporate Reporting 2008* **Email:** corporatereporting@blacksunplc.com
Deloitte	*A telling performance: Surveying narrative reporting in annual reports* **Website:** www.deloitte.co.uk/atellingperformance
FRC	*Louder than Words: Principles and actions for making corporate reports less complex and more relevant* **Website:** www.frc.org.uk/press/pub1994.html
Merchant	*"Who's doing what" series* **Website:** www.merchant.co.uk/thinking_publications.html
PricewaterhouseCoopers	*A snaphot of FTSE 350 reporting: Compliance mindset suppresses effective communication* **Website:** www.pwc.co.uk/eng/publications/a_snapshot_of_ftse_350_reporting.html
Radley Yeldar	*How does it stack up? Annual reports 2009* **Website:** www.howdoesitstackup.co.uk
The Virtuous Circle	*Just how many greenhouse gas reporting (GHG) standards do we need?* *Update on narrative reporting* **Website:** www.thevirtuouscircle.co.uk/NEWS_SEPTEMBER09.html

Our research process

Our sample

The companies in our sample were selected by assigning a random number to each company and selecting the 25 FTSE 100, 15 FTSE 250 and 10 SmallCap with the largest random number. Because investment trusts do not share similar characteristics to other types of companies, we excluded them from our sample by selecting the next largest number. We also needed to exclude companies with year-ends between 1 May and 30 September since the enhanced business review requirements were not applicable to the 2008 report and the 2009 report was not yet available at the time of our review. The next largest random number was selected in these instances.

The companies in the sample are as follows:

FTSE 100	FTSE 250	SmallCap
Amlin	Beazley Group	Chime Communications
Cable & Wireless	Big Yellow Group	Cineworld Group
G4S	Bodycote	Low & Bonar
InterContinental Hotels Group	Chloride Group	LSL Property Services
International Power	Cookson Group	Marshalls
Invensys	Cranswick	Photo-Me International
Kingfisher	Dignity	ProStrakan Group
Lloyds Banking Group	Filtrona	Quintain Estates & Development
Marks & Spencer Group	GKN	Real Estate Opportunities
Next	Great Portland Estates	Unite Group
Old Mutual	Logica	
Pearson	London Stock Exchange Group	
Pennon Group	Melrose Resources	
Prudential	PV Crystalox Solar	
Reed Elsevier	Spirent Communications	
Rexam		
Rolls-Royce Group		
Royal Bank of Scotland Group		
RSA Insurance Group		
Shire		
Standard Chartered		
Standard Life		
Thomson Reuters		
Vodafone Group		
Xstrata		

Our scoring method

In completing our assessment, we have scored each company for each of the eight CA topics using a five-point scoring system. The system is described below using risk reporting as an example:

1/5 – Not compliant with the law	Normally reserved for instances where there is a glaring omission of required information. For example, a company without a principal risk section would have received this score.
2/5 – Compliant but	The information included in the report technically complies but falls short of the spirit of the requirements. For example, one company listed 33 principal risks and we have trouble seeing how such a large number of risks could all be principal.
3/5 – Compliant in spirit	Information is included to a good standard that meets with the spirit of the requirements. For example, companies give some company-specific explanation for a list of risks that are clearly principal.
4/5 – Best practice: content	Goes beyond compliance to provide the type of best practice reporting outlined in the RS. For example, some companies listed risks that were clearly principal and went on to provide context for the risk and its likely effect on the business along with risk mitigation.
5/5 – Best practice: content and communication	Has best practice content and demonstrates good communication according to the *Principles for Effective Communication* in the FRC's *Louder than Words* publication. For example, a company with a full description of risks presented in an easy-to-understand table would have received this score.

Results

The percentage of the sample companies achieving each score is outlined below for all eight CA topics. If you are interested in more detail on the scores, see our full results report at *www.frc.org.uk/asb/narrativereporting.*

	Percentage (%) with score:				
Organisation	**1**	**2**	**3**	**4**	**5**
Fair review: Business description [CA 417(3)(a)]	6	52	32	2	8
Fair review: Strategy [CA 417(3)(a)]	8	44	30	10	8
Principal risks [CA 417(3)(b)]	0	66	28	6	0
Performance and position [CA 417(4)(a&b)]	4	20	54	12	10
Trends and factors [CA 417(5)(a)]	6	56	20	14	4
CSR [CA 417(5)(b)]	12	34	34	14	6
Contractual and other arrangements [CA 417(5)(c)]	12	52	28	6	2
Financial KPIs [CA 417(6)(a)]	6	34	38	16	6
Non-financial KPIs [CA 417(6)(b)]	32	20	30	10	8

Carbon reporting initiatives

There are a number of proposals for carbon reporting requirements or guidance stemming from the following sources:

- *The Carbon Reduction Commitment User Guide,* published in draft in March 2009 by the UK Department for Energy and Climate Change (DECC) and Department for Environment, Food and Rural Affairs (DEFRA)
- *Guidance on how to measure and report your greenhouse gas emissions,* (draft guidance published for comment in June 2009) published October 2009 by DEFRA to meet the requirements of the Climate Change Act
- *All together now: a common business approach for greenhouse gas emissions reporting,* published in May 2009 by the CBI as input to the above DEFRA guidelines
- *CDSB Reporting Framework Exposure Draft,* published in May 2009 by the Climate Disclosure Standards Board (CDSB), a body established at the World Economic Forum
- *Greenhouse Gas Emissions Report: An illustration for business climate change and greenhouse gas emissions reporting,* published in May 2009 by PricewaterhouseCoopers. The guidance is in the form of a model annual report for a fictional UK listed technology company – Typico plc.
- *ISO 14064,* published by the International Organization for Standardization in June 2009

Do's and don'ts for companies

1 **Do** provide context for principal risks and uncertainties – are they increasing or decreasing...**don't** simply include generic descriptions of risks that could easily be cut and pasted into another company's report.

2 **Do** use tables to link principal risks to related actions to manage the risks... **don't** shrink the risk content down to fit the table, instead expand the table to fit the content.

3 When articulating strategy, **do** ensure that you describe 'what' your goals are and 'how' you plan to achieve them...**don't** make bland statements like 'our plan is to grow' with no further explanation.

4 **Do** use your KPIs to demonstrate progress against stated objectives and strategies... **don't** just tick the box by providing a KPI table that does not link to the rest of the narrative.

5 **Do** explain why CSR is important to the business...**don't** include information on employees, environment and social and community that is not important.

6 **Do** include non-financial KPIs to explain how the key drivers of the business are monitored...**don't** include peripheral measures such as number of employees just to tick a box.

7 **Do** provide an explanation of your business model – how you make money incorporating discussion of processes, distribution methods and structure...**don't** limit this to discussion of just products and services or resort to the use of undefined technical jargon.

8 **Do** support your discussion of relevant industry trends with external evidence... **don't** be afraid to quantify the trends instead of relying on bland statements like 'the outlook for our industry is good'.

The Financial Reporting
Council Limited is a company
limited by guarantee.

Registered in England
number 2486368.

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5th Floor, Aldwych House
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Designed and produced by Addison.
Printed by Beacon Press.

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