



# Annual report insights 2015

## The reporting landscape

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# 1. Executive summary

## 1. Executive summary

## 2. How to use this document

## 3. Regulatory overview

## 4. Survey objectives and methodology

## 5. Overall impressions

## 6. Summary material

## 7. The strategic report

## 8. Key performance indicators

## 9. Principal risks and uncertainties

## 10. Going concern and viability

## 11. Corporate governance

## 12. The work of the audit committee

## 13. The auditor's report

## 14. Primary statements

## 15. Notes to the financial statements

## Appendix 1 – Glossary of terms and abbreviations

## Other resources available

### Survey of Annual Reports

#### Overview

Deloitte has been surveying annual reports for over ten years. And while the building blocks of annual reports have grown in number over that time, they have also become ever more sophisticated and varied. Back in 2006 the average report was a mere 85 pages long. Now the average report is over 50% longer, due to the increasing complexity of regulations. Efforts and initiatives, not least those of the Financial Reporting Council to make reports ever more clear and concise, continue. But we live in a complicated world and it is the task of this survey to make sense of it and provide timely and useful guidance.

Each year we survey a sample of 100 LSE Premium-listed companies, selected to be as representative of the entire market as possible. The purpose of this survey is simple. Our aim is to provide a clear view of how annual reporting is evolving and unfolding. We look at how things have changed and show how companies have dealt with the new challenges. We highlight innovation and link it to broader discussions in the reporting world. We identify the areas where improvement may be needed and provide examples of good practice to show the way forward and ease future change. In short, our survey opens up the world of annual reporting and enables the depth of understanding that people need.

Here are some of our key findings.

#### Length of reports

One measurement of how successful the FRC's drive to make annual reports clear and concise has been is a simple one – the length of reports. And this year, once again, the average length of the reports we surveyed, inexorably, still moved up. It wasn't a huge jump, but an increase of three pages up to a total of 135 shows that the size of reports is still creeping in the wrong direction and over time these changes add up. When we conducted our first survey of IFRS annual reports back in 2006, the average length of a report was just 85 pages. The increase since then is driven by new and revised regulations.

But it is clear that companies are making a real effort to keep the increase to a minimum. Indeed, on average, their financial statements were two pages shorter this year. Though that was offset by an increase in the average length of the narrative reports of five pages.

#### Linkage

Linkage remains a weak link. The level of linkage shown in annual reports has largely remained the same as recent years. Worryingly, only 10% of companies demonstrated comprehensively how all of the various elements of the report linked together, not just through providing cross references between them, but also by providing clear evidence of a coherent thought process showing the process by which the information had been pulled together. This is another of the FRC's campaigns. Their 'Guidance on the Strategic Report' sets out ideas for how companies can effectively demonstrate this kind of linkage.

#### Integrated reporting

Integrated reporting ('<IR>') is not mandatory in the UK but many investors are calling on companies to adopt its principles in preparing their annual reports. Our survey shows that seven of the companies in our sample made an explicit reference to <IR>. There is, of course, a significant crossover between the suggestions for effective reporting in the <IR> Framework and what is seen as best practice in complying with the existing requirements for the content of a strategic report. For example, some 51 companies included a clear reference to relationships or resources used as inputs or outputs, what <IR> terminology would call 'capitals', within the description of their business model. So companies with good strategic reports often look as if they are some way along the path to an <IR>-style report. But, of course, a truly integrated report is an output of integrated thinking. In particular, the linkage in it comes naturally - it flows from the integration of business processes and behaviours.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Alternative Performance Measures

Alternative Performance Measures, or non-GAAP measures as they are also known, have always been a regulatory focus. Our survey shows that the use of non-GAAP measures by companies continued to be almost ubiquitous, with 81% of companies highlighting them to investors as part of the summary section of the report, while some 54% presented them more prominently than the associated GAAP measures. So, quite clearly, companies view non-GAAP measures as essential to tell their story. But there are a couple of things that they should bear in mind when doing this.

- A recent survey of investment professionals, by CFA UK, showed that only 40% of respondents said they trusted the non-GAAP measures presented in company reports as much or more than the IFRS-compliant numbers.
- ESMA's recently published 'Guidelines on Alternative Performance Measures' require both that the closest comparable IFRS measures be presented for each APM used and that APMs are not presented more prominently than IFRS measures. On top of this the guidelines will also require companies to reconcile all APMs to the financial statements. Our survey shows that a significant proportion of companies do not do this at the moment. Some 42% of the companies using non-GAAP measures as KPIs did not provide enough information to reconcile the measures to the financial statements. But on a note of encouragement companies are moving in the right direction. Last year's comparable figure was 64%.

### Readiness for the 2014 Code

As companies gear up to prepare reports for September 2015 or later, they need to take the requirements of the 2014 version of the UK Corporate Governance Code into account. So we surveyed what companies were saying about how they would comply. The new Code will affect the whole of the front half of the report, with new requirements expanding the disclosures around principal risks, introducing the new longer-term viability statement, and further requirements for remuneration and governance reports.

What we found was that 52% of the companies surveyed referred to the changes that would be necessary to adopt the 2014 Code, but only a handful had early-adopted any of the new provisions. One company noted that they had done so in relation to the new requirements around directors' remuneration. Another included a viability statement. And two companies specifically discussed how the directors had made a robust assessment of the risks facing them.

### Compliance with the 2012 Code

It is harder to judge the level of compliance with the existing Code given the nature of its 'comply or explain' basis. But our survey showed that full compliance had fallen from 57% to 51% this year. But on a more positive note, 76% of those companies that did not fully comply provided a meaningful explanation for their non-compliance with the Code. Similarly, 57% made it clear that this non-compliance was temporary. Most of them explained that non-compliance with the Code had arisen from current circumstances rather than a decision that compliance with certain of the provisions was inappropriate for the company.

### Audit committee reporting

Our survey suggests that most companies could still improve their audit committee reporting. Only 23% of companies included comprehensive descriptions of the significant financial reporting issues considered by the committee. This was, admittedly, an increase on last year's figure of 16%. But only 9% gave detailed insights into how they had assessed the effectiveness of the external audit process.

### Board diversity

As we all know the issue of board diversity continues to be high on the news agenda. Our survey reports that the average number of female directors on the Boards of the FTSE 100 companies in our sample rose to 24%, up from 21% last year. But only 22% of FTSE 100 companies claimed to have met Lord Davies' recommended target that a quarter of Board members should be female by 2015, and only 13% of the FTSE 250 companies surveyed provided a target for the proportion of women on the Board, though both of these percentages were up on last year. References to other aspects of diversity, like experience, nationality, disability and age, were up from 52% to 63%.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Succession planning

Our survey shows that currently some 80% of companies do not provide a clear explanation of their succession plans. This year the FRC has made it clear that it sees Board succession planning as an issue it wants to concentrate on. A project on this is under way and a report and recommendations will be published. Another area of focus for the FRC is corporate culture. Only 15% of companies in our survey provided a meaningful discussion of the Board's responsibilities in this area, and only one referred to assurance activities having been undertaken in respect to corporate culture. This is another area that would repay early thinking and effort.

### Implementing IFRSs 10, 11 and 12

The biggest and most significant change in financial statement requirements this year was the introduction of what became known as the 'package of five' new consolidation standards. For most companies this didn't have a large impact. The survey shows that only two companies reported that the adoption of IFRS 10 has had an impact on the scope of their consolidation. Some 42 companies reported they had to assess the impact of adopting IFRS 11 on their joint arrangements. But for most companies it didn't result in a change in the accounting treatment. Only five companies reported that they had joint arrangements that were classified as joint operations rather than joint ventures. And a few companies had to apply equity accounting to their joint ventures instead of proportional consolidation. Only twelve companies included specific disclosures about judgements that had been made when classifying interests in other entities, as is now required by IFRS 12.

### New UK GAAP readiness

Looking ahead, 2015 is the year when new UK GAAP comes into force. The 51 companies in the survey sample that currently use old UK GAAP to prepare their parent company-only financial statements will need to select and apply either full IFRSs, FRS 101 or FRS 102 instead. The most attractive option is likely to be FRS 101 but to be able to apply it a company has to have notified its shareholders in writing that it intends to do so. And only twelve of the companies in our survey gave notice of such an intention in their current year report.

### How to improve your report

Companies looking to improve their annual reports should consider the following.

- The Financial Reporting Lab has recently issued several reports on how companies can make their financial statements clearer and more concise.
- Investors are demanding more information on areas such as the level of reserves available for distribution. 39 companies in our survey included some disclosure of this.
- The FRC's conduct committee keeps an eye on the quality of financial statements. Chapter Three in this survey highlights details of some of the areas where companies often make mistakes.

## 2. How to use this document

### 1. Executive summary

### 2. How to use this document

### 3. Regulatory overview

### 4. Survey objectives and methodology

### 5. Overall impressions

### 6. Summary material

### 7. The strategic report

### 8. Key performance indicators

### 9. Principal risks and uncertainties

### 10. Going concern and viability

### 11. Corporate governance

### 12. The work of the audit committee

### 13. The auditor's report

### 14. Primary statements

### 15. Notes to the financial statements

### Appendix 1 – Glossary of terms and abbreviations

### Other resources available

This publication has been written with the overriding aim of providing you, the user, with insight into current best practice in annual reporting so that you can take advantage of this knowledge and make your own report as effective as possible. It has a specific focus on areas of regulatory change, as well as those that have been highlighted by regulators and investors where companies can do better – chapter 3 provides an overview of these. Therefore, whether you are an audit committee member, a company secretary or a finance director; work in investor relations or the finance department, there is something in here for you.

It is based upon an extensive survey of the annual reports of 100 UK listed companies – see chapter 4 for details. As a result it is packed with insight into historical trends that will allow you to benchmark your own report against our sample, along with plenty of examples of better practice identified from companies across the FTSE.

In our accompanying guide *A clear steer for your annual report* we have distilled the key pitfalls to avoid, regulatory developments to watch out for, ideas for making your report stand out and ways to ensure that it is 'clear and concise'.

#### What are the benefits of a good annual report?

As one of the most important opportunities for a company to communicate with its stakeholders, the quality of its annual report helps to shape a company's reputation. And reputation is something that companies ignore at their peril – according to the 2015 UK Reputation Dividend Report<sup>1</sup>, for UK listed companies "at best, reputation contributes £1 in every £2 of market cap; at worst, it is 'destroying' £1 of value in £7."

But there are other reasons to produce a high-quality report as well.

- As well as attracting investment, 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 are required by the UK Corporate Governance Code to state that they consider the annual report and the accounts, taken as a whole, to be "fair, balanced and understandable". A strong report will therefore reflect well on the quality of a company's governance.
- Prizes are awarded by a number of bodies for the best annual reports, bringing with them further prestige and good publicity.
- The Financial Reporting Council's Conduct Committee monitors the quality of corporate reporting in the UK and investigates reports that it thinks may be defective. For obvious reasons it is desirable to avoid criticism from the regulator and the bad publicity this can bring.

1. [http://www.reputationdividend.com/files/5014/2480/0950/Summary\\_of\\_2015\\_UK\\_Reputation\\_Dividend\\_Report.pdf](http://www.reputationdividend.com/files/5014/2480/0950/Summary_of_2015_UK_Reputation_Dividend_Report.pdf)



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Which parts of this document are most relevant to me?

The table below will help you to identify those areas of the publication likely to be of most interest to you. As well as our thoughts and findings, most of the chapters listed below contain links to further guidance and examples of good practice taken from real life annual reports.

One of the focus areas of our surveying this year is the extent to which companies are applying the principles of integrated reporting. However, rather than having a separate chapter on this, our findings have been integrated into each of the chapters that make up the report.

Theme	Chapter	What is examined
Background information	3 – Regulatory overview	An overview of recent and future changes in the requirements that UK listed companies are subject to, as well as regulatory hotspots.
	4 – Survey methodology	The methodology used in our survey.
Annual report as a whole	5 – Overall impressions	Trends in overall report structure, from the length of the report and its various sections to the speed of reporting timetables and the cohesiveness of the report as a whole.
	6 – Summary material	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 – Strategic report	Disclosures in 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.
Narrative reporting	8 – Key performance indicators	The types of measure identified as KPIs, how they are presented and the quality of linkage to other areas, such as directors' remuneration.
	9 – Principal risks	The risk areas commonly identified as principal, the level of detail given and ways of presenting the information effectively, including linking it to other parts of the annual report.
	10 – Going concern	The assessment and reporting of going concern, including the extent to which companies have anticipated the introduction of the new viability statement.
Corporate governance	11 – Effective company stewardship	The quality of disclosure given by companies regarding their compliance with the 2012 UK Corporate Governance Code, including explanations for areas of non-compliance, as well as discussion of the changes that will be required to comply with the 2014 version of the Code.
	12 – The work of the audit committee	Insight into best practice around Audit Committee reporting, in particular the discussion of significant issues the committee has considered in connection with the financial statements and consistency with similar information elsewhere in the report.
Financial statements	13 – The auditor's report	An insight into this year's developments around auditor reporting, including consistency with audit committee reports.
	14 – Primary statements	The way in which companies present information in their primary statements, in particular the use of non-GAAP measures.
	15 – Notes to the financial statements	Key findings from reviewing the notes to the financial statements, including ideas for making them clearer and more concise by improving accounting policy disclosures and ensuring consistency with narrative reporting.

# 3. Regulatory overview

## 1. Executive summary

## 2. How to use this document

## 3. Regulatory overview

## 4. Survey objectives and methodology

## 5. Overall impressions

## 6. Summary material

## 7. The strategic report

## 8. Key performance indicators

## 9. Principal risks and uncertainties

## 10. Going concern and viability

## 11. Corporate governance

## 12. The work of the audit committee

## 13. The auditor's report

## 14. Primary statements

## 15. Notes to the financial statements

## Appendix 1 – Glossary of terms and abbreviations

## Other resources available

When preparing their annual reports, UK listed companies have to follow requirements and guidance from many different sources. These require or suggest not just what should be included in the report but also how it should be presented. Some of the most significant requirements arise from:

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

Companies also need to pay attention to regulatory pronouncements from bodies such as the Financial Reporting Council (FRC), the Financial Conduct Authority (FCA) and the European Securities and Markets Authority (ESMA).

This chapter sets out an overview of the key developments that management teams will need to bear in mind when preparing their annual reports for 2015 and beyond, as well as highlighting current areas of regulatory focus<sup>2</sup>. It is not a comprehensive guide to all of the requirements – other publications produced by Deloitte, such as *GAAP: UK reporting* and *GAAP: Model annual report and financial statements for UK listed groups*, provide comprehensive information on all of the requirements, with the latter publication presenting a model annual report for a UK listed group. In addition, information on the latest developments, including news articles, thought pieces and supporting resources, can be found on Deloitte's one-stop-shop for all accounting, governance and regulatory matters, [www.ukaccountingplus.co.uk](http://www.ukaccountingplus.co.uk). Where specific developments have been discussed below we have included hyperlinks to the associated pages on UK Accounting Plus, which include Deloitte publications designed to help you understand how these changes will affect you.

2. Areas of regulatory focus have been identified from a variety of sources, but in particular the FRC's Corporate Reporting Review Annual Report 2014
3. <http://www.iasplus.com/en-gb/news/2015/07/uk-study>
4. <http://www.iasplus.com/en-gb/news/2014/06/frc-strategic-report-guide>

## The big picture

With the amount of requirements that exist, it is no surprise that some companies struggle to produce an annual report that meets regulatory as well as investor demands. Indeed a recent survey of 290 investment professionals by the CFA Society of the UK<sup>3</sup> found that not only did 60% of them believe that financial reports contain too much irrelevant information but 55% also believed that financial reports also omit important information, suggesting that there is still some way to go to please all or even most investors.

To assist preparers in balancing these demands, in June 2014 the FRC launched its 'Clear & Concise' initiative with the publication of its 'Guidance on the Strategic Report'<sup>4</sup> (the 'FRC Guidance'). This initiative sets out to promote good communication in corporate reporting and ensure that annual reports provide relevant information for investors. Since the launch of the initiative, various publications have been released by the FRC's Financial Reporting Lab (the 'Lab') under its aegis.

- [Accounting policies and integration of related financial information](#) (July 2014), which explores investor views on the presentation of accounting policies and the integration of financial review and financial statement information.
- [Towards Clear & Concise Reporting](#) (August 2014), which explores several insights based on observations that the Lab made during a review of 2013 year-end reporting.
- [Clear & Concise case study: William Hill – accounting policies](#) (February 2015), a discussion of investor reactions to a radical change in accounting policy presentation.
- [Digital present: Current use of digital media in corporate reporting](#) (May 2015), an assessment of investor views on digital communication mechanisms.

In addition to these Lab reports, the Clear & Concise initiative also encompasses the FRC's Corporate Reporting Review activities and its efforts to influence those setting disclosure requirements in Europe and internationally.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

In recognition of the fact that smaller listed companies in particular can struggle to produce an annual report that is 'Clear & Concise', last year the FRC launched 'Smaller listed and AIM company reporting'<sup>5</sup>, a three-year project aimed at achieving a step change in the quality of reporting by smaller listed and AIM companies. In its first phase, which culminated in a Discussion Paper<sup>6</sup> published in June 2015, this project looked to gather and assess evidence as to why such companies struggle to produce high quality reports. It found that the following are the main contributing factors to poor reporting by smaller listed companies.

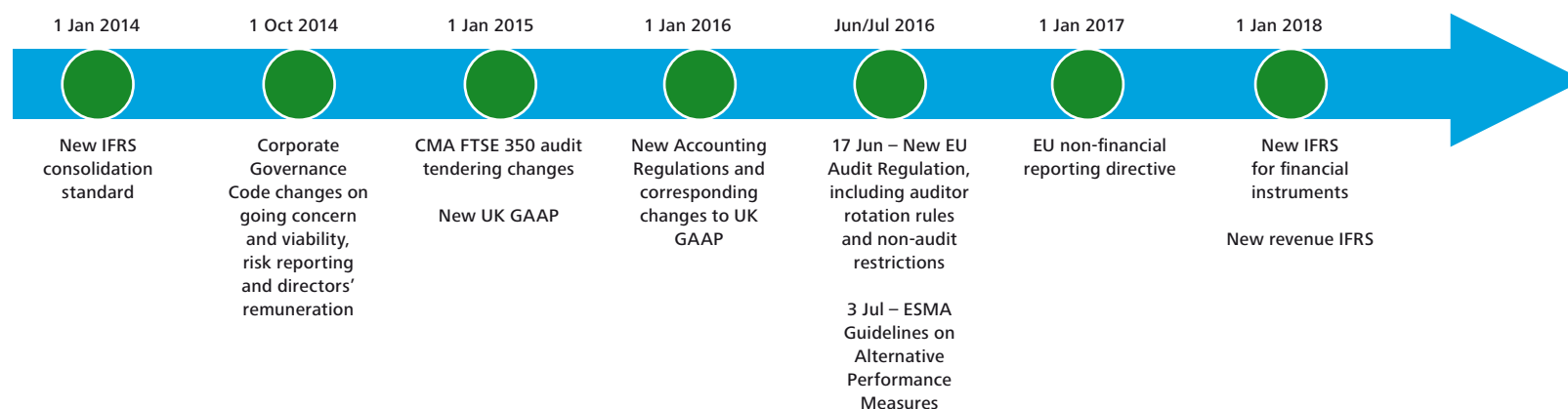
- Smaller companies see reporting as a compliance exercise, as they do not think investors read their annual reports.
- They find preparing annual reports a challenge due to a lack of skilled resources and access to up to date technical information.
- They have limited access to external financial reporting expertise.

The discussion paper also asked for views on several proposals intended to help smaller companies address these challenges. Throughout our survey we highlight areas where, from our survey data, it appears that companies outside the FTSE 350 struggle in their reporting.

It is not just the FRC that is producing guidance for companies looking to improve their annual reports. In May 2015 the Institute of Chartered Secretaries and Administrators also produced 'Good practice for annual reports'<sup>7</sup>, a short document setting out the features that they believe make the best annual reports.

### UK corporate reporting – timeline of key changes

Effective for periods commencing on or after:



5. <http://www.iasplus.com/en-gb/news/2014/07/smaller-listed-and-aim-company-reporting-frc>

6. <http://www.iasplus.com/en-gb/news/2015/06/frc-smaller-listed-and-aim-quoted-dp>

7. <http://www.iasplus.com/en-gb/news/2015/04/icsa-guidance-notes-annual-reports>



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Other significant initiatives:

FRC's 'Clear & Concise' initiative and 'Smaller listed and AIM company reporting' project

IIRC integrated reporting framework

IASB disclosure initiative

IASB conceptual framework and FRC/European contribution to 'Getting a Better Framework'

Financial reporting lab projects on business models, dividend policy and digital reporting

IASB project to develop a new leasing standard

**Narrative reporting**

In the world of narrative reporting, the last year has been a period of relative stability. Since the significant shift arising from the introduction of the Strategic Report for periods ending on or after 30 September 2013, the only real change has been the introduction for years ending on or after 1 September 2014 of two new Listing Rule requirements relating to cross-referencing of information and agreements with 'controlling shareholders'. Neither of these has had a significant effect for the vast majority of companies.

That is not to say that there has been no change in the reports themselves. As well as the FRC Guidance, which provides companies with insight into producing an effective strategic report, the International Integrated Reporting Council (IIRC)'s International (<IR>) Framework<sup>8</sup> has been steadily gathering momentum. Although neither of these is mandatory, both have nevertheless made a significant impact. While the FRC Guidance deals purely with reporting considerations, the <IR> Framework is bolder, seeking to change not just reporting but underlying business processes through the introduction of its underlying concept of integrated thinking.

Additionally, companies looking to improve their disclosure around human rights could consider:

- summarising the disclosures that are made in the Slavery and Human Trafficking Statement that they are required to make by the Modern Slavery Act 2015<sup>9</sup>; and
- the UN Guiding Principles Reporting Framework<sup>10</sup> published by the Human Rights Reporting and Assurance Frameworks Initiative in February 2015.

8. <http://www.iasplus.com/en-gb/resources/sustainability-en-gb/iirc#ir-history>

9. <http://www.legislation.gov.uk/ukpga/2015/30/section/54/enacted>

10. <http://www.iasplus.com/en-gb/news/2015/03/un>

Our survey findings in relation to narrative reporting are discussed in chapters five to ten of this publication.



**Existing requirements**

Section 415 of the Companies Act 2006 (CA06) requires a directors' report to be prepared as part of any UK company's annual report. All UK companies other than those that meet the CA06 definition of 'small' are also required to prepare a separate strategic report, which should be approved by the directors, although this approval may be combined with that of the directors' report, as long as it is clear that each report has been approved by the board. The strategic report is required to contain:

- a fair review of the company's business;
- a description of the principal risks and uncertainties facing the company; and
- 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, the strategic report should also contain the following (although the first two items are only required to the extent necessary for an understanding of the company's development, performance or position):

- information on the main trends and factors likely to affect the future development, performance and position of the company's business;
- information on environmental matters, employees and social and community issues, including any policies in these areas and their effectiveness (if any of these disclosures are omitted this should be stated);

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

- a description of the company's business model and its strategy (plus its objectives, as suggested by the UK Corporate Governance Code and the FRC's guidance on the strategic report – see below); and
- a gender analysis of the parent company's directors, the group's senior management and the group's employees as a whole.

Nowadays, this leaves relatively little content for inclusion in the directors' report, but for quoted companies one substantial requirement is for certain information on greenhouse gases emissions to be disclosed therein. Often this is included alongside corporate social responsibility disclosures in the strategic report, and cross-referred to from the directors' report.

Companies have the option to provide shareholders with the strategic report and other specified supplementary material, in place of the full annual report. This replaced the option of providing summary financial statements.



#### New requirements

The main new requirement that will become effective for the 2015 reporting season is the 2014 Corporate Governance Code, which will impact disclosures in the strategic report as well as the corporate governance statement. See 'Governance' below for a full discussion of these changes.



#### Areas of regulatory focus

The following areas of regulatory focus have been identified in relation to narrative reporting.

- Making the report (being both the narrative and the financial statements) **clear and concise**. Measures such as removing immaterial information and making effective use of cross-references to avoid duplication can help preparers meet this challenge.

- Presentation of **non-GAAP measures**. In light of the publication of ESMA's Guidelines on Alternative Performance Measures (see 'Future developments' below), this is likely to be an area of focus for regulators. Even though the ESMA Guidelines are not yet effective, companies should consider carefully the way in which non-GAAP measures are presented in their narrative reports, for example making clear their basis of calculation (this point applies equally to KPIs). The identification of items excluded from non-GAAP measures (often described as 'exceptional items') is also likely to be an area of continued focus – see the Financial statements section of this chapter for more detail.

- The information included within the strategic report should be **fair, balanced and understandable**. This includes balancing analyses that use non-GAAP measures with analyses that use unadjusted metrics and ensuring discussions of performance and position are suitably comprehensive and not omitting 'bad news'.

- The **linkage and consistency** of the information included in the 'front half' and 'back half' of the annual report. Companies should ensure that there is cohesion between the information reported and effective linkage throughout the annual report. For example, consistency could be expected between adjusted measures presented prominently in the narrative, those presented in the income statement, those in the IFRS 8 segmental disclosures and the metrics identified as key performance indicators.

- The level of disclosure provided by **smaller companies**. In light of the FRC Discussion Paper on proposals to improve the quality of reporting of smaller listed and AIM quoted companies, regulators will continue to look carefully at smaller companies' reports. In their discussion paper, the FRC said that smaller companies' "business reviews, and subsequently, strategic reports, are not always balanced or comprehensive, as required, or appear inconsistent with other information in the annual report." Examples the FRC identified included poor explanations of performance and limited references to exceptional items.

- Identification of **principal risks and uncertainties**, bearing in mind the changes described in the new governance requirements below. Companies should focus on *principal* risks and describe the mitigation activities undertaken – this is a problem area for smaller companies in particular.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available



### On the horizon

There are also some other new requirements coming further down the line:

#### *ESMA's Guidelines on Alternative Performance Measures<sup>11</sup>*

These affect a variety of documents but in particular include within their scope the narrative sections of annual reports (but not the financial statements themselves). Although they are described as 'Guidelines', ESMA has stated that they expect compliance with them to be enforced by 'Competent Authorities' – in the UK this means the FRC, as part of the activities of their Conduct Committee. As issued by ESMA, the guidelines would apply to documents published on or after 3 July 2016.

They set out a framework for the presentation of Alternative Performance Measures ('APMs'), also known as non-GAAP measures, aimed at promoting their usefulness and transparency. In particular, they require that:

- APMs should be defined and the basis of calculation set out;
- APMs should be reconciled to the most directly reconcilable line item, subtotal or total presented in the financial statements;
- APMs should not be displayed with more prominence, emphasis or authority than measures directly stemming from financial statements;
- APMs should be accompanied by comparatives for the corresponding previous period; and
- APMs should be consistent over time, with changes in or the cessation of use of an APM explained.

11. <http://www.iasplus.com/en-gb/news/2015/06/esma-apm>

12. <http://www.iasplus.com/en-gb/news/2014/11/eu-esg>

13. <http://www.iasplus.com/en-gb/news/2015/07/consultation-gender-pay-gap>

14. <http://www.iasplus.com/en-gb/news/2015/07/tax-strategy-consultation>

15. <http://www.iasplus.com/en-gb/news/2014/09/frc-publishes-2014-code>

### *The EU Directive on disclosure of non-financial and diversity information<sup>12</sup>*

This Directive has yet to be transposed into UK law but will become effective for financial years beginning on or after 1 January 2017. It will extend existing diversity disclosure requirements so that large listed companies will also be required to provide information on their diversity policy, covering age, gender and educational and professional background. Also, it will introduce requirements for listed companies to disclose information on anti-corruption and bribery matters, including related policies. Although the EU would have permitted country by country reporting, which becomes effective for periods commencing on or after 1 January 2015, to be included in companies' annual reports this option was not carried forward in the UK, which requires a separate stand-alone report.

### *Recent UK Government consultations*

Recently the Government Equalities Office issued a consultation on 'Closing the Gender Pay Gap'<sup>13</sup> and HM Revenue & Customs has sought views on 'Improving Large Business Tax Compliance'<sup>14</sup>. Both of these consultations have the potential to result in new disclosure requirements being imposed for narrative reporting.

### **Corporate governance**

In terms of mandatory requirements the last reporting season was a relatively quiet year in the world of corporate governance, with no new requirements becoming effective. However, with the revised 2014 version of the UK Corporate Governance Code (the '2014 Code') and supporting Guidance on Risk Management, Internal Control and Related Financial and Business Reporting<sup>15</sup> having been published in September 2014, many companies have been considering the impact that these new pronouncements will have on their reports. Although the new requirements are only effective for periods commencing on or after 1 October 2014, a few companies have early-adopted some of the requirements – see chapter 11 for more details.

Our survey findings in relation to corporate governance are discussed in chapters 11 and 12 of this publication, with going concern and viability statements discussed in chapter 10.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available



### Existing 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 a statement as to whether they have complied with the provisions of the Code providing explanations for any failures to comply. During the period covered by this year's survey companies will also have followed the associated FRC documents 'Internal Control: Guidance to Directors' and 'Guidance on Audit Committees', both of which recommend various disclosures for inclusion in the annual report.

Under the Code 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 also 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. The FRC Financial Reporting Lab recently published an implementation report assessing how companies are responding to investor demands in relation to effective audit committee reporting<sup>16</sup>.

Under the Code, FTSE 350 companies also need to put the audit out to tender at least every ten years, subject to transitional provisions – see below for further impending requirements around audit tendering and rotation.

The Code requires companies to describe the work of the nomination committee, including 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.

16. <http://www.iasplus.com/en-gb/news/2015/06/fr-lab-audit-committees>

17. <http://www.iasplus.com/en-gb/news/2015/01/gc-100-directors-remuneration-supplementary-guidance>

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. For periods commencing on or after 1 October 2014 this disclosure should be prepared in accordance with the new version of this guidance published in September 2014, which is discussed in more detail below.

Quoted companies reporting under the Act are also required to include a directors' remuneration report. The remuneration report must contain a statement by the chair of the remuneration committee telling the story of the year in respect of remuneration. Following this the report is 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 is subject to a binding shareholder vote. The annual report on remuneration is subject to an annual advisory vote and includes a 'single figure' directors' remuneration table. The GC100 and Investor Group has published guidance on these requirements, which was updated at the end of 2014<sup>17</sup>.



### New requirements

#### *The 2014 Code*

The 2014 Code introduces the following significant changes to existing requirements.

- In place of the existing going concern statement, directors will be required to include two statements regarding the health of the business.
  - A statement of whether they consider it appropriate to adopt the going concern basis of accounting, and any material uncertainties identified in assessing this. This statement must cover a period of at least twelve months from the date of approval of the financial statements and is required in half-yearly reports as well as annual reports. The scope of this is narrower than the existing requirement, which requires a statement that the business is a going concern more generally.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

– A new statement that, taking account of the company's current position and principal risks, the directors have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due, drawing attention to any qualifications or assumptions as necessary. The period covered by this assessment should also be stated, along with the reasons why that period is appropriate. It is expected that, except in rare circumstances, the period will be significantly longer than 12 months from the date of approval of the financial statements.

- Boards will have to confirm that they have undertaken a robust assessment of the principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity, and how those risks are managed and mitigated. Rather than the one-off annual assessment required by previous versions of the Code, Boards will have to monitor risk management and internal control systems on an ongoing basis and will need to explain actions taken to remedy and failings or weaknesses identified. As mentioned above, new guidance in this area has also been issued and becomes effective at the same time as the revised Code, recommending disclosure of, inter alia, the likelihood and impact of risks as well as changes in the year.

- The 2014 Code now explicitly requires that remuneration policies should be designed to promote the long-term success of the company. In addition, a new provision has been added, requiring (as usual, on a comply-or-explain basis) that company remuneration schemes should include arrangements for clawback and withholding of remuneration.

- Boards will now be required to set out what action they intend to take in response to situations where a significant proportion of votes have been cast against a resolution at any general meeting, for example the advisory vote on the annual report on remuneration.

In addition to the 2014 Code itself and the general guidance for directors highlighted above, the FRC also published supplementary Guidance for Directors of Banks on Solvency and Liquidity Risk Management and the Going Concern Basis of Accounting.

### Auditor rotation

The other major area of activity recently in the world of corporate governance has been changes to the rules around auditor rotation. In September 2014 the Competition and Markets Authority published its final Order implementing reforms of the audit market in the UK, introducing a requirement (effective from 1 January 2015) that FTSE 350 companies put their statutory audit engagement out to tender at least every 10 years. The 2014 Code also contains the same requirement. However, the Department for Business, Innovation and Skills ('BIS') and the FRC are both currently drafting final legislation and standards to implement the new EU Audit Directive. It is expected that, once this implementation process is finalised, all listed companies (as well as other companies designated as 'Public interest entities') will be required to tender their audit at least every 10 years, with a change of auditor required at least every 20 years.

All of these requirements contain complex transitional provisions, which depend on the term of office of the current auditor. The earliest tenders required under the new rules could be for financial years commencing on or after 17 June 2016.

In addition to the new rules around tendering, the CMA Order also gives audit committees increased responsibilities for auditor independence and oversight, which come into force for financial years commencing on or after 1 January 2015.



### Areas of regulatory focus

In relation to governance there are several areas of regulatory focus at the moment.

- The **quality of explanations** given where a company does not comply with one or more provisions of the Code. The FRC included additional guidance on 'what constitutes a good explanation' in the 2012 version of the Code and has been monitoring the effect this has had.
- The level of detail given in the audit committee report, including in relation to **significant financial reporting issues** considered by the committee, **effectiveness of the external audit** and **safeguards on non-audit services**.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

- The quality of **succession planning** within the company. This should encompass more than just short-term plans to replace board members as they retire – in the words of David Styles, director of corporate governance at the FRC “Companies need to be prepared for a sudden departure of the CEO but it is not just at the CEO level where succession is important. There should be planning at non-executive and middle management level as well.”

- Whether the culture actually practiced within the company is the same as the **corporate culture** espoused by the Board. Boards have a responsibility for shaping the company culture, both within the boardroom and across the organisation as a whole, and should think hard about the assurance they have over how an appropriate culture is embedded within the business.

- As part of its project on **smaller listed and AIM company reporting**, the FRC has said it will consider governance arrangements in place at such companies.

The FRC has announced that in 2016 it will undertake major new projects on both succession planning and corporate culture.



#### On the horizon

The FRC has a policy of updating the UK Corporate Governance Code on a biennial basis, so the next update to the Code is expected to occur in 2016. It is expected that this update will incorporate various changes into the Code as a result of the UK implementation of the EU Audit Directive, as well as the CMA's recommendations in relation to audits of FTSE 350 companies.

#### Financial statements

For most of the companies in our survey sample, the big change this year was the adoption of the ‘package of five’ new consolidation standards<sup>18</sup>. The most significant impact of the adoption of these new standards was the removal of the option to proportionally consolidate jointly controlled entities – instead, equity accounting or accounting similar to proportional consolidation is required depending on the substance of the arrangement. See chapter 15 for further discussion of the impact of adoption of these standards.

18. IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements*, IFRS 12 *Disclosure of Interests in Other Entities*, IAS 27 *Separate Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures*.

Our survey findings in relation to financial statements are discussed in chapters 14 and 15 of this publication, with audit reports discussed in chapter 13.



#### Existing 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, although for periods commencing on or after 1 January 2015 they will need to adopt either IFRSs or FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, which replaces existing UK GAAP.

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. Another option is to apply FRS 102 with reduced disclosure. To apply FRS 101 or FRS 102 with reduced disclosure a company must notify its shareholders in writing and they must not object to its use. Companies wishing to do this in future could provide this written notification in a note to their next set of financial statements, proposing FRS 101's use in the following year's financial statements.

The auditor's report on the financial statements must comply with the requirements of ISA (UK and Ireland) 700. For those companies reporting under the Code, the auditor's report includes material on the most significant risks of material misstatement, materiality and the scoping of their audit work.



#### New requirements

For companies thinking about their 2015 or (pre-December) 2016 accounts, the changes to IFRSs that need to be dealt with are relatively minor – indeed for December year-end reporters there are no mandatory changes in 2015. For other year-ends, or those companies wishing to early-adopt amended standards, details can be found in the accompanying table.



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

However, the same cannot be said for company-only financial statements. Those companies still using existing UK GAAP at the moment will need to deal with its removal (effective 1 January 2015) by adopting one of the alternative frameworks available. One option is to move to full EU-adopted IFRSs for the company-only financial statements, which has the advantage of consistency with the group financial statements. However, we expect that companies will find it more attractive to adopt FRS 101 *Reduced Disclosure Framework*<sup>19</sup>, which uses the recognition and measurement requirements of EU-adopted IFRSs but provides adopters with exemptions from some of the more onerous disclosure requirements. Companies could also choose to apply FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*<sup>20</sup> in their company-only financial statements.

Title	Per IASB IFRSs, mandatory for accounting periods starting on or after:	Per EU-endorsed IFRSs, mandatory for accounting periods starting on or after:
<a href="#">IFRS 10 – Consolidated Financial Statements</a>	1 January 2013	1 January 2014
<a href="#">IFRS 11 – Joint Arrangements</a>	1 January 2013	1 January 2014
<a href="#">IFRS 12 – Disclosure of Interests in Other Entities</a>	1 January 2013	1 January 2014
<a href="#">IAS 27 (revised May 2011) – Separate Financial Statements</a>	1 January 2013	1 January 2014
<a href="#">IAS 28 (revised May 2011) – Investments in Associates and Joint Ventures</a>	1 January 2013	1 January 2014
<a href="#">Amendments to IFRS 10, IFRS 12 and IAS 27 (Oct 2012) – Investment Entities</a>	1 January 2014	1 January 2014
<a href="#">Amendments to IAS 32 (Dec 2011) – Offsetting Financial Assets and Financial Liabilities</a>	1 January 2014	1 January 2014
<a href="#">Amendments to IAS 36 (May 2013) – Recoverable Amount Disclosures for Non-Financial Assets</a>	1 January 2014	1 January 2014
<a href="#">Amendments to IAS 39 (Jun 2013) – Novation of Derivatives and Continuation of Hedge Accounting</a>	1 January 2014	1 January 2014
<a href="#">IFRIC 21 – Levies</a>	1 January 2014	17 June 2014
<a href="#">Annual Improvements to IFRSs: 2010-12 Cycle (Dec 2013)</a>	1 July 2014*	1 February 2015
<a href="#">Amendments to IAS 19 (Nov 2013) – Defined Benefit Plans: Employee Contributions</a>	1 July 2014	1 February 2015
<a href="#">Annual Improvements to IFRSs: 2011-13 Cycle (Dec 2013) – Annual Improvements to IFRSs: 2011-13 Cycle</a>	1 July 2014	1 January 2015

\*Amendments to IFRS 2 *Share-based Payments* and IFRS 3 *Business Combinations* apply prospectively to transactions occurring on or after this date. All other amendments apply to annual periods commencing on or after 1 July 2014.

19. <http://www.iasplus.com/en-gb/standards/uk-gaap/frs101>

20. <http://www.iasplus.com/en-gb/standards/uk-gaap/frs102>

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available



### Areas of regulatory focus

In relation to financial statements, significant areas of regulatory focus at the moment include the following.

- Identification of **exceptional items**. Various issues in relation to the identification of items as exceptional have been highlighted by the FRC, including:
  - lack of or poorly designed accounting policies and inconsistent application of them;
  - recurring or immaterial items identified as exceptional;
  - lack of symmetry between good and bad news; and
  - failure to present comparative information.

As discussed in the narrative reporting section, the presentation of non-GAAP measures such as 'profit before exceptional items' in the front half of the annual report is also likely to be an area of regulatory focus this year.

- Disclosure of **accounting policies**. As discussed in the Lab report [Accounting policies and integration of related financial information](#), policies should be specifically tailored to the current circumstances of the business and not just regurgitate the requirements of IFRSs. Companies should not be afraid to remove irrelevant or immaterial accounting policy disclosures from their reports.
- **Revenue recognition**. Regulators will continue to focus on unusual policies and aggressive revenue recognition, especially when a new line of business may be taking time to build momentum. Companies' policies should reflect their specific circumstances rather than being boilerplate and, although the effective date of IFRS 15 *Revenue from Contracts with Customers* is still several years away, the FRC expects that companies should be making meaningful disclosure regarding its expected impact on their financial statements.

- Clarity and completeness of **critical judgements**. Companies should ensure that disclosures explain the judgement made and its application, rather than just repeating the company's accounting policy. They should also ensure that a clear distinction is made between critical judgements and key sources of estimation uncertainty, even where they relate to the same item. Regulators can now compare the significant financial reporting issues considered by the audit committee, the auditor's identification of risks of material misstatement and the disclosures of critical judgements and key sources of estimation uncertainty and may challenge any apparent inconsistencies between them. Care should generally be taken in providing disclosures around judgemental areas, such as provisions and contingent liabilities.
- Application of the disclosure requirements of **IFRS 12 *Disclosure of Interests in Other Entities***, particularly where these relate to the application of the requirements of **IFRS 10 *Consolidated Financial Statements*** regarding de facto control, where one entity is able to control another despite holding less than 50% of the voting rights. This can arise in public companies where there is a single large minority shareholder and the other shareholdings are widely dispersed.
- Correct accounting for **business combinations**. When entities of a similar size are brought together in a business combination, care should be taken to correctly identify the acquirer for accounting purposes, which will not always be the legal acquirer. Also, companies should ensure they exercise sufficient diligence in identifying intangible assets acquired in a business combination, rather than just assuming that any excess paid above the fair value of previously recognised assets of the acquiree represents goodwill. Finally, care should be taken to identify any contingent payments that should be accounted for as remuneration expenses.
- Calculation and disclosure related to **impairment assessments**. Despite improvements, some companies are still failing to fully describe the key assumptions made and how values have been assigned to them. The identification of CGUs and allocation of goodwill to CGUs can also be subject to scrutiny. Other potential issues include use of a single pre-tax discount rate for multiple cash-generating units (CGUs) with different risk profiles or unrealistic assumptions regarding the turnaround of a loss-making business. Finally, companies should ensure that any required sensitivity disclosures are clear in setting out the situations in which impairments could arise.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

- Accounting issues relating to **pension schemes**, primarily defined benefit schemes. The FRC has highlighted several issues – these are:
  - the sufficiency of disclosure regarding governance of pension plans and the applicable regulatory framework;
  - whether an accounting surplus represents a recognisable asset;
  - whether companies have correctly identified and described the effect of minimum funding requirements;
  - schemes that purport to turn pension obligations into equity instruments; and
  - the sufficiency of sensitivity disclosures for actuarial assumptions.

At the time of writing, clarifications to IFRIC 14 were also expected<sup>21</sup>.

- **Financial instruments disclosures**, especially the relatively new IFRS 13 *Fair Value Measurement* disclosures for items in level 3 of the fair value hierarchy (which also apply to other assets measured at fair value). Companies should ensure that level 3 disclosures are sufficiently detailed and robust and provide sufficient quantitative information about significant unobservable inputs.
- **Tax accounting** is another current hot topic, with some potential issues including:
  - unexpected items in the reconciliation of profit to total tax;
  - inadequate justification to support recognition of deferred tax assets that are dependent on future profitability – this is particularly relevant for loss-making businesses;
  - incorrect recognition in other comprehensive income of tax on items recognised directly in equity; and
  - apparent discrepancies between the tax reconciliation and the discussion of items in the strategic report.

- Misclassification of items in **cash-flow statements**, inappropriate netting of cash flows and reporting of non-cash movements as cash flows continue to crop up in the FRC's reviews of accounts, although they are less prevalent than in the past.
- Disclosure issues relating to **intangible assets**. Where companies have recorded material intangible assets care should be taken to ensure compliance with IAS 38 *Intangible Assets* and that adequate disclosure has been provided.
- **Capital management** disclosures. These are too often boilerplate in nature and fail to reflect company-specific circumstances. Information presented should also be consistent with that presented in the narrative reporting.

21. <http://www.iasplus.com/en-gb/standards/ifric/ifric14>

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available



### On the horizon

Looking further ahead, the table below shows other new standards and amendments published by the IASB, along with their effective dates and EU endorsement status.

Title	Per IASB IFRSs, mandatory for accounting periods starting on or after:	Per EU-endorsed IFRSs, mandatory for accounting periods starting on or after:
<a href="#">IFRS 14 – Regulatory Deferral Accounts</a>	1 January 2016	TBC
<a href="#">Amendments to IFRS 10, IFRS 12 and IAS 28 (Dec 2014) – Investment Entities: Applying the Consolidation Exception</a>	1 January 2016	TBC – endorsement expected Q1 2016
<a href="#">Amendments to IAS 1 (Dec 2014) – Disclosure Initiative</a>	1 January 2016	TBC – endorsement expected Q4 2015
<a href="#">Annual Improvements to IFRSs: 2012–2014 Cycle (Dec 2014)</a>	1 January 2016	TBC – endorsement expected Q4 2015
<a href="#">Amendments to IFRS 10 and IAS 28 (Sept 2014) – Sale or Contribution of Assets between an Investor and its Associate or Joint Venture</a>	1 January 2016	Postponed – awaiting completion of the IASB's project on 'Elimination of gains or losses arising from transactions between an entity and its associate or joint venture'
<a href="#">Amendments to IAS 27 (Aug 2014) – Equity Method in Separate Financial Statements</a>	1 January 2016	TBC – endorsement expected Q4 2015
<a href="#">Amendments to IAS 16 and IAS 41 (Jun 2014) – Agriculture: Bearer Plants</a>	1 January 2016	TBC – endorsement expected Q4 2015
<a href="#">Amendments to IAS 16 and IAS 38 (May 2014) – Clarification of Acceptable Methods of Depreciation and Amortisation</a>	1 January 2016	TBC – endorsement expected Q4 2015
<a href="#">Amendments to IFRS 11 (May 2014) – Accounting for Acquisitions of Interests in Joint Operations</a>	1 January 2016	TBC – endorsement expected Q4 2015
<a href="#">IFRS 9 – Financial Instruments</a>	1 January 2018	TBC – endorsement expected H2 2015
<a href="#">IFRS 15 – Revenue from Contracts with Customers</a>	1 January 2018	TBC – endorsement expected Q1 2016

In addition to these items, at the time of writing the IASB also has ongoing projects to develop:

- [a new lease accounting standard](#);
- [a new standard dealing with insurance contracts](#);
- [revisions to the Conceptual Framework for Financial Reporting](#); and
- [the disclosure initiative, a broad-based initiative to explore how IFRS disclosures can be improved](#).

## 4. Survey objectives and methodology

### 1. Executive summary

### 2. How to use this document

### 3. Regulatory overview

### 4. Survey objectives and methodology

### 5. Overall impressions

### 6. Summary material

### 7. The strategic report

### 8. Key performance indicators

### 9. Principal risks and uncertainties

### 10. Going concern and viability

### 11. Corporate governance

### 12. The work of the audit committee

### 13. The auditor's report

### 14. Primary statements

### 15. Notes to the financial statements

### Appendix 1 – Glossary of terms and abbreviations

### Other resources available

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 and the extent to which preparers are taking on board the principles of integrated reporting;
- the content of strategic reports, including the level of detail provided, the ways that business models are described and common themes on key performance indicators and 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;
- 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 judgments 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.

To produce this publication the annual reports of 100 UK listed companies were surveyed to determine current practice. Our sample was selected from all the UK-incorporated companies with a premium listing of equity shares on the London Stock Exchange. We excluded investment trusts (apart from real estate investment trusts) from our sample due to their specialised nature. Investment trusts are those companies classified by the London Stock Exchange in the 'Equity Investment Instruments' sector. The 100 companies surveyed consisted of 57 companies in the FTSE 350 and 43 smaller companies outside the FTSE 350.

In the current year we have updated our sample to reflect the composition of the market at 30 April 2015. Although 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, it could not be identical. Replacements and additional reports were selected to ensure that overall the composition of our sample remains consistent with that of the market as a whole. The annual reports used are those for years ending on or after 28 September 2014 and published before 15 August 2015.

Although our survey data uses only companies from this sample, when selecting examples of good practice we have used material from the reports of companies that, in our view, best illustrate a particular requirement or innovation, regardless of whether they are in our sample or not.

## 5. Overall impressions

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Top tips

- Focus on quality rather than quantity – annual reports again continued to get longer with a 3% increase in average length from 132 to 135 pages. Despite a continuing focus on irrelevant content being excluded from annual reports, narrative reports got longer by an average of five pages, although financial statements have on average got two pages shorter.
- Utilise the Integrated Reporting (<IR>) Framework as a new lens for viewing the business in terms of its ability to create long-term value for all its stakeholders – only seven of the companies surveyed made any specific reference to <IR> in their annual reports.
- Link key aspects of the annual report together in the narrative section. Effective linkage of objectives, strategy, risks and KPIs provides a means to present a concise report – this is particularly important given the increase in the average length of the narrative section from 77 to 82 pages.

### Keep an eye on

- Ways to make your report more 'clear and concise' e.g. 26% of the companies surveyed included a summary remuneration policy rather than present the policy in full.
- How to format the annual report – the majority of investors prefer annual reports in a PDF format and this was reflected in our sample with an increase in companies choosing not to present any HTML format at 71% (2014: 68%).
- Integrate non-financial information throughout the narrative in the annual report – non-financial considerations are not solely for the Corporate Social Responsibility section of the narrative.

22. <https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Strategic-Report.pdf>

23. <http://integratedreporting.org/wp-content/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf>

In this chapter we examine overall trends across the annual reports surveyed. These trends are based on those encompassed by the FRC's Communication Principles (included in the FRC's Guidance on the Strategic Report<sup>22</sup>) and the International <IR> Framework's Guiding Principles<sup>23</sup>. Both of these sets of Principles consider the content of the annual report and the presentation of information therein, including discussion around connectivity, conciseness, and balance (see below). The overall concept of <IR> is discussed in more detail in the Regulatory overview in Chapter 3 and the Strategic Report is examined in Chapter 7.

### FRC's Communication Principles

- The strategic report should be comprehensive but concise.
- The strategic report should highlight and explain linkages between pieces of information presented within the strategic report and in the annual report more broadly.
- The strategic report should be fair, balanced and understandable.
- Section 5 of the FRC Guidance also includes guidance on applying the concept of materiality to the strategic report.
- Where appropriate, information in the strategic report should have a forward-looking orientation.
- The strategic report should provide information that is entity-specific.
- The structure and presentation of the strategic report should be reviewed annually to ensure that it continues to meet its objectives in an efficient and effective manner.
- The content of the strategic report should be reviewed annually to ensure that it continues to be relevant in the current period.

### <IR> Framework Guiding Principles

- Conciseness
- Connectivity of information
- Stakeholder relationships
- Materiality
- Strategic focus and future orientation
- Consistency and comparability



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

This chapter also examines some overall trends in specific areas of the annual report e.g. the directors' remuneration report and auditor report and considers how companies are choosing to publish their reports electronically and whether there is still a trend to make a preliminary announcement. We start by looking at the structure of the annual report as a whole.

### Structure and approval

The structure of the annual report continues to vary company by company, with a popular format being the use of four clear sections (excluding any summary pages upfront):

1. a strategic report;
2. a governance section (incorporating the Directors' Report);
3. financial statements; and
4. other information.

'Other information' sections varied from including administrative information (such as the notice of the AGM) and a glossary, to analyses of shareholdings and five year financial information summaries.

98 companies clearly identified a section of their annual report as their strategic report. 98% of these (2014: 100%) made the strategic report clearly distinct from the directors' report. The company which had not done so had, in fact, appeared to include the disclosures necessary to satisfy the Act's requirements for disclosures of a directors' report, however they had not clearly identified the information as forming the directors' report.

Of those which did not present a strategic report, one presented a "Strategic review" and the other provided a "Strategic and operational review" within the Chief Executive's review.

All of the banks within the survey had separate sections for their detailed Risk Management disclosures and Financial Review; overviews of these matters were also provided in the strategic report itself, to meet regulatory requirements. However, this was a useful way of structuring the annual report such that the information presented in the strategic report was uncluttered and, on the whole, free of technical banking jargon.

Interestingly, two companies retained references to former narrative reporting requirements which have been superseded by the strategic report: one maintained the presentation of a Business Review in addition to (and separate from) the strategic report and directors' report, and one provided an Operating and Financial Review within its strategic report.

The Act requires the strategic report to be approved by the board of directors and signed on behalf of the board by a director or the secretary of the company. Only 71 companies (2014: 73) clearly disclosed the approval of the strategic report by the board, with many of these incorporating the strategic report into the directors' report by cross-reference, rather than recognising it as a legally separate report. While failure to include this approval clearly may not cause investors great concern, it may raise a question around the effectiveness of the governance processes around the annual report more widely.

It is not clear in the Act whether the approval of the strategic report needs to be separate from that of the directors' report or not. Of those companies clearly disclosing the board's approval of the strategic report, 92% (2014: 67%) presented the approval separately from the board's approval of the directors' report, with the remaining 8% combining both approvals in one disclosure.

### Length of the report and conciseness

Our survey results this year demonstrate an increase in report length of three pages from those annual reports surveyed in 2014 – see Figure 5.1. This was driven by an increase of five pages in the length of the front-half of annual reports, conversely the length of the financial statements decreased by an average of two pages. This perhaps suggests that, although quantitative materiality considerations have been applied to the back-half of annual reports, the application of materiality may have proved more problematic to the narrative sections of annual reports.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

The problem of the excessive length of annual reports remains an ongoing issue with a recent CFA Institute survey of its members highlighting “the creep of seemingly unproductive and irrelevant content” in annual reports<sup>24</sup>. The main complaint in this area continues to be the inclusion of immaterial information whilst at the same time omitting important or obscuring material, company-specific information. It could therefore be argued that the issue is more one of balance within the annual report rather than of the actual length of the report itself.

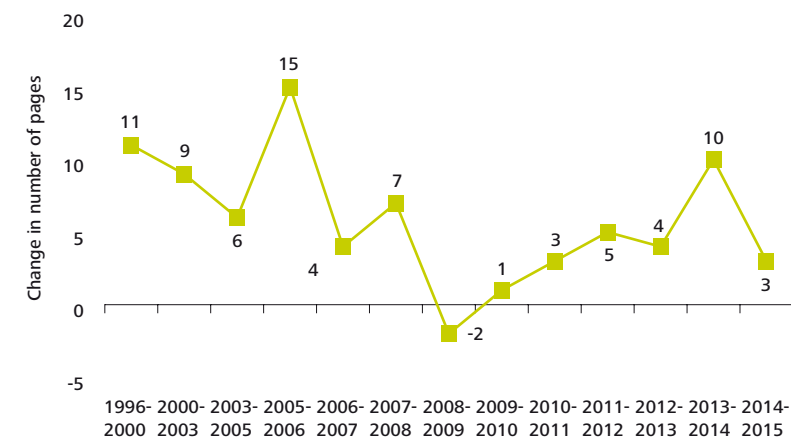
The FRC’s commitment to improving the effectiveness of corporate reporting continues through the work of its Financial Reporting Lab. This included the publication in February 2015 of their first case study report to review the steps that an individual company, William Hill PLC, has taken to address the issues raised by the FRC’s ‘Clear & Concise’ reporting initiative and the reaction of investors and analysts to these changes<sup>25</sup>. The IASB also continue the work on their Disclosure Initiative project to encourage more concise and effective communication within financial statements. The IASB is due to publish a discussion paper on ‘Principles of Disclosure’ later in 2015 and is expected to propose objectives for disclosure in addition to principles for communication, consistency and cross-referencing information. Among other things, this project is intended to increase the distinction between general guidance on disclosure and specific disclosure requirements, as well as whether requirements apply only to the primary statements or the financial statements as a whole.

Such continued efforts by regulators to help directors ascertain what matters to investors seem to be justified given the fact that annual report length has continued to increase. Our survey results this year are consistent with the upward trend in report length over the past few years and particularly the notable increase seen in our last survey (as companies addressed a number of new reporting requirements). The average length of the annual report excluding the banks surveyed increased from 121 pages to 127 pages. The banks in our sample managed to make their annual reports considerably shorter but continued to produce the longest annual reports with an average report length of 392 pages (2014: 468). This reduction in length was primarily driven by a decrease in areas of the narrative including the section dealing with the disclosure of risks. It is not surprising that banks continue to produce the longest reports given additional regulatory requirements, and lengthy financial instruments disclosures.

24. [https://secure.cfauk.org/assets/1345/Analysis\\_of\\_FRAC\\_survey\\_2015.pdf](https://secure.cfauk.org/assets/1345/Analysis_of_FRAC_survey_2015.pdf)

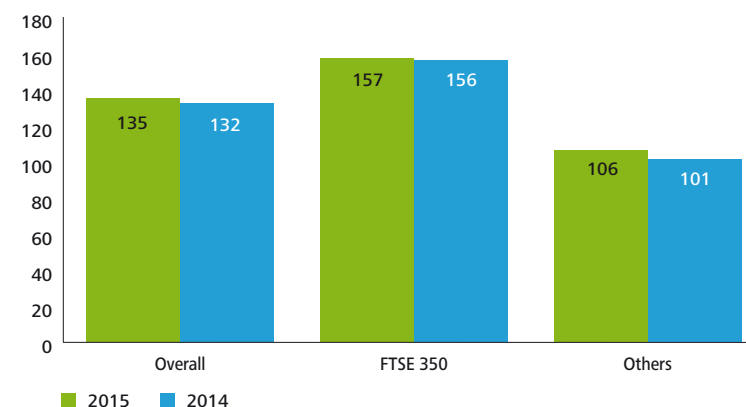
25. <https://frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/FRC-Lab-William-Hill-accounting-policies.pdf>

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



This increase was consistent across all companies surveyed, as illustrated by Figure 5.2, with the largest increase in year-on-year length seen in companies outside the FTSE 350.

Figure 5.2. How long is the annual report?



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Despite an increase in report length, some companies are taking heed of previous criticism over excessively long reports, making an effort to be more 'clear and concise' in the annual report. This ties into the linkage or 'connectivity' within annual reports, another principle highlighted by both the <IR> Framework and the FRC.

The ease of navigation of annual reports has remained broadly consistent with 78% of the companies surveyed producing reports that were judged easy to navigate (2014: 74%). A number of companies included contents pages throughout the report for each section e.g. strategic report, corporate governance, financial statements, in addition to the main contents page which was useful for longer annual reports. 84% of companies surveyed were judged to have 'visually interesting' annual reports (2014: 85%) with the majority of companies including at least some visual variety in their reports through the use of graphics and photographs.

### Linkage/connectivity

One of the FRC's Communication Principles relates to the need for companies to emphasise and explain linkages between pieces of information presented within the strategic report and in the annual report more broadly. The FRC's Guidance on the Strategic Report<sup>26</sup> goes on to provide a number of examples as to how this can be achieved. It differentiates between 'linkage' and 'signposting' with the former relating to the relationships and interdependencies between information and the latter relating to simple cross-references between sections of the annual report e.g. KPIs and strategic objectives, or to where there is more detail provided. The impact of the layout of annual reports, including the use of cross-referencing and 'signposting', was discussed by the FRC's Financial Reporting Lab's 'Towards Clear & Concise Reporting' published in August 2014<sup>27</sup> and is examined in more detail in Chapter 6; this chapter focuses on the more over-arching concept of linkage.

26. <https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Strategic-Report.pdf>

27. <https://www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/FRC-Lab-Towards-Clear-Concise-Reporting.pdf>

## <IR> connectivity

The FRC's principle of linkage is very much consistent with one of the guiding principles of <IR> ('connectivity of information'), however the FRC's Guidance does not explicitly encompass the key factor of integrated thinking – the active consideration by an organisation of the relationships between its various operating and functional units and the capitals that the organisation either uses or affects.

The idea of <IR> connectivity is a reflection of this integrated thinking within an organisation, with all the parts of the organisation acting and moving together. For those companies that have adopted such integrated thinking we would expect this integrated thinking to be apparent in their annual report through a high level of connectivity. To demonstrate <IR> connectivity an organisation would therefore have to show a high level of linkage to illustrate the interdependencies and relationships existing between the information as a result of the organisation and its operations being considered as a coherent whole.

In determining what level of linkage exists within an annual report it is necessary to review key information including objectives, strategy, risks and KPIs to determine whether demonstrable links between this information exists e.g. how do stated KPIs relate to a company's overall strategy as outlined in their annual report.

Our survey this year indicated that, although the majority of surveyed companies (58%) included some level of linkage (see Figure 5.3), there was a slight decrease on the previous year in which 64% of all companies were assessed as having some degree of linkage. The number of companies displaying comprehensive linking between information in the narrative was disappointingly low at 10% overall (2014: 9%).

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

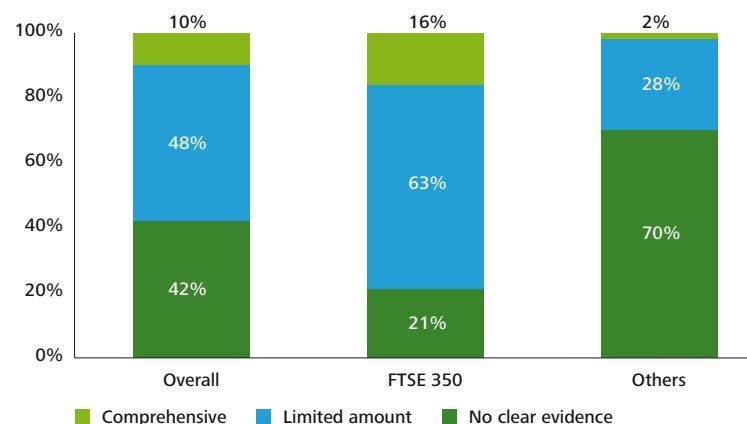
14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Figure 5.3. How much linkage is evident in annual reports?



Those companies surveyed that were judged to have a 'comprehensive' degree of linkage were those that had tended to encompass the idea of <IR> connectivity into their annual reports and as a result presented strategy/strategic objectives, KPIs and risks that were inter-related to one another as part of a coherent whole. Intertek Group Plc is a good example of a company displaying connectivity.

## How we run our business

OUR BUSINESS MODEL	OUR STRATEGIC PRIORITIES	ACHIEVEMENTS IN 2014 See Chairman and CEO's reports on pages 2 and 4, and Operating reviews on pages 20 to 29	KPIs See principal KPIs on page 10	PLANS FOR 2015 See Chairman and CEO's reports on pages 2 and 4	RISKS See Principal risks and uncertainties on page 11
MARKET SALES GROWTH	LEADING POSITIONS IN CORE INDUSTRIES	<ul style="list-style-type: none"> <li>Leading positions in Softlines, Hardlines and Transportation Technologies</li> <li>Diversification into services for operating expenditure in the oil and gas industry</li> <li>Added incremental services to portfolio</li> </ul>	<ul style="list-style-type: none"> <li>Divisional and business line growth</li> <li>Key country growth</li> </ul>	<ul style="list-style-type: none"> <li>Further geographic expansion in key markets</li> <li>Continued portfolio development across all business lines</li> </ul>	<ul style="list-style-type: none"> <li>Cyclical risk</li> <li>Loss or abuse of accreditation</li> <li>Harm to the Group's reputation</li> </ul>
GLOBAL NETWORK	GLOBAL NETWORK & SERVICE EXPANSION	<ul style="list-style-type: none"> <li>Additional accreditations achieved in 2014 include ISO 22301, ISO 55001 and EDGE</li> <li>New market offerings</li> <li>Three acquisitions in Industry &amp; Assurance</li> </ul>	<ul style="list-style-type: none"> <li>Divisional mix</li> <li>Geographic mix</li> </ul>	<ul style="list-style-type: none"> <li>Expanding service offerings and global reach through organic investment</li> </ul>	<ul style="list-style-type: none"> <li>Political risk</li> <li>Financial irregularity risk</li> <li>Labour and human rights</li> </ul>
CUSTOMER EXPERIENCE	CUSTOMER RELATIONSHIPS & SERVICE	<ul style="list-style-type: none"> <li>Superior Supplier Quality Award in the US</li> <li>Contractor Safety Awards (from a global customer)</li> <li>Supplier of the Year in Norway</li> </ul>	<ul style="list-style-type: none"> <li>Customer satisfaction</li> <li>Turnaround times</li> <li>Claims value</li> </ul>	<ul style="list-style-type: none"> <li>Global Account Management programme development</li> <li>Enhancements to customer business intelligence tools and technologies</li> </ul>	<ul style="list-style-type: none"> <li>Key staff reliance</li> <li>Harm to the Group's reputation</li> <li>Loss or abuse of accreditation</li> <li>Major claims</li> </ul>
STRATEGIC ACQUISITIONS	INDUSTRY CONSOLIDATION & TARGETED ACQUISITIONS	<ul style="list-style-type: none"> <li>Acquisition of INSPEC in UAE to enhance our global capabilities in Non-Destructive Testing</li> <li>Acquisition of ScanBi Diagnostics and the analytical division of QPS Bioserve India to enhance our capabilities in Food &amp; Agriculture Services</li> </ul>	<ul style="list-style-type: none"> <li>Return on Invested Capital ('ROIC')</li> <li>Internal rate of return</li> </ul>	<ul style="list-style-type: none"> <li>Expansion of service offerings and global reach through acquisitions</li> </ul>	<ul style="list-style-type: none"> <li>Financial irregularity risk</li> <li>Key staff reliance</li> <li>IT systems risk</li> </ul>
OPERATIONAL EXCELLENCE	PROCESS EFFICIENCY	<ul style="list-style-type: none"> <li>Continuation of global Shared Service Centre ('SSC') strategy – two new SSCs opened in Manila and Johannesburg</li> <li>Restructuring initiatives to streamline business processes and respond quickly to declining businesses</li> </ul>	<ul style="list-style-type: none"> <li>Cash flow from operations</li> <li>Revenue per employee by division</li> <li>Operating profit per employee by division</li> </ul>	<ul style="list-style-type: none"> <li>Continuation of global SSC strategy</li> <li>Continuing roll-out of global general ledger and Chart of Accounts</li> <li>Country operational excellence focus</li> </ul>	<ul style="list-style-type: none"> <li>Environment and climate change</li> <li>IT system risk</li> </ul>
PEOPLE DEVELOPMENT	INVESTING IN PEOPLE	<ul style="list-style-type: none"> <li>Internal development and promotion</li> <li>Over 250 people participated in Management Development programmes or academies</li> <li>130,000 training courses completed by 17,000 employees</li> </ul>	<ul style="list-style-type: none"> <li>Engagement scores</li> <li>Number of people per division</li> <li>Male:Female mix</li> <li>Number of training courses completed</li> <li>Health &amp; Safety metrics</li> </ul>	<ul style="list-style-type: none"> <li>CEO departure – successful recruitment</li> </ul>	<ul style="list-style-type: none"> <li>Key staff reliance</li> <li>Business ethics and bribery and corruption</li> <li>Operational Health &amp; Safety</li> </ul>

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

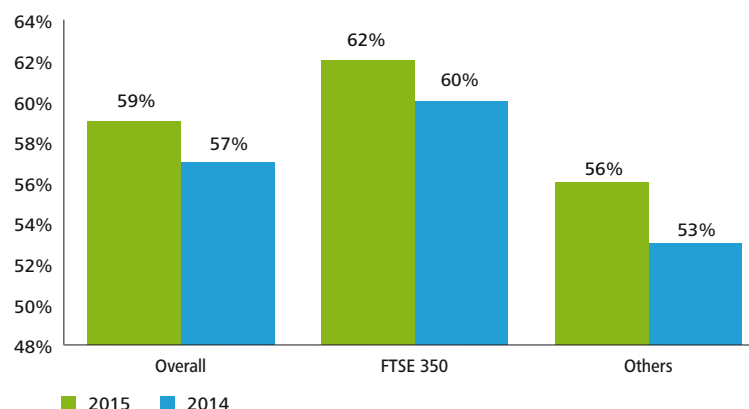
Appendix 1 – Glossary of terms and abbreviations

Other resources available

One area which was rarely linked to others was the risks identified for the company; this fact was mirrored by the CFA Institute's survey which found the disclosure of principal risks and uncertainties is the area of the annual report in greatest need of improvement<sup>28</sup>.

The ideas of linkage and of 'connecting' the information in the annual report can be seen as increasingly important given the fact that the upward trend in the overall length of annual reports for the companies surveyed, was driven by an increase in the length of the narrative from 77 pages in 2014 to 82 pages. There was also an increase in the percentage of narrative information contained within the reports surveyed compared to the % of report length dedicated to the financial statement information – see Figure 5.4. The highest percentage increase could be seen in the smaller companies surveyed which now contain 56% narrative information compared to 53% in 2014. By inter-linking the information in their narrative sections companies are more likely to make their annual reports more concise and avoid replicating information.

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



Inter-linking of information is important given the variety of information covered in the narrative sections of the companies surveyed including:

- individual case studies from across the company – these can help to bring an annual report to life if used sparingly and presented carefully, however, they can add unnecessary clutter if there are too many and if presented haphazardly. An example of a report in which case studies were used in a beneficial way was [Centrica plc](#) which included brief examples in context with the surrounding narrative. Case studies that were not so effective were inserted into the annual report in a manner which interrupted the overall narrative flow;
- detail of stakeholder engagement – discussed in more detail below; and
- detail of future trends in the company's particular industry sector – this is generally considered useful to give context to the strategy/performance of the company, as long as the impact that the market trends have on the company itself are explained. An example of this can be seen in the annual report of [Vodafone Group Plc](#).

28. [https://secure.cfauk.org/assets/1345/Analysis\\_of\\_FRAC\\_survey\\_2015.pdf](https://secure.cfauk.org/assets/1345/Analysis_of_FRAC_survey_2015.pdf)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## <IR> narrative

Seven of the companies surveyed made specific reference to <IR> in their annual report narrative, of these:

- two companies indicated that their annual reports were prepared in line with the principles of the <IR> Framework;
- one stated it had implemented an “integrated CSR reporting framework” in the year in order to integrate their CSR strategies into their day-to-day business activity;
- two mentioned that they aimed to report in an ‘integrated’ way with one referencing the <IR> Framework in relation to non-financial reporting;
- one indicated that it was a member of the International Integrated Reporting Council’s (IIRC) pilot and aim to have a fully compliant report by 2016; and
- one mentioned that their Audit Committee had discussed the presentation of the annual report in the context of <IR>.

## Stakeholder engagement

One of the <IR> Framework’s guiding principles is stakeholder engagement: an integrated report should provide insight into the nature and quality of the organisation’s relationships with its key stakeholders.

## <IR> stakeholder engagement

The <IR> Framework notes that value is not created by or within a company alone; it is dependent on and influenced by the external environment, relationships with stakeholders and other resources. To maximise potential value creation, companies should therefore be engaging with relevant stakeholders as a matter of course to understand their needs and interests.

As such, there is a requirement for an integrated report to provide insight into the nature and quality of a company’s relationships with its key stakeholders, including how and to what extent the company understands, takes into account and responds to their legitimate needs and interests.

The FRC’s Guidance on the Strategic Report states the description of the business model should provide shareholders with a broad understanding of the relationships that are necessary for the success of the business and that information on the environment, employees, social, community and human rights issues should be included when its influence, or potential influence on the development, performance, position or future prospects of the entity’s business is material to shareholders.

90 of the companies surveyed referred to stakeholders other than shareholders in their reports. Of these, the most common stakeholders were customers and employees – see Figure 5.5. Other stakeholders mentioned included NGOs, the ‘environment’ and industry associations. Only 27% of companies surveyed that mentioned their wider stakeholders did not define who these stakeholders were.



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

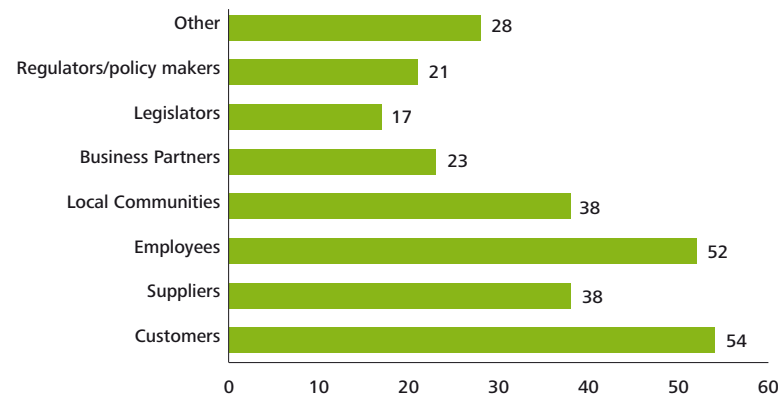
14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Figure 5.5. What different stakeholders are defined?



23% of companies identifying stakeholders beyond shareholders alone described the nature and quality of their relationships with those other key stakeholders. A good example of this is The Weir Group PLC. Other good examples include [Barclays PLC](#) and [Paypoint plc](#).



[The Weir Group PLC Annual Report and Financial Statements 2014 \(p. 53\)](#)

## Materiality

An overriding consideration in determining which information should be included in the annual report is materiality – is what is included, material to the users of the report? The FRC's 'communication principle' that the strategic report should be fair, balanced and understandable addresses the fact that users of the report should not be misled as a result of the omission of material information. The FRC's Guidance on the Strategic Report makes it clear that materiality is entity-specific and more likely to be based on qualitative factors than materiality judgements made in the context of the financial statements i.e. a more traditional view of 'materiality'<sup>29</sup>. The IASB is also in the process of developing a Practice Statement on materiality which will address various issues including the tendency to focus too much on the quantitative aspects of materiality<sup>30</sup>.

33 companies surveyed referred to materiality within the annual report. References made to materiality were more frequently made in relation to the risk determination and monitoring processes (see chapter 9), or else to sustainability issues and to how these were assessed as being material to the company's operations. 13 companies mentioned financial statement materiality, generally in the context of Audit Committee's discussions with external auditors. One of the banks cross-referred to a materiality report available on their website which identified issues that their Responsible Business Committee consider to be material to the business and key stakeholders.

The Global Reporting Initiative ('GRI') has developed their own sustainability reporting guidelines, the latest version of which is referred to as 'G4'<sup>31</sup>. The G4 guidelines have an increased emphasis than previous versions on the need for companies to focus on reporting on those issues which are material to their business and key stakeholders (note that the 'reporting' referred to here is focused more on a company's individual sustainable report, rather than the mandatory annual report, per se). The 'materiality' focus is intended to make reports more relevant, credible and user-friendly.

29. <https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Strategic-Report.pdf>

30. <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2015/March/AP11A-Disclosure%20Initiative.pdf>

31. <https://www.globalreporting.org/standards/g4/Pages/default.aspx>

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

It is not surprising, therefore, to see a number of companies disclosed information about their materiality determination process with respects to sustainability reporting. The challenge for companies adopting <IR> is to extend this process beyond sustainability-specific disclosure (see chapter 7), to include the wider disclosure requirements of the annual report.

## <IR> materiality

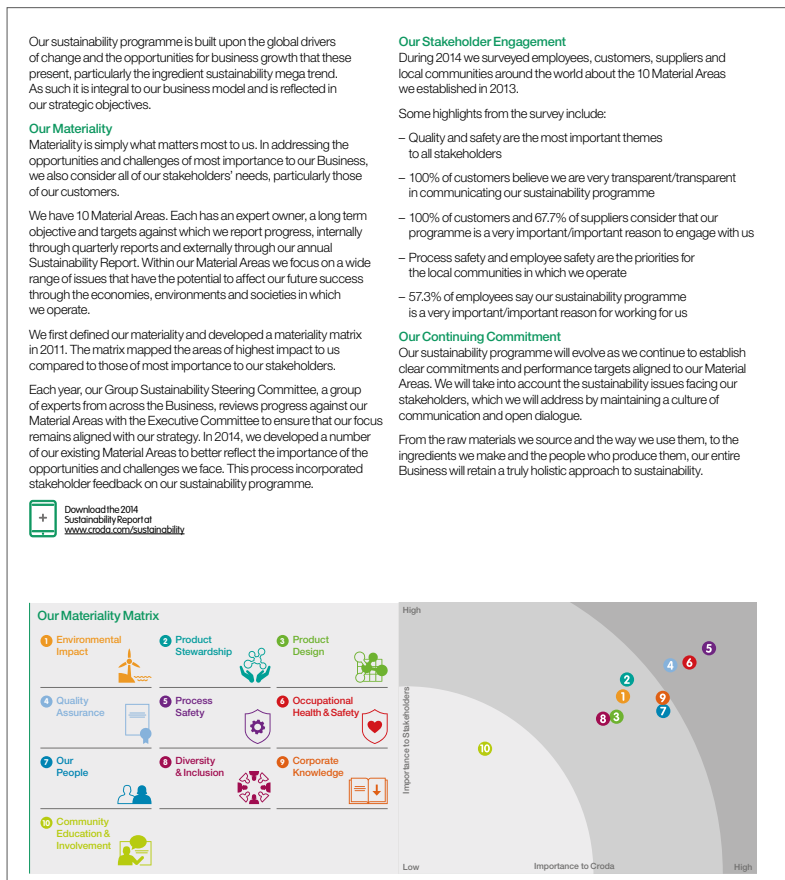
The <IR> Framework requires an integrated report to disclose information about matters that substantively affect the organization's ability to create value over the short, medium and long term i.e. those matters which are material. Similarly, materiality needs to be applied when considering how to apply the guiding principle of conciseness.

From the stakeholder engagement process, companies should have a better understanding of what matters to each stakeholder group, what their particular needs and interests in the company are, and how this impacts the company. This then feeds directly into the materiality determination process, which the <IR> Framework sets out as:

- identifying relevant matters based on their ability to affect value creation;
- evaluating the importance of relevant matters in terms of their known or potential effect on value creation;
- prioritizing the matters based on their relative importance; and
- determining the information to disclose about material matters.

To be most effective, the materiality determination process is integrated into the company's management processes and includes regular engagement with stakeholders to ensure the integrated report meets its primary purpose.

A good example of references to the materiality determination process with respect to sustainability is Croda International Plc, which explicitly refers to the consideration of stakeholders' needs as part of the materiality determination process. Another good example of a detailed description of determining materiality is [Premier Oil Plc](#). Another, slightly briefer description, was provided by [Johnson Matthey Plc](#).



[Croda International Plc Annual Report and Accounts 2014 \(p. 34\)](#)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

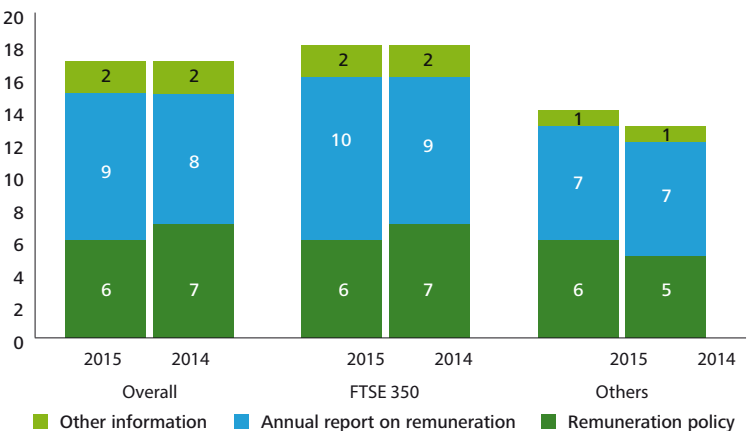
Appendix 1 – Glossary of terms and abbreviations

Other resources available

# Directors' remuneration reporting

Revised directors' remuneration reporting requirements for listed companies in the previous year caused a notable increase in the length of the various components of the remuneration report. In 2015 the average length of the total director's remuneration report stayed consistent – see Figure 5.6.

Figure 5.6. How long, on average, is the directors' remuneration report?



33% of FTSE 350 companies opted to present a summary of their remuneration policy alongside information as to where the full remuneration policy could be found for example [Chesnara plc](#). It should however be noted that the full policy must be reproduced in a year when a shareholder vote on the policy is to be held (at least every three years).

Overall, of those companies surveyed that included the full policy, 40 of those had changed their policy since the previous year whereas 59 included the full policy for reference. The remaining one company was required to present the full policy as it was a new listing in the current year. Given the increasing length of annual reports this is an area where companies could make their reports more 'clear and concise' by including a brief summary of their remuneration policy with a reference to where the full policy can be accessed. The length of the annual report on remuneration and other information presented (typically an introduction from the Chair of the Remuneration Committee) remained consistent with the previous year.

# Auditor reporting

Auditors' reports continue to get longer as auditors include more detailed descriptions of the risks identified and the procedures performed to enable them to reach their opinion in line with the amendments to ISA 700 *The Independent Auditor's Report on Financial Statements* issued in 2013. The average length of the group audit report increased to 4.2 pages overall (2014: 3.4 pages), with the longest group audit report reaching eight pages (2014: seven). 17 of the companies surveyed included other separate audit reports, generally for the company only financial statements. Combining the group and company reports into a single report can reduce the number of pages devoted to auditor reporting in the annual report and therefore help to make the report more 'clear and concise'.

The subject of auditor reporting remains at the fore with IAASB new and revised Auditor Reporting Standards becoming effective for audits of financial statements for periods ending on or after 15 December 2016<sup>32</sup> and EU legislation effective for periods commencing on or after 17 June 2016 (see Chapter 3 Regulatory overview). The auditor's report is discussed in further detail in Chapter 13.

32. <http://www.iasplus.com/en/news/2015/01/iaasb>

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Electronic communication

The final part of this chapter focuses briefly not on the overall content of the annual reports surveyed but on three issues relating to their production: electronic communication, the reporting timetable and making preliminary announcements.

In May 2015 the FRC's Financial Reporting Lab produced 'Digital present', a report on the current use of digital media in corporate reporting<sup>33</sup>. The results of the report highlighted how both companies and investors preferred PDF as a digital format for annual reports. Investors preferred a PDF format as it can be downloaded (and therefore not then able to be manipulated or removed) and is searchable. For companies this format also has the advantage of being relatively cheap, quick and easy to produce. The report also reflected a general sentiment that, so useful is the PDF format perceived to be, there is no advantage in producing more complex, 'snazzier' formats with investors attaching little value to e-books or interactive PDFs.

The consensus reflected in the FRC's 'Digital present' report is reflected in our survey with the majority of companies surveyed continuing to choose to offer their annual report as a basic pdf document – see Figure 5.7a. In fact there has been a decrease in the number of companies producing enhanced/navigable pdf versions with only 14% producing these in 2015 compared to 17% in 2014.

Figure 5.7a. What type of pdf reports are prepared by companies?

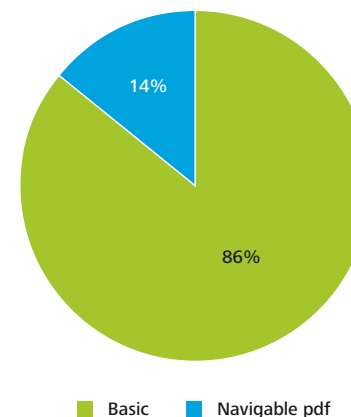
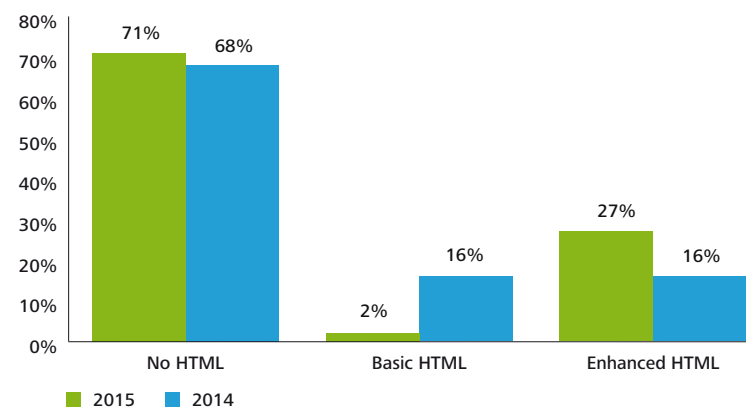


Figure 5.7b What type of electronic reports are produced by companies?



33. <https://www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/Lab-Project-Report-Digital-Present.pdf>

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

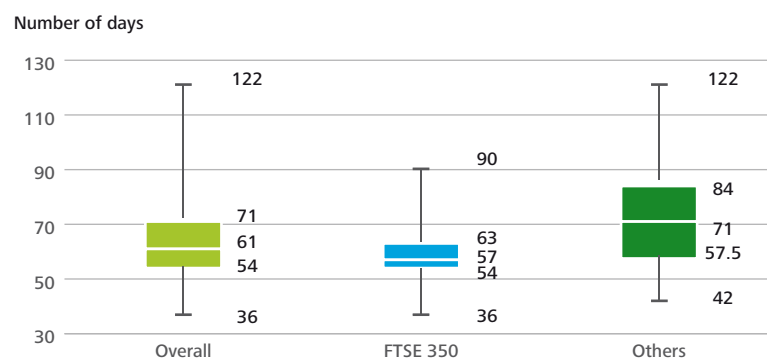
There was also a decrease in the number of companies producing an HTML version of their annual report. Those that did provide an HTML version tended to do so by providing additional enhanced content rather than just the PDF in a different format – see Figure 5.7b. Enhancements accompanying the annual reports included video interviews with company executives discussing the key issues contained within the report ([Barclays PLC](#)) and interactive maps detailing the company's activity around the world ([Compass Group PLC](#)).

### Reporting timetable

There was a small decrease in the average reporting time for companies approving their reports, with the median company reporting in 61 days (2014: 62 days).

The fastest reporter approved their report in 36 days (2014: 37) and the slowest in 122 days (2014: 121), but still within the four month filing deadline set out in the DTR. Figure 5.8 shows the reporting times for the companies surveyed.

**Figure 5.8. How quickly was the annual report approved?**



However, the time between year-end and the reporting date is only part of the picture in terms of reporting timetable. Most companies begin putting together their annual report months in advance of the year-end, creating a structure and thinking about the key developments in the business during the year, ready for the final figures to be slotted in once they are known. Obviously, as this is an internal process we are unable to collect data on it in our survey. Our accompanying publication, *Ideas for your annual report*, gives our thoughts on how companies can structure this process to produce a high-quality report as quickly as possible post year-end, increasing the timeliness of information provided to shareholders.

### Preliminary announcements

99% (2014: 96%) of the companies surveyed produced some form of preliminary announcement indicating that, although voluntary, companies continue to see the importance of making an announcement to markets/stakeholders prior to the publication of their annual report itself. Issuing some form of preliminary announcement also provides an easy way for companies to comply with requirements under DTR 2.2 (disclosure of price sensitive information) and Listing Rule 9.7A.2 (announcement of dividend and distribution decisions) for such types of information to be announced as soon as possible. The vast majority of these (89%) were based on audited results with the number of companies producing a preliminary announcement based on unaudited results reducing to four (three of which were FTSE 350 companies) from twelve in 2014. Only three of the companies surveyed (all outside the FTSE 350) issued a preliminary announcement that contained their full annual report in unedited text.

In terms of timing, the average number of days between year-end and the preliminary announcement was 61, with FTSE 350 companies issuing these slightly quicker at an average of 58 days.

## 6. Summary material

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Top tips

- An upfront summary section can provide an overview of how key information in the annual report, e.g. strategy, KPIs, is inter-related, yet only 22% of companies surveyed that included a summary section (2014: 29%) took advantage of this opportunity.
- The use of signposting in relation to the information in the summary section allows users of the annual report to navigate quickly and easily to where they can access more detailed information in the body of the annual report – 47% of the companies surveyed provided such signposting.
- Focus on company-specific information that gives readers of the report a good introduction to the company as a whole. We would expect strategy to be a key component of this but only 37% of companies presented such information in their summary section.

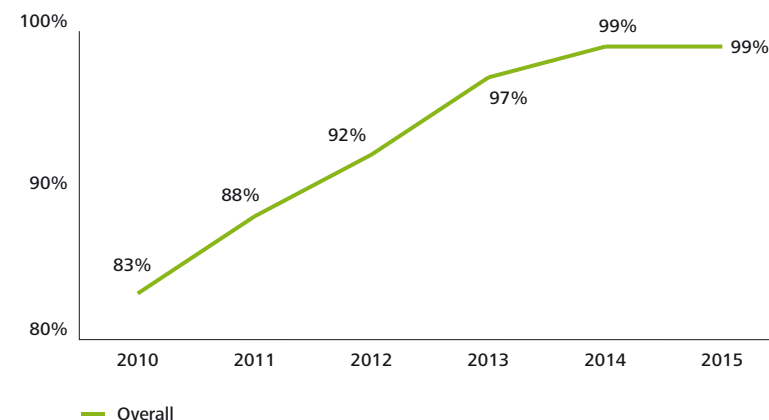
### Keep an eye on

- A continuing focus on the role of non-GAAP measures by various regulatory authorities means companies should focus on displaying non-GAAP measures that reconcile to information provided in the remainder of the annual report – however 11% of reports surveyed failed to do this.
- The consistency of information that is included in the summary section – are these in line with the measures that are important to the company i.e. the KPIs? 10% of companies surveyed that included performance measures in their summary section did not include any KPIs in these.

Almost all of the companies surveyed in 2015 produced a summary section at the beginning of their annual reports (see Figure 6.1). With annual reports getting longer, as discussed in Chapter 5, and the continuing calls for 'clear and concise' reporting, setting the scene upfront is a great way to help a user of the report understand the key messages. A well-structured and informative summary section highlights the key financial and non-financial information contained within the annual report, demonstrates how they link together and provides signposts to further detail within the annual report.

Determining what constituted a summary section as distinct from the strategic report required some level of judgement. Many companies did not make a clear distinction between the two, whereas others more clearly identified a discrete section before the strategic report. Nevertheless, in the former scenario summary-type information still tended to be provided very close to the start of the annual report. The information included in what we believed to represent summary sections, even if they were not labelled as such, is discussed in more detail below.

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



There are no direct regulatory requirements in respect of summary sections, however, directors must ensure that the information contained in one does not mean they fall short of the requirement that "the annual report and accounts, taken as a whole is fair, balanced and understandable" under provision C.1.1 of the UK Corporate Governance Code 2012, for example by giving undue prominence to good news in the summary whilst relying on the detail to cover less good news. To meet this requirement directors must consider whether the annual report as a whole "provides the information necessary for shareholders to assess the company's performance, business model and strategy".



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

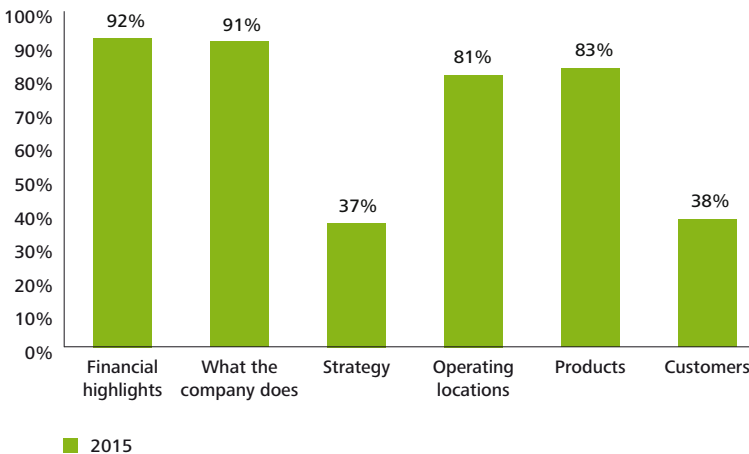
Appendix 1 – Glossary of terms and abbreviations

Other resources available

### What kind of information is included in the summary section?

Companies presented a wide variety of information in their summary section – the more common types of information are shown in Figure 6.2. Those companies that included financial highlights in their summary section very slightly decreased from the previous year (2014: 95%)

Figure 6.2. What kind of summary information is presented?



The majority of companies surveyed use the summary section to present more over-arching information on their operations e.g. what the company does, where in the world they operate and details on the products/services that they provide. Only 7% of companies surveyed that presented a summary section included information that was specifically described as an investment case/proposition. This suggests that companies have paid heed to the reason behind the FRC's introduction of the 'fair, balanced and understandable' requirement, being to avoid narrative reporting that is 'promotional' in nature.

Other information provided in the summary section included:

- timelines showing key events in the company's history (for example [Cobham plc](#) and [BT Group plc](#));
- awards won in the year (for example [National Grid plc](#) and [International Personal Finance plc](#));
- details of the company's corporate social responsibility policy/initiatives (for example [The Unite Group plc](#) and [Mondi Group plc](#)); and
- case studies of employees' experiences or commentary on the importance of the workforce (for example [AO World plc](#) and [Thomas Cook Group plc](#)).

Another popular choice of information to be included in the summary section was a breakdown of the company by division (generally in pictorial format) with accompanying brief information on the operation of these divisions. This information frequently included a breakdown of company financials by operating division – a good example of this was provided by Hill & Smith Holdings plc.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

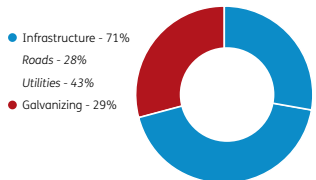
**Infrastructure Products**

For the core markets of Roads and Utilities – supplying products and services such as permanent and temporary road safety barriers, fencing, industrial platforms and flooring, street lighting columns, bridge parapets, glass reinforced composite railway platforms and flood prevention barriers, variable road messaging solutions, traffic data collection systems, plastic drainage pipes and pipe supports for the power and liquefied natural gas markets, energy grid components and security fencing.

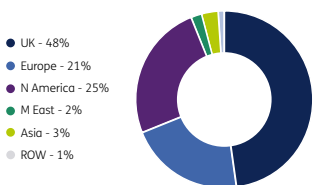
Operating from subsidiaries in Australia, France, India, Norway, Sweden, Thailand, the UK and the USA.

- › Operating in international territories with the prospect of sustained long term investment in infrastructure.
- › Focused on engineered products for the roads and utilities markets.
- › Accounts for 71% (2013: 71%) of the Group's revenue and 46% (2013: 43%) of the Group's underlying\* operating profit.

**2014 Revenue of £454.7m - by segment**



**Percentage of 2014 revenue £454.7m shown by end market geography**



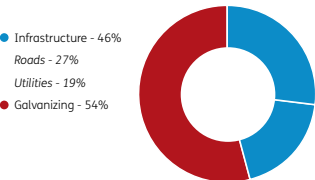
**Galvanizing Services**

Providing zinc and other coating services for a wide range of products including fencing, lighting columns, structural steelwork, bridges, agricultural and other products for the infrastructure and construction markets.

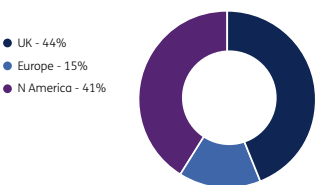
Services are delivered from a network of galvanizing operations in the UK, France and the USA.

- › Geographical diversity - France 10 plants; UK 8 plants; USA 7 plants.
- › Strong market positions in the chosen territories and with a reputation for service and quality.
- › Accounts for 29% (2013: 29%) of the Group's revenue and 54% (2013: 57%) of the Group's underlying\* operating profit.
- › Total volume of production from all plants 457,000 tonnes in 2014, up 7% (2013: 426,000).

**2014 Underlying\* operating profit of £49.2m - by segment**



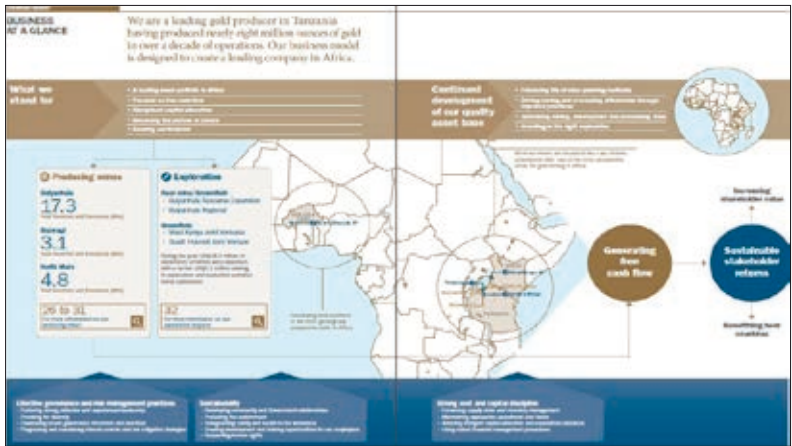
**Percentage of 2014 underlying\* operating profit £49.2m shown by location of the operating site**



[Hill & Smith Holdings PLC Annual Report 2014 \(p. 3\)](#)

Various companies looked at the bigger picture, not just their own businesses, by including material on the wider industry in which they operated. Such information generally included details on where their industry was headed and the impact of changes on future products/services (good examples of this were provided by [Vodafone Group plc](#) and [Treant plc](#)).

A number of companies surveyed used the summary section to demonstrate how they create value for their stakeholders. Displaying a company's overall business model and how it operates, as well as linking to other aspects of the business was demonstrated well by Acacia Mining plc and their 'Business At A Glance' summary section:



[Acacia Mining plc Annual Report & Accounts 2014 \(p. 4 – 5\)](#)

Summary sections were generally the area of the annual report that contained more visually interesting content. However, given ongoing criticism of the amount of superfluous information included in annual reports, coupled with the increasing length of narrative, discussed in Chapter 5, companies should be aware of keeping summary sections concise and related to the remainder of the annual report.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

**Linkage to the rest of the report**

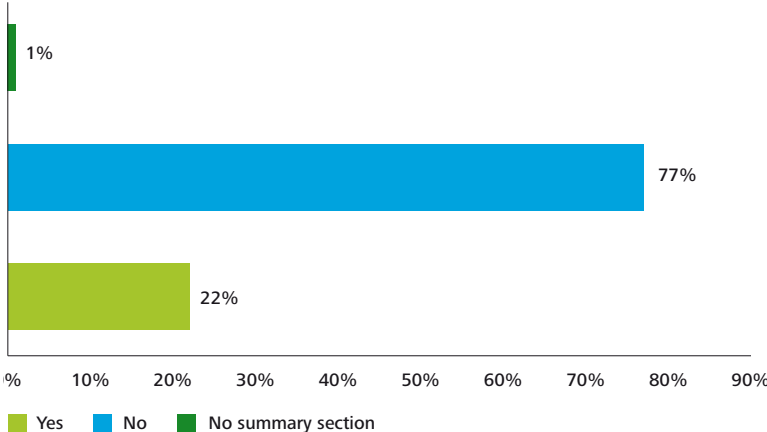
Given the current focus on making annual reports clearer, the summary section presents an opportunity for companies to indicate the linkage between sections of their annual reports, particularly strategy, objectives, risks and KPIs. The Financial Reporting Lab report 'Towards Clear & Concise Reporting', published in August 2014, stressed the importance of layout and particularly the use of cross-referencing and signposting to improve the clarity of annual reports<sup>34</sup> and this is particularly relevant for summary sections.

There was a very slight decrease in the percentage of companies surveyed that provided cross-references from the summary section to where information within was addressed elsewhere in the report at 53% (2014: 60%). This still indicates that, for many companies, useful links are not being made to where information is discussed in more detail in the body of the report. This sort of linkage can prove incredibly helpful in pulling together the different information provided in a report, regardless of any nearby contents page that provides more basic signposting.

34. <https://www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/FRC-Lab-Towards-Clear-Concise-Reporting.pdf>

Figure 6.3 sets out the percentage of companies surveyed that linked together information such as strategy, objectives, risks and KPIs in their summary section. Disappointingly, this has dropped slightly from the previous year when 29% of companies provided some linkage.

**Figure 6.3. Do companies link together various elements of their report in the summary?**



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

A good example of a summary section displaying linkage between the various areas of the annual report and signposting to further information was provided by Morgan Sindall Group plc:

Overview		
Our strategic priorities	Our performance in 2014	Looking forward
The Group's long-term strategy, to enhance its market-leading position across its chosen markets and use the cash generated from its construction activities to invest in and grow its regeneration activities, remains unchanged.	Confidence in the strategy has been reinforced by a strong performance from Urban Regeneration in 2014.	The Group will continue to be managed in line with its strategic priorities and to deploy its capital structure and management expertise to generate sustainable returns without taking undue risks.
<b>Target markets that offer the best potential for growth</b>	Significant appointments have been secured in the Group's key markets of social housing, education, transport and commercial.	Further investment in regeneration opportunities supported by improvement in the Group's order book provides confidence that the Group is well positioned to deliver future growth.
<b>Maximise returns by focusing on relationships with key customers</b>	New work has been secured on existing long-term frameworks and appointments secured on significant new frameworks.	The Group is committed to developing long-term relationships, creating strategic partnerships and securing positions on major frameworks.
<b>Utilise the Group's complementary range of skills to provide an integrated offering</b>	Sister divisions have collaborated on long-term, complex schemes around the UK involving investment, development and construction, for example the Towcester regeneration scheme (see page 21).	Investments continues its strategy to unlock prime long-term construction opportunities for sister divisions.
<b>Use the cash generated through construction activity to invest in regeneration</b>	Urban Regeneration has performed strongly, with a significant increase in operating profit and 13% growth in its regeneration and development pipeline.	Firm financial discipline will be applied to overheads, cash and working capital to ensure the Group has sufficient cash to invest from its construction activities into quality regeneration opportunities.
To read more see pages 9 to 11.	Pages 9 to 11 and 18 to 27.	Pages 9 to 11 and 18 to 27.

Overview continued

Business model	2014 key performance indicators ('KPIs')	Risk awareness
The Group's business model comprises five distinct but complementary drivers of growth that help the Group to deliver its strategy.	The Group uses financial and non-financial KPIs to measure its progress in delivering its strategy priorities.	The Group has a long established culture of mature risk and control processes to manage both material and day-to-day circumstances.
<b>People</b> <ul style="list-style-type: none"><li>Highest standards maintained in health and safety</li><li>Morgan Sindall Group People Promise ('People Promise') launched to position the Group as employer of choice.</li></ul>	<b>Accident Incident Rate</b> <b>306</b> <b>Number of graduates recruited</b> <b>67</b> <b>Average number of training days per employee</b> <b>2.2 days</b>	The Group's performance and business conduct affects employees, subcontractors and the public and in turn can affect its reputation and commercial performance.
<b>Winning in our markets</b> <ul style="list-style-type: none"><li>Close collaboration with clients and partners</li><li>Driving continuous improvement through Perfect Delivery</li><li>Targeting markets with highest opportunities for growth.</li></ul>	<b>Regeneration and development pipeline</b> <b>£3.2bn</b> <b>Perfect delivery</b> <b>81%</b> <b>Committed order book</b> <b>£2.7bn</b>	The Group undertakes several hundred contracts each year and needs to ensure that contractual terms relate to the risks arising from the nature and complexity of the works.
<b>Maximising efficiency</b> <ul style="list-style-type: none"><li>Long-term relationships with trusted suppliers and subcontractors</li><li>Optimising business processes and support functions.</li><li>Reducing energy consumption and carbon emissions.</li></ul>	<b>Gross margin</b> <b>8.2%</b> <b>Overhead as a proportion of revenue</b> <b>7.2%</b> <b>Carbon intensity (Scopes 1, 2 and 3)</b> <b>16.95</b>	If employees are not properly engaged with the culture of the business, clients are less likely to receive exceptional levels of service.
<b>Disciplined use of capital</b> <ul style="list-style-type: none"><li>Rigorous cash management</li><li>Long-term joint ventures and strategic alliances</li><li>Forward selling schemes with leading financial institutions.</li></ul>	<b>Working capital as a proportion of revenue</b> <b>(2.5%)</b> <b>Adjusted operating cash flow as a percentage of adjusted operating profit*</b> <b>8%</b>	Without sufficient liquidity, the Group's ability to meet its liabilities as they fall due would be compromised which could ultimately lead to its failure to operate as a going concern.
<b>Pursuing innovation</b> <ul style="list-style-type: none"><li>Empowering employees to think differently</li><li>Identifying innovative routes to market</li><li>Pioneering commercial structuring and funding solutions</li><li>Creating new design and construction techniques.</li></ul>	<b>Group revenue generated from Investments funding solutions</b> <b>£68.4m</b>	If the Group fails to encourage an innovative approach across its divisions it could lose its competitive edge and suffer reputational damage.
Pages 6 to 8.	Pages 6 to 8.	Pages 31 to 43.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

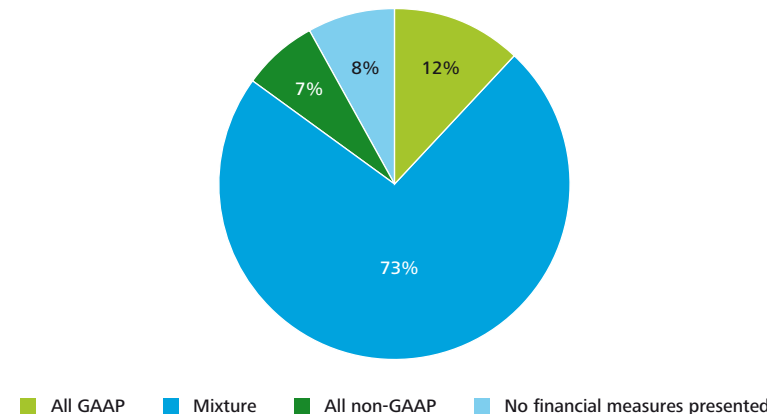
Other resources available

**Presentation of financial highlights and use of GAAP v non-GAAP measures**

Alongside the range of narrative information presented as part of the summary section by the companies surveyed, the vast majority presented some sort of financial highlights (92% per Figure 6.2 above). The type of financial measures presented in the summary section is displayed in Figure 6.4. This shows that 81% of companies presented financial measures based on non-GAAP/adjusted measures although the vast majority of these (73%) were included in conjunction with GAAP measures.

For the purposes of our survey, adjusted metrics such as profit before exceptional items have been regarded as non-GAAP measures, in line with common usage of the term. However, for those companies where these measures were presented in the IFRS 8 analysis because they were those reported internally for management purposes, it should be noted that this is technically not the case.

**Figure 6.4. What type of financial measures are presented in the summary section?**



A recent study<sup>35</sup> by the CFA Society of the UK (a body representing investment professionals) highlighted continuing concern over the use of non-GAAP measures with only a third of respondents preferring non-IFRS measures over IFRS. In general adjusted measures presented by management were seen as useful provided that the adjustments being made are disclosed sufficiently.

In a speech in March 2015 the Chairman of the IASB, Hans Hoogervorst, acknowledged that the use of non-GAAP measures can provide useful additional information to investors but that the IFRS numbers should serve as the primary performance measures<sup>36</sup>.

The prominence given to non-GAAP measures was also highlighted, specifically that they should not over-shadow the IFRS numbers.

Obviously summary information provided up front in a report has a high degree of prominence. With only 40% (2014: 37%) of companies surveyed presenting corresponding GAAP measures associated with non-GAAP measures they included in their summary sections, companies should be aware of potential challenge from regulators in this area. The IASB is undertaking a review of alternative performance measures as part of its Disclosure Initiative with a discussion paper on the 'Principles of Disclosure' expected to be published in the first quarter of 2016<sup>37</sup>.

The European Securities and Markets Authority (ESMA) published their 'Final Report: ESMA Guidelines on Alternative Performance Measures' in June 2015<sup>38</sup>. This report took account of surveys and work undertaken on 'Alternative Performance Measures' (APMs) by various European bodies including the FRC's Lab project report 'Accounting policies and integration of related financial information' issued in July 2014<sup>39</sup>. As in the speech discussed above, the key issues in the ESMA Guidelines are the prominence of non-GAAP measures within the annual report (outside of the financial statements) and ensuring that relevant disclosures necessary for the understanding of any APMs presented are made. The ESMA Guidelines are discussed in more detail in the Regulatory Overview in chapter 3.

Figure 6.5 shows how consistent the non-GAAP measures presented in the summary section by companies surveyed are with the financial information disclosed in the remainder of the annual report.

35. [https://secure.cfauk.org/assets/1345/Analysis\\_of\\_FRAC\\_survey\\_2015.pdf](https://secure.cfauk.org/assets/1345/Analysis_of_FRAC_survey_2015.pdf)

36. <http://www.ifrs.org/Alerts/Conference/Pages/Hans-Hoogervorst-speech-Mind-the-GAP-March-2015.aspx>

37. <http://www.ifrs.org/Current-Projects/IASB-Projects/Disclosure-Initiative/Pages/Disclosure-Initiative.aspx>

38. [http://www.esma.europa.eu/system/files/2015-esma-1057\\_final\\_report\\_on\\_guidelines\\_on\\_alternative\\_performance\\_measures.pdf](http://www.esma.europa.eu/system/files/2015-esma-1057_final_report_on_guidelines_on_alternative_performance_measures.pdf)

39. <https://frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/Accounting-policies-and-integration-of-related-fin.aspx>

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

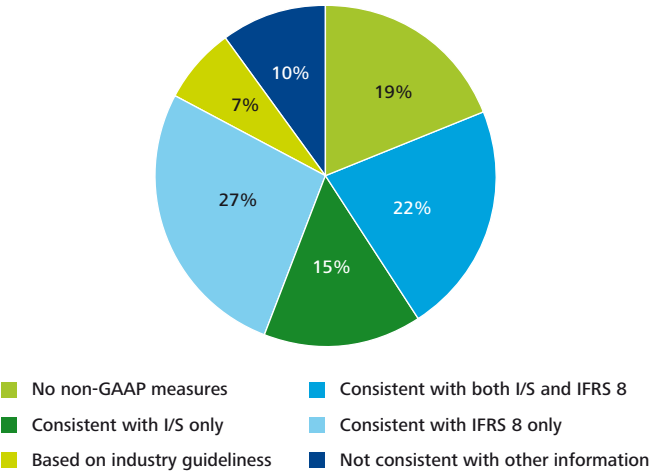
Appendix 1 – Glossary of terms and abbreviations

Other resources available

The use of non-GAAP measures can be useful as a means for companies to present the results of their operations in the way they believe to be most meaningful i.e. based on the metrics used by those charged with governance in the day-to-day running of the company, or those used by analysts following their industry sector. The % of companies presenting non-GAAP measures consistent with only their IFRS 8 *Operating Segments* note has increased 27% (2014: 15%) with the % of companies presenting non-GAAP measures that are consistent with both the income statement and the IFRS 8 note decreasing from 34% in 2014.

There has been a decrease in companies presenting non-GAAP measures that are not consistent with any other financial information presented in the annual report (down from 19% in 2014). The presentation of some non-GAAP measures e.g. revenue/profit at constant currency can be useful to users. For some of the companies surveyed the non-GAAP measures included were company KPIs and therefore did provide valuable information that reflected how the company was run.

Figure 6.5. How consistent are non-GAAP measures?



When companies are presenting such measures, they should be careful to consider if these are useful and that they will not simply serve to confuse users of their report. It should also be noted that the ESMA guidelines will require a reconciliation of any non-GAAP measures used in the narrative part of the annual report to the IFRS numbers presented<sup>40</sup>.

A further point that was highlighted in the CFA survey was the importance of the non-GAAP measures presented being consistent over time to enable meaningful comparisons of financial performance to be made<sup>41</sup>. The FRC's Corporate Reporting Review 2014 also considered the use of non-IFRS measures, frequently arrived at by stripping out 'exceptional items' from the statutory figures, and the need for companies to provide an accounting policy for such items<sup>42</sup>. For further discussion on this see Chapter 14.

40. [http://www.esma.europa.eu/system/files/2015-esma-1057\\_final\\_report\\_on\\_guidelines\\_on\\_alternative\\_performance\\_measures.pdf](http://www.esma.europa.eu/system/files/2015-esma-1057_final_report_on_guidelines_on_alternative_performance_measures.pdf)  
41. [https://secure.cfauk.org/assets/1345/Analysis\\_of\\_FRAC\\_survey\\_2015.pdf](https://secure.cfauk.org/assets/1345/Analysis_of_FRAC_survey_2015.pdf)  
42. <https://frc.org.uk/Our-Work/Publications/Corporate-Reporting-Review/Corporate-Reporting-Review-Annual-Report-2014.pdf>



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

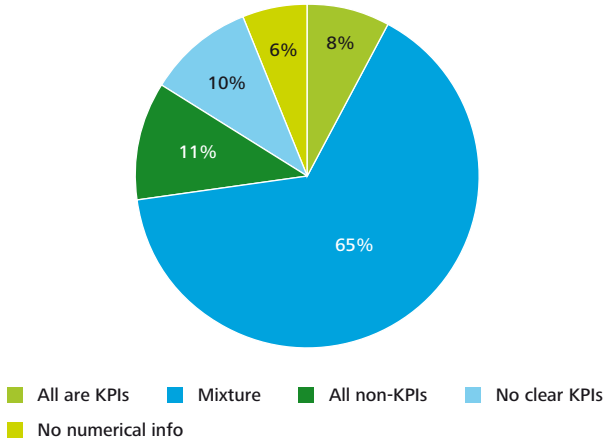
Appendix 1 – Glossary of terms and abbreviations

Other resources available

**Inclusion of KPIs in the summary section**

The majority of companies surveyed (90%) identified clear KPIs in their annual reports. When looking at the information presented in the summary section, 73% included KPIs either as the sole performance measures presented or, more commonly, in conjunction with non-KPI measures – see Figure 6.6.

**Figure 6.6. Are measures presented in the summary section the same as KPIs?**



The use of KPIs in the performance measures presented in the summary section is beneficial in illustrating that those measures of key importance to the company's performance are consistent throughout the annual report. The majority of companies presenting KPIs included financial KPIs (82%) with the remainder choosing to present a mixture of financial and non-financial KPIs.

The fact that only 8% (2014: 5%) of companies presented no measures that were not KPIs in their summary section suggests that the majority of the companies surveyed see the presentation of a broad set of financial and non-financial measures in the summary section to be useful to users of the annual report, regardless of whether such measures are identified as the company's KPIs.

However, more surprising is that only 5% (2014: 13%) of companies presented all their KPIs in their summary section – an example of this was provided by [Huntsworth plc](#). Where measures have been identified elsewhere as being key to understanding the performance of the business, it seems inconsistent that these are not also the measures that the company would want to highlight to users of the annual report with the greatest prominence – by including them in the summary section.

The types of measures identified by companies as KPIs are discussed in more detail in chapter 8.

# 7. The strategic report

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## Top tips

- Clearly showing how the business model, strategy, risks and KPIs link together will facilitate the presentation of a coherent, holistic description of how the company generates and preserves value.
- Explicitly describing how the business model creates value and in turn linking this to how the strategy will create value will provide further insight, and possibly confidence, for investors. Surprisingly, only 54% of companies talked of value creation in their business model and only 35% identified clearly how the company's strategy related to its ability to create value.
- When describing the company's business model, consider including an overview of the market that the company operates in. This helps give more depth of understanding around a company's business activities and how it is able to create and capture value. Only 68 companies did so.
- To present a more holistic overview of the company, consider incorporating relevant CSR type information throughout the report, rather than leaving it as an additional section bolted on at the end.

## Keep an eye on

- In light of the new EU Directive likely to be in force from 2017, review your CSR policies, processes and risk assessments to ensure you will have all the information required to meet the proposed disclosure requirements, particularly around bribery and anti-corruption, which is currently not required in the UK.
- Presenting a visual representation alongside the description of your business model can really bring it to life, but consider carefully whether it really demonstrates the features unique to your company, rather than being generic and applicable to any company.

The requirement under the Act for companies to produce a strategic report has now been in place for a couple of years and it is good to see the disclosure requirements have now bedded down in most annual reports. Those companies wishing to enhance their strategic report seem to have applied the principles of the FRC's *Guidance on the Strategic Report* (the 'FRC Guidance'), as demonstrated by the good examples highlighted within this chapter. Others have taken on board some or all of the principles of Integrated Reporting ('<IR>'), although only seven companies referred explicitly to <IR> (see chapter 5). For those companies wishing to improve the communication of their message to investors, the FRC Guidance and the <IR> Framework, along with the good practice examples identified within this chapter, illustrate how this can be done. The disclosure requirements under the Act, the FRC Guidance, <IR> and other initiatives impacting the strategic report are discussed in further detail in the regulatory overview in chapter 3.

The FRC has recently produced other advice and guidance documents around corporate reporting, specifically covering narrative reporting. A notable one was the FRC's Financial Reporting Lab ('the Lab') insight report *Towards clear & concise reporting*<sup>43</sup> in August 2014. This report looked at communication channels, content, materiality and layout. Its nine recommendations covered all aspects of the annual report. Those particularly relevant to the strategic report included:

- presenting a single story – ensuring the narrative reporting is consistent with the financial statements;
- discussing how the money is made – giving a clear and balanced account which includes an explanation of the business model and the salient features of the company's performance (both good and bad);
- consistency of information, specifically clearly reconciling highlighted measures (including adjusted measures, KPIs and non-GAAP measures) to the financial statements;
- cutting the clutter – an ongoing theme of the FRC's advice for over five years now;

43. <https://www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/FRC-Lab-Towards-Clear-Concise-Reporting.pdf>

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

- clarity of language, ensuring it's precise and avoids jargon and boiler-plate statements; and

- explaining significant changes from the prior period, whether matters of presentation or policy.

One company specifically made reference to the FRC Guidance as well as to *Towards clear & concise reporting* in their annual report. A further company made reference to the FRC's cutting clutter initiative (the predecessor of its current 'Clear & concise' project), while two retailers acknowledged the FRC's request in December 2014 for retailers to provide high quality disclosures around complex supplier arrangements and provided enhanced disclosures in this area.

The broad objectives of the strategic report are to provide:

1. Context for the financial statements.
2. Insight into the company's business model, objectives and strategies.
3. An analysis of past performance.
4. To describe the principal risks and uncertainties that a company faces.

In addition, the strategic report should provide signposting to the location of supporting detail.

The FRC Guidance sets out three broad categories of content elements, most of which are drawn directly from the law:

**Strategic management**

**How the entity intends to generate and preserve value**

**Environmental context**

**The internal and external environment in which the entity operates**

**Business performance**

**How the entity has developed and performed and its position at the year end**

- Strategy and objectives
- Business model

- Trends and factors
- Principal risk and uncertainties
- Environmental, employee, social, community and human rights matters

- Analysis of performance and position
- Key performance indicators (KPIs)
- Employee gender diversity

The key elements discussed in this chapter are the business model, strategy and how the business interacts with its stakeholder groups in a broader sense (often known as corporate social responsibility disclosures). Also discussed below is the greenhouse gas emissions disclosures which quoted companies are required to disclose in their annual report.

Key performance indicators (KPIs) and principal risks and uncertainties are discussed in further detail in chapters 8 and 9 respectively of this survey.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## Business Model

The Act requires a quoted company to include “a description of its business model”. The FRC Guidance expands on this, encouraging the description to include:

- how value is generated or preserved over the longer term, and how an entity captures that value;
- what the entity does and why it does it;
- what makes the entity different from, or the basis it competes with, its peers;
- how the entity is structured, the markets it operates in, and how the entity engages with those markets; and
- the nature of the relationships, resources and other inputs that are necessary for the success of the business.

## <IR> business model

Like a strategic report, an integrated report must also describe the business model, including the key inputs, business activities, outputs and outcomes. The <IR> Framework defines a company's business model as “its system of transforming inputs, through its business activities, into outputs and outcomes that aims to fulfil the organisation's strategic purposes and create value over the short, medium and long term”. This is explored in greater detail below.

Depending on the size and complexity of the company and its business activities, the business model can range from a simple brief descriptive overview to something which requires significant explanation in order to provide a full understanding. As such, the extent to which companies disclose their business model varies.

In July 2015, the Lab invited companies, investors and analysts to participate in a project on effective business model reporting, the first in a series of projects which will also look at principal risk reporting and viability statement reporting.

The project aims to assist companies in understanding how the investment community is using the disclosures in their decision making processes, what information is most useful and how it may best be presented. A report with findings is due to be published in early 2016.

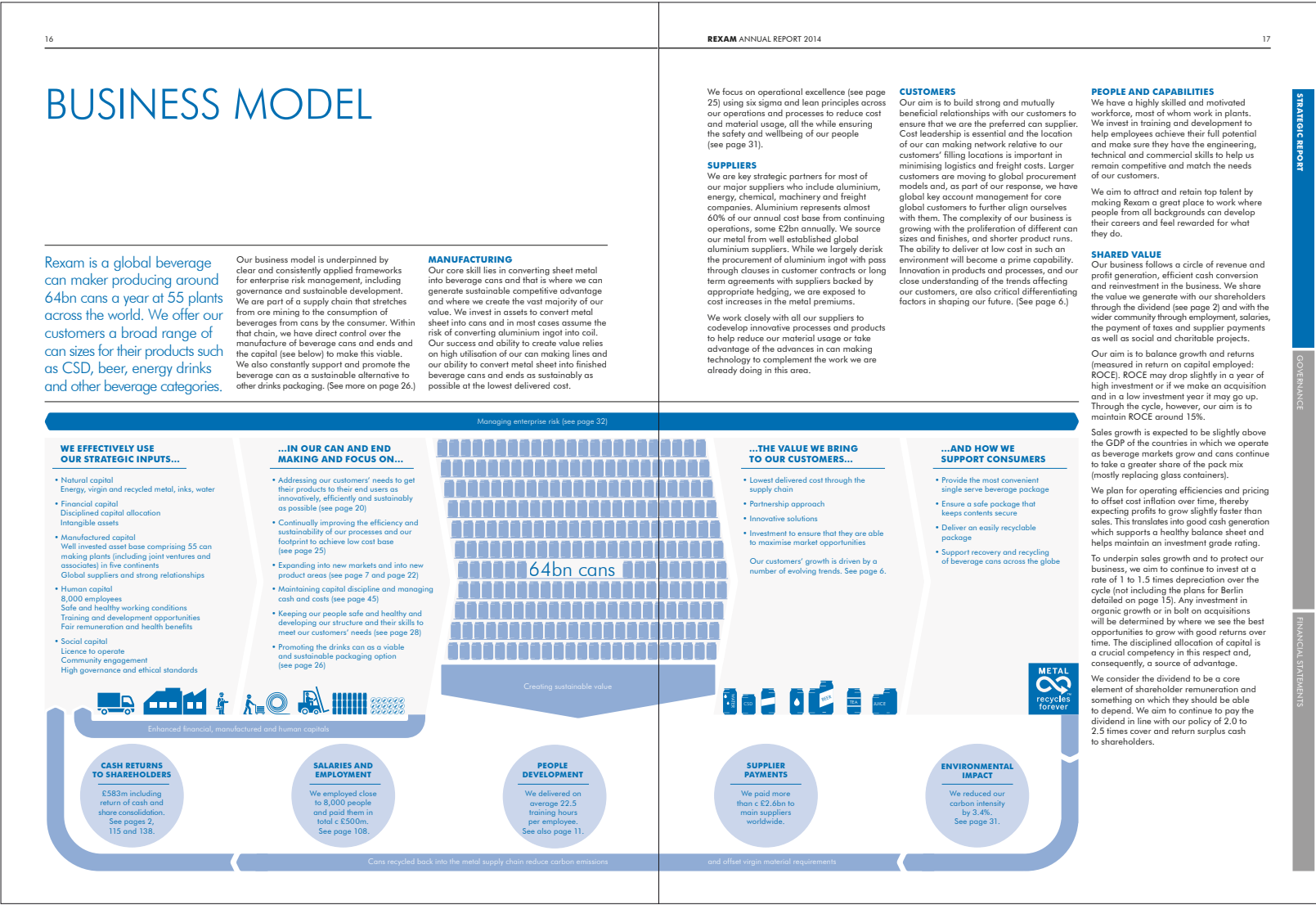
As discussed in Chapter 6, the business model is, effectively, the backbone for an organisation, as all aspects of the business (for example the strategy, risks, KPIs) can be linked back to it. As such, the FRC Guidance identifies the business model as being a good place to demonstrate this linkage. Overall linkage and holistic connectivity of annual reports is discussed in chapter 6.

87 companies (2014: 94) provided a meaningful section entitled “Business model”. Of those that did not, nine (2014: two) disclosed a description of their business model even though it was not clearly entitled as such. For the remaining four companies (2014: four), no clear description of the business model could be identified. It is good to see that nearly all companies feel comfortable describing their business model, compared to the 23 companies that did not view presenting a business model disclosure as a necessary part of their annual report in our 2013 survey, before there was an explicit requirement to describe one.

## Visual representations

Business models, particularly where the company's activities are complex, can require lengthy narrative explanations, particularly where the company is intending to include a description of all five elements as stipulated by the FRC Guidance. In such cases it may be useful to provide a visual representation of sorts. 57 companies did so (2014: 59) and of these, 67% were considered to make the business model easier to understand. Even when presenting meaningful visual representations of their business, companies should ensure that they are making them specific to the company's activities. Generic, or boilerplate diagrams – commonly circular in design – will often not be able to express how value is created and captured by the company and what it is that makes the company unique. Preparers should challenge themselves when including a visual representation as to whether it could be applied to any company, or whether it really highlights the individual circumstances of the company. A good example of a highly tailored diagram was given by Rexam PLC, which used the visual representation to summarise the key messages from the detailed narrative accompanying it.

1. Executive summary
2. How to use this document
3. Regulatory overview
4. Survey objectives and methodology
5. Overall impressions
6. Summary material
7. The strategic report
8. Key performance indicators
9. Principal risks and uncertainties
10. Going concern and viability
11. Corporate governance
12. The work of the audit committee
13. The auditor's report
14. Primary statements
15. Notes to the financial statements
Appendix 1 – Glossary of terms and abbreviations
Other resources available



Rexam PLC Annual Report 2014 (p.16)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

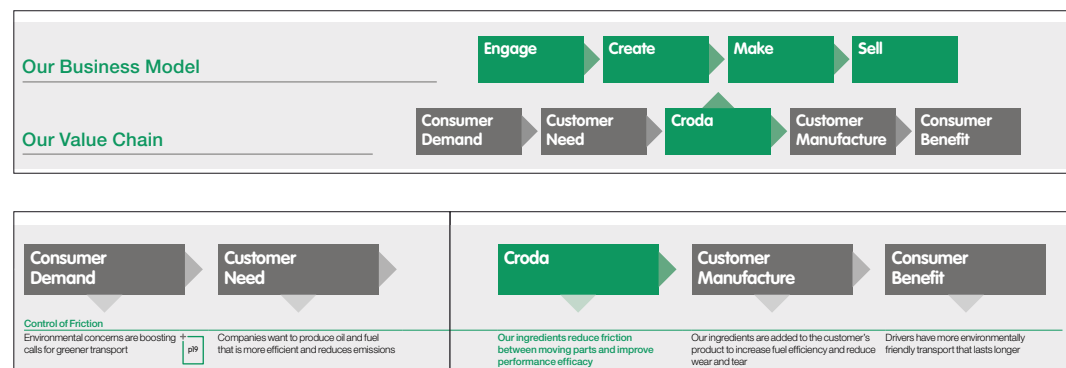
14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Visual representations that enhance the description need not be complicated. For example, Croda International Plc, a specialist chemical manufacturer, provided a simple visual representation accompanying detailed text to show at a glance how its business model (i.e. the company's actual business activities) fits into the wider value chain (that reaches beyond the company itself to the end consumer of their product). The visual representation and an example extract from the more detailed text is provided on this page.



[Croda International Plc Annual Report and Accounts 2014 \(p. 10, 11 and 13\)](#)

**Make**

We manufacture to consistently high standards across the world.

**Intimate customer relationships mean that we...**

produce high quality, high value ingredients on a customer demand driven basis, as close to their manufacturing operations as possible.

**A culture of innovation drives us, so...**

we think differently about where and how we manufacture, developing new production technologies that offer flexibility and security of supply.

**We do this sustainably by...**

using raw materials from sustainable sources and working closely with our supply chains. We develop new ingredients from co-streams and invest in our own renewable energy.

**Our people make a difference, because...**

our highly trained production teams have the expertise to design and operate complex manufacturing processes, whilst ensuring that safety and quality remain paramount.

[Croda International Plc Annual Report and Accounts 2014 \(p. 10, 11 and 13\)](#)



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available



[Bodycote plc annual report 2014 \(p. 11\)](#)

## Business activities

Where a company's actual business activities are complex or have many stages to them, it is often helpful for those companies to provide an easily digestible explanation (usually accompanied by pictures) or example of what they do. This assists in meeting the FRC Guidance requirement to simply set out what the entity does and why it does it. Good examples of this include Bodycote plc, which provided examples of component journeys, and National Grid plc, which provided comprehensive descriptions of their activities along the generation and supply chain of electricity and gas.

## Relationships and resources

The FRC Guidance talks of disclosing key relationships and resources in two regards: firstly, in the description of the business model (see above); and secondly within the discussion of the entity's performance. The strategic report, it says, should include information on the entity's key strengths and tangible and intangible resources (such as reputation, brand, customers, natural resources, employees, research and development, and intellectual capital). Providing information about these resources and relationships, which go beyond those reflected in the financial statements, fits well within the business model; it enables the company to explain more easily how value is generated and captured if reference is made to these wider resources.

A good example of providing a clear and comprehensive description of resources and relationships that are necessary for the success of the business was St Modwen Properties PLC. This was included as part of the wider discussion of the business model which spanned four pages.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Strategic Report

What we do – Electricity

The electricity industry connects generation sources to homes and businesses through transmission and distribution networks. Companies that pay to use transmission networks buy electricity from generators and sell it to consumers.

System operator

As system operator (SO) for England and Wales, we coordinate and direct electricity flows onto and over the transmission system, balancing generation supply and user demand. Where necessary, we pay sources of supply and demand to increase or decrease their generation or usage.

We have the same role for the two high voltage electricity transmission networks in Scotland and we are SO for the offshore electricity transmission regime.

Our charges for SO services in the UK are subject to a price control approved by Ofgem. System users pay us for connection, for using the system and balancing services.

As electricity transmission SO, our price control includes incentives to minimise the costs and associated risks of balancing the system through buying and selling energy, as well as procuring balancing services from industry participants.

In the US, similar services are provided by independent system operators.

1 Generation

Generation is the production of electricity from fossil fuel and nuclear power stations, as well as renewable sources such as wind and solar. In the US, we own and operate 50 fossil fuel-powered stations on Long Island and 4.6 MW of solar generation in Massachusetts. We do not own or operate any electricity generation in the UK.

We sell the electricity generated by our plants on Long Island to LIPA under a long-term power supply agreement. The contract allows us to recover our efficient operating costs and provides a return on equity on our investment in the generation assets.

For solar generation, we recover our costs and a reasonable return from customers in Massachusetts through a solar cost adjustment factor. This is added to the electricity rate, net of revenues earned from the solar assets.

2 Interconnectors

Transmission grids are often interconnected so that energy can flow from one country or region to another. This helps provide a safe, secure, reliable and affordable energy supply for citizens and society across the region. Interconnectors also allow power suppliers to sell their energy to customers in other countries.

Great Britain is linked via interconnectors with France, Ireland, Northern Ireland and The Netherlands. National Grid owns part of the interconnectors with France and The Netherlands. We are also now entering the construction phase for two new interconnectors, between the UK and Belgium and Norway. We are continuing to work on developing additional interconnector projects, which we believe

will deliver significant benefits to consumers. These include opportunities for interconnection with Iceland, Denmark and a further link with France.

We also jointly own and operate a 224 kilometre interconnector between New England in the US and Canada.

We sell capacity on our UK interconnectors through auctions and on our US interconnector through wholesale markets and bilateral contracts.

3 Transmission

Transmission systems generally include overhead lines, underground cables and substations. They connect generation and interconnectors to the distribution system.

We own and operate the transmission network in England and Wales. We operate but do not own the Scottish networks. We are also working in a joint venture with Scottish Power Transmission to construct an interconnector to reinforce the GB transmission system between Scotland and England and Wales.

In the US, we jointly own and operate transmission facilities spanning upstate New York, Massachusetts, New Hampshire, Rhode Island and Vermont.

4 Distribution

Distribution systems carry lower voltages than transmission systems over networks of overhead lines, underground cables and substations. They take over the role of transporting electricity from the transmission network, and deliver it to consumers at a voltage they can use.

We do not own or operate electricity distribution networks in the UK.

In the US, our distribution networks serve around 3.5 million customers in upstate New York, Massachusetts and Rhode Island.

5 Supply

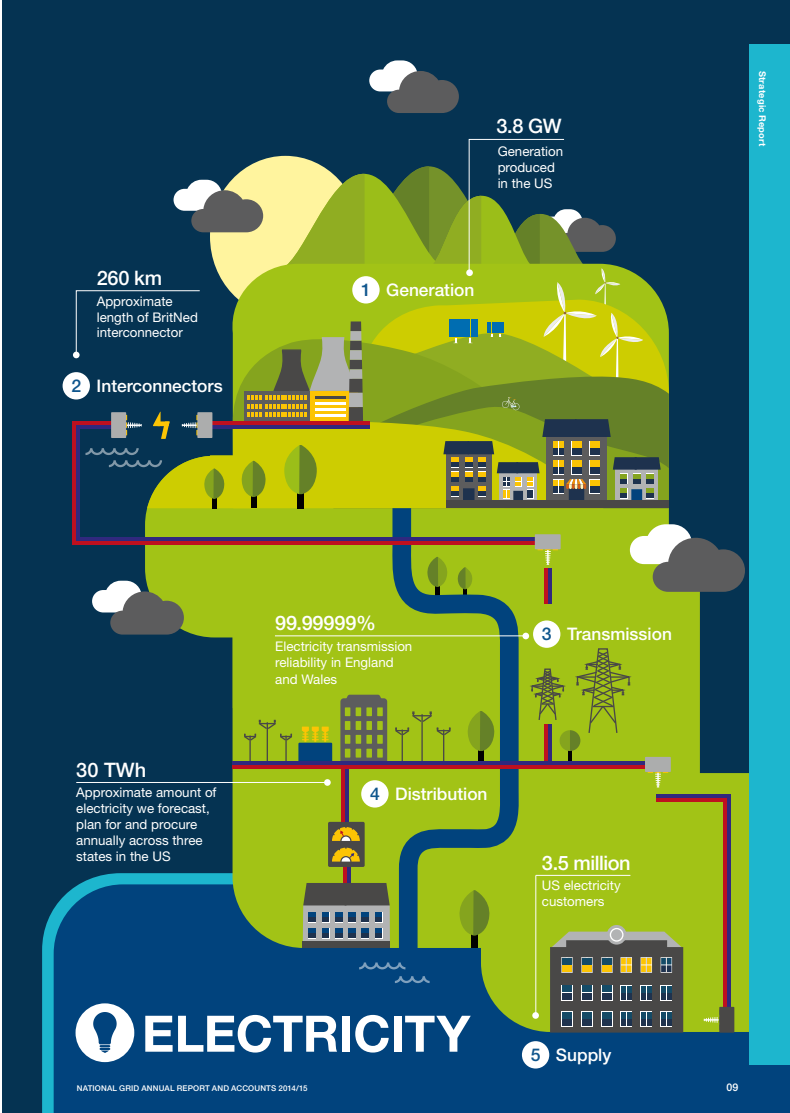
The supply of electricity involves buying electricity and selling it to customers. It also involves customer services, billing and the collection of customer accounts.

We do not sell electricity to consumers in the UK.

All our customers in the US can select a competitive supplier for the supply component of electricity utility services. Where customers choose National Grid, they pay us for distribution and electricity costs. Where they choose to buy electricity from third parties, they pay us for distribution only and pay the third-party supplier for the electricity. Our base charges for electricity supply are calculated to recover the purchased power costs.

Our business model  
pages 12–13

Overhead line replacement in our US business, page 35.



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Strategic Report

## OUR BUSINESS MODEL

continued

### Resources

#### EMPLOYEES

Our employees are a valued and vital part of the business and we aim to attract, develop and retain the best people, whose efforts, expertise and judgement we can leverage across our extensive portfolio. We have a highly skilled in-house team encompassing all facets of the industry. They safeguard our principles of delivering high-quality, sustainable developments as a legacy for businesses and communities to enjoy for years to come.



#### FINANCIAL CAPITAL

We are a stable business, operating from a robust financial position and underpinned by a recurring income stream from our £539m portfolio of income producing assets. This enables us to acquire assets to which we can add value. In turn, our partners and key stakeholders can trust in our ability to fulfil contracts and deliver projects on time and to budget.



#### LAND BANK

We actively manage a £1.3bn UK-wide portfolio of development opportunities across a land bank of 5,900 acres. We acquire this land specifically to develop it out to create homes and communities in which people can live and work. At any point in time we are either actively building, remediating or pursuing planning permissions which allow us to transform this land into thriving communities or business destinations that will encourage growth across the country.



#### BUILDINGS

Across our portfolio we retain a bank of assets which generate income whilst awaiting development. Once we are ready to progress their redevelopment we will reclaim and recycle as much of the existing materials as is possible. The redeveloped asset is then either retained for income or sold.



### Relationships

#### LOCAL COMMUNITIES AND TENANTS

Our network of seven regional offices provides us with local knowledge and expertise that keeps us abreast of the needs of local communities, ensuring we remain politically and economically sensitive to each area.

We engage with communities throughout the entire development process and value their input and support.

Our locally-based asset management teams regularly engage with our tenants, many occupying more than one site across our portfolio.



#### PRIVATE SECTOR AND JOINT VENTURES

We have formed strong relationships with many private sector partners. Linked by our skills and culture, these partnerships are established through joint ventures, strategic land acquisitions and development agreements. All bring about successful regeneration and development projects that in turn stimulate investment and growth. Our private sector partners include VINCI PLC, Persimmon PLC and Salfia Real Estate Company K.S.C.



#### PUBLIC SECTOR AND REGULATORS

We also work hand in hand with a variety of public sector organisations across the Country including many local authorities, some of which we have been in partnership for over 10 years either through joint venture initiatives or Development Agreements. We also work closely with key Government regulators such as the Environment Agency and Highways Agency to ensure our projects are of the highest standard.



#### SUPPLY CHAIN

We have a careful contractor selection process. Many of our contractors work with us on a number of schemes and we share a mutual trust to deliver our projects to the highest standard, within budget and on time. We maintain close involvement with our contractors throughout the construction process.



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## <IR> inputs, outputs and outcomes

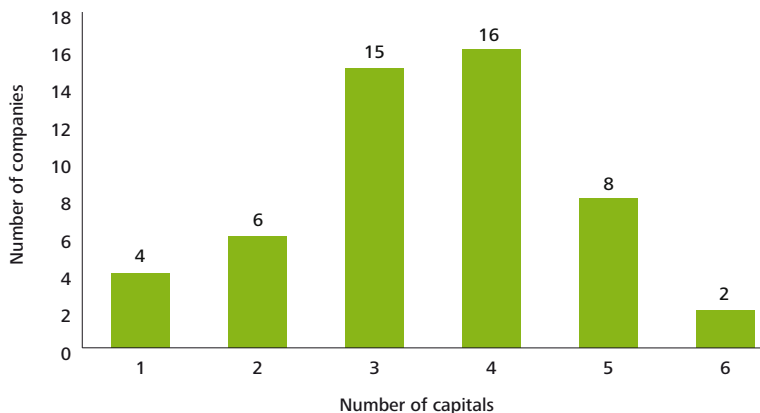
The <IR> description of a business model includes key inputs, business activities, outputs and outcomes. A company should demonstrate how key inputs relate to the capitals on which the company depends, or that provide a source of differentiation to the company. This is, in part, an extension of the FRC Guidance which recommends that the description of the business model should provide shareholders with a broad understanding of the nature of the relationships, resources and other inputs that are necessary for the success of the business, and also a description of what makes the entity different from its peers.

Outputs of the business activities are considered to be items such as products, services, by-products and waste. An outcome is the next stage in the business cycle, namely the internal and external consequences (both positive and negative) as a result of the business activities and outputs.

The <IR> Framework refers to these relationships and resources as “capitals” and determines that, broadly, there are six categories of capitals: financial, manufactured, intellectual, human, natural and social and relationship. There is no requirement under the <IR> Framework to identify all six capitals as being material to the company, nor to use the same terminology as that used in the <IR> Framework. The examples below of companies applying the concepts of the <IR> Framework to their business model demonstrate the different resources and relationships, specific to the companies themselves, which have been identified as capitals.

51 companies included clear reference to relationships or resources (or “capitals”, using <IR> terminology) used as inputs or outputs within the description of their business model. This finding includes those companies who have discussed resources and relationships identified as inputs, as defined in the FRC Guidance, as well as those companies who have gone a step further and followed more closely the <IR> Framework’s identification of capitals as outputs and outcomes. Of these companies, most identified relationships and resources that related to three or four of the six <IR> capitals, as shown by figures 7.1. Two companies identified key relationships and resources that fell into each of the six <IR> capitals; both of these companies had explicitly made reference to applying the <IR> Framework within their annual report.

Fig 7.1. How many different <IR> categories of capitals were identified by each company?



As shown in figure 7.2, of the different relationships and resources identified, the most commonly identified were human (75% of companies identifying this as a key relationship or resource) and social and relationship (78% of companies). It is not surprising that human capital (such as employees) and social and relationship (most commonly supplier and customer relationships) were so popular, given their relevance to most industries. However, it was somewhat surprising that financial capital was identified clearly as a key input or output by only 61% of companies, given that finance is a fundamental part of every company. Possibly some companies assumed that financial inputs (through raising funds via equity and debt) and outputs (cash generated by the company, either passed on to shareholders through dividends or reinvested into the company as an input) were too generic a part of the business model to require inclusion in the description.



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

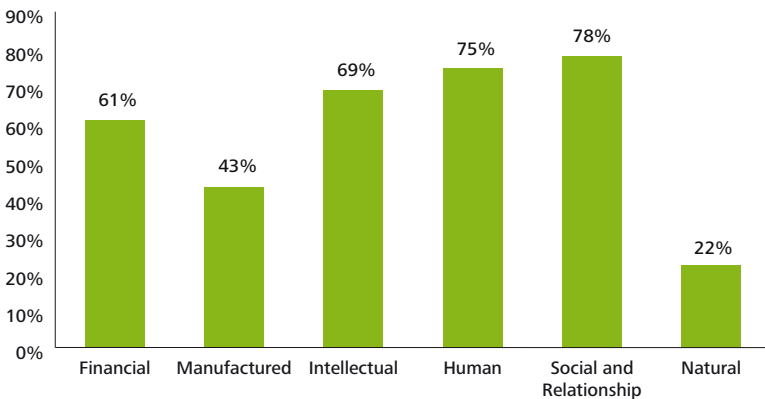
14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

**Fig 7.2. Of those companies identifying <IR> capitals in their business model, which ones are referred to?**



Also common was intellectual capital, with 69% of companies identifying this. This tended to be either brand, reputation or other intellectual property (e.g. patents). It is good to see that so many companies are identifying brand as key in the value creation process; the 2015 Reputation Dividend<sup>44</sup> report estimated that total UK corporate reputations are worth over £620bn. At best, reputation represents £1 in every £2 of market capitalisation; at worst, it is destroying £1 of value in every £7. For companies to meet their objective of creating maximum returns for their shareholders, it is clearly imperative that boards are aware of their brand value and that preservation of it is built into both the business model and the strategy.

A number of companies had clearly adopted the principles of the <IR> Framework when presenting their business model, even if they had not disclosed compliance with it. GlaxoSmithKline plc and Aggreko plc both clearly identified inputs and outputs, while BT Group plc differentiated between their outputs (being mainly the portfolio of products and services which they sell) and their outcomes (being both financial results and the wider impact of the business, such as strength of their brand).

44. The 2015 UK Reputation Dividend Report, Reputation Dividend, March 2015  
[http://www.reputationdividend.com/index.php/download\\_file/view/101/112/](http://www.reputationdividend.com/index.php/download_file/view/101/112/)

## Our business model

*How we create value*

Our success depends on our ability to research and develop innovative healthcare products and make them accessible to as many people as possible.



[GlaxoSmithKline plc Annual Report 2014 \(p. 11\)](#)

1. Executive summary
2. How to use this document
3. Regulatory overview
4. Survey objectives and methodology
5. Overall impressions
6. Summary material
7. The strategic report
8. Key performance indicators
9. Principal risks and uncertainties
10. Going concern and viability
11. Corporate governance
12. The work of the audit committee
13. The auditor's report
14. Primary statements
15. Notes to the financial statements
Appendix 1 – Glossary of terms and abbreviations
Other resources available

STRATEGIC REPORT CONTINUED

HOW WE CREATE VALUE  
THROUGH OUR BUSINESS MODEL



**Human**  
We have a highly skilled and professional workforce of over 7,700 employees worldwide

**Supply chain**  
We work with suppliers to ensure the components and services they provide comply with our quality standards

**Design and manufacture**  
We work closely with engine manufacturers and technology partners to design and manufacture equipment that is fuel efficient, emissions compliant and with a unique capital cost advantage

**Financial**  
The Group has a strong balance sheet with sufficient facilities available

**Intellectual**  
We invest in our technology and operating procedures to deliver better performance

**Power**  
9,695MW £926m  
assets<sup>1</sup>

**Chillers**  
1,294MW £53m  
assets<sup>1</sup>

**Oil-free air**  
634cfm £12m  
assets<sup>1</sup>

**Ancillaries**  
£95m  
assets<sup>1</sup>

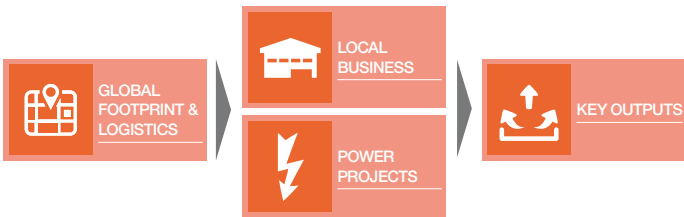
**KEY INPUTS**

**Relationships**  
We have longstanding relationships with many of our suppliers, notably Cummins, our main engine supplier. We also have sourcing relationships across the globe where we work very closely with suppliers to ensure that the components and services provided comply with our quality standards.

1 Net asset value

How our strategy maximises performance  
➔ Page 22

Risks that are involved  
➔ Page 28



**Maintain and Service**

**211**  
Sales and Service Centres worldwide operating a hub and spoke model

**4**  
Power Projects hubs on major shipping routes

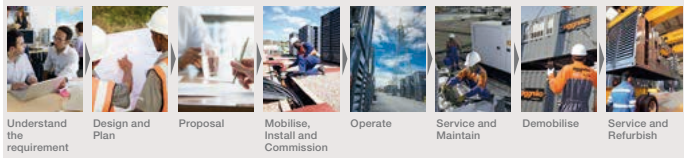
**Local business revenue**  
£904m  
Average contract value: £21k  
The Local business rents power and temperature control equipment to a diverse range of customers who operate it themselves; we service and maintain it

**Power Projects revenue**  
£625m (excluding pass-through fuel)  
Average contract value: £5 million per annum  
The Power Projects business sells electricity which we deliver using power plants built, owned and operated by ourselves

**The value we create**

- Supporting industry and commerce
- Providing power for countries and communities
- Enabling key events around the world
- Innovating to build a sustainable business
- Global employment
- Strong brand and good reputation
- Rewarding careers
- Shareholder returns

OUR PROJECT LIFE CYCLE IS EXPLAINED ON THE NEXT PAGE





1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

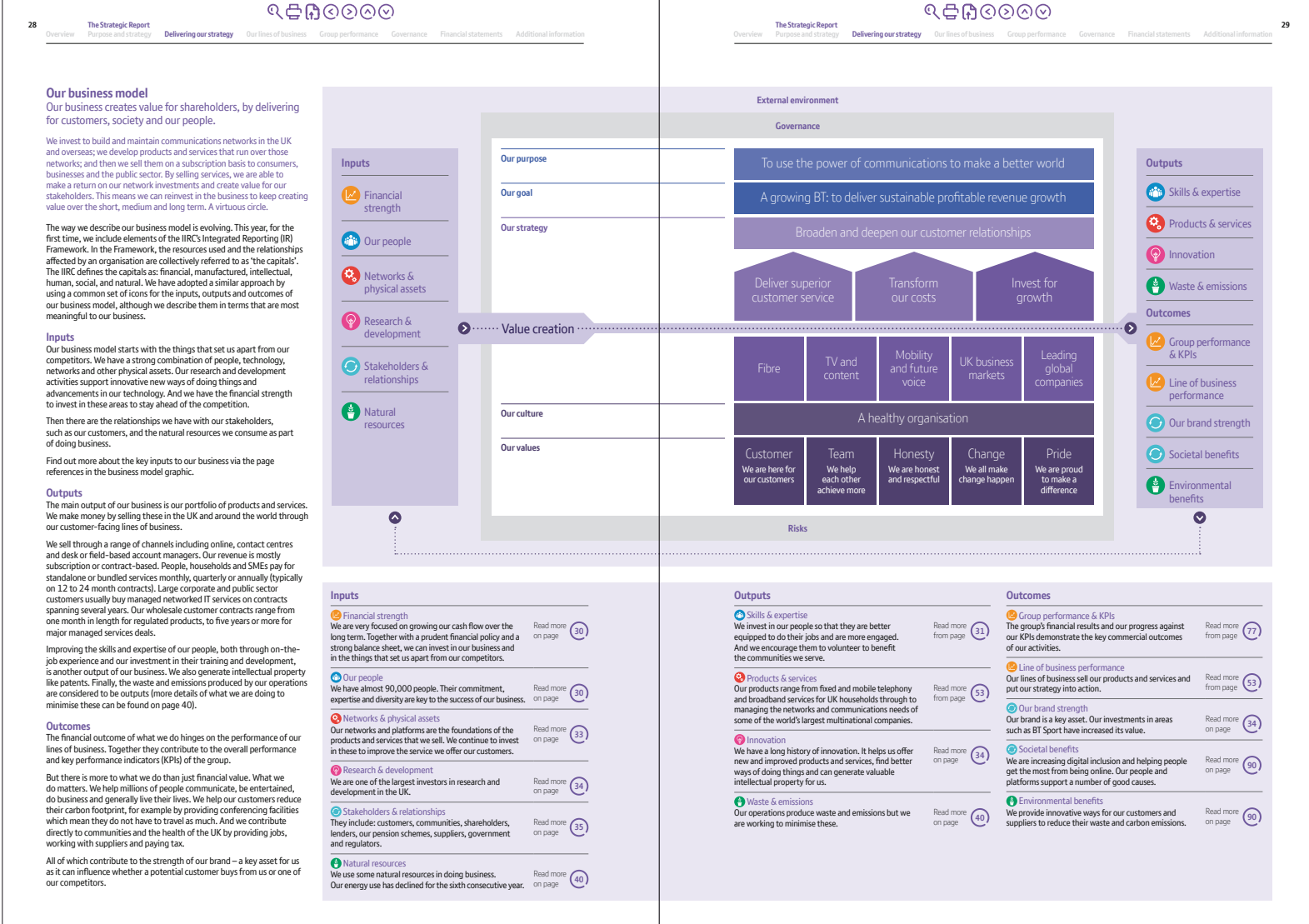
13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

**Value creation**

The notion of value creation is equally applicable to companies of all sizes – all businesses aim to create value in some way, particularly for their shareholders but often for other stakeholders, too. The FRC Guidance encourages companies to include within their business model a description of how the company generates or preserves value over the long term (which is also required by the Code) and how it captures that value. This is in line with the <IR> notion of a business model describing value creation over the short, medium and long term (see below). Value creation for shareholders could be in terms of financial returns through dividends, or else creating value through reinvestment in the company, thus in turn increasing the company's future operating potential.

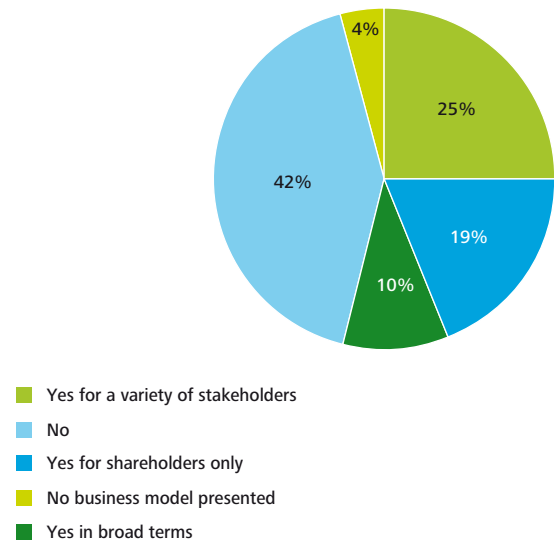
**<IR> value creation**

In the world of <IR>, value is not restricted to financial capital for just the company and its shareholders, but is considered more widely in terms of value generated by the impact of the business activities and outputs upon all capitals. The ability of a company to create value for itself is linked to the values that it creates for others. For example, value can be created through enhancing customer satisfaction, suppliers' willingness to trade with the company and the terms under which they do so, and the impact of business activities on the company's brand. An integrated report includes details of those interactions, activities and relationships which are material to the company's ability to create value for itself.

As per figure 7.3, most companies (54%) do indeed explicitly refer to value creation when explaining their business model, although the level of detail provided as to whom the value is created for varies from company to company. Given a business model is used to describe how a business generates value, it is surprising that so many companies are not explicitly referring to value creation as part of the explanation of their business models.

An explanation of value creation goes beyond just explaining what the business' processes are – it also explains how undertaking these activities generates value for the business and its stakeholders.

**Fig 7.3. Does the business model talk about value creation?**



Good examples of how financial value has been distributed to varying stakeholders during the year include Johnson Matthey Plc (below) and Mondi plc. The pie chart approach adopted by Johnson Matthey Plc was used by a number of companies, while some simply listed out financial statistics of value distribution. Either way, it is useful to provide accompanying narrative to explain where the values have derived from, particularly where they do not directly reconcile to the financial statements.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

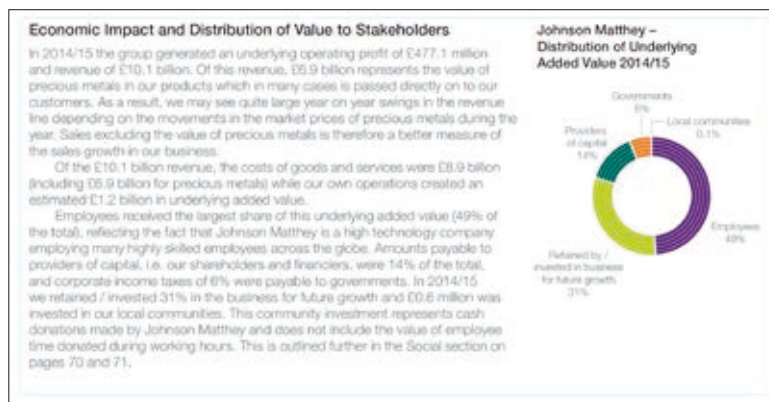
13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available



[Johnson Matthey Annual Report & Accounts 2015 \(p. 31\)](#)

### Value creation over time

As part of their fiduciary duties, institutional investors such as pension funds must consider the needs of future as well as current beneficiaries; they must achieve financial returns over the long term to meet future liabilities. It is in a company's interest, therefore, to provide investors with information about how it creates value in the long term. Of the 54 companies in our survey explicitly discussing value creation, 35 of these made reference to value being created over a particular timeline (short, medium and long term). All but two of these companies referred to long term value creation, as required by the Code; four companies referred to medium term; and six referred to short term value creation.

While the definition of short, medium and long terms will vary from company to company due to varying operating cycles, being able to demonstrate when value will be created over the different timelines provides further insight.

In a recent survey of investors performed by the CFA Society of the UK<sup>45</sup>, it was clear that investors perform forecasts over a variety of periods, from one year to more than three years, and similarly have varying time horizons upon which they make investment recommendations (often varying depending on whether they are buy-side or sell-side analysts).

Clearly, the more insightful information a company can provide about its ability to create value over the short, medium and long terms, the more accurately investors can assess a company's potential and make more informed investment decisions as a result.

Further, with the introduction of the new statement of longer term viability under the Code (see chapter 10), those charged with governance will need to determine an appropriate timeframe upon which to base their considerations of the company's viability, and disclose why they have chosen that particular timeframe. It would seem reasonable that such assessments to determine an appropriate timeframe would require careful consideration of the company's strategy and the operating cycle as per the business model. Similarly, the discussion of the business model, strategy and value creation in the strategic report would itself be enhanced by identification of relevant timeframes, particularly the short, medium and long term. An example of clear disclosure of timeframes, although the terminology of short, medium and long term is not used, is from TT Electronics plc.

45. CFA UK annual survey on Financial Reporting and Analysis, July 2015  
[https://secure.cfauk.org/assets/1345/Analysis\\_of\\_FRAC\\_survey\\_2015.pdf](https://secure.cfauk.org/assets/1345/Analysis_of_FRAC_survey_2015.pdf)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

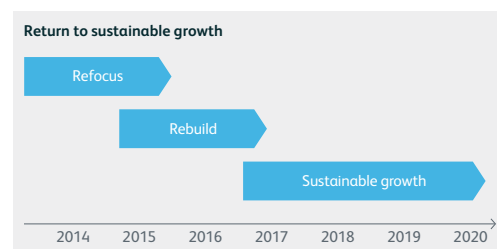
Appendix 1 – Glossary of terms and abbreviations

Other resources available

## Strategic framework

Our journey to transform our business performance has three phases, underpinned by six priorities as we are working together to deliver three outcomes.

### Three phases



The business review conducted in late 2014 has enabled us to refocus the Group on the key issues and opportunities we face. We have developed a clear strategic plan to rebuild the performance of the business and deliver sustainable growth.

### Six priorities



These six priorities underpin our strategic plan. We are focusing on these areas to rebuild a platform for sustainable growth. As part of this plan we are implementing a series of process standardisations and enhancements to drive improvement in the overall business performance.

### Three outcomes



The delivery of our strategy will be measured by three outcomes: improved customer performance, improved operational performance and improved returns and cash generation creating a better quality business with stronger returns to shareholders.

### How strategy enables value creation

As well as discussing how its business model enables it to create value for stakeholders, it is also important that a company should set out how its strategy will assist in creating this value.

Explaining and demonstrating this is proving difficult for a lot of companies, with only 35 companies identifying clearly how the organisation's strategy would enable it to create value. A further 22 companies were considered to identify this in part. An example of clear articulation as to how the company's strategy creates value, not just for shareholders, is from National Grid plc.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## How our strategy creates value

Our vision and strategic objectives explain what is important to us, so we can meet our commitments and deliver value.

### Customer and community value

**Safety and reliability** – we strive to provide reliable networks safely, which is essential to safeguard our customers, employees and the communities in which we operate.

**Affordability** – we strive to provide services efficiently, which helps to reduce the amount of money consumers have to pay for their energy.

**Customer service** – providing essential services that meet the needs of our customers and communities is a crucial part of the value they expect from us.

**Sustainability** – we strive to protect the environment and preserve resources for current and future generations.

**Emergency services** – we provide telephone call centres, coordinate the response to gas emergencies, and respond to severe weather events.

**Community engagement** – we listen to the communities we serve and work hard to address concerns about the development of our networks. Our employees volunteer for community-based projects and we support educational initiatives in schools.

### Shareholder value

**Regulatory frameworks** – operating within sound regulatory frameworks provides stability. Making sure these frameworks maintain a balance between risk and return underpins our investment proposition.

**Reputation** – our approach to safety and our reliability record underpin our reputation. These are crucial factors that contribute towards positive regulatory discussions and help us pursue new business opportunities.

**Efficient operations** – efficient capital and operational expenditure allows us to deliver network services at a lower cost and reduces working capital requirements.

**Maximising incentives** – if we perform well against our incentives, and deliver the outputs our customers and regulatory stakeholders require, we can make the most of our allowed returns.

**Funding and cash flow management** – securing low-cost funding and carefully managing our cash flows help us maintain strong returns for our investors.

**Disciplined investment** – we can increase our revenue and earnings by investing in both regulated and non-regulated assets. This helps us deliver attractive returns for our shareholders.

[National Grid plc Annual Report and Accounts 2014/15 \(p. 15\)](#)

[Intertek Group plc](#) demonstrates value creation in a practical sense through a series of case studies. It also provides a holistic overview of the various elements that impact value creation by demonstrating how the business model (i.e. the process by which value is created) links to strategy, KPIs and risks (see chapter 5).

### Market overview

As recommended in the FRC Guidance (see above), it is useful for companies to disclose a high-level description of how the entity is structured, the markets in which it operates, and how it engages with those markets. This helps give more depth of understanding around a company's business activities and how it is able to create and capture value. Such disclosures could include a description of which part of the value chain the entity operates in, its main products and services, its customers and its distribution methods.

The market overview also serves to provide context for a company's own performance, for example by being able to demonstrate how external trends have impacted financial results and, where appropriate, how the company's strategy has changed in response to these. Companies may be hesitant to discuss at length any trends which may have had an adverse impact, but this would provide a good opportunity to demonstrate the resilience of the business model.

73 companies (2014: 57) provided an overview of the markets that the company operates in. The most clear and comprehensive of these often include integration of the overview with the company's structure or product range, as this then facilitates linkage to strategy and, where possible, KPIs and risks.

A good example of a clear market overview is AO World Plc.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Trends and insights  
in our markets

UK Major Domestic Appliances (MDA)



Link to strategy:  
Drive, Broaden.



The UK MDA market is estimated at  
£3.6bn inc. VAT.

13%

It is estimated that AO's share is 13%  
of the total UK MDA market.

The UK MDA market is estimated at £3.6bn inc. VAT, being management's best estimate based on a number of sources. Recent growth has been driven in part by increased UK households as a result of Government backed Buy-To-Let schemes and reduced Stamp Duty Taxes stimulating home movers.

The market continues to be dominated by the top four manufacturers which account for over 50% of the market (Top 10 have 73%) hence AO have further continued to invest in long-term strategic partnerships with their key suppliers.

Despite the growing UK MDA market, AO has also gained market share. It is estimated that AO's share is approximately 13% of the total UK MDA market.

The MDA market is predicted to grow by 3.1% each year (CAGR) between 2014 and 2019.

Other UK – Small Domestic Appliances (SDA) and Audio Visual (AV)



Link to strategy:  
Build, Drive, Broaden.



AO successfully launched into the  
£4.2bn "AV" (Audio Visual – TVs,  
Home Entertainment Systems,  
Soundbars, accessories etc.).

£1.9bn

The UK SDA market which  
AO operates in is worth  
approximately £1.9bn.

AO successfully launched into the £4.2bn "AV" (Audio Visual – TVs, Home Entertainment Systems, Soundbars, accessories etc.) market in May 2014, allowing AO to further leverage its logistics infrastructure. The top four major manufacturers account for 63%, with whom AO have established strong trading relationships, resulting in improved ranging and competitive pricing. During the year, AO also introduced its own-label brand "Techwood" to better compete with entry level models offered elsewhere in the market.

This year has seen further technological advancements such as Ultra HD and OLED, stimulating demand for high end TVs. Increased digitalisation of media services such as LoveFilm, Amazon Prime and Netflix has meant that consumers are increasingly demanding affordable smart and connected TVs as traditional set-top boxes decline.

After a full year of trading in the SDA market, AO has developed key relationships with Dyson, Vax, Daewoo and Sebo to further enhance the Small Appliances and Food Preparation range and proposition. The UK SDA market which AO operates in (i.e. Small Appliances, Food Preparation, Floor Care) is worth approximately £1.9bn inc. VAT and is predicted to grow by 2.4% each year (CAGR) between 2014 and 2019.

Channel switching



Link to strategy:  
Drive, Expand.



Online migration is set to continue.

c40%

MDA continues to have the highest  
online penetration rates of consumer  
goods (c.40%) due to not being a  
"take home today" product.

The UK is the most technologically advanced country in Europe, with the highest levels of internet access, online penetration and smart device usage resulting in continued migration to online, albeit at a slower rate than experienced in previous years.

In the Electricals market in the UK and across Europe, MDA continues to have the highest online penetration rates of consumer goods due to them not being a "take home today" product. Online shopping provides greater choice and flexibility in the purchase process for consumers and with the increase of tablets, consumers are finding it easier to shop online.

Management estimate that AO's share of the online UK MDA market is approximately 34%.

European Markets



Link to strategy:  
Build, Expand.



Compared to the UK, the rest  
of Western Europe indicates  
excellent growth opportunities  
as internet access increases.

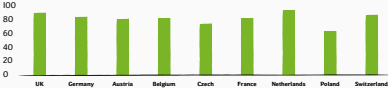
£7.2bn

AO.de was launched in Germany  
(initially selling MDAs only)  
entering a market worth  
approximately £7.2bn inc. VAT.

In October 2014 AO.de was launched in Germany (initially selling MDAs only) entering a market worth approximately £7.2bn inc. VAT. Germany continues to present strong growth prospects for AO due to the current low online penetration rates and high migration to online that is being experienced.

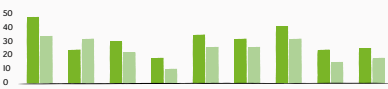
Compared to the UK, the rest of Western Europe indicates excellent growth opportunities as internet access increases, availability of affordable high speed internet improves and the adoption of smart devices continues to grow.

Percentage of population with internet access



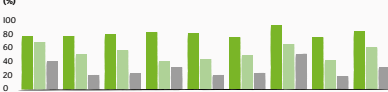
Source: WorldBank

Online penetration purchases



Source: WorldBank and Google Barometer

Device penetration



Source: Google Barometer

Last year  
launching in a new  
territory was very  
much a theory.



By October  
we had built  
everything and  
were ready for  
business.

Note to readers: figures contained in this section are management's best estimate based on a number of sources including the OCGC Report 2013, prepared in conjunction with our IPO, recent Euromonitor Data, Google Barometer and other industry information.

AO World Plc  
Annual Report and Accounts 2015  
22

[AO World Plc Annual Report and Accounts 2015 \(p. 22\)](#)



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Similarly, Vodafone Group Plc provided a detailed overview of “Where the industry is heading” before then linking it clearly into the strategy, as summarised in the diagram shown here. The linkage here between market trends and strategy demonstrates that an analysis of the market may well identify opportunities for growth, as well as risks, which can then be built upon as part of the strategy. In Vodafone Group Plc’s case, market analysis showed strong demand from emerging markets; the strategy has been devised to include a focus on these markets.



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## <IR> outlook and opportunities

An integrated report should answer the question “What challenges and uncertainties is the organisation likely to encounter in pursuing its strategy, and what are the implications for its business model and future performance?” “Part of this forward-looking outlook is identifying relevant risks (see chapter 9) and also the opportunities that the company faces. This is beyond the Act’s requirement to include the main trends and factors likely to affect the future development, performance and position of the company’s business (often included in strategic reports under the heading “Outlook”).

38 of the companies surveyed had clearly identified opportunities available to the company in addition to providing commentary on the outlook. Of these, 82% were from the FTSE 350 companies. Discussion of opportunities was usually provided in the Chairman or CEO’s statements.

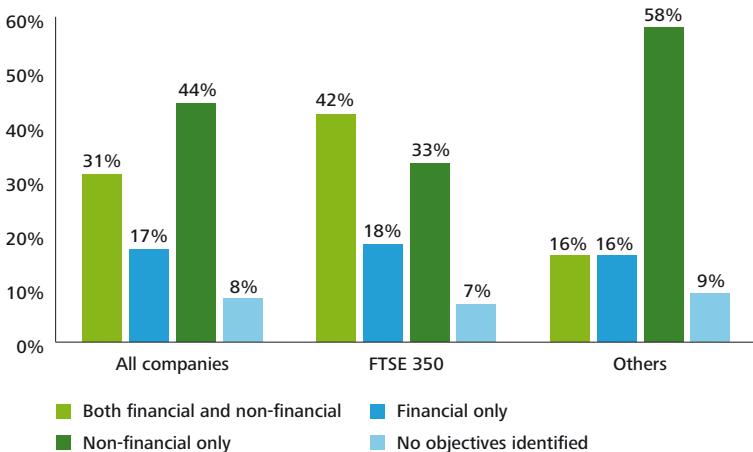
### Strategy

The Act requires a quoted company to describe, in its strategic report, its strategy. While there is no legal requirement to also describe the objectives that the strategy is intended to achieve, it would appear unusual to discuss one without the other – the FRC Guidance notes that “strategy, objectives and business model are inter-related concepts”. Further, the Code notes that the annual report should contain an explanation of ‘the strategy for delivering the objectives of the company’ (Provision C.1.2). While all companies have an overall objective to achieve maximum shareholder returns, most have more granular aims through which to achieve this.

As strategy, objectives and the business model are inter-related concepts, companies tend to interpret and apply them in different ways. Similarly, different terminology is used by companies to describe ‘objectives’. For the purpose of this survey, the objectives were determined to be the ultimate goals, aims or missions of the company, while the strategy was the intended plan as to how those objectives would be achieved.

92 companies (2014: 99) identified the objectives of the business. These included both objectives which were defined in terms of financial performance, even high-level goals such as “to grow revenue”, and non-financial objectives, such as market position or aims relating to corporate responsibility (see figure 7.4).

Figure 7.4. What type of objectives are identified by companies?



Interestingly, it was the larger companies who tended to have more comprehensive objectives, containing both financial and non-financial elements, whereas the objectives of the smaller companies tended to be shorter and simpler, along the lines of striving to be the best in the marketplace, or the best provider of a particular product.

Of those companies discussing their objectives, 38% of companies (2014: 41%) referred to long term objectives. This links in with the identification of long term value creation, as discussed above in the context of the business model. Setting out clear long term goals provides further insight into the company’s development, performance and future prospects, and also enables shareholders to make an assessment of the appropriateness of the strategy.

Crest Nicholson Holdings plc outlined five strands to their strategy and then presented the detail of each, an extract of which is below. This is a good example of providing more detail around the timeframes of the strategic plan as well as linking metrics, risks and resource allocation (see below) to each strand of the strategy.

### Other resources available

Crest Nicholson Annual integrated report 2014

27

Strategic report

9	How we do business
12	Our Group
14	Chairman's statement
17	Chief Executive's review

Corporate governance

21	Our changing landscape
22	Dialogue and partnering
23	Strategy
24	Performance

Financial statements

54	Key performance indicators
59	Governance and leadership
61	Principal risks and uncertainties
64	Finance Director's review

In detail

Key: ■ Short-term (1–2 years) ■ Medium-term (2–5 years) ■ Long-term (5–10 years)

## 1

Managed growth of the business

- **1.1** Selectively growing the business and driving strong levels of earnings by adopting a disciplined approach to returns.
- **1.2** Increasing outlet numbers within our existing areas of operation.
- **1.3** Developing additional revenue streams through a diversified portfolio, including targeting the private rental sector.
- **1.4** Maintaining a balanced risk and reward profile in relation to land.
- **1.5** Maintaining managed and sustainable growth.
- **1.6** Looking to return cash to shareholders in favourable market conditions.
- **1.7** Continue to review product range in light of changing demographics and financial status of core markets.

Targets	Metrics	Risk factors	Resource requirements	Examples
■ Reach £1bn of revenue within the next three years, with changes in the mix of product and locations driving the increase, along with growth in volumes.	<ul style="list-style-type: none"> <li>■ Unit numbers.</li> <li>■ Average selling price.</li> <li>■ Sales revenue.</li> <li>■ Operating margin.</li> <li>■ Return on capital employed.</li> <li>■ Earnings per share.</li> <li>■ Land units and gross development value.</li> </ul>	<ul style="list-style-type: none"> <li>■ Adverse economic climate.</li> <li>■ Shortage of materials and skilled labour.</li> <li>■ Government policy changes (e.g. removal of Help to Buy).</li> <li>■ House price inflation in excess of wage inflation, stretching affordability.</li> <li>■ Planning regime.</li> <li>■ Build cost inflation.</li> </ul>	<ul style="list-style-type: none"> <li>■ Investment in skills and capacity building.</li> <li>■ Access to capital.</li> </ul>	<ul style="list-style-type: none"> <li>■ Launch of new Children division.</li> <li>■ Selective additions to land pipeline including high-value sites in Cambridge, Marlow and Putney.</li> </ul>

■ **1.8** Creating value  
Quality design and place making exemplified:  
Port Marine, Portsmouth.

## 28 Strategic report

### Strategy

## 2

### Delivering to customers and communities

- **2.1** Exploring imaginative solutions for place making, building on our Garden Village principles and providing well-designed homes to meet the needs of different customer groups.
- **2.2** Creating great places that support sustainable lifestyles and well-being, with green open space, good connectivity and accessible local infrastructure.
- **2.3** Maintaining excellent customer service and aftercare.
- **2.4** Driving quality and value through high standards of design and construction.
- **2.5** Consulting and engaging with local residents and stakeholders, enabling their full participation in neighbourhood plans and development proposals.
- **2.6** Developing innovative, affordable legacy solutions (e.g. Community Interest Companies) to help neighbourhoods grow and thrive.

Targets	Metrics	Risk factors	Resource requirements	Examples
<ul style="list-style-type: none"> <li>■ Retain 5-star customer service rating.</li> <li>■ Maintain 9 out of 10 for customer recommendation rating.</li> </ul>	<ul style="list-style-type: none"> <li>■ HBF/NHBC customer service rating.</li> <li>■ Customers recommending Crest Nicholson to a friend.</li> <li>■ Proximity of developments to public transport and local amenities.</li> <li>■ Qualitative data on public and green open space.</li> <li>■ Number of alternative management solutions.</li> <li>■ Number of plots planned as Garden Villages.</li> </ul>	<ul style="list-style-type: none"> <li>■ Customer service affected by delays and/or quality issues.</li> <li>■ Varied neighbourhood planning processes affecting delivery.</li> </ul>	<ul style="list-style-type: none"> <li>■ Staff and supply chain with strong design, production and consultation skills.</li> <li>■ Quality procedures and inspection.</li> </ul>	<ul style="list-style-type: none"> <li>■ Our first neighbourhood plan in Henley.</li> <li>■ Industry awards and benchmarks, e.g. Sustainable Housebuilder of the Year and Building for Life (2 BILT) at Bishop's Cleeve, Wexley.</li> <li>■ Community Interest Company at Monkswear Park.</li> </ul>

## 3

### Skills and leadership

- **3.1** Establishing strong foundations for learning and continuous improvement within the organisation and supply chain.
- **3.2** Developing our workforce and leadership capacity through a focus on training and mentoring across the board, from management level to apprentice and graduate level.
- **3.3** Showing leadership and driving improvement in health and safety.
- **3.4** Embedding mechanisms for performance monitoring, feedback and learning to support business improvement.

Targets	Metrics	Risk factors	Resource requirements	Examples
<ul style="list-style-type: none"> <li>■ Apprentices to be at least 10% of employee base.</li> </ul>	<ul style="list-style-type: none"> <li>■ % of vacancies filled by internal promotions.</li> <li>■ Number of apprentices.</li> <li>■ Number of graduates.</li> <li>■ Training hours, total and by discipline.</li> <li>■ Accident rate.</li> </ul>	<ul style="list-style-type: none"> <li>■ Recruiting and retaining skilled staff in a buoyant market.</li> </ul>	<ul style="list-style-type: none"> <li>■ Investment in training.</li> <li>■ Investment in recruitment and employee engagement to increase capacity.</li> </ul>	<ul style="list-style-type: none"> <li>■ Delivering Professional Excellence training.</li> <li>■ Graduate training programme.</li> </ul>

Crest Nicholson Holdings plc Annual integrated report 2014 (p. 27 – 28)

95 companies (2014: 100) clearly set out the strategy as to how their objectives would be achieved. As would be expected, various levels of detail was provided by different companies, with many being able to communicate their strategy clearly and concisely. Some companies disclosed significant amounts of information around this, with one dedicating nine pages to a review of their strategy, which felt rather cumbersome to read. Another presented a lively, more discursive account of what the business does and how it does it, all under the title of “strategic overview”, but it was very difficult to determine what exactly the company’s strategy was.

There is no 'one size fits all' answer as to how best a strategy should be discussed, but companies should be mindful of the FRC Guidance that strategic reports should be comprehensive but concise.

Some companies provided a concise overview of their strategy, and then brought it to life using case studies to demonstrate how it had been applied during the year. A good example of the use of such case studies is [The Weir Group PLC](#). Care should be taken that case studies are, themselves, concise (so that they do not begin to clutter up the report) and logically located (so it is clear why the case study is included and can be linked to the narrative).

For some, the challenge of concise disclosure was increased by the fact that they had reached the end of their previous strategy and were about to head into a new strategic phase. One company which dealt with this clearly and concisely was Lloyds Banking Group plc, who covered off performance under the old strategy upfront in the Chairman's statement, Group Chief Executive's review and disclosure of the KPIs, before then setting out in two pages their new strategy and targets.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available



[Lloyds Banking Group plc Annual Report and Accounts 2014 \(p. 20 – 21\)](#)

As noted above, for the purpose of this survey the objectives were determined to be the ultimate goals, aims or missions of the company, while the strategy was the intended plan as to how those objectives would be achieved. Many companies describe these as “strategic priorities”.

Just as the objectives of companies varied as to whether they related to financial or non-financial matters, so the strategy also varied in nature. Arguably, where a company has identified material relationships or resources in its business model that are deemed crucial to value creation, it may be expected that the strategy set by directors would include a focus on these relationships and resources. This would reflect the belief that there are more forces at play than simply financial matters when creating value to achieve the company's objectives, and that these should be focused on. An example of a ‘well-rounded’ strategy, incorporating a balance of financial, operational, and sustainability-related strategic priorities, was Persimmon Plc.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## Strategic priorities

# How we maximise performance

Our strategy is to build a larger, stronger business by improving margins, investing in high quality land and increasing profitability, thereby generating surplus cash to deliver our £1.9bn Capital Return Plan to shareholders.

## Our principal priorities are set out below

### 1 Build sustainable homes

- ▶ Improve the energy efficiency of our homes and reduce running costs
- ▶ Use modern methods of construction to support site production rates and overcome any potential labour shortages
- ▶ Invest in Space4
- ▶ Improve resource and waste efficiency

[Read more](#)  
See pages 23 and 30

### 2 Excellent customer focus

- ▶ Improve customer satisfaction and service levels
- ▶ Build good quality homes in attractive locations
- ▶ Continued sales and customer care training programmes

[Read more](#)  
See page 29

### 3 Robust health and safety

- ▶ Continued management and staff training
- ▶ Continue to improve safety culture
- ▶ Maintain a high level of compliance with health and safety standards

[Read more](#)  
See page 31

### 4 Selective new site acquisitions

- ▶ Traditional site layouts
- ▶ Buy land in excellent locations
- ▶ Appropriate product mix

[Read more](#)  
See page 28

### 5 Improve margins

- ▶ Continue to control development costs
- ▶ Acquisition of new land at attractive prices
- ▶ Prioritise strategic land investment to improve shareholder returns
- ▶ Maximise sale prices

[Read more](#)  
See pages 26 to 28

### 6 Strong cash generation

- ▶ Appropriate capital structure
- ▶ Capital discipline
- ▶ Accelerating returns to shareholders
- ▶ Minimise finance costs
- ▶ Good flexibility

[Read more](#)  
See pages 18 and 27

[Persimmon Plc Annual Report – December 2014 \(p. 7\)](#)

In our view, the strongest disclosures of strategy are those which demonstrate authentic linkage between the constituent parts of a company's strategic management, including relevant risks. Also, this often includes identifying in the discussion of objectives and strategy what measures it uses, or intends to use, to measure performance against the objectives or strategies. 38 companies clearly linked their discussion of objectives to relevant performance metrics (usually KPIs, but not always the case). Of these, 24 clearly linked all objectives to a performance metric, while the remaining 14 did so in part, linking some of their objectives to relevant metrics. Some companies to link their discussion of KPIs and risks back to the strategy, with 45% and 27% respectively doing so (see chapters 8 and 9).

Good examples of clear linkage between strategy and KPIs, as well as relevant risks, include Ladbroke's PLC, below, [BTG plc](#) and [Rexam PLC](#).



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee






13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

OUR STRATEGIC PRIORITIES										
OPERATIONAL PROGRESS IN 2014				KPIs		PRIORITIES IN 2015		RELEVANT RISKS		
				Achieved	Ongoing	Not achieved	(See pages 34-37 for further details)			
	<b>RETAIL EXCELLENCE</b> Retail betting is increasingly a genuine leisure experience in both our core market and overseas. We strive to innovate continually, providing customers with a differentiated product offer, whilst optimising both margin and operational efficiency.	1,700 bet service betting terminals rolled out across the UK Retail estate driving increased football betting		✓			<b>UK Flatbet<sup>1</sup> gross win per shop per week</b> <b>£6,942</b> +0.3%	<b>UK Retail operating profit<sup>2</sup> per shop per week</b> <b>£995</b> -9.3%	<ul style="list-style-type: none"><li>Continue optimisation of the UK Retail estate</li><li>Drive increased starting in football products</li><li>Drive machine growth through increased customer activity in lower staking B3 games</li><li>Improve performance of bet service betting terminals and increase machines in deployment</li><li>Continue evolution of our offer in Belgium</li><li>Expansion into other Spanish regions as and when regulation permits</li><li>Cost savings to drive efficiency</li></ul>	<ul style="list-style-type: none"><li>Operational and bookmaking: Recruitment and retention of key employees and succession planning</li><li>Loss of key locations</li><li>Information Technology and Communications: Technology failure/Data management technology changes</li><li>Failure in the supply chain</li><li>Betting and Gaming Industry: Increased cost of product</li><li>Taxes, laws, regulations and licensing, regulatory compliance</li><li>Marketplace: Competition</li></ul>
		Over 9,000 new gaming machines rolled out across the UK Retail estate		✓						
UK Retail estate optimisation: 88 marginal shops closed improving estate quality		✓								
Investment in Belgium Retail: introduction of virtual betting products and 100THs across estate		✓								
Expansion in Spain, launch in Catalunya		✓								
	<b>DIGITAL CAPABILITY</b> The digital betting and gaming market continues to grow and remains highly competitive. We aim to provide competitive products and offers across all digital devices supported by resilient and flexible technology platform.	All Digital operations machines delivered, re-establishing a wider digital competitiveness		✓					<b>Net revenue</b> <b>£215.1M</b> +22.9%	<b>Operating profit<sup>3</sup></b> <b>£14.0M</b> +70.7%
		Strong Mobile sports betting growth driven by market leading product		✓			<b>Mobile net revenue</b> <b>£77.4M</b> +18.2%			
Migration to a hybrid casino product completed		✓								
Single wallet across all platforms improving customer acquisition and retention		✓								
Ladbrokes have delivered enhanced CRM and digital marketing intelligence		✓								
	<b>PRICING, TRADING AND LIABILITY MANAGEMENT</b> The utilisation of a proprietary trading platform, enhancement of algorithms and increasing use of automated trading tools enables us to improve liability management and reduce earnings volatility.	Gross win margin up across UK Retail and Digital		✓					<b>UK Retail OTC gross win margin</b> <b>16.4%</b> +0.5 percentage points	<b>Sportsbook gross win margin</b> <b>7.8%</b> +0.3 percentage points
		Improved value offers to customers ensuring we compete aggressively but sensibly		✓						
Deliver a highly competitive offer in the World Cup for our customers		✓								
Further development of proprietary trading platform to enable traders to increase productivity		✓								
	<b>CUSTOMER AND BRAND</b> Ladbrokes is one of the most recognised betting brands in the UK. We intend to evolve the brand with an emphasis on excitement. The development of our core bet is in Digital or Retail, is centred around improving the experience of our customers.	Launch of new advertising campaign to further enhance Ladbrokes brand appeal		✓					<b>OTC stake per slip</b> <b>£8.72</b> +1.6%	<b>Digital<sup>4</sup> real money sign ups</b> <b>586,000</b> +40.2%
		Re-energise our Odds On loyalty card offer		✓			<b>Digital<sup>4</sup> active players</b> <b>960,000</b> +14.4%			
Maintain our position as number one betting brand in UK		✓								
	<b>REGULATORY LEADERSHIP</b> The continued evolution of law and regulation is a key influence on the development of our business. Ladbrokes is playing a leading role in ensuring that the Government and all regulatory authorities fully understand our commitment to responsible gambling and our significant contribution to the economy, employment and taxes.	Implementation of the ABE Code of Conduct on Firm Membership		✓					<b>Charitable donations to the Responsible Gambling Trust</b> <b>£682,500</b>	<b>Seed funding for the Betnet Group</b> <b>£800,000</b>
		Leader in establishment of the Betnet Group, an industry wide independent body to establish and monitor socially responsible practices across the industry		✓						
Establishment of a Board Committee on responsible gambling and remuneration policies aligned with social responsibility		✓								
Continued significant charitable contributions to tackle problem gambling and to other important causes in our markets		✓								

1) Excludes broadband losses and associate income

2) OTC bettors bet, net bettors advance and associate bettors

3) Ladbrokes.com

(1) Includes greyhound racing and associated income. (2) Profit before tax, net finance expense and exceptional items. (3) Ladbrokes.com (4) Includes Ladbrokes.com

[Ladbrokes PLC Annual Report and Accounts 2014 \(p. 14 – 15\)](#)



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## <IR> resource allocation

The <IR> Framework requires an integrated report to answer the question “Where does the organisation want to go and how does it intend to get there?” Ordinarily, this would include identifying the resource allocation plan the company has to implement its strategy.

Seven companies clearly identified some resource allocation plans, while another 21 companies provided this detail in part. Resource allocation can range from identifying financial investment needed in particular strategic plans, to the need to recruit a certain number of people to be able to carry out planned strategic activities.

## Interaction with stakeholders

How the business interacts with its stakeholder groups, such as employees, suppliers, regulators and the local community, is becoming increasingly important as companies begin to focus on sustainable long term value creation. Often known as Corporate Social Responsibility (CSR) there are various disclosures in this area required by the Act, specifically information on the impact of the business on the environment, detail of the entity's employees and relevant information about social, community and human rights issues. Discussion of these matters should include descriptions of any relevant policies and the effectiveness of those policies. Further, where information on any of these matters is not included in the strategic report because it is not considered necessary for an understanding of the development, performance or position of the business, the strategic report should state this fact.

## <IR> impact on stakeholders

Through the very process of identifying its capitals, a company would have identified the relevant stakeholders upon whom its business activities materially impacts. Similarly, to satisfy the <IR> Framework's question of “What does the organisation do and what are the circumstances under which it operates?” a company should consider factors affecting the external environment which, in turn, impact the company. These impacts could be direct or indirect, such as influencing the availability, quality and affordability of a capital that the company uses or affects.

Applying integrated thinking requires an organisation to consider not only the outputs of their business, but also the outcomes i.e. the effects that outputs have on other capitals including those capitals directly related to the sustainability of the business. As such, the impact of these wider groups of stakeholders would ordinarily be considered.

Embedding integrated thinking into an organisation's activities requires better connection of external reporting and the information used for management reporting, analysis and decision-making. For entities operating in silos, the preparation and presentation of separate sustainability or corporate responsibility reports, can often be seen as bolt-on processes to other reporting.

Integrated reporting often initiates processes to integrate sustainability or corporate responsibility information into business management and reporting systems, and, where necessary, to identify and develop smarter non-financial information and KPIs. An integrated report would therefore naturally weave into its discussion of strategy, business model and performance the impact upon all relevant stakeholders, therefore eliminating the common standalone CSR sections.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

CSR information can be wide-reaching for many companies, and the amount of relevant data required by different groups of stakeholder may be considerable. For example, a non-governmental organisation may be primarily interested in the environmental or social impacts of a company's business, whereas an investor may be more concerned about the financial implications of the company's activities. This is sometimes an area where it appears companies struggle to apply materiality in an effort to appear 'green' when the material, although perhaps of interest to some stakeholders, might not always be material to the shareholder. Similarly, if the company has not identified a CSR-type performance measure as a KPI, thus recognising it as a vital part of their operations, it can seem unusual for lengthy CSR sections to be bolted on as part of the strategic report. Alternatively, as discussed in chapter 8, the challenge for companies may be more around the fact that aspects of CSR are actually part of the company's backbone, yet no KPIs have been identified to monitor and measure this.

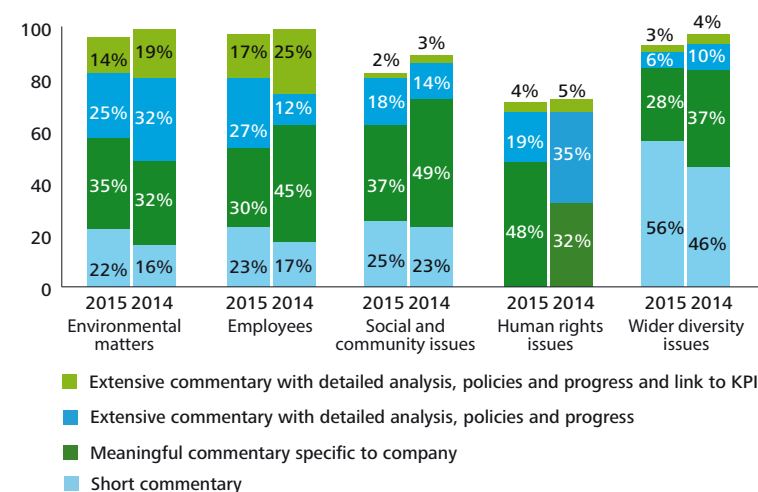
Given this broad range of interest, the FRC Guidance recommends that information on the CSR topics that a company wishes to put in the public domain, yet is not considered relevant for an understanding of the company's development, performance or position, should be located elsewhere, such as on the company's website.

34 companies (2014: 21) cross-referenced to a separate CSR publication or else a section of the company's website that contained further detail.

This is also reflective of some key points raised in the Lab's recent report 'Towards Clear & Concise, Reporting' which itself builds upon the previous FRC project 'Cutting clutter' by encouraging high-level, key information to be included in the annual report and standing or supporting information to be available elsewhere.

In November 2014, the EU published a Directive on disclosure of non-financial and diversity information ('EU non-financial reporting Directive') by certain large companies and groups addressing environmental, social, and governance issues. These requirements are expected to be mandatory for periods beginning on or after 1 January 2017 in the UK. Under the EU non-financial reporting directive, large public-interest companies (including all main market listed companies) with more than 500 employees will be required to disclose information in their annual reports on environmental, social and employee matters and respect for human rights. The disclosure will need to include a description of the policy pursued by the company related to these matters, the results of these policies and the risks related to these matters and how the company manages those risks. The directive will extend the level of disclosures required on diversity (for example policies on age, gender, educational and professional background) and will specifically require reporting on bribery and corruption matters for the first time. This complements and further extends the required disclosures under the UK's existing narrative reporting regulations.

Fig 7.5. To what extent is the CSR information included within the report?



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

As noted above, the Act requires disclosure of all of these topics, except for explicitly requiring wider diversity information (which will be required under the proposed EU non-financial reporting directive). A statement must be included where any of this information has not been provided. 41 companies did not clearly disclose information on one or more of the CSR topics. Of these, seven companies stated expressly that they had not done so; the remaining 34 were silent.

It is good to see that most companies continue to provide meaningful or extensive commentary on these topics, thus fulfilling the disclosure requirements of the Act. Under the proposed EU non-financial reporting directive, companies will need to consider the link between these matters and the risks related to these matters, including how the company manages those risks.

Clearly, an area which companies still struggle with is human rights, where only 4% of companies had disclosed commentary including policies and progress against them and 26% of companies were silent on the matter. One of those companies with extensive commentary in this area was Acacia Mining Plc.

[Acacia Mining Plc  
Annual Report &  
Accounts 2014 \(p. 45\)](#)

**Security and human rights**

In 2014, the Company continued its enhancement of security and safety infrastructure, as well as completing a review of its security resourcing and operational model. As a result, the Company transitioned management of security at North Mara and some regional security support services to an external provider, with encouraging initial results. In addition to this, the increased integration of security operations with community relations activities took on a greater focus in 2014 and will continue in the year ahead. This reflects the recognition that security practices need to focus on understanding and addressing the underlying drivers of security incidents in the areas in which we operate.

Throughout the year, security policies, procedures and techniques were subject to ongoing reviews to align with evolving best practice and the operational requirements of each of our operations, something which will continue into 2015 as part of overall security governance practices. We also completed an annual external review of our performance against a number of international standards and principles, including the Voluntary Principles on Security and Human Rights and use of force protocols. The outcome of these reviews was encouraging overall, showing consistent levels of improvement across all operations.

We also affirmed our commitment to the activities of Search for Common Ground, an international NGO focused on conflict reduction and building sustainable peace through dialogue, media and community engagement. Search for Common Ground conducted over 300 sessions with more than 12,000 stakeholders in the communities around Buzwagi, Bulyanhulu and North Mara on topics including conflict resolution, human rights, sexual harassment and violence against women and the dangers of illegal intrusion. This included providing training to over 1,500 members of Tanzanian Police units based in the vicinity of our operations on Voluntary Principles, Use of Force procedures and the detection and prevention of sexual harassment. We will continue to work with Search for Common Ground to progress our joint commitment to promoting human rights and appropriate conflict resolution practices as part of programmes aimed at promoting secure and safe environments in and around our operations.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Those companies wishing to seek guidance regarding human rights can turn to the recently issued *UN Guiding Principles Reporting Framework*<sup>46</sup>. The framework will help companies wanting to improve their reporting on human rights and provides guidance on identifying human rights content for inclusion in an integrated report. It provides a concise set of questions and offers companies clear and straightforward guidance on how to answer these questions with relevant and meaningful information about their human rights policies, processes and performance. It is also intended as an incentive to improve these policies and processes and the performance over time.

Further, the Modern Slavery Act 2015<sup>47</sup>, which will come into force in October 2015, has some transparency requirements around the steps taken to ensure businesses and their supply chains are modern slavery free. This does not have to go into the annual report, but may be a useful source of information to summarise in the strategic report, and should at least be consistent with any human rights disclosures.

As noted above, for affected companies, the proposed EU non-financial reporting directive will extend the level of disclosures required on diversity (for example policies on age, gender, educational and professional background) and will specifically require reporting on bribery and corruption matters for the first time. 66% of companies (2014: 69%) mentioned bribery or corruption, with 59% of these doing so in the strategic report and the remaining 41% of companies mentioning them elsewhere. Commonly, the reference was a passing comment in relation to anti-bribery or anti-corruption policies that the company has in place, with little or no further discussion provided. A small number of companies provided detail on the matter, such as St James's Place plc.

46. <http://www.ungpreporting.org/>

47. <http://www.legislation.gov.uk/ukpga/2015/30/contents/enacted>

## Bribery Act 2010

The Board is responsible for the oversight of the Company's anti-bribery, corruption and whistleblowing policies and procedures. During 2014, the Company carried out its annual review to ensure that it has adequate policies and procedures in place to prevent bribery and corruption. This included reviewing the Bribery Act Policy Statement, along with other related policies and procedures, and providing training to employees and Partners with regards to money laundering, fraud, bribery and corruption via an online training programme, the completion of which is compulsory.

The Company also operates a Whistleblowing policy, whereby it encourages all employees and Partners to advise the appropriate person in the Company if they become aware of any wrongdoing, which they can do on an anonymous basis. The key contact for Whistleblowing is the Chair of the Audit Committee.

During 2014, no employees or Partners were disciplined or dismissed due to non-compliance with the Anti-Bribery and Corruption policies and no fines were levied against the Company in relation to bribery or corruption.

The Bribery Act Policy Statement and the Whistleblowing procedure are available to all employees and Partners via the Company's intranet.

[St James's Place plc Annual Report and Accounts 2014 \(p. 90\)](#)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

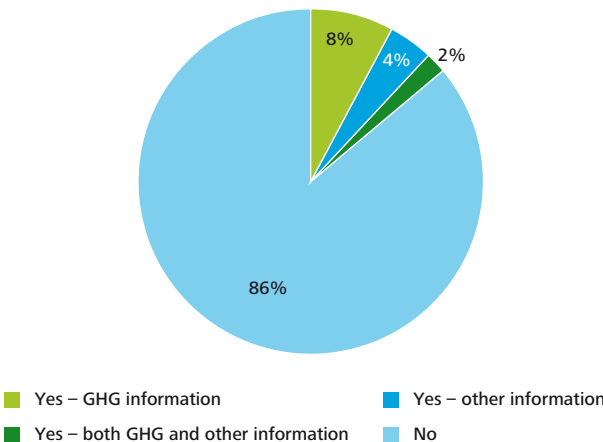
Appendix 1 – Glossary of terms and abbreviations

Other resources available

# Assurance

Assurance around non-financial information is a hot topic, particularly as more non-financial metrics are being linked to directors' remuneration and so there is more focus on the robustness of these measures. As per Fig 7.6, 14 companies were identified as having sustainability information assured by external assurance providers, whether it be greenhouse gas ('GHG') reporting, other environmental reporting, or both. Only one of these companies was outside of the FTSE 350.

Fig 7.6. Has sustainability information been externally assured?



# Carbon reporting

A company must, under the Act, disclose the quantity of emissions in tonnes of carbon dioxide equivalent from activities for which the company is responsible (known as greenhouse gas emissions, or 'GHG'), to the extent that it is practicable for the company to obtain the information. This includes both the combustion of fuel and the operation of any facility. The most widely accepted approach is to identify and categorise emissions-releasing activities into three groups.

1. Scope 1 – direct emissions: activities owned or controlled by the organisation that release emissions, including fuel usage.
2. Scope 2 – energy indirect: those emissions released into the atmosphere associated with the company's consumption of purchased electricity, heat, or steam cooling.
3. Scope 3 – other indirect: those emissions which are a consequence of the company's actions but occur at sources which are not owned or controlled by the company and which are not classed as Scope 2, such as waste disposal or purchased materials.

The Act does not require Scope 3 emissions to be disclosed, but it does require Scopes 1 and 2 carbon disclosures. The Act provides an exemption from these disclosures if it is impractical to do so, but this must be explained in the report.

Five companies did not provide Scopes 1 and 2 disclosures, an improvement from last year when 13 companies surveyed did not clearly comply. Two of these companies presented a single total figure without identifying the Scopes 1 and 2 contributions. The remaining three companies confirmed that the disclosure had not been made. An example of the justification for this given by one of our companies (a real estate investment trust), was that such disclosures were not applicable due to their lack of employees or premises and the fact that they were administered externally and therefore had negligible carbon emissions.

Although not required to by law, 16 companies in the FTSE 350 group and six others (2014: 31 total) disclosed Scope 3 emissions. For these companies, it may be the case that they consider the provision of this sustainability information to be of genuine strategic importance, and not simply an exercise in legal compliance.

Also required is at least one ratio which expresses the company's annual emissions in relation to a quantifiable factor associated with the company's activities. 92% of companies (2014: 89%) disclosed at least one intensity ratio, with several companies choosing to present more than one. Figure 7.7 shows which categories the quantifiable factor related to.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

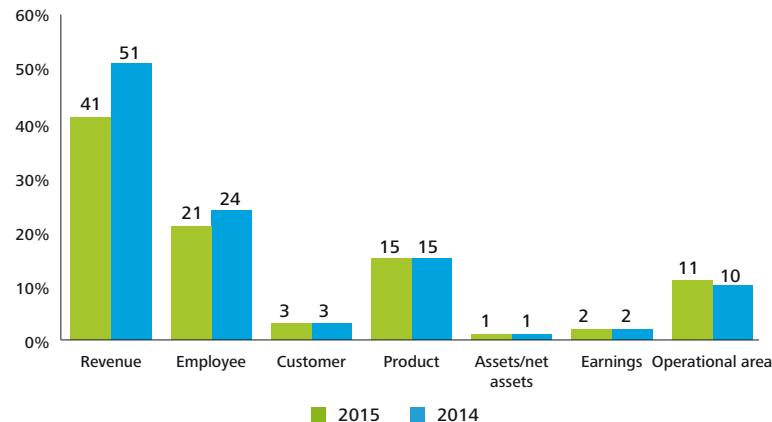
14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

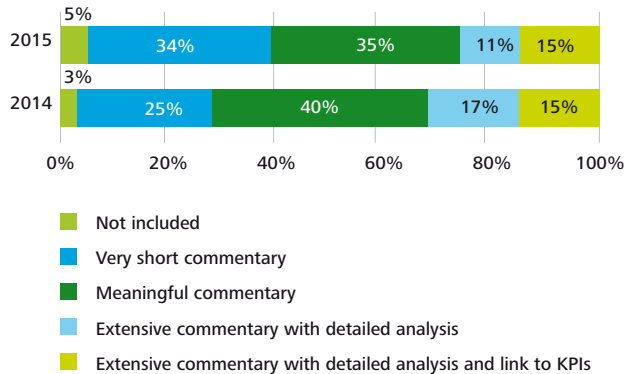
**Figure 7.7. Which operational measures did companies choose to compare to greenhouse gas emissions?**



Revenue continues to be the most popular measure for smaller companies, with 59% of all intensity ratios presented by smaller companies using this measure (2014: 55%). The FTSE 350 companies presented a broader range of ratios, with only 39% of them being based upon revenue (2014: 48%), 21% upon employee numbers and 18% on product measures.

The methodology used to determine the greenhouse gas emissions must be disclosed but aside from the general requirement to provide information on the company's impact on the environment, no specific commentary on greenhouse gas emissions is required. The majority of companies provided some level of commentary in addition to the methodology used, as shown by figure 7.8.

**Figure 7.8. To what extent has the company provided narrative disclosures regarding greenhouse gas emissions?**



The extent of narrative commentary around GHG emissions was broadly the same as last year, although a small rise was noted in the number of companies providing a very short statement, usually not much more than simply disclosing the numbers and methodology. While acknowledging that GHG emissions are not material to all industries, the best disclosures in this area were those which were able to identify the drivers of changes in emissions year on year, and discuss how GHG emissions impact their strategy or business model. A good example of detailed disclosure of GHG emissions, explaining changes year on year and also providing information around targets, is Mothercare plc.



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

2 Environment

FY2015 marks the end of a two year programme of environmental target reductions, which we set in FY2013. These targets focused on our biggest environmental impacts – greenhouse gas emissions from buildings and transport, waste and packaging. The table below outlines our environmental performance on a range of key performance indicators. The fields shaded blue highlight the performance for which we had set targets, and these are discussed in greater detail in the notes underneath.

Key Performance Indicators	FY2012/13 Baseline	FY2013/14 Performance	FY2014/15 Performance	FY2015 vs FY2013 (+/-)%	Target (green as achieved)
Building energy use (m kWh)	55.2	48.7	43.74	-21%	–
Transport fuel used (m litres)	1.3	1.1	0.92	-27%	–
Transport mileage (m miles)	3.5	3.0	2.57	-26%	–
CO <sub>2</sub> e emissions (tonnes)*	25,000	21,300	20,847	-17%	–
CO <sub>2</sub> e emissions (per '000 sq. ft.)	13.8	12.2	12.57	-9%	–
Of which:					
Buildings	21,700	18,500	18,453	-15%	10%
Transport	3,300	2,800	2,394	-27%	10%
Packaging used (tonnes, UK only)	8,500	7,200	6,177	-27%	–
Packaging per £100 (kg, UK only)	17.1	15.7	13.48	-21%	2%
Recycled waste (tonnes, UK only)	2,900	3,900	4,851	67%	–
Recycled waste (%)	92%	95%	95%	3% points	90%

\* Greenhouse Gas emissions methodology: we have reported on all the emission sources required under the Companies Act 2006 (Strategic Report and Directors' Reports) Regulations 2013. These sources fall within the activities for which we have operational control. There are no material exclusions from this data. The data has been prepared in accordance with the UK Government's Environmental Reporting Guidance (2013 version).

**Building emissions – target to reduce emission by 10% against FY2013 – achieved**

We continued to reduce our electricity and gas usage at our stores, UK office and at our National Distribution Centre (NDC) in FY2015, achieving a 15% reduction compared with our FY2013 baseline. This reduction was achieved in part due to planned store closures and milder winter temperatures. This year we have included a small number of emissions from our overseas sourcing offices and from our customer delivery distribution centre, where we assumed operational control at the start of the year.

**Transport emissions – target to reduce emission by 10% against FY2013 – achieved**

During FY2015 we reduced the number of road miles distributing products by a further 14% over the previous year, linked to our planned store closure programme. As a result we have exceeded our 10% reduction target, achieving a 27% reduction compared with FY2013.

**Packaging handled – target to reduce kg per £100 of sales by 2% against FY2013 – achieved**

Packaging per £100 of goods sold in the UK has fallen by 21% compared with FY2013. While lower sales volumes explain part of the reduction, we also continued efficiency projects to reduce the amount of packaging around our products.

**Waste recycling – target to maintain 90% of waste recycled – achieved**

During FY2015 we increased the amount of waste we recycled across our stores, as a result of improving their recycling facilities. This year we also included waste volumes from our customer delivery distribution centre. Our NDC continues to be zero waste to landfill, recycling all of its discarded waste. Mothercare recycles 95% of its waste, continuing to exceed our target of maintaining a 90% recycling rate.

**Targets FY2016**

In FY2016 we will aim to set further long-term targets for our future environmental performance. The targets for FY2016 are as follows:

- Reduce CO<sub>2</sub> emissions through buildings by 5%.
- Reduce CO<sub>2</sub> emissions through transport by 5%.
- Reduce packaging per £100 (kg, UK only) by 1%.

[Mothercare plc Annual report and accounts 2015 \(p. 36\)](#)

Gender diversity

Gender diversity in the boardroom and Lord Davies' recommendations are discussed in detail in chapter 11. With regards gender diversity for the company as a whole, the Act requires disclosure of gender diversity for three levels of employee: directors, senior managers, and other employees. Absolute numbers (rather than percentages) must be given.

95% of companies (2014: 95%) provided some disclosure of employee gender diversity. For one entity the disclosure was deemed not to be relevant as it had no employees; the other companies were silent on the non-disclosure.

Of those companies making the disclosure, 84% provided absolute numbers, whereas 16% (2014: 18%) disclosed only percentages. Nearly all companies disclosing gender diversity information provided the disclosure for the three levels required, with 96% doing so (2014: 95%). Some companies went further than the requirements and published gender diversity information on a divisional level, such as [NMC Health plc](#). Further good examples of gender diversity (in the context of board diversity) are provided in chapter 11.

In July 2015 the government launched a consultation on how to address the discrepancy between the average earnings of men and women employed by the largest UK employers (referred to as the 'Gender Pay Gap')<sup>48</sup>. The consultation asks for views on equal pay reporting regulations and ideas on wider actions that could be taken to reduce the Gender Pay Gap. The government is proposing that private and voluntary sector employers in Great Britain with at least 250 employees would be required to publish information about the pay of their male and female employees. There is no implication that this information will be required to be presented in the annual report, but may be a useful source of information to summarise in the strategic report, and should at least be consistent with any other gender pay disclosures. The continuing debate is indicative of the fact that gender diversity remains a hot topic.

48. <https://www.gov.uk/government/consultations/closing-the-gender-pay-gap>

## 8. Key performance indicators

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Top tips

- Provide a clear link between KPIs and objectives or strategy to help identify why a particular measure is relevant to the company's business – only 41% of companies provided a clear link between KPIs and strategy, with a further 16% providing a more general discussion of this link (2014: 47% and 9%, respectively).
- Refresh KPIs when there are changes in business objectives and the strategy and include the reasons for any changes – seven companies clearly disclosed a change in their KPIs from the previous year but only five of these companies included discussion of the reasons.
- Set out how each KPI is defined and calculated, particularly for financial non-GAAP measures, and avoid selecting complicated or difficult to understand measures as KPIs. This improves the transparency and understandability of the report - 64% of companies in the current year clearly defined their KPIs and explained their method of calculation (2014: 61%).
- Comment on future targets for KPIs to help investors assess future prospects of the company and success of the strategy – 26% of companies provided commentary on future targets for some or all of KPIs presented (2014: 30%).

### Keep an eye on

- The requirement of the Act to include in the analysis of the business relevant non-financial KPIs, as well as financial ones – only 68% of companies clearly identified non-financial KPIs (2014: 64%).
- How well KPIs are reconciled to the financial statements – failure to do this may impact on their understandability, undermining the requirement for directors to state that the annual report is fair, balanced and understandable – only 19% of companies presenting non-GAAP measures as financial KPIs reconciled all of them to the financial statements (2014: 19%).

- How the source of the underlying data used in non-financial KPIs is explained, where relevant, to help users to understand the figure and how it has been arrived at – only 22% of companies provided this information for some or all of their non-financial KPIs (2014: 14%).
- Ideas from the integrated reporting framework, which requires management to take a holistic view of the company when determining which measures are most appropriate (or 'key') to monitor value creation and performance.

### Legal requirement

The strategic report is required to include a fair review of the company's business, which, to the extent necessary for an understanding of the development, performance or position of the company's business, must include an analysis using financial and, unless the company qualifies as medium-sized, where appropriate, non-financial key performance indicators (KPIs).

KPIs are crucial in showing investors how the company has performed against its objectives and how effectively it has implemented its strategy. However, disclosure of KPIs is an area of focus for regulators. In their Corporate Reporting Review Annual Report 2014<sup>49</sup> the FRC highlighted inadequate explanations of key performance indicators as an issue commonly raised by their Conduct Committee. This is likely to remain an area of focus so companies should make sure they explain why the identified measures are important and what the figures presented actually mean in terms of company performance.

### Presentation of KPIs

As discussed in chapter 6, only 5% of companies surveyed presented all of their KPIs in the summary section of the annual report, while 73% presented some of their KPIs alongside other performance measures (2014: 13% and 60%, respectively). The fact that so few companies present all of their KPIs in the summary section is surprising. One might assume that KPIs would be those measures that the company should feel the need to highlight most prominently to investors, and therefore sometimes this raises the question of whether the measures identified as KPIs are really the 'key' ones.

49. <https://frc.org.uk/Our-Work/Publications/Corporate-Reporting-Review/Corporate-Reporting-Review-Annual-Report-2014.pdf>

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

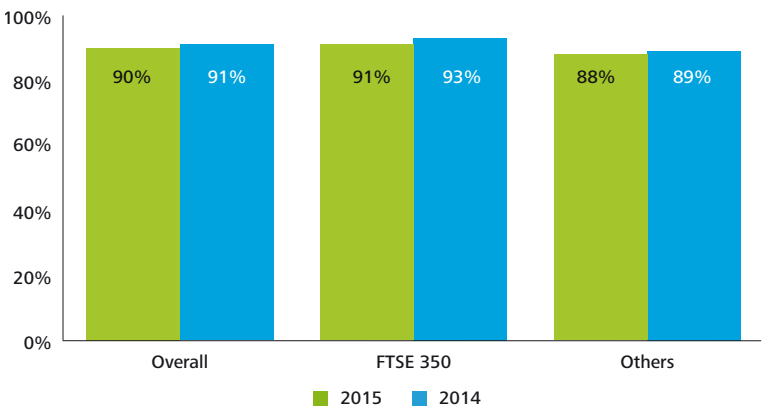
Other resources available

In addition, some companies appear unsure as to which are their key metrics, for example describing different metrics as 'KPIs' in different sections of the annual report, which can be very unclear and confusing for the readers of the report.

Companies are required to describe their strategy in their strategic report and most disclose the objectives that the strategy is intended to achieve (see chapter 7 on the strategic report). In order for these to be meaningful there should be some measures, whether financial or non-financial, identified at the outset which will enable the company to demonstrate to investors how the company is developing and performing against its objectives and strategy.

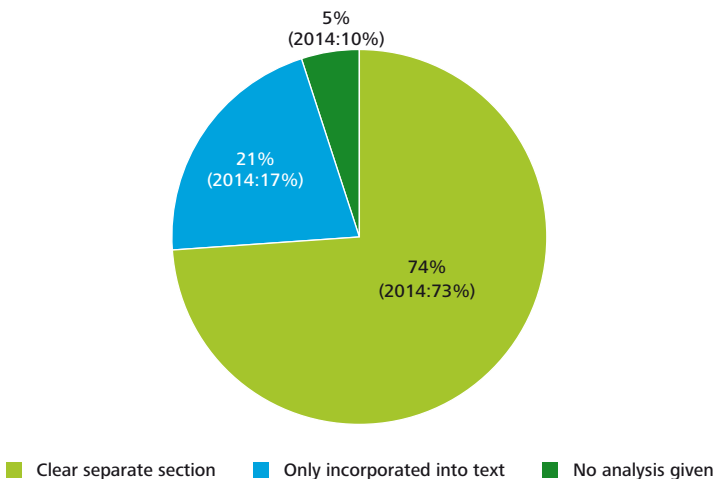
Figure 8.1 shows that 90% of companies surveyed this year clearly identified which performance measures they considered to be KPIs, which is broadly in line with last year (2014: 91%). Additionally, 7% of the companies surveyed discussed measures that appeared to fulfil the purpose of KPIs but were described in another way.

**Figure 8.1. How many companies clearly identified which performance measures they considered to be KPIs?**



There is no legal requirement to present KPIs in a separate section of the strategic report. However, as Figure 8.2 shows, 74% of companies (2014: 73%) do present them in this manner, in addition to incorporating them into their narrative analysis. Fewer companies in the current year, only 4%, gave no analysis of their KPIs (2014: 9%), with a significant drop among companies outside of the FTSE 350 from 14% to 2%. These few companies merely stated which measures they considered to be KPIs without giving any further explanation of them, which seems unlikely to meet the legal requirement to present an analysis using KPIs.

**Figure 8.2. How do companies present their KPIs in 2015?**



Although the separate section approach continues to be more prevalent, it is worth noting that incorporating KPIs into the narrative can help to provide a clearer linkage to other aspects of the report and to identify the purpose of selected measures. A good example of the narrative approach is given by Mitie Group plc, which incorporated KPIs into the financial review, while Halma plc provides a good example of the separate section approach with a comprehensive KPI section.

1. Executive summary
2. How to use this document
3. Regulatory overview
4. Survey objectives and methodology
5. Overall impressions
6. Summary material
7. The strategic report
8. Key performance indicators
9. Principal risks and uncertainties
10. Going concern and viability
11. Corporate governance
12. The work of the audit committee
13. The auditor's report
14. Primary statements
15. Notes to the financial statements
Appendix 1 – Glossary of terms and abbreviations
Other resources available

3

Operational excellence

We focus on delivering efficiency – that's why clients enjoy working with us. But in addition to the day-to-day services, clients are seeking value-added advice and innovations that reduce their total occupancy costs and improve service levels.

We never rest on our laurels and never tire of looking for ways to do things better. Sometimes that means lateral thinking and approaching a task or service from a completely new angle. At other times, it can involve introducing new or improved technology such as MiWorld, a web-based management information portal that enables clients to monitor and manage all their buildings and equipment in one place, in real time.

We continue to invest in these capabilities right across our business, and in doing so create true partnerships with our clients, drive cross selling and improve retention.

Headline operating profit margin KPI

%

2010	5.4
2011	5.7
2012	6.2
2013	6.1
2014	6.0

**Description:**  
Our headline operating profit margin provides us with a good indicator of the profitability of our business. Where we have material restructuring and acquisition related items, such as non-recurring integration costs, we exclude these from our measure.

**Objective:**  
Margin increases over the medium-term.

**Comment:**  
Our headline operating profit margin was 6.0%.

Key Performance Indicators – KPIs

Strategic focus

Through careful selection of our market niche and strategic investment in people development, international expansion and innovation we aim to achieve organic growth in excess of our targeted market growth rate, broadly matching revenue and profit growth in the medium term. The key companies with business and market characteristics similar to those of our target market are: Acquired businesses have been a good fit with our operating culture and strategy in addition to being value-enhancing financially.

Organic profit growth % (constant currency)

7% Performance

>5% Target

18

15

12

10

8

7

2011 2012 2013 2014 2015

Acquisition profit growth %

5% Performance

>5% Target

10

8

6

4

3

2011 2012 2013 2014 2015

EPS growth % (adjusted earnings per share)

9% Performance

>10% Target

25

20

15

10

8

2011 2012 2013 2014 2015

**KPI definition**  
Organic profit growth is calculated as constant currency and excludes the impact of currency translation. It is the annualised percentage change in profit achieved in the current year compared with the prior year from continuing Group operations. The effect of acquisitions and disposals made during the current or prior financial year has been excluded.

**Comment**  
Organic profit growth of constant currency exceeded our minimum target. Growth of 7.2% included strong performance in Process Safety, Introduction Safety and Medical Services.

**2016 target**  
The Board has established a long-term minimum organic growth target of 5% p.a., slightly above the historical long-term average growth rate of our markets.

**Remuneration linkage**  
Growth in organic profit is a key element of the economic value added performance which forms the basis of the annual bonus plan, impacting consistent annual and long-term growth, meeting disciplined financial performance. The use of 5% clearly reinforces the Group's strategic objective to double group profitability by year 2020.

**Also see**  
– Chief Executive's Strategic Review P100  
– Financial Review P102  
– Principal Risks and Uncertainties P103  
– Note 5 to the Accounts P115

**KPI definition**  
Acquisition profit growth measures the annualised contribution to the Group's operations derived from acquisitions made in the year, measured at the date of acquisition.

**Comment**  
Annualised acquisition profit growth met our target of 5% for the year. We have substantial financial capacity and have been able to finance more value-enhancing acquisitions.

**2016 target**  
2016 target with one acquisition in the first quarter. Acquisitions must meet our demanding criteria and we continue to have a strong pipeline of opportunities to meet our 5% growth target.

**Remuneration linkage**  
Growth in acquired profit is the second key element of the economic value added performance which forms the basis of the annual bonus plan, impacting consistent annual and long-term growth, meeting disciplined financial performance.

**Also see**  
– Chief Executive's Strategic Review P101  
– Financial Review P102  
– Principal Risks and Uncertainties P103  
– Note 3 to the Accounts P113

**KPI definition**  
Adjusted earnings are calculated as earnings from continuing operations excluding the amortisation of acquired intangible assets, acquisition costs, profit or loss on disposal of operations, the effect of changes to future benefit accrual of the defined benefit pension plan and of associated costs (2014 only), and associated tax thereon.

**Comment**  
Performance was just below target and would have exceeded it if the impact of currency translation and disposals had been excluded.

**2016 target**  
We aim for the combination of organic and acquisition growth to exceed 10% per annum over the long term. The Directors consider that adjusted earnings represent a more consistent measure of underlying performance.

**Remuneration linkage**  
EPS provides a clear link to the success of the business growth strategy. It is a key financial driver for our business and provides a clear line of sight for our stakeholders. EPS is 50% of the performance condition attaching to the new Executive Share Plan.

**Also see**  
– Note 2 to the Accounts P115

Halma plc Annual Report and Accounts 2015 (p. 22 – 25)

Strategic focus

Since 2007, Halma has conducted an annual survey of the workforce to assess how well the Group's values are aligned with its employees' current experiences and future aspirations.

Values alignment (out of 10)

6 Performance

≥5 Target

6

5

4

3

2

2011 2012 2013 2014 2015

**KPI definition**  
The survey of Group employees looks for matching values in a comparison of the 10 current culture values including the highest number of value with the equivalent 10 values employees want to see in their working culture.

**Comment**  
The results indicate an improving alignment of values, exceeding the target of five or more matching values. This is an excellent result reflecting well on the structural changes made at the beginning of the financial year. Numbers of participants in the survey have increased by one third since last year.

**2016 target**  
The minimum target of the matching values remains relevant, the goal for 2016 will be to continue to improve the Group's communication of its values and to maintain the high rate of employee participation in such surveys.

**Also see**  
– Chief Executive's Strategic Review P105  
– Corporate Responsibility P102

Strategic focus

Halma has an excellent health and safety record, with no work related fatalities in 2014/15 or in prior years. Safety is critical and a major priority for the Group. Halma collects details of its worldwide reported health and safety incidents and encourages all Group companies to seek continuous improvement in their health and safety records and culture.

Health & Safety (Accident Frequency Rate)

0.15 Performance

<0.09 Target

0.21

0.20

0.19

0.18

0.15

2011 2012 2013 2014 2015

**KPI definition**  
The year-to-date Accident Frequency Rate (AFR) is the total number of reportable incidents in the period divided by the number of hours worked. In the period employees (including temporary staff and any overtime) multiplied by 100,000 hours (representing the estimated number of working hours in an employee's work lifetime). The AFR figure represents an indication of how many incidents an employee will have in their working life.

**Comment**  
The AFR performance this year was 0.15 (2014: 0.08) which exceeded the position achieved last year. We have reduced the incidents contributing to this increase and there are no specific underlying problems which cause concern.

**2016 target**  
The target is maintained at 0.09 to match the health and safety performance which was achieved in 2013/14, with a view to ultimately setting a sustainable incident target rate of zero.

**Also see**  
– Corporate Responsibility P102

Strategic focus

The Halma Graduate Development Programme (HGDTP), the Halma Management Development Programme (HMDP) and the Halma Graduate Development Programme (HGDGP) provides excellent, market leading and has been recognised with the necessary skills they need for their current and future roles.

Development programme (management development)

60% Performance

>50% Target

71

64

58

51

48

2011 2012 2013 2014 2015

**KPI definition**  
Number of current employees having attended an in-house development programme compared with the estimated pool of qualifying participants.

**Comment**  
Recognising the value that our people play in delivering organic growth, our training courses have been designed to enhance the skills of the next generation of directors, managers and executives. The performance metric is influenced by the introduction of new courses and more eligible employees joining the Group through acquisitions. Overall we are satisfied with our performance and progress.

**2016 target**  
The introduction of the Halma Graduate Development Programme in 2013 with its launch later in 2015 is an important expansion of the Group's development programme and is targeted to bring further new talent into the Group.

**Also see**  
– Chief Executive's Strategic Review P105  
– Corporate Responsibility P102

Annual report insights 2015 72

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## KPIs and the <IR> Framework

The <IR> Framework does not prescribe specific KPIs or other measurement methods, instead acknowledging that those responsible for the preparation and presentation of the integrated report need to exercise judgement to determine which matters are material and how they are disclosed. It also acknowledges that KPIs could be helpful in explaining how a company creates value, as well as demonstrating how the company has performed during the period.

The concept of integrated reporting requires management to take a holistic view of the company when determining which measures are most appropriate (or 'key') to monitor value creation and performance. This would include considering all relevant aspects of the company's business model, including the material capitals that impact or are affected by the company's activities (i.e. the inputs, outputs and outcomes). Naturally, this would drive the consideration of a range of non-financial metrics.

While most companies identified a combination of both financial and non-financial KPIs, and some linked KPIs to their strategy, many companies are not necessarily looking holistically at their business when determining their KPIs. For example, a number of companies made positive statements regarding the importance of their employees, describing them in some cases as the company's "greatest asset", yet there were no KPIs in place that appeared to measure, for example, employee engagement or employee retention. Applying integrated thinking would challenge this, as human capital would have been identified as a material resource in the company's business model.

### Financial vs. non-financial KPIs

The Act requires UK companies, other than those that are medium-sized, where appropriate, to include non-financial KPIs as well as financial ones. Figure 8.3 shows how many of the companies surveyed identified financial as well as non-financial KPIs in the current year. This was broadly in line with the previous year, as shown in Figure 8.4. We would not expect to see a big change in the selection of KPIs, unless the company is aligning them with a change in its business objectives or strategy. Only seven companies surveyed reported a change in their KPIs this year – although others might have changed their KPIs but not clearly disclosed this fact in their report.

Figure 8.3. How many companies identified financial and non-financial KPIs?

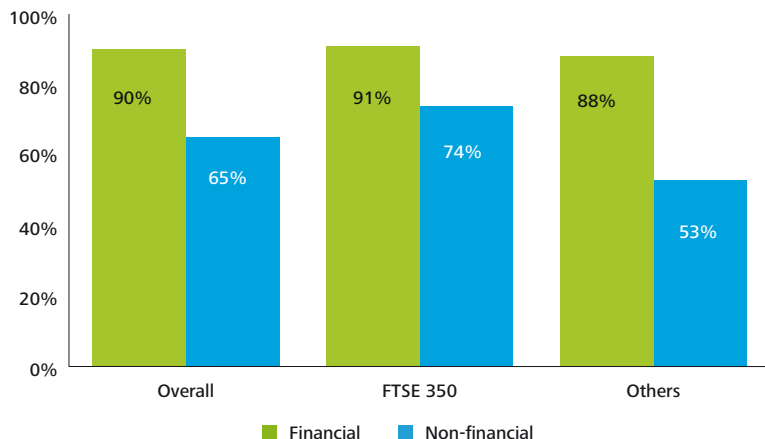
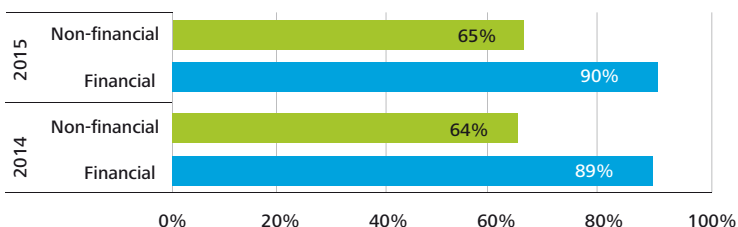


Figure 8.4. How many companies identified financial and non-financial KPIs in 2015 and 2014?





1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations


Other resources available

# <IR> measurement of 'dual benefits'

As noted above, the <IR> Framework does not specify how KPIs should be identified, but it is clear that a company which embarks on a journey of integrated thinking would consider a broad range of relationships and resources when determining appropriate measures to capture the value created by or performance of an entity.

The <IR> Framework introduces the notion of 'dual benefit' measures. These are measures (not necessarily needing to be KPIs) that combine financial measures with other components (e.g. the ratio of greenhouse gas emissions to sales) or narrative that explains the financial implications of significant effects on other capitals and other causal relationships (e.g. expected revenue growth resulting from efforts to enhance human capital). Such measures may be used to demonstrate the connectivity of financial performance with performance regarding other capitals. In some cases, this may also include monetising certain effects on the capitals (e.g. carbon emissions and water use).

A measure that demonstrates dual benefit can be used to demonstrate to investors the financial value creation of the company while implementing strategic decisions around non-financial capitals in which other stakeholders have material interests. A good example of disclosure of a dual benefit measure is from Unilever PLC, below, which identifies the financial cost-saving impact of technology investment otherwise designed to positively impact the company's environmental footprint.



**NEW DOVE BOTTLES – LESS PLASTIC. LOWER COSTS**

In 2014 Unilever launched a newly developed packaging technology for Dove Body Wash bottles that uses 15% less plastic. Projected cost savings for the whole portfolio are €50 million. This is another substantial step towards the USLP target of halving Unilever's waste footprint by 2020.

The technology represents a breakthrough for Unilever and the industry. With up to 59 million Dove Body Wash bottles sold across Europe, the new technology will save approximately 180 tonnes of plastic a year overall. A full roll-out across every Unilever product and packaging format could save up to 27,000 tonnes of plastic per year.

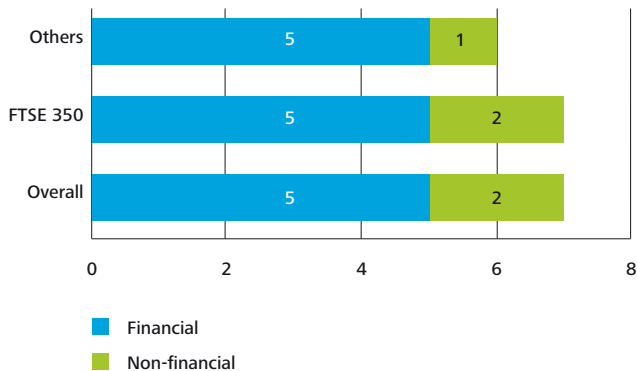
The MuCell® Technology for Extrusion Blow Moulding was created in partnership with two packaging suppliers – ALPLA and MuCell Extrusion. By using gas-injection to create gas bubbles in the middle layer of the bottle wall, it reduces the density of the bottle and the amount of plastic required.

Unilever has waived exclusivity rights from 1 January 2015, so that other manufacturers can also use the technology.

[Unilever PLC Annual Report and Accounts 2014 \(p. 1\)](#)

Figure 8.5 shows the median number of financial and non-financial KPIs identified. The noticeable change from previous years is a significant increase in the median number of non-financial KPIs identified by the 'other' companies in our sample, from one to two. The maximum number of financial KPIs identified by companies in our sample was 12 and for non-financial KPIs was 10 (2014: 18 and 19, respectively) and the maximum number of total KPIs identified by one company was 17 (2014: 24). While it can be insightful to link various aspects of the business to the performance measures, identifying too many KPIs undermines the identification of them as 'key'.

**Figure 8.5. How many financial and non-financial KPIs are identified by companies?**



The number of non-financial KPIs identified continues to be relatively low when compared to financial KPIs, probably reflective of the fact that financial measures are easier to link directly to the return that the company makes for its shareholders. However, it is worth noting that non-financial measures can be just as insightful when looking at how a company is performing against its strategy.



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

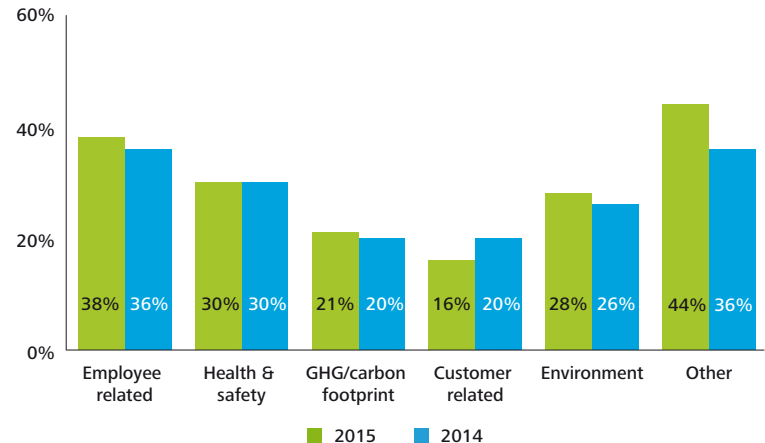
Appendix 1 – Glossary of terms and abbreviations

Other resources available

One way in which this can be done is to use them as indicators of a company's progress in managing risks. For example, a customer satisfaction KPI could be used to illustrate how well a company is managing its demand risk; a KPI for number of stores opened linked to an identified risk of failing to grow the business; or corporate responsibility matters such as the risk of employees leaving measured by using an employee engagement KPI. For those companies embracing the concepts behind integrated reporting, non-financial KPIs can also be important in showing how the company is generating value for wider stakeholder groups.

Figure 8.6 shows the types of non-financial KPIs identified by companies in our sample in the current year. Employee related KPIs (such as an employee engagement index) continue to be the most popular non-financial measure, with 37% of those companies in our sample that presented some non-financial measures (2014: 36%) including such a measure.

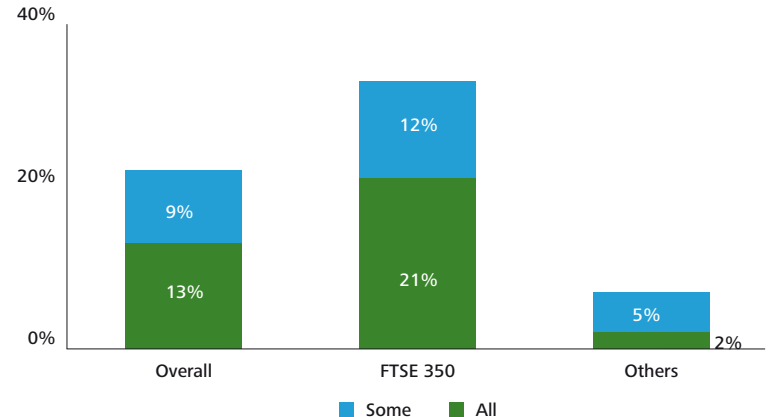
Figure 8.6. What types of non-financial KPIs are included in the annual report?



When presenting non-financial KPIs it is important that a user can understand the figure and how it has been arrived at. The FRC Guidance recommends that additional information should be disclosed explaining the source of underlying data, where relevant. Non-financial KPIs can often be unique to the company and so the calculation methods will not be familiar to users. Additionally, sources of underlying data are not always obvious or presented elsewhere in the report.

Figure 8.7 shows how many companies in our sample disclosed the source of the underlying data for all or some of the non-financial KPIs they have identified. Quite a significant number of companies still do not see the need to present this information. However, there has been a significant improvement on last year, with the overall number of companies which provided such information for some or all of their non-financial KPIs increasing from 14% to 22% in 2015. In particular, the FTSE 350 contributed to this increase by more than a half, from 14% to 33%. Disappointingly, the number of smaller companies disclosing underlying data for some or all non-financial KPIs decreased from 14% last year to only 7% in the current year, despite the increased recognition of the importance of non-financial KPIs by those companies (as indicated by the increase in their usage by these companies discussed above).

Figure 8.7. How many companies disclosed the source of the underlying data used in non-financial KPIs?



A good example of a company which identifies a broad selection of non-financial KPIs and provides disclosure of the source of the underlying data used in calculations is National Express Group PLC.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

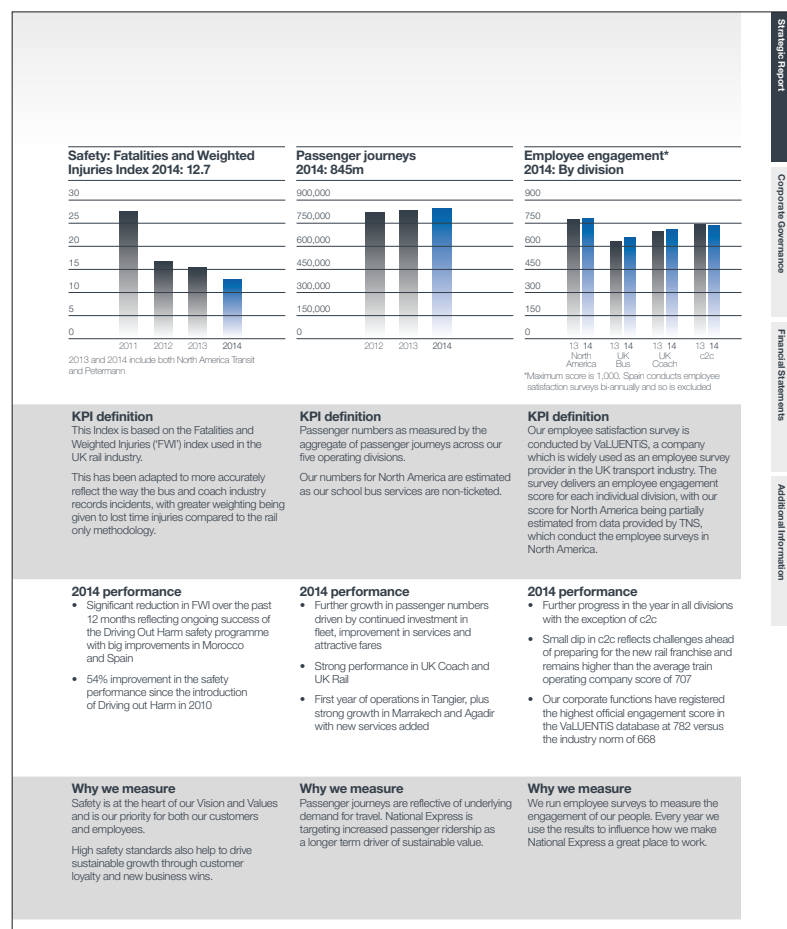
13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available



[National Express Group PLC Annual Report and Accounts 2014 \(p. 23\)](#)

It is also worth mentioning that some companies surveyed disclosed the source of the underlying data in the Glossary section at the end of the annual report, although they often failed to include cross references to this information in the KPIs section, potentially limiting its usefulness to users.

**Reconciliations of financial KPIs**

When selecting meaningful and insightful financial performance measures for use as KPIs, companies often consider it necessary to use what are commonly termed 'non-GAAP measures' – financial measures that are adjusted from those presented in accordance with IFRSs in some way. These can either be measures already presented directly alongside the IFRS financial statements (see chapter 14 for more discussion of how such figures are presented) or represent a financial statement line-item adjusted in some way. In the former scenario the measure can be easily tracked to the financial statements. However, the latter will require further explanation or reconciliation in order to make the KPI understandable to the user.

83% of companies identifying financial KPIs in our sample selected non-GAAP measures to make up some or all of them (2014: 75%). Figure 8.8 shows that although fewer companies used measures already presented alongside the financial statements (such as adjusted operating profit) than in 2014, a significantly larger number reconciled some or all of them to the financial statements, helping to make the report more transparent and understandable. However, the number of companies failing to reconcile adjusted or manipulated KPIs to the financial statements remains quite high. Failing to ensure that the report is understandable in this relation could undermine the requirement for directors to state that information included in the report is fair, balanced and understandable. Looking forward, we expect that such reconciliations will become more prevalent once the ESMA 'Guidelines on Alternative Performance Measures' become effective – see Chapter 3 for more details.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

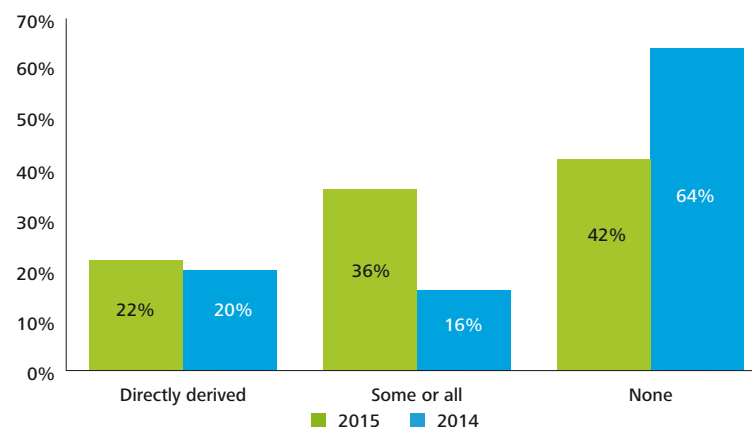
14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

**Figure 8.8. How many companies presenting financial KPIs as non-GAAP measures reconciled them to the financial statements?**

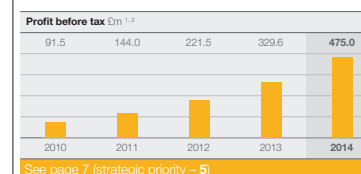
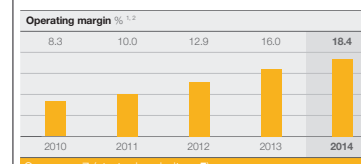


The Regulatory overview in chapter 3 includes discussion of the more general use of financial non-GAAP measures in annual reports and chapter 6 discusses the use of financial non-GAAP measures in summary information sections.

Most companies which reconciled non-GAAP measures to the financial statements did so by adding footnotes either for each KPI or for the KPIs section of the report with an explanation of the adjustments. One good example of adding a footnote to each non-GAAP measure is given by Persimmon Plc. However, a good example of an effective way of providing reconciliations unobtrusively, by presenting detailed reconciliations in an appendix to the financial statements and adding a cross reference to it in the KPIs section, is given by BT Group plc.

#### Profit measures

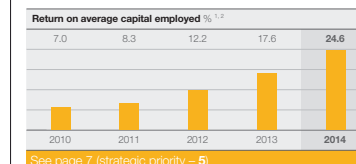
Our margin has historically been one of the best in the sector and our cost reduction and efficiency programmes have been undertaken to maintain this position.



1 Stated before exceptional items and goodwill impairment. After exceptional items and goodwill impairment the figures are as follows: Operating margin: 18.1% (2013: 16.3%; 2012: 12.7%; 2011: 10.6%; 2010: 13.2%); Profit before tax: £467.0m (2013: £337.1m; 2012: £218.2m; 2011: £143.1m; 2010: £149.9m).  
2 2010–2012 comparatives restated for IAS 19 Employee Benefits (revised).

#### Return measures

A combination of revenue and margin improvement will deliver growth in return on invested capital. We will continue our disciplined approach to working capital management.



1 Stated before exceptional items and goodwill impairment. After exceptional items and goodwill impairment the figures are as follows: Return on average capital employed: 24.2% (2013: 18.0%; 2012: 12.0%; 2011: 8.8%; 2010: 11.1%).  
2 2010–2012 comparatives restated for IAS 19 Employee Benefits (revised).

[Persimmon Plc Annual Report – December 2014 \(p. 14 – 15\)](#)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor’s report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Group performance

Our progress against our KPIs

We have again delivered on our three financial KPIs with strong growth in adjusted EPS and cash flow. Our customer service performance is up 4.7% but we still want to do better.

We use four key performance indicators (KPIs) to measure how we are doing against our strategy. Our financial KPIs measure: the trend in underlying revenue excluding transit; our adjusted earnings per share; and normalised free cash flow. Customer service improvement is also a vital non-financial KPI for us. These KPIs are used to measure the variable elements of our senior executives’ pay each year as set out in the **Report on Directors’ Remuneration** (see page 111).

We have outlined our performance against each KPI here, together with an explanation in italics of how we define each measure. You can find reconciliations of the financial measures to the closest IFRS measure in the **Additional information** section on pages 202 to 204.

202 BT Group plc  
Annual Report 2015

Alternative performance measures

Introduction

We assess the performance of the group using a variety of alternative performance measures. We principally discuss the group’s results on an ‘adjusted’ basis. The rationale for using adjusted measures is explained below. Results on an adjusted basis are presented before specific items.

We also explain financial performance using measures that are not defined under IFRS and are therefore termed ‘non-GAAP’ measures. The non-GAAP measures we use are: the trend in underlying revenue excluding transit, and in underlying operating costs excluding transit, as well as in reported and adjusted EBITDA; reported and normalised free cash flow; and net debt. A reconciliation from these non-GAAP measures to the nearest measure prepared in accordance with IFRS is presented below. The alternative performance measures we use may not be directly comparable with similarly titled measures used by other companies.

Specific items

The group’s income statement and segmental analysis separately identify trading results before specific items. The directors believe that presentation of the group’s results in this way is relevant to an understanding of the group’s financial performance, as specific items are identified by virtue of their size, nature or incidence. This presentation is consistent with the way that financial performance is measured by management and reported to the Board and the Operating Committee and assists in providing a meaningful analysis of the trading results of the group. In determining whether an event or transaction is specific, management considers quantitative as well as qualitative factors such as the frequency or predictability of occurrence.

Examples of charges or credits meeting the above definition and which have been presented as specific items in the current and/or prior years include disposals of businesses and investments, regulatory settlements, historic insurance or litigation claims, business restructuring programmes, asset impairment charges, property rationalisation programmes, net interest on pensions and the settlement of multiple tax years. In the event that other items meet the criteria, which are applied consistently from year to year, they are also treated as specific items.

Specific items are disclosed in note 8 to the consolidated financial statements.

Trends in underlying revenue and operating costs

Underlying revenue and underlying operating costs are measures which seek to reflect the underlying performance of the group that will contribute to long-term sustainable, profitable growth. As such they exclude the impact of acquisitions or disposals, foreign exchange movements and specific items. We focus on the trends in underlying revenue and underlying operating costs excluding transit, as transit traffic is low-margin and is significantly affected by reductions in mobile termination rates.

A reconciliation from the decrease in reported revenue and in reported operating costs, the most directly comparable IFRS measures, to the decrease in underlying revenue and underlying operating costs excluding transit, is set out below.

Year ended 31 March	2015 %	2014 %	2013 %
<b>(Decrease) increase in reported revenue</b>	<b>(1.7)</b>	<b>1.0</b>	<b>(4.7)</b>
Specific items	(0.7)	(1.3)	(0.8)
<b>Decrease in adjusted revenue</b>	<b>(2.4)</b>	<b>(0.3)</b>	<b>(5.5)</b>
Transit revenue	0.6	1.0	1.3
Acquisitions and disposals	–	(0.1)	0.2
Foreign exchange movements	1.4	(0.1)	0.9
<b>(Decrease) increase in underlying revenue excluding transit</b>	<b>(0.4)</b>	<b>0.5</b>	<b>(3.1)</b>

Year ended 31 March	2015 %	2014 %	2013 %
<b>Decrease in reported operating costs</b>	<b>(4.2)</b>	<b>(0.1)</b>	<b>(5.9)</b>
Depreciation and amortisation	0.3	1.2	(0.3)
<b>(Decrease) increase in reported operating costs before depreciation and amortisation</b>	<b>(3.9)</b>	<b>1.1</b>	<b>(6.2)</b>
Specific items	(1.0)	(1.3)	(2.5)
<b>Decrease in adjusted operating costs before depreciation and amortisation</b>	<b>(4.9)</b>	<b>(0.2)</b>	<b>(8.7)</b>
Transit costs	1.0	1.4	1.7
Acquisitions and disposals	–	(0.1)	0.2
Foreign exchange movements	1.5	–	1.0
<b>(Decrease) increase in underlying operating costs before depreciation and amortisation excluding transit</b>	<b>(2.4)</b>	<b>1.1</b>	<b>(5.8)</b>

Overview The Strategic Report Purpose and strategy Delivering our strategy Group performance Governance Financial statements Additional information 203

EBITDA

In addition to measuring financial performance of the group and lines of business based on operating profit, we also measure performance based on EBITDA and adjusted EBITDA. EBITDA is defined as the group profit before depreciation, amortisation, net finance expense and taxation. Adjusted EBITDA is defined as EBITDA before specific items. EBITDA is a common measure used by investors and analysts to evaluate the operating financial performance of companies, particularly in the telecommunications sector.

We consider EBITDA and adjusted EBITDA to be useful measures of our operating performance because they approximate the underlying operating cash flow by eliminating depreciation and amortisation. EBITDA and adjusted EBITDA are not direct measures of our liquidity, which is shown by our cash flow statement, and need to be considered in the context of our financial commitments.

Within the lines of business we may also consider our performance using an underlying EBITDA measure, which additionally excludes the impact of acquisitions and disposals and foreign exchange.

A reconciliation from group operating profit, the most directly comparable IFRS measure, to reported and adjusted group EBITDA, is set out below. A reconciliation between operating profit and adjusted EBITDA for our lines of business is set out in note 4 to the consolidated financial statements.

Year ended 31 March	2015 £m	2014 £m	2013 £m
<b>Operating profit</b>	<b>3,480</b>	<b>3,145</b>	<b>2,948</b>
Depreciation and amortisation	2,538	2,695	2,843
<b>Reported EBITDA</b>	<b>6,018</b>	<b>5,840</b>	<b>5,791</b>
Specific items	253	276	352
<b>Adjusted EBITDA</b>	<b>6,271</b>	<b>6,116</b>	<b>6,143</b>

Earnings per share

We also measure financial performance based on adjusted earnings per share, which excludes specific items. Basic and adjusted earnings per share, and the per share impact of specific items, are as follows:

Year ended 31 March	2015		2014		2013	
	Pence per share	£m	Pence per share	£m	Pence per share	£m
<b>Basic earnings per share/profit<sup>a</sup></b>	<b>26.5</b>	<b>2,135</b>	<b>25.7</b>	<b>2,016</b>	<b>24.8</b>	<b>1,946</b>
Specific items <sup>b</sup>	5.0	406	2.5	196	1.5	111
<b>Adjusted basic earnings per share/profit</b>	<b>31.5</b>	<b>2,541</b>	<b>28.2</b>	<b>2,212</b>	<b>26.3</b>	<b>2,057</b>

<sup>a</sup> The stated profit amounts are the components of the total profit which are attributable to equity shareholders excluding non-controlling interests.  
<sup>b</sup> Specific items are set out in note 8 to the consolidated financial statements.

We disclose reported earnings per share, both basic and diluted, in note 10 to the consolidated financial statements.

Free cash flow

Normalised free cash flow is one of the group’s key performance indicators by which our financial performance is measured. Normalised free cash flow is defined as the net increase in cash and cash equivalents less: cash flows from financing activities (except net interest paid); the acquisition or disposal of group undertakings; the net sale of short-term investments and excluding: the cash impact of specific items; purchases of telecommunications licences; and the cash tax benefit of pension deficit payments. For non-tax related items the adjustments are made on a pre-tax basis.

Normalised free cash flow is primarily a liquidity measure. However, we also believe it is an important indicator of our overall operational performance as it reflects the cash we generate from operations after capital expenditure and financing costs, both of which are significant ongoing cash outflows associated with investing in our infrastructure and financing our operations. In addition, normalised free cash flow excludes cash flows that are determined at a corporate level independently of ongoing trading operations such as dividends, share buybacks, acquisitions and disposals and repayment and raising of debt. Normalised free cash flow is not a measure of the funds that are available for distribution to shareholders.

Our key free cash flow measure changed from adjusted free cash flow to normalised free cash flow in 2012/13 following the £2.0bn lump sum pension deficit payment made in March 2012. The £520m tax credit relating to this deficit payment would have distorted our free cash flow measure in 2012/13, as would the £202m payment for the 4G spectrum licence. Certain historical incentive share awards still use adjusted free cash flow as one of the performance criteria for vesting. Adjusted free cash flow does not exclude purchases of telecommunications licences and the cash tax benefit of pension deficit payments.

[BT Group Plc Annual Report 2015 \(p. 80, 202 and 203\)](#)

Linkage

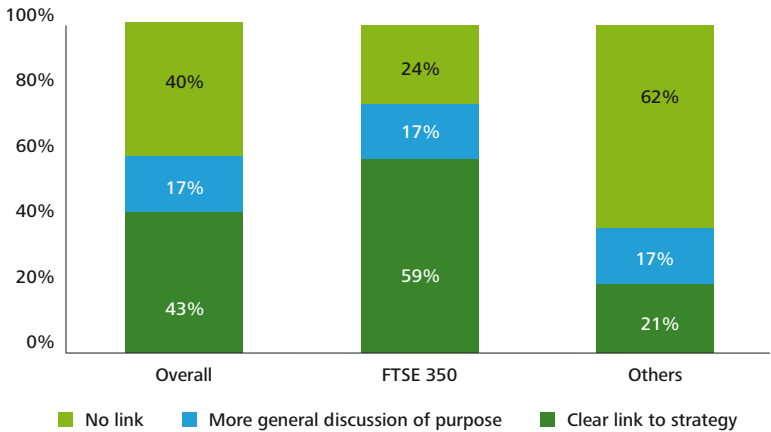
Where a company identifies KPIs to help analyse the development, performance and position of the business, it is not very meaningful to just list these measures without providing a clear link between the KPIs and a company’s objectives and strategy.

1. Executive summary
2. How to use this document
3. Regulatory overview
4. Survey objectives and methodology
5. Overall impressions
6. Summary material
7. The strategic report
8. Key performance indicators
9. Principal risks and uncertainties
10. Going concern and viability
11. Corporate governance
12. The work of the audit committee
13. The auditor's report
14. Primary statements
15. Notes to the financial statements
Appendix 1 – Glossary of terms and abbreviations
Other resources available

One way to address this is to include, for each identified KPI, a discussion of how that particular measure is relevant to the company and why it is important for assessing the company's progress against a specific objective or strategy element. Another way to present this, which appears to be the most common way, is to link KPIs to the strategy using symbols for different strategy elements.

Figure 8.9 shows how well the companies surveyed linked their KPIs to their strategy. 60% of the companies which identified KPIs provided either a clear link to strategy or included some general discussion of the purpose of their KPIs, which is an improvement on last year (2014: 56%). However, a significantly larger number of FTSE 350 companies (59%) showed a clear link to strategy, compared to only 21% of other companies, broadly in line with the previous year (2014: 61% and 30% respectively). Chapter 7 includes discussion of the related but separate concept of linkage in the other direction, from the company's objectives and strategy to their KPIs.

Figure 8.9. How many companies with KPIs provided a link to the strategy of the business?



Good examples of linking KPIs and the strategy of the business in an effective way are shown by St. James's Place plc, which presented KPIs as part of the discussion of business objectives, and Acacia Mining plc, which included a discussion of the relevance of each KPI to the strategy.

## Our Objectives and Related Key Performance Indicators

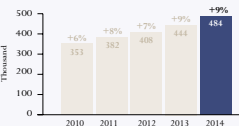
### Clients

*To deliver positive outcomes to an increasing population of clients*

#### PROGRESS DURING 2014

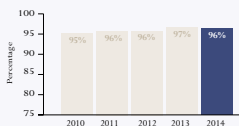
2014 was another successful year as the business continued to grow. Client numbers grew by 9% contributing to the increase in investment of new funds. The quality of the client outcome, as reflected in client retention and feedback, continued to be as strong as ever.

#### Client Numbers



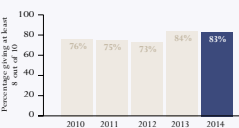
Our business model is based on managing client wealth and so the number of clients is a key measure of the health of the business. As well as reflecting past performance, it also indicates future opportunity, as our experience suggests that over 90% of new business comes from existing clients or their referrals. In 2014, we were pleased that client numbers increased from 444,000 to 484,000.

#### Client Retention



Our business is long-term and client retention feeds directly into the financial result. However, it is also an indication of minimum standards having been met. We are therefore delighted that retention has continued at the very high rate of 96% compared to 97% in 2013.

#### Client Satisfaction



Our reputation is vitally important to our business model and this is best expressed through the experience of our clients. We are therefore delighted that our client satisfaction levels have been maintained this year at an outstandingly high level for the industry of 83%.

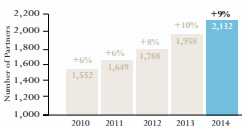
### Partners

*To continue to grow and develop the Partnership*

#### PROGRESS DURING 2014

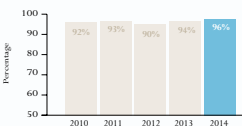
Our proposition continued to be attractive to advisers in the year which, alongside development of the existing community, led to improvements in quality both in terms of business credentials and qualifications. The Partnership also welcomed graduates from the Academy initiative and new Partners from The Henley Group.

#### Partner Numbers



Without our Partners, we would have no clients. We were therefore pleased to deliver growth ahead of our long-term aspirations, supported by Academy Partners and acquisition of The Henley Group. Partner numbers grew from 1,958 in 2013 to 2,132 this year.

#### Partner Retention



Partner retention reflects Partners continuing satisfaction with our proposition but also the maintenance of their quality against the standards we require. We were therefore pleased retention increased slightly to 96% compared to 94% in 2013.

#### Single Premiums per Partner



Productivity of Partners is a measure of their success as business people, but also feeds into success for the Company. We are pleased that in 2014 individual adviser productivity continued to increase, leading to an overall increase in single premiums per Partner from £3.5 million to £3.8 million.

Registered No. 03183415

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available



[St. James's Place plc Annual Report and Account 2014 \(p. 13\)](#)



[Acacia Mining plc Annual Report & Accounts 2014 \(p.20 – 21\)](#)

In a similar manner, links can be made between KPIs and the company's principal risks, providing a helpful indication of how movements in the company's KPIs might help it to detect issues arising in relation to those risks. For example, if health and safety compliance is a principal risk of the company, then a KPI measuring the number of health and safety incidents would indicate a potential issue if the number of incidents increased. This kind of deep linkage could be seen as an example of the concept of integrated thinking, which underpins integrated reporting – making sure everything links together and makes sense on an underlying level.

[Intertek Group plc](#) provides a good example of how KPIs can be linked to business objectives and to principal risks (see chapter 5).



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Linkage between KPIs and directors' remuneration

One area that has been attracting more and more attention in recent years is the way in which directors' remuneration schemes are designed. One way to demonstrate how remuneration schemes are designed to promote the long-term success of the company (a requirement of the 2014 Corporate Governance Code – see chapter 11 for more details) is to show the links between KPIs and the metrics used in incentive schemes. Various measures of performance were used to determine levels of performance-related remuneration by the companies in our survey. Financial metrics are understandably popular but 27 companies also included non-financial measures, such as health and safety or customer service/satisfaction measures. Overall 67% of companies assessed pay using at least some measures that were consistent with their KPIs, indicating that, in the majority of cases, executive remuneration is aligned with the company's overall performance measures to a greater or lesser extent.

A good example of how companies can provide a clear link with the measures used to determine directors' remuneration is given by Halma plc (see extract earlier in this chapter).

### Effective analysis of KPIs

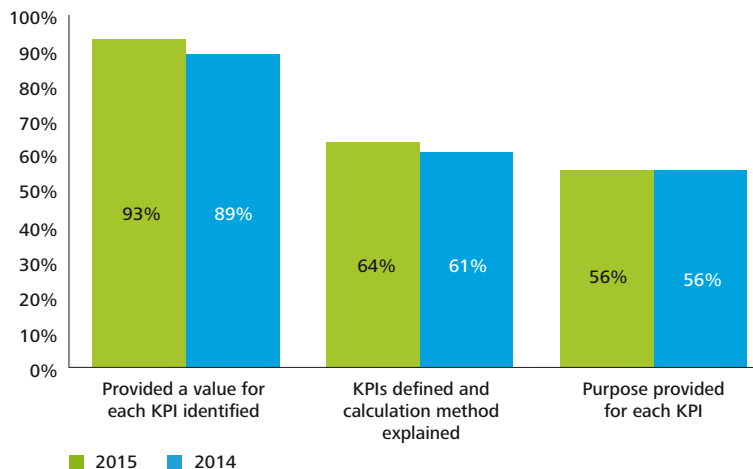
There are a few steps companies can take to help them present their analysis of the business using KPIs in the most effective way. The first step is to select an appropriate balance of financial and non-financial KPIs, as well as GAAP and non-GAAP measures, and to explain why these particular measures are relevant to the company's business. Linking KPIs to business objectives and strategy can be one way of explaining their purpose. The next key feature of effective reporting on KPIs is to set out how each KPI is defined and calculated. This is particularly important for financial non-GAAP measures, to allow investors to reverse-engineer the calculation if they wish to do so for their particular reason. This underlines the transparency and understandability concepts as well as helping to avoid companies selecting complicated and difficult to understand measures as their KPIs. Another key feature of good KPI reporting is comparability and consistency year on year as well as with industry peers, where this does not undermine the purpose of the KPIs.

The FRC Guidance recommends that a company should identify and disclose all relevant information that enables users to understand each KPI presented in the strategic report. It indicates that, for each KPI, this information should include, at a minimum:

- its definition and calculation method;
- its purpose;
- the source of underlying data;
- any significant assumptions made; and
- any changes in calculation method or relevant accounting policies compared to the previous financial year.

Figure 8.10 shows what level of analysis companies provided for their KPIs. As we would expect, most companies provided numerical information for each KPI identified, rather than just listing them. However, 36% (2014: 39%) of the companies surveyed failed to clearly define all of their KPIs and explain the method of calculation used, with 44% (2014: 44%) failing to make clear the purpose of each measure.

Figure 8.10. How much detail do companies give regarding their KPIs?



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

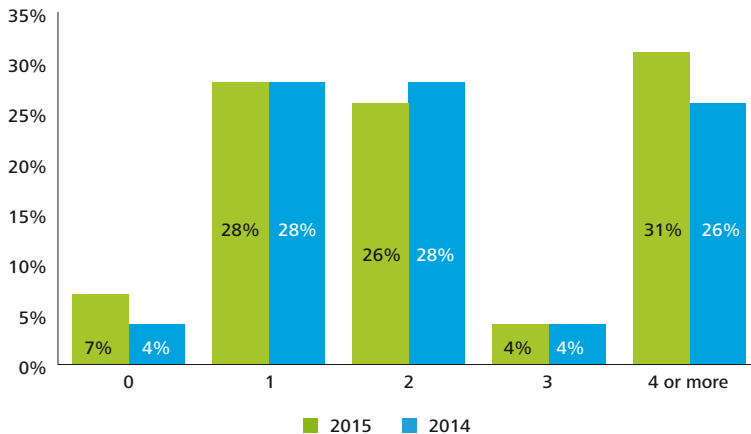
### Comparatives and consistency

In order to provide useful trend analysis on how a company is progressing and performing against its objectives year on year, it is helpful for each KPI to include comparatives and an explanation of reasons for any significant movement. Similar to our findings last year, the majority of companies surveyed provided comparatives for their KPIs. Figure 8.11 shows a slight overall increase in the number of comparative periods presented by companies. 31% of companies provided at least four years of comparative information (2014: 26%) – this may be because it then shows a consistent timeframe to the five year summary of financial results which many UK companies present.

Another way of increasing comparability, as recommended by the FRC Guidance, is by identifying those KPIs which are widely used generally accepted measures, whether within a specific company's industry or more broadly. But care should be taken not to allow comparability of KPIs between industry peers to override the effectiveness of the KPIs for assessing an individual company's performance.

Consistency of KPIs year on year is valuable. However, where a company changes its business objectives or its strategy, it is likely that the KPIs will need to be revisited to ensure they are relevant to measuring progress against the revised strategy and objectives. In our sample, only seven companies specifically disclosed a change in the KPIs presented from the previous year, five of which were in the FTSE 350. Five of these companies included discussion of the reason for that change. Among the reasons given were 'to better reflect the issues that matter most to the company and its stakeholders' and 'to better reflect development of the business and progress in delivering sustainable growth'. Vodafone Group Plc provides a good example of such disclosure as part of their KPIs section. Another good example is given by National Grid plc, which goes even further and discloses a plan for the next year to include two new KPIs.

Figure 8.11. How many years' worth of comparatives do companies present for KPIs?



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

**Changes to KPIs this year**

We have updated our KPIs this year to better align to our strategy and changing business model.

For our strategic KPIs, we have changed the focus of European mobile towards 4G and increasing data usage to better reflect the investments we are making with Project Spring. We have also expanded the scope of our strategic KPIs to address the growing importance of unified communications and the growth of data in emerging markets.

With the financial KPIs, we have moved to an absolute measure of EBITDA rather than margin and have removed adjusted operating profit, following the disposal of our interest in Verizon Wireless in the 2014 financial year.

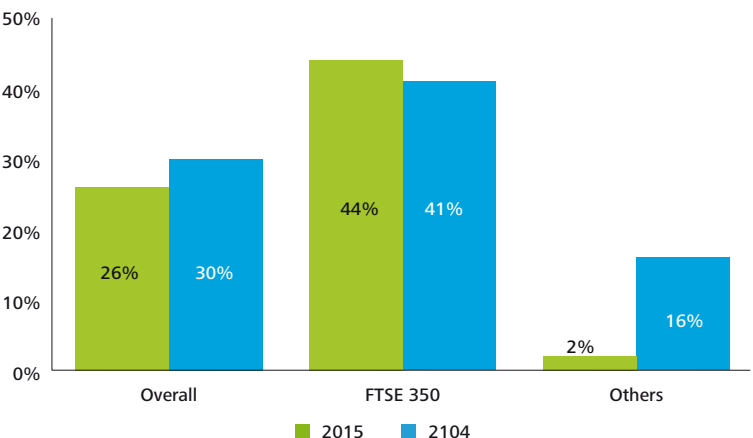
We have also removed mobile market share as a KPI as our focus is on improving our customer experience and we monitor the results of that through our financials.

[Vodafone Group Plc Annual Report 2015 \(p. 19\)](#)

We are adding new KPIs to better reflect the issues that matter most to our Company and our stakeholders. For this 2014/15 Report, we have included information about workforce diversity, as set out on pages 18 and 19. We aim to include two further new KPIs in our 2015/16 Report. These relate to community engagement and investment in education, skills and capabilities. Executive remuneration is linked to some of our KPIs.

[National Grid plc Annual Report and Accounts 2014/15 \(p. 17\)](#)

Figure 8.12. How many companies commented on future targets for some or all of KPIs presented?



**Future targets**

As discussed above, quantifying business objectives is one of the most efficient ways of providing a meaningful analysis of a company's performance and position, as well as helping investors to assess the future prospects of the company and success of strategic implementation. Surprisingly, fewer companies in our sample this year commented on future targets for KPIs. Figure 8.12 shows how many companies provided commentary on future targets for some or all of the KPIs presented. The increased reluctance to disclose such information in the annual reports may be due to perceived commercial sensitivity as well as caution in setting up unachievable targets in unstable economic and political environments.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

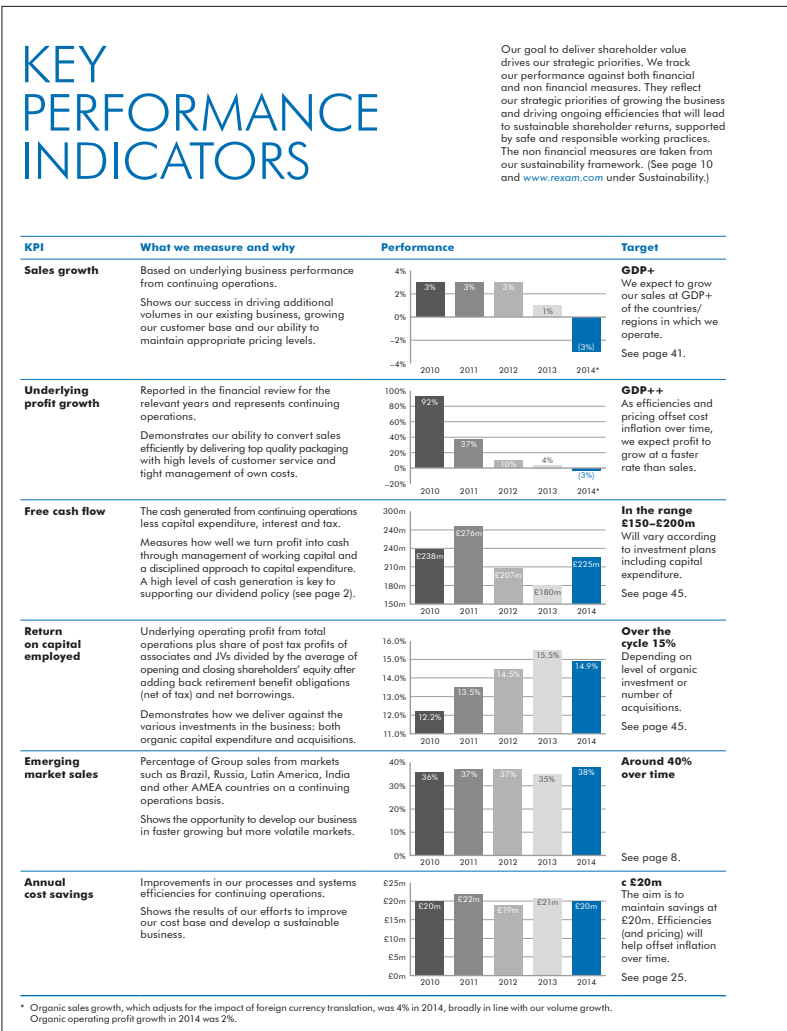
14. Primary statements

15. Notes to the financial statements

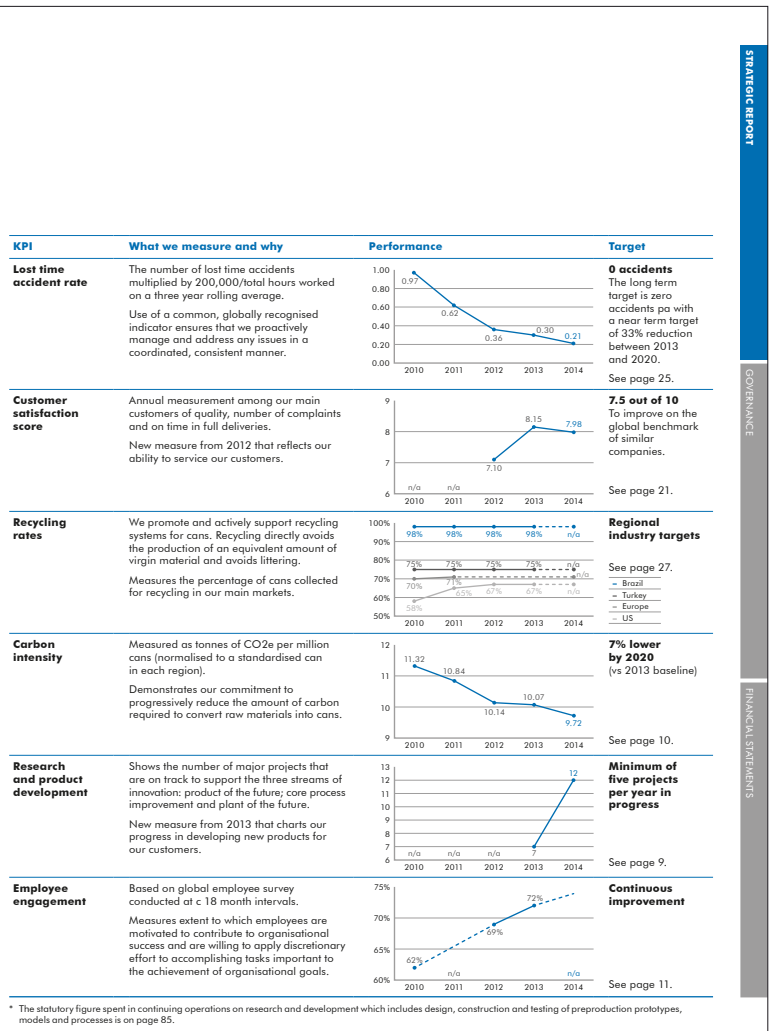
Appendix 1 – Glossary of terms and abbreviations

Other resources available

A good example of providing numerical targets for each KPI presented with a short description and a link to further information is given by Rexam plc. St. Modwen Properties PLC shows a different approach by including narrative discussion of future targets for their KPIs.



REXAM PLC Annual Report 2014 (p. 30 – 31)



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## STRATEGIC FOCUS continued

### KPIs – WHAT WE HAVE ACHIEVED

#### Key performance indicators applied

#### SECURE EXCELLENT RETURNS...



#### PROFIT BEFORE ALL TAX £m



#### DIVIDEND PAID p



#### THROUGH A FOCUS ON LONG-TERM SIGNIFICANT ADDED VALUE...



#### LAND BANK developable acres



#### ASSET RECYCLING: DISPOSALS AS A PROPORTION OF PROPERTY ASSETS AT THE START OF THE YEAR %



#### WHILE PROTECTING OUR ASSETS



#### GEARING %



#### RATIO OF RENTAL AND OTHER INCOME TO OPERATING COSTS INCLUDING INTEREST %



#### SEE-THROUGH LOAN-TO-VALUE %



### NEXT STEPS

#### Link to remuneration (pages 77–100)

#### Targets

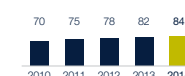
#### EQUITY NET ASSETS PER SHARE p



Profit before all tax, total dividend for the year and post-dividend growth in shareholders' equity net asset value per share were corporate performance measures of the annual bonus arrangements for executive directors in the year.

Continue to grow development profits and create valuation gains, particularly through planning gain. Strive to demonstrate and grow the Group's inherent value and long-term prospects. Grow net assets so that dividends can also grow. Continue to secure profitable development to generate consistent future returns.

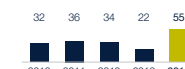
#### MANAGEMENT WITH MORE THAN 3 YEARS SERVICE %



Executive directors' individual objectives for the year's annual bonus arrangements included people-related targets.

Selective and capital efficient acquisitions. Continued recycling of assets with limited opportunity for further significant added value. Continue to retain, recruit and motivate highly-skilled people throughout the business.

#### COMMITTED FACILITIES TO COVER DRAWN DEBT months



Gearing was a corporate performance measure of the annual bonus arrangements for executive directors in the year. In addition, their individual objectives included funding-related measures.

Effective asset management to maximise returns. Manage existing finance facilities to support ongoing growth. Continued management of investment and development programme to maintain appropriate debt ratios.

[St. Modwen Properties PLC Annual Report and Financial Statements 2014 \(p. 10 – 11\)](#)

## 9. Principal risks and uncertainties

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Top tips

- Disclose only those 'principal' risks which are material to shareholders to ensure a 'clear and concise' annual report. Of the companies surveyed, the median number of principal risks that were disclosed was nine (2014: nine).
- Demonstrate the linkage between the discussion of principal risks and other information in the annual report, such as KPIs or strategic priorities – 36% (2014: 22%) of companies linked the discussion of risks to other information in the report.
- Make risk descriptions specific to the business and avoid discussing generic risks without clearly illustrating how these risks affect the business – 58% (2014: 64%) of companies provided a specific description of risks.
- Provide information on the changes in the level of the risk from prior period to illustrate to users the changes in the risk environment surrounding the business – 35% (2014: 33%) of companies did this.

### Keep an eye on

- Consider the provisions of the new Code, effective for the next reporting period. Companies will be required to:
  - disclose that the directors have carried out a robust assessment of the principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity. 3% (2014: nil) of companies surveyed indicated they had performed a robust assessment of risks in the current year; and
  - explain how the principal risks identified by the company are being managed or mitigated. 96% (2014: 94%) already provide this information.

- Discuss the impact and likelihood of the principal risks you have identified as the FRC Risk Guidance becomes effective. 11% and 7% of companies discussed impact magnitude and likelihood of principal risks respectively in this year's survey.
- Consider how best to link discussions on principal risks and the viability statement when preparing disclosures to comply with the new Code and associated FRC Risk Guidance.

In September 2014 the FRC published the 2014 version of the UK Corporate Governance Code, which, as well as governance more widely, has implications for risk reporting – this is discussed in more detail in the regulatory overview in Chapter 3 and also in Chapter 11. Legally, all companies are required to provide a description of the principal risks and uncertainties facing the business, unless the company is entitled to the small companies exemption. Information on the risks faced by a business provides investors with information on what could potentially be preventing the company from achieving its objectives and how the company, through its risk management process and internal control systems, manages the risks it faces in pursuing its strategic objectives. The modifications to the Code and the issuance of the FRC's 'Guidance on Risk Management, Internal Control and Related Financial and Business Reporting'<sup>50</sup> ('FRC Risk Guidance'), effective for periods beginning on or after 1 October 2014, will require enhancements to risk disclosures that companies will need to consider when preparing their next annual reports. The changes to the Code with respect to risks, and the extent to which companies have applied them ahead of the effective date, are considered in this chapter.

The FRC's 'Guidance on the Strategic Report' (the 'FRC Guidance') also contains recommendations for companies regarding how their risk reporting can be made as meaningful as possible. Its messages are similar to those of the FRC Risk Guidance, although in particular it stresses the importance of linking risk reporting to other elements of the strategic report.

50. <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Risk-Management,-Internal-Control-and-.pdf>



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## Identification of principal risks

The provisions of the new Code will require directors to confirm in the annual report that they have carried out a robust assessment of the principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity. As shown by Figure 9.1, the majority of companies surveyed have not yet considered these new requirements. However, 3% of the companies surveyed had already stated that they had carried out a robust assessment of their risks and had made the disclosures required by the new Code. The companies in our sample that made this disclosure did so at the beginning of their risks section. An example of this is Savills Plc.

### Principal risks

The Directors have carried out a robust assessment of the principal risks facing the Company – including those that would threaten its business model, future performance, solvency or liquidity. Our consideration of the key risks and uncertainties relating to the Group's operations, along with their potential impact and the mitigations in place, is set out below. It is not possible to mitigate fully all of our risks and there may be other risks and uncertainties besides those listed below which may also adversely affect the Group and its performance. More detail can be found in the Audit Committee Report on pages 45 to 48.

### In summary, our principal risks are:

1. Achieving the right market positioning in response to the needs of our clients
2. Economic/country and currency risks
3. Recruitment and retention of high-calibre staff
4. Reputational and brand risk
5. Legal risk
6. Failure or significant interruption to our IT systems causing disruption to client service
7. Conduct risk
8. Changes in the regulatory environment

## Savills Plc Report and Accounts 2014 (p. 24)

Whilst few companies disclosed that they had carried out a robust assessment of the principal risks, 25% clearly indicated that they had refreshed their assessment of risk exposures in the current year. This was either through an explicit statement at the top of the risk section or a clear indication of new risks which had been identified during the period. Xchanging plc provided narrative at the beginning of their risks section on the outcome of their risk assessment. Disclosing this information can provide useful information to shareholders on the changes in the risk environment since the previous reporting period.

## Principal risks and uncertainties

Xchanging maintains risk registers covering each significant operation, business sector, and the Group. We review our risk assessment four times a year, which helps to ensure we focus on the right risks and have appropriate mitigating actions.

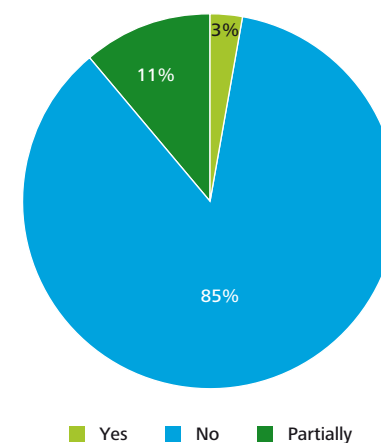
The Audit Committee reviews the risk assessment at each meeting and the Board reviews the Group risk register annually.

2014 has seen the overall risk profile of the Group increase as we have invested in growing our technology-enabled products and services, and as a result of the acquisition activity in the year. The risk from our concentration of customer contracts has reduced, following an increase in the number of contracts, as outlined in the Chairman's statement. All other risks remain stable.

The Corporate governance section on pages 56 to 57 includes details about Xchanging's risk management process.

## Xchanging plc Annual Report 2014 (p. 24)

Figure 9.1. Have companies considered the risk requirements of the 2014 Code?



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

95% (2014: 95%) of companies surveyed specified that the risks and uncertainties discussed were the principal ones facing the business. Four of the five companies that did not specify the risks as principal were outside the FTSE 350. The term 'principal' is defined in the FRC Guidance as "facts or circumstances that are considered material to a shareholder's understanding of the development, performance, position or future prospects of the business". In a recent CFA Institute survey<sup>51</sup>, 90% of respondents considered the principal risks and uncertainties section to be a "useful disclosure". Respondents in the same survey also considered this to be an area of the annual report that "shows greatest need for improvement by a considerable margin" with one respondent noting that disclosures have "grown exponentially". Clearly signposting the risks as principal and providing a succinct discussion will help address this area for improvement and provide information to users that is clearly considered to be important.

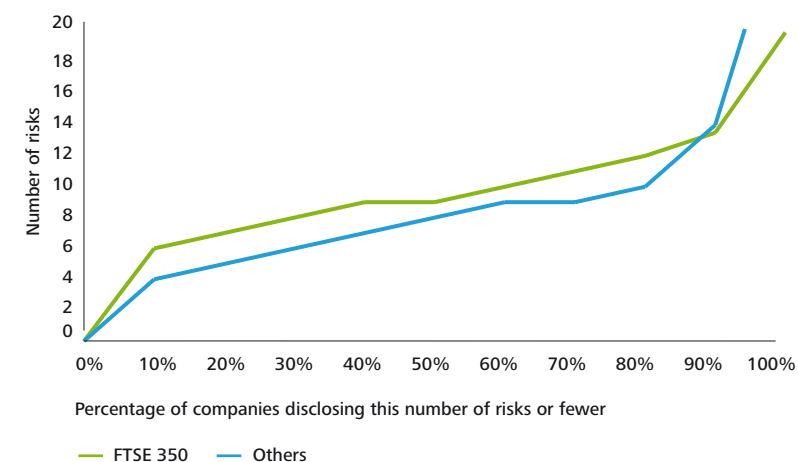
Tailoring the risk description to the company is another area where risk disclosures could be improved; one of the respondents in the CFA Institute survey noted risk disclosures had become a "general legal tick-box exercise to note every risk and worst case rather than more bespoke review". The latest FRC Risk Guidance encourages companies to provide descriptions which show how the risk affects the company specifically; the extent to which companies have considered this guidance is discussed further below.

### Number of principal risks

Of the companies surveyed, the median number of principal risks that was identified was nine (2014: nine). This suggests companies continue to discuss only those risks which are considered material to a shareholder's understanding of the business. Four companies also chose to discuss 'other' risks alongside the discussion of principal risks. While providing shareholders with additional information could have some use, directors should seek to produce 'clear and concise' annual reports.

Figure 9.2 shows the number of risks identified by companies, split by FTSE 350 and others, in our 2015 sample, plotted on a cumulative basis. It is interesting to see that, whilst FTSE 350 companies tend to discuss more risks than smaller companies, the difference is only marginal which suggests a company's size does not mean it necessarily faces fewer risks. This trend is broadly consistent with the result of the prior year survey. Whilst the size of the company may not impact the number of risks they faced, the type of risks faced by FTSE 350 and other companies do differ.

Figure 9.2. How many risks were identified by companies in 2015?



51. [https://secure.cfauk.org/assets/1345/Analysis\\_of\\_FRAC\\_survey\\_2015.pdf](https://secure.cfauk.org/assets/1345/Analysis_of_FRAC_survey_2015.pdf)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

# Types of risks discussed

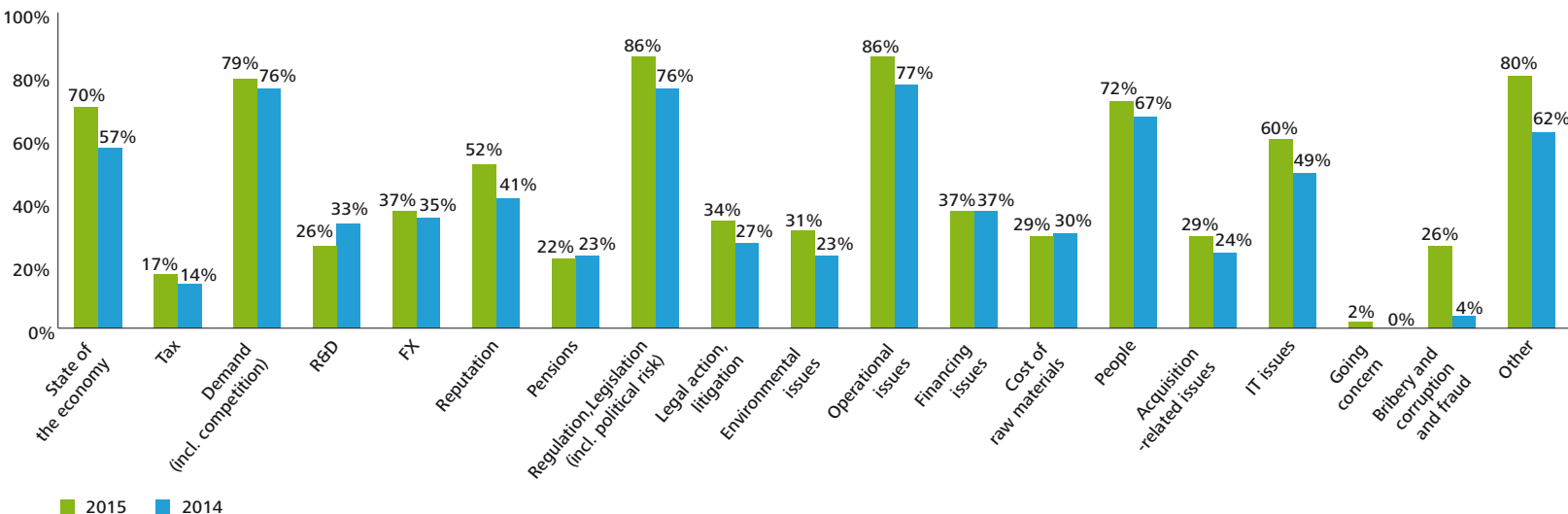
99% (2014: 100%) of companies surveyed provided a discussion of the full range of business risks facing the company. The FRC Risk Guidance encourages directors to consider risks which are both financial and non-financial in nature. Only one company was considered not to have covered a full range of risks in their discussion of principal risks as they did not discuss any financial risks, although these were considered in the discussion of 'other' risks in the company's annual report. Companies should endeavour to keep reports 'clear and concise' and avoid discussing 'other' risks that are not material to a shareholder's understanding of the business.

The new Code will require directors to focus on those risks which could threaten the company's business model, future performance, solvency or liquidity. These risks should be treated as principal risks and the extent to which they are mitigated should be discussed. The discussion of these risks, and the considerations made in respect of the long term viability statement (see chapter 10 for more detail), is likely

to result in a degree of overlap with the disclosures of principal risks and the going concern/viability disclosures. Companies should consider the best way of linking these discussions. Of the companies in our 2015 survey, 2% (2014: 0%) considered going concern as part of the discussion of principal risks. Once the provisions of the new Code become effective, it is likely that companies will be more transparent in their disclosure of the risks which have the potential to impact going concern and longer term viability.

Figure 9.3 shows the types of risk most commonly identified by companies. Of the companies surveyed, 28% (2014: 21%) and 6% (2014: 3%) respectively discussed risks that related to liquidity and solvency as part of their principal risk disclosures. This shows a moderate increase on the prior year, perhaps as directors consider these areas more carefully in advance of the provisions of the new Code becoming effective. Whilst it is encouraging to see a small increase, these percentages are still low considering the new provisions will be effective for the next reporting period.

Figure 9.3. What are the main categories of risk disclosed?



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Companies will need to consider how best to adapt their existing risk disclosures to incorporate the new requirements with respect to risks that could threaten the company's business model, future performance, solvency or liquidity.

IT issues continued to show an increase with 60% (2014: 49%) of companies surveyed considering them to be a principal risk. With cyber-attacks and data losses receiving prominent media coverage in the past year, it is no surprise more companies are considering this in their risk assessment process.

The discussion of bribery and corruption risks also increased compared to the prior year with 26% (2014: 4%) of companies discussing these risks. The EU Directive<sup>52</sup> on the disclosure of non-financial information will require certain large companies to make disclosures in respect of policies, risks and outcomes as regards bribery and anti-corruption issues. The increase is perhaps down to larger companies considering these issues in advance of the legal requirement to disclose this information.

Despite using a broad range of categories in order to identify what risks companies were discussing, we noted a large increase in companies discussing risks which did not fit into one of these categories with 70% (2014: 62%) of companies discussing other risks. Some of the more common other risks disclosed were:

- health and safety issues;
- concentration risk, including over-reliance on key customers and loss of major contracts; and
- strategic failures, including failure to appropriately implement strategy and achieve growth.

Figure 9.4. What are the main categories of risks disclosed?

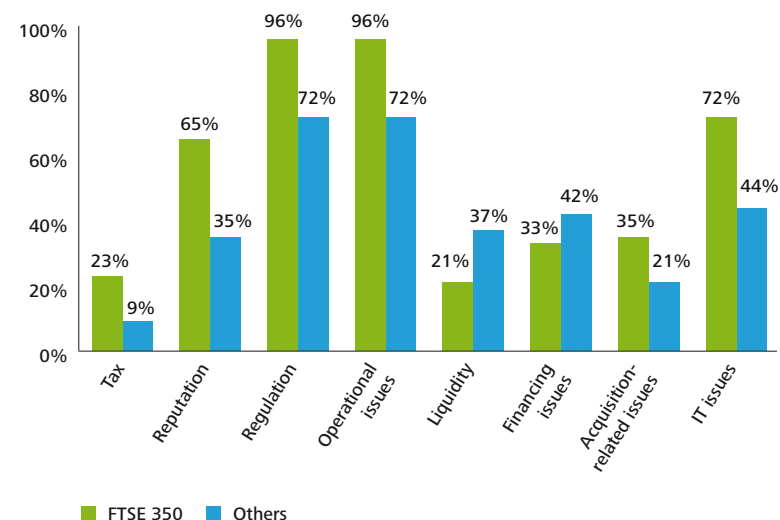


Figure 9.4 shows the most significant differences between the types of risks discussed by size of company. As discussed above, the size of the company appears to have little impact on the number of risks it faces, however the size of the company does appear to impact the types of risk a company faces. The percentage of FTSE 350 companies disclosing tax risks was 23% compared to 9% in other companies, potentially as larger companies operate in multiple jurisdictions and are exposed to more tax regulations than smaller companies. The percentage of other companies disclosing liquidity and financing risks was 37% and 42% respectively compared to 21% and 33% respectively in FTSE 350 companies. This suggests smaller companies face more working capital issues and difficulties in raising finance compared to larger companies.

52. <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0095>

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations



Other resources available

The new FRC Risk Guidance encourages companies to explain in the risk description how the risk will impact the company specifically. Of the companies surveyed, 58% (2014: 64%) provided a detailed description of the risks whilst 5% (2014: 2%) of companies provided just a list of generic risks. The remainder provided a mixture of generic and specific descriptions of risks. With the latest FRC Risk Guidance becoming effective for the next reporting period, companies should aim to provide a detailed description of risks which are unique to the company, and where a risk is more generic, companies should be clear on how that risk impacts the company specifically.

The new Code will also require companies to explain how the principal risks identified are being mitigated, although regulators have historically already stated an expectation for this to be provided. It is encouraging to see that in advance of the new Code becoming effective, 96% (2014: 94%) of companies surveyed provided disclosure on how principal risks were being managed or mitigated, with 88% (2014: 86%) discussing the mitigation activities separately from the description of the risks. Whilst not required, this method potentially provides users with a clearer understanding of the risk and the associated mitigating activities being performed.

### Principal Risks and Uncertainties

Halma's principal risks and uncertainties are detailed below and are supported by the robust risk management and internal control systems and procedures noted on pages 26 and 27.

Strategic objective	Risk description	Movement	Potential impact	Mitigation
	<b>Globalisation</b> A key operational risk emanates from the remoteness of operations from Head Office and the increasing global spread of our businesses.	▲	<ul style="list-style-type: none"><li>– Weakening of financial, tax, audit and legal control and divergence from overall Group strategy in remote operations, leading to businesses taking on more risks than intended or unexpected financial outcomes</li><li>– Failure to comply with local laws and regulations in unfamiliar territories, leading to reputational issues and legal or regulatory disputes</li><li>– Continued international growth increases risk</li><li>– Missed opportunities due to failure to mobilise resources efficiently</li></ul>	<ul style="list-style-type: none"><li>– Control is exercised locally in accordance with the Group's policy of autonomous management. We seek to employ local high-quality experts.</li><li>– The increasing geographic diversity of operating personnel emphasises the importance the Group places on local knowledge and experience.</li><li>– The Group's acquisition model ensures retention of management and staff in acquired businesses, meaning that local expertise is retained.</li><li>– Sector Chief Executives ensure that overall Group strategy is fulfilled through ongoing review of the businesses. The right balance between autonomy and adherence to the overall objectives of the Group is a key function of the Sector Chief Executives, Sector Vice Presidents and Senior Finance Executives.</li><li>– Regular visits to the more remote operations and maintenance of key adviser relationships by senior management, finance staff and Internal Audit support local control.</li></ul>
	<b>Competition</b> The Group faces competition in the form of pricing, service, reliability and substitution.	▶	<ul style="list-style-type: none"><li>– Loss of market share due to price pressure and changing markets</li><li>– Reduced financial performance arising from competitive threats</li></ul>	<ul style="list-style-type: none"><li>– 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.</li><li>– 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.</li><li>– The Group operates in specialised global niche markets offering high barriers-to-entry.</li></ul>

[Halma Plc Annual Report and Accounts 2015 \(p. 28\)](#)

### Presentation of risks

The prominence given to risk disclosures varies greatly from company to company, despite it being an area of investor focus. While some companies make the link between risks and other disclosures clearly in their up-front summary section, for others there may be few if any mentions of risk until a discussion of principal risks is reached, 40 or 50 pages into the report. This can give the appearance that risks are being treated as an afterthought, something that companies should be keen to avoid.

Companies tended to present their risk disclosure in either a tabular or narrative format. Halma Plc showed a good example of a tabular approach – their risk disclosure also provides a good illustration of how a change in the level of the risk and its potential impact can be indicated, as well as how risks can be linked to strategic objectives. Serco Group Plc provided a good example of a narrative approach. Providing the required information has been presented and the relevant FRC Risk Guidance has been considered, either method of presentation is reasonable. Of the companies surveyed, the tabular format was used by the majority.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Strategic Report

Principal Risks and Uncertainties

In our business, we face many risks and uncertainties which we mitigate and manage through our Board-approved risk management processes. The Group Risk Register identifies the principal risks facing the business as a whole, including those that are managed directly at the Group level through our Executive Committee and reported to the Board.

During 2014, we commenced a three-year programme to refresh our overall risk management approach to better support the development and ongoing performance of the global business. In 2014 we enhanced our policies, processes and systems and gave more clarity on roles and responsibilities, governance and reporting. In 2015 we will continue training our business leaders and employees, improve risk management capacity and capability in our global business, and improve our policies and systems focusing on management information and decision-making. In 2016, we will evaluate our progress and ensure that our risk management programme is fully embedded at all levels of the business to the contract level and within all Group functions.

In 2014, we also undertook a review of the risks and uncertainties affecting our business which resulted in changes to the key risks on the Group Risk Register. Summarised below are the key risks and uncertainties that face us: our operations, people, revenue, profit and cash flow.

Contract non-compliance and contract performance

Our success depends on our ability to write contracts which balance risk and reward and meet the contractual requirements into which we have entered with our customers, which could be through direct delivery of services, through the use of sub-contractors, or through Joint Venture consortium partners. We are subject to risks associated with bidding for and entering into contracts (most of which are multi-year and/or fixed price contracts), including correctly assessing and agreeing pricing terms that provide for a level of return on the contract appropriate to the risks involved, accurately anticipating the costs of strict performance conditions, employee requirements and other obligations, correctly evaluating contractual and operational risks, and the risks of potential early termination or change of scope of contracts by customers. Failure to bid and negotiate performance criteria and contract provisions that can be operationally delivered at the price estimated can result in losses. Unclear, ambiguous, misread, misinterpreted contract obligations and expectations of contract performance can result in perceived or actual contract non-compliance and/or poor performance. The same is true if we, or our sub-contractors or consortium partners do not have the right expertise, tools and resources adequately to manage and monitor compliance with contract obligations and expectations. These potential failures could result in the cancellation of a contract, claims for loss, or compensation arrangements under the

contract being triggered, as well as reputational damage leading to a decrease in business being undertaken with one or several customers, and an adverse effect on our financial condition, or operating or financial results and on our ability to win new business.

We are party to a number of contracts that are multi-year, fixed price, carry strict performance conditions and/or contain volumetric or other risks relating to original bid assumptions that have proven incorrect, and we expect to result in losses, as a result of which we have determined the contracts to be onerous. In the second half of 2014 there were several contracts where operational issues and/or discussions with our customers resulted in us substantially revising upwards our estimates of the costs to complete our obligations under such contracts or lowering our revenue expectations. A risk-based independent review of our principal contracts to identify loss-making contracts against a specific scope revealed that we have a number of contracts that have, or are expected to result in, or could result in material loss, which we have determined to be onerous. The costs to complete these contracts outweigh the financial benefit, and they are, therefore loss-making resulting in lower than expected returns and economic damage for which provisions have been made in the accounts, and there is a risk that the losses damage our reputation. The scope of contract reviews was based on a structured interview process with the relevant business and divisional teams addressing contractual features, operational and financial performance and outlook, each contract being categorised as high, medium or low risk based on the level of risk, uncertainty and judgement existing in each contract.

High risk contracts underwent a full scope review including a full financial review of the contract, a review of the accounting model including challenging and stress testing the assumptions as well as a contract balance sheet review. Those contracts deemed to be medium risk were subject to a review of specific contract risks as well as a focus on the financial impact of the key contractual clauses and a review of the contract balance sheet. Where a contract was deemed low risk, no further work was undertaken. It has not been practical to complete a full legal, operational and financial review of every contract, given the scale, complexity and volume of the contracts and the cost and time that this would have taken. No assurance can be given that the onerous provisions that we have recorded will be sufficient to cover the losses ultimately incurred under the contracts for which onerous provisions have been made or that further provisions for such contracts will not be required in the future or that the costs of fulfilling other contracts to which any member of the Serco Group is a party will not exceed the actual or expected economic benefit under such contracts resulting in the need for further onerous provisions for such contracts. Inevitably, the review of contracts was carried out at a specific point in time and with the information available at that time, which may not prove to have been entirely accurate or complete. Further, the review could not cover all possible circumstances on all contracts under which losses could in the future possibly be incurred. Contracts that have not been reviewed may in future become loss-making and losses on contracts that have been reviewed may turn out to be worse if,

15

[Serco Group Plc Annual Report and accounts 2014 \(p. 15\)](#)

Principal Risks continued

1. Deterioration in the macroeconomic environment adversely impacting our markets

Risk

The Group's revenue is derived from global defence/security and commercial markets. The level and type of customer spending is dependent on a complex mix of macroeconomic, fiscal and strategic defence and security imperatives.

Changes in government/customer spending or other external factors could lead to programme/contact terminations or delays, or changes in market growth.

Impact

Deterioration in demand affecting shorter cycle businesses or a fundamental shift in how customers procure products or services could have an adverse effect on the Group's future results leading to:

- Mixed growth targets
- Reduced earnings
- Failure to win new business, leading to adverse results against strategic plan

Mitigation

A review of near and long term market trends is conducted as part of the Group's annual strategic planning process to ensure that actual and anticipated impacts from macroeconomic environment risks are minimised and managed effectively.

Regular review of externally sourced market demand data, with the re-forecasting and adjusting of internal planning in line with market demand.

Increased emphasis is being placed on identifying adjacent markets in which the Group's proven and transferable technologies can be applied.

The Group is creating more balance in its portfolio towards commercial markets, with the aim to grow through all economic cycles.

A culture of continuous improvement will enable Cobham to have market leading operating performance, while reducing costs. This will enable Cobham to grow market share and also remain competitive in the face of volume declines or price pressures and retain flexibility to adjust the cost base appropriately to changing market conditions.

Link to KPIs

- Organic revenue growth
- Underlying EPS growth
- Cash conversion
- Return on invested capital

Risk status indicator ⓘ

Global macroeconomic conditions remain uncertain.

ⓘ Unchanged ⓘ Increasing Risk ⓘ Decreasing Risk ⓘ Emerging New Risk

36

Cobham plc  
Annual Report and Accounts 2014

[Cobham plc Annual Report and Accounts \(p. 36\)](#)

The latest FRC Risk Guidance states that significant changes in principal risks, such as a change in the likelihood or possible impact, or the inclusion of new risks, should be highlighted and explained. Providing an indication of the change in the level of the risk from the prior year was demonstrated by 35% of companies surveyed. This was usually done through up/down arrows presented alongside a description of the risk. An example of a company that used such an approach was Cobham plc.

Of the companies surveyed, fewer companies specifically indicated the level of potential impact and likelihood of principal risks compared to those indicating a general change to the level of the risk, with only 7% indicating the likelihood of risks and just 11% showing the magnitude of potential impact. When assessing this, we were looking for a company to indicate the degree of likelihood and the magnitude of the impact the risk could have on the business. Whilst a number of companies provided a general description of the possible impacts, we were looking for a clearer indication of the severity of these. Clearly indicating the magnitude of the impact each risk could have on the business allows users to make an assessment of the impact relative to other risks, which provides more useful information than just a general description. This information was usually demonstrated through a heat map, although some companies used a traffic light approach to indicate the impact of the risk on the entity. Johnson Matthey Plc indicated a change in the level of the risk through arrows and a traffic light system.



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

The following table sets out the 2014/15 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 the year. The net risk rating (after mitigating controls) is also shown.

STRATEGIC		
Growth within our existing business		
Responding to, identifying or capitalising on appropriate growth opportunities within our existing business.		
<b>Risk and impact</b> The group's existing activities are well placed to deliver good growth over the coming years. Failure to identify and respond to customer requirements or competitor activity could impact the ability of the group to achieve its strategy and / or maintain growth and / or market share.	<b>Mitigation</b> <ul style="list-style-type: none"><li>The group and each business prepare a strategic plan to review demand in existing markets and potential new opportunities. These plans are regularly monitored and challenged.</li><li>The business structure, skills and resources are continuously assessed and amended where appropriate.</li></ul>	<b>Changes since 2014 annual report</b> No change.  <b>Risk rating</b>  High

[Johnson Matthey Plc Annual Report and Accounts 2015 \(p. 23\)](#)

United Utilities Group Plc, in addition to a description of the risk, linked business objectives and potential impacts on the company, provided information on the likelihood of occurrence of the risk, its impact after mitigation strategies, an indication in the change in the level of the risk from the previous year and its mitigation strategies. This provides useful information to shareholders in a clear and concise manner.

Principal risks and uncertainties							

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

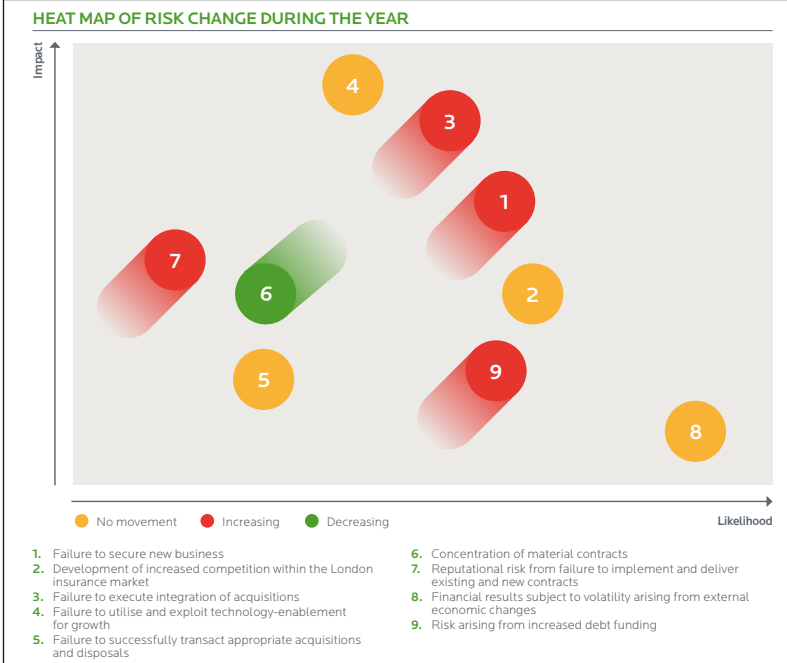
13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available



[Xchanging Plc Annual Report 2014 \(p. 24\)](#)

**Linkage of risks to the rest of the report**

Effective linkage improves the usefulness of information disclosed in the annual report and increases the relevance of that information to investors. The FRC Guidance encourages linkage between information presented within the strategic report, such as the principal risks and uncertainties and the business model, and also linkage between these and other information disclosed in the annual report, in order to produce a more cohesive document.

It was encouraging to see a moderate increase in the number of companies in our survey that showed linkage between the principal risks and uncertainties and other information presented in the annual report – 36% of the reports in our sample demonstrated such linkage compared to 22% in last year's survey. 27% (2014: 18%) of companies surveyed linked strategic priorities to principal risks. This was most commonly achieved through a symbol which linked through to the discussion of strategy elsewhere in the annual report. An example of this method is demonstrated by National Grid Plc.

**<IR> risks and opportunities**

The <IR> Framework requires companies to discuss the specific risks and opportunities that affect an organisation's ability to create value and how they impact the availability, quality and affordability of relevant capitals in the short, medium and long term. The background behind integrated reporting is discussed in more detail in the regulatory overview in Chapter 3 and in Chapter 5. The requirements of UK Company Law and the Code mean UK Companies already discuss the principal risks affecting the business and, whilst not required by law, the FRC Guidance does encourage the discussion of opportunities arising from internal or external factors (see Chapter 7 for details of how companies have discussed opportunities in their annual reports). However, the concepts of 'integrated thinking' and 'connectivity' in writing the annual report are new concepts introduced under <IR>. This is more than just linking sections of the report through cross-referencing; it's about providing a holistic picture of the combination, inter-relatedness and dependencies between the factors that affect the business' ability to create value over time.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

**Our principal risks**

Accepting that it is not possible to identify, anticipate or eliminate every risk that may arise and that risk is an inherent part of doing business, our risk management process aims to provide reasonable assurance that we understand, monitor and manage the main uncertainties that we face in delivering our objectives.

This includes consideration of inherent risks, which exist because of the nature of day-to-day operations in our industry, and financial risks, which exist because of our financing activities. An overview of the key inherent risks we face is provided on pages 173 to 176,

as well as an overview of our key financial risks, which is incorporated within the Notes to our consolidated financial statements on pages 94 to 156.

Our corporate risk profile contains the principal risks that the Board considers to be the main uncertainties currently faced by the Company as we endeavour to achieve our strategic objectives. An overview of these risks is provided below, together with examples of the relevant controls and current mitigating actions we are taking.

**Strategic objective Risk description**

**Drive growth**

Failure to identify and execute the right opportunities to deliver our growth strategy.

Failure to sufficiently grow our core business and have viable options for new business over the longer term would negatively affect the Group's credibility and jeopardise the achievement of intended financial returns.

Our ability to achieve our ambition for growth is subject to a wide range of external uncertainties, including the availability of potential investment targets and attractive financing and the impact of competition for onshore transmission in both the UK and US; and internal uncertainties, such as the performance of our operating businesses and our business planning model assumptions.



**Example of mitigations**

- We regularly monitor and analyse market conditions, competitors and their potential strategies, the advancement and proliferation of new energy technologies, as well as the performance of our Group portfolio. We are also looking to access new sources of finance and capabilities through partnering.
- We have internal processes for reviewing and approving investments in new businesses, disposals of existing ones and organic growth investment opportunities. These processes are reviewed regularly to make sure our approach supports our short- and long-term strategies. We undertake due diligence exercises on investment or partnering opportunities and carry out post-investment reviews to make sure we learn lessons for the future.

[National Grid Plc Annual Report and Accounts 2014/2015 \(p. 39\)](#)

Strategic priorities can also provide a framework for the discussion of risks. This method of presentation involves identifying each of the company's strategic objectives and then discussing all of the principal risks that specifically impact the company in its delivery of that strategic objective. An example of how this can be done is shown by St Modwen Properties PLC. Emphasising the relationship between a company's principal risks and uncertainties and progress against its strategy can provide useful information to investors on how the failure to manage these risks could affect the achievement of strategic objectives.

## OUR PRINCIPAL RISKS

**Strategic objective**

**Risk and potential impact**

**Mitigation**

**SECURE EXCELLENT RETURNS...**



Market/economic changes such as higher interest rates, reduced demand for land/new properties, reduced availability of credit and declining investment yields restrict business development and cause valuation falls. Significant upcoming **political events** which delay and/or impact investment decisions and reduce returns.

- Regional spread and portfolio diversity mitigates sector or location-specific risks.
- Active portfolio management achieves a better than market utilisation of assets.
- Hedging policy reduces interest rate risk.
- Investment and financing strategy is determined against a backdrop of potential outcomes of political events.

Changes to **local and national planning processes** adversely impacts our strategy by limiting our ability to secure viable permissions and/or by removing our competitive advantage.

- Use of high-quality professional advisors.
- Active involvement in public consultation.
- Constant monitoring of all aspects of the planning process by experienced in-house experts.
- Lobbying to/contact with both central and local Government.

Inadequate **due diligence** on major new schemes, **programme management, construction delivery and/or procurement** leads to unforeseen exposures, quality issues and/or cost overruns causing customer dissatisfaction and/or financial loss.

- Acquisitions, development and ultimate disposals are reviewed and financially appraised in detail, with clearly defined authority limits.
- Strong internal construction management team.
- Clearly defined formal tender process that evaluates qualitative and quantitative factors in bid assessment.
- Use and close supervision of a preferred supply chain of high-quality trusted suppliers and professionals.
- Contractual liability clearly defined.

Financial collapse of, or dispute with, a key **joint venture partner** leads to financial loss.

- Monthly review of performance to identify if senior management intervention is required.
- Flexible but legally secure contracts with partners.
- Fewer but financially strong partners.

[St. Modwen Properties PLC Annual Report and Financial Statements 2014 \(p. 40\)](#)

7% (2014: 3%) of companies surveyed demonstrated a link between KPIs and the discussions of principal risks and uncertainties. Whilst this showed only a moderate increase on the prior year, it was encouraging to see companies demonstrating this linkage. Doing so can also help to show the impact of risks on the performance of the business, as well as the extent to which mitigation strategies are effective in managing risk in order to deliver on the business' strategic objectives.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

An example of a company that demonstrated this link was [Intertek Group Plc](#) (see Chapter 5). This shows a summary page that was presented at the beginning of the strategic report and provides a link between various sections of the report and clearly signposts to where there is more detail in the rest of the annual report.

15% of companies surveyed linked the discussion of risks to further information presented in the annual report. This included linking the change in the level of the risk from the prior year with more detailed discussions on the business environment included within the market overview, linking the principal risk disclosure to information on risk management and internal control systems, and linking environmental risk to the section covering Corporate Social Responsibility. This can be an effective way of ensuring a concise report where relevant information which is specific to the risks can be clearly signposted to avoid repetition. A good example of this approach was shown by Unite Group plc.

Risk and Impact	How we mitigate this risk	Change	What has happened during the year
<b>Market risks</b>			
Changes in government policy (such as Higher Education funding and immigration) may affect student numbers and behaviour. <b>May reduce demand and hence profitability and asset values.</b>	Ongoing monitoring of government policy and its impact on, and forecasts of, UK, EU and international student numbers studying in the UK whilst regularly reviewing our portfolio to ensure we have the highest quality portfolio appropriately sized and in the right locations.	→	Student numbers in the UK continue to recover strongly following the reduction in student numbers with the introduction of higher tuition fees in 2012. The 2014 intake at UK Universities was 512,000, a record level. This is likely to increase further following the removal of the student number cap in 2015. <b>■ Read more on pages 16 – 17</b>  At Unite Students, occupancy of 99% (2014/15) compared with 98% (2013/14) demonstrates this recovery in student numbers is translating into occupancy. <b>■ Read more on page 31</b>  In November 2014, tougher rules were imposed on Universities and Colleges sponsoring international students studying in the UK, although Higher Education partners are not reporting any reduction in demand from international students.

[Unite Group plc Annual Report and Accounts 2014 \(p. 27\)](#)

# 10. Going concern and viability

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## Top tips

- Directors should consider the most appropriate period for the going concern basis of accounting and the period covered by the statement of longer term viability. Whilst the former can be limited to a period of 12 months from the approval of the financial statements, the FRC's guidance suggests that the latter should be significantly longer than this.
- Provide clear, specific cross references to further detail in the annual report when disclosing the directors' considerations in the going concern assessment 77% (2014: 71%) of companies provided cross references to further detail in the annual report in their going concern disclosure.

## Keep an eye on

- The new 2014 Code requires one board statement on going concern and another on viability. The former states whether the directors believe that the going concern basis of accounting was appropriate, and the latter explains how the board has assessed the prospects of the company (taking account of its current position and principal risks), over what period they have done so and why they consider that period to be appropriate.

## Overall

The 2014 update to the UK Corporate Governance Code is now effective, with the amendments to the Code applying to accounting periods beginning on or after 1 October 2014. The amendments have the aim of making a clearer distinction between the meaning of going concern in the broad context meant by Lord Sharman in his review and the narrower context used in accounting standards. They also ask companies to make a clearer link between the assessment of principal risks to the viability of the business and the broader risk assessment that should form part of a company's normal risk management and reporting processes. Whilst the requirements were not effective for the reporting season surveyed, the extent to which the companies surveyed have considered this link has been discussed further within Chapter 9.

In establishing the new provisions with respect to going concern and viability, the FRC attempted to balance the information needs of investors with setting appropriate reporting requirements. The results were two board statements: the board's confirmation of the appropriateness of the going concern basis of accounting and a broader, longer term assessment by the board of the company's ongoing viability (see Chapter 3 for more details on these two statements).

In light of these amendments, it was interesting to see that 52 of the companies surveyed mentioned the requirements of the new Code, usually within discussions in the corporate governance section of the annual report.

Whilst there was no requirement to consider these amendments for the reporting period surveyed, it is important that boards are taking these changes into account and making appropriate modifications to their risk management and internal controls systems so that they can demonstrate how they have assessed the prospects of the company and determined an appropriate period of assessment for their viability statement.

National Express Group Plc mentioned the requirements of the new Code in their annual report and made a statement explaining that they are establishing the necessary processes in order to meet the new requirements in time for the next reporting period.

The Board is mindful of the changes made to the UK Corporate Governance Code in 2014 with regard to the longer term viability statement, compliance with which will apply to the Company for the financial year ended 31 December 2015. The Directors are ensuring that processes are in place in order to be in a position to report in compliance with such enhanced disclosure in next year's Annual Report.

[National Express Group Plc Annual Report and Accounts 2014 \(p. 52\)](#)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Early adoption of the longer term viability statement

We are aware of four companies, including some from our survey sample, that provided a viability statement in their annual report this year. Also, from our sample EVRAZ Plc included a statement in their annual report addressing the period that their viability statement will cover next year.

#### VIABILITY STATEMENT

- The Directors confirm that they have a reasonable expectation that the Group will continue to operate and meets its liabilities, as they fall due, for the next three years. The Directors' assessment has been made with reference to the Group's current position and prospects, the Group's strategy, the Board's risk appetite and the Group's principal risks and how these are managed, as detailed in the Strategic Report.
- The strategy and associated principal risks underpin the Group's three year plan and scenario testing, which the Directors review at least annually. The three year plan is built on a fund by fund basis using a bottom up model. The three year plan makes certain assumptions about the launch and investment of successor funds and new strategies, the ability to refinance debt as it falls due and the acceptable performance of the underlying portfolio. The plan is stress tested in a robust downside scenario as part of the Board's review of the Group's Internal Capital Adequacy Assessment Process (ICAAP). The stress test uses the 2008/09 financial crisis as its basis, thereby reflecting the principal risks of the business, primarily through reducing new funds raised, lowering the deployment of capital and increasing impairments.
- The three year plan review is underpinned by the regular Board briefings provided by the business unit heads and the discussion of any new strategies undertaken by the Board in its normal course of business. These reviews consider both the market opportunity and the associated risks, principally the ability to raise third party funds and invest capital. These risks are considered within the Board's risk appetite framework.

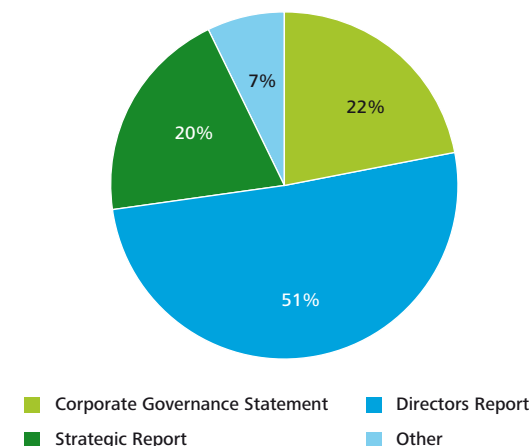
[Intermediate Capital Group plc Annual Report and Accounts 2014 \(p. 36\)](#)

Intermediate Capital Group plc included their viability statement in the strategic report alongside their risk management disclosures. This ensures that the Board is covered by the safe harbour provision and also helps to demonstrate that risk management and the consideration of longer term viability have been well integrated. Other FTSE 350 companies which provided a viability statement early include BAE Systems plc, Derwent London plc and United Utilities plc. All follow a similar content style and length to the Intermediate Capital Group plc report, in terms of providing an explanation of the lookout period chosen, a description of the business planning process and a discussion of the key assumptions.

The lookout period chosen varied from three to five years with the statement being included either in the strategic report, as for Intermediate Capital Group plc, or the corporate governance statement.

### Placement of going concern basis of accounting statement

Figure 10.1. Where is the going concern statement positioned?



As shown by Figure 10.1, the majority of companies chose to present their main statement of going concern within the directors' report with 51% of all companies opting to do so. This is a moderate increase on the prior year where 44% chose to present their main statement in the directors' report. This movement is made up almost entirely of companies who previously chose to present the going concern statement as part of the corporate governance statement.

It was interesting to see the number of companies choosing to present their going concern statement in the strategic report remained broadly consistent with the prior year. We would have expected an increase in companies locating the statement here since this could facilitate linkage with the discussion of principal risks located within the strategic report, a link which is suggested by the FRC Guidance.



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

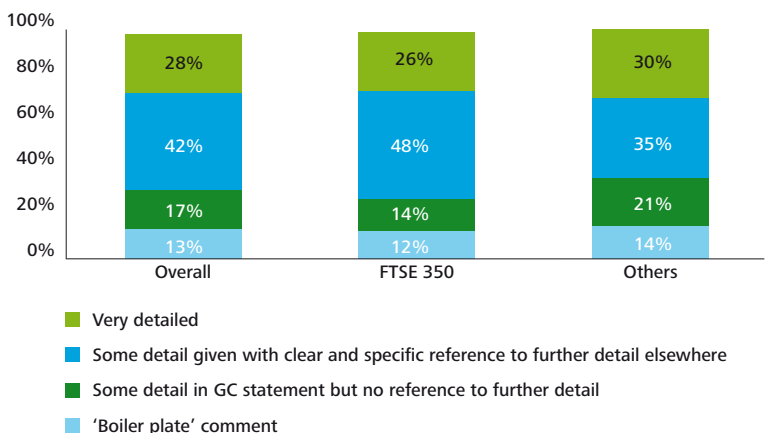
Appendix 1 – Glossary of terms and abbreviations

Other resources available

As mentioned above, the changes to the Code require companies to give a clearer and broader review of solvency, liquidity and risk management with respect to their assessment of longer term viability. Locating both the going concern statement and the new longer term viability statement in the strategic report could allow companies to more easily draw upon the various considerations they have made in assessing going concern and longer term viability, which are likely to have been discussed in detail within the strategic report. Once companies apply the amendments to the Code, including both statements in the strategic report may become more popular in order to facilitate this linkage. Although, given that the viability statement is a new requirement under the Code, companies may favour locating this statement within the corporate governance section of the annual report. Providing companies make a fair, balanced and understandable disclosure with appropriate cross references to other information in the report, there is nothing to say one location is necessarily more appropriate than another.

### Quality of going concern disclosures

Figure 10.2. How detailed are the going concern disclosures?



As shown by Figure 10.2, 28% of companies surveyed provided very detailed going concern disclosures. These companies produced a standalone statement that provided all of the detail of the directors' considerations in their assessment of going concern. 42% of companies surveyed provided some detail in their going concern statements with clear and specific cross references to further detail elsewhere. Whilst either method can provide the necessary detail to the user on what the directors have considered in making the statement, directors should ensure cross references are as specific as possible, as generic cross references to large sections of the annual report are of little help to users in identifying what specific considerations have been made in determining the basis for going concern.

Of the companies surveyed, 77% (2014: 71%) made cross references to other disclosures in the annual report within their statement of going concern. 70% of those companies surveyed referred to the discussion of risks in their going concern disclosure. This was either through a cross reference to the principal risks or a cross reference to other risks discussed in the back half. This compares to 55% of companies in the prior year. It is encouraging to see an increase in the percentage of companies considering risks in their assessment of going concern ahead of the new Code which will require principal risks to be considered in making the statement of long-term viability.

62% of companies with cross references made reference to the company's liquidity position in their consideration and 53% made a generic cross reference to the strategic report. Whilst a generic cross reference to the strategic report does indicate to users what information has been considered in the assessment of going concern, a more specific cross reference, such as one to the discussion of principal risks or the liquidity position, would be more helpful to users in indicating what specific information has been considered in making the assessment. 57% of companies cross-referencing did so to other sections of the annual report in their going concern disclosure.

FTSE 350 companies surveyed provided more detailed going concern disclosures than other companies, with 73% of FTSE 350 companies providing very detailed going concern statements or statements that provided some detail with clear and specific cross references to further detail elsewhere, compared to 65% of other companies. 13% of all companies surveyed produced a 'boiler plate' going concern disclosure, which was broadly consistent with last year's survey.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

GOING CONCERN

The Group has two diverse operating divisions, both of which operate in a growing market. The Board have undertaken an assessment of the future prospects of the Group and the wider risks that the Group is exposed to. In its assessment of whether the Group should adopt the going concern basis in preparing its financial statements, the Board has considered:

*Operating risk:* The Board receives monthly management reports covering key operational matters, monthly comparison to budget and updated forecasts on a half yearly basis for the full financial year to ensure that the business is trading in line with its expectations. The management team prepare a Group budget for each financial year and a cashflow forecast for the following 18 months which allows the Board to monitor the financial position of the Group and to consider appropriate risks which the business may face from a financial perspective.

*Financing risk:* The Company has worked to structure its debts for the medium and long term as well as utilising short term facilities to meet the Group's working capital requirements. The funds raised as a result of the share issue undertaken at IPO in April 2012 and the US\$300m five year syndicated term debt facility, of which US\$225m has been drawn down to date, are more than sufficient to fund the Group's material capital projects. The Group has banking arrangements through a spread of local and international banking groups. Debt covenants are reviewed by the board each month. The Board believes that the level of cash in the Group, the spread of bankers and the improved debt facility terms agreed during 2013 mitigates the financing risks that the Group faces from both its capital expenditure program and in relation to working capital requirements.

*Customer and Supplier risk:* Both the Healthcare and the Distribution divisions have continued their positive growth trends. All major financial and non-financial KPIs showed good improvement during 2014. In NMC Healthcare, trade receivables are monitored regularly, provisions made where necessary and the Group has no history of significant bad debts. In the Distribution division, the increase in revenue and product flow has an adverse effect on the Group's working capital position. Trade receivables are monitored regularly and management maintain a close working relationship with all major suppliers to monitor performance as well as signs of financial risk. The Board has reviewed a high level budget for 2015 as well as considered growth forecasts for the healthcare sector in UAE, and considers the Group's future forecasts to be reasonable.

*Impairment risk:* The Board has considered the carrying value of inventories, accounts receivable and property and equipment and concluded that there are no indicators of material impairment of these items and therefore no material cash flow impact associated with any loss in those areas.

The Board has reviewed the cash flow forecast that has been prepared for the period to 30 June 2016 and this forecast indicates that the Group has positive cash flows with sufficient headroom.

In its review, the Board considered other areas of potential risk, including regulatory risk, insurance and legal risks and potential areas of material contingent liability and found no matters which are likely to affect the viability of the Group in the medium term.

The Directors therefore continue to adopt the going concern basis in the preparation of the financial statements.

[NMC Health plc Annual Report 2014 \(p. 47\)](#)

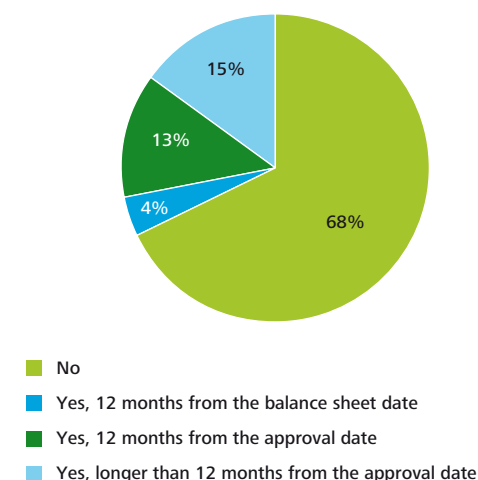
NMC Health plc provided a good example of a stand-alone going concern statement that discusses the specific risks in respect of going concern, and their associated mitigation strategies, considered in making their assessment.

In September 2014 the FRC published the finalised 'Guidance on Risk Management, Internal Control and Related Financial and Business Reporting' alongside the updated version of the Code and it is applicable from the same date. This guidance replaces the 2009 Guidance 'Going Concern and Liquidity Risk: Guidance for Directors of UK Companies'. Whilst the latest guidance was not effective for the reporting period surveyed, companies will need to consider its requirements in the coming year. This will require taking account of the company's current position and principal risks in assessing the ongoing viability of the company. Previously, the 2009 guidance has only suggested linking the going concern statements with the discussion of principal risks where considered relevant to the company.

However, this year more companies have incorporated going concern and longer term viability into their discussions of principal risks and uncertainties which does show some consideration of the new guidance. See Chapter 9 for further details of this.

Timeframes considered

Figure 10.3. Are the lengths of forecasts and budgets disclosed?



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

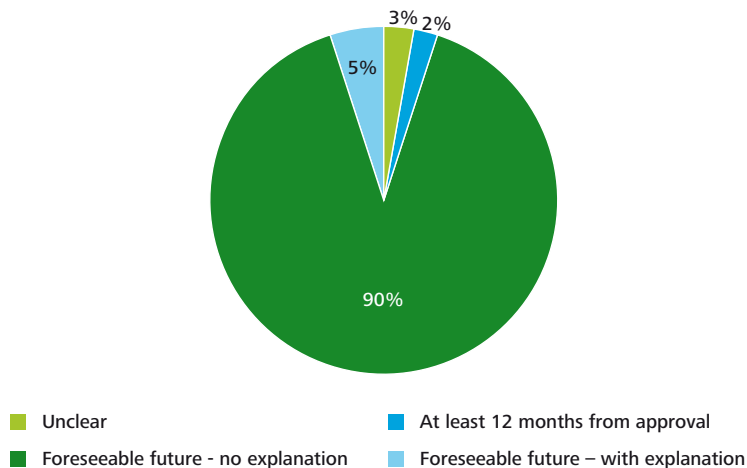
Going forward, the FRC Risk Guidance states that companies should consider all available information about the future at the date of approval of the financial statements, including the information obtained from budgets and forecasts, when making the statement of going concern.

Figure 10.3 shows the lengths of forecasts and budgets being reviewed as part of the going concern assessment. Of the companies surveyed, 68% chose not to disclose this information at all. This compares to 73% in the prior year. The largest movement was in companies considering forecasts of twelve months from the approval date in their assessment of going concern; this has seen an increase from 8% to 13% in the current year.

Under existing going concern guidance, disclosing the length of the budgets and forecasts considered is not required. However, providing this information can provide users insight into what period the directors have considered in making this statement.

Whilst not required for the going concern basis of accounting statement, disclosing the lengths of budgets and forecasts used in considering the period of assessment for the new statement of ongoing viability may be helpful. The new Code will require companies to indicate the period covered by the viability statement, and why they consider that period to be appropriate, which will obviously be easier if mentioning budgets and forecasts. In considering the period of assessment, directors should note that the new requirements of the Code refers to the Board “a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment”. It should be stressed that a ‘reasonable expectation’ does not mean certainty. The period over which companies can perform reliable forecasting is likely to be a key factor in the determining the period covered by the viability statement. Companies will have to consider the most appropriate period of assessment based on facts and circumstances specific to the company, although the FRC Risk Guidance does state that the period, except in rare circumstances, should be significantly longer than twelve months.

**Figure 10.4. What period does the going concern statement cover?**



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

As shown by Figure 10.4, the vast majority of companies continue to consider going concern for the foreseeable future with no explanation as to the specific length of this assessment, with 90% doing so for the current reporting period. Whilst the pre-2014 Code does not specify a period of assessment, previous guidance issued by the FRC and auditing standards suggested the review should usually cover a period of at least twelve months from the date of approval of the financial statements and that if the period was any shorter this should be disclosed. The new Code now incorporates this guidance and requires directors to state whether they have considered it appropriate to adopt the going concern basis of accounting, and identify any material uncertainties to the company's ability to continue over a period of at least twelve months from the date of approval of the financial statements.

With the provisions of the new Code focussing on the longer term viability of the Company, it will be interesting to see what period companies will consider for their going concern basis of accounting, and the period covered by the statement of longer term viability. There is an increased likelihood that the period considered by the going concern statement will now explicitly be described as at least twelve months from approval, the minimum required by the new Code, as opposed to the 'foreseeable future', and companies will then go on to consider a longer period in their assessment of longer term viability.

### Going concern uncertainties

With the UK economy continuing to improve it is no surprise that for the third year running the proportion of companies in our sample discussing uncertainties (other than general uncertainty regarding forecasts) in their going concern statements has remained consistently low at 10% (2014: 10%). Of these:

- five discussed concern about financing and shareholder support, including breach of covenants; and
- three discussed concern about trading volumes.

However, for only one of these companies was the level of uncertainty material and therefore led to an emphasis of matter in its audit report. None of the companies in our 2015 sample had a qualification in their audit report with respect to going concern.

# 11. Corporate governance

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## Top tips

- Comply or explain – A meaningful explanation for non-compliance should clearly describe the company-specific context, provide convincing rationale with a specific timeline, explain any mitigating actions and be clear about how any deviations from the Code still contribute to good governance.
- Make it clear that the Board has considered the benefits that diversity can bring to the Boardroom - and that this is diversity in its broadest sense, not just gender diversity.
- Corporate culture is a new hot topic for 2015; think hard about assessing whether the culture practised and encouraged within the company is actually in line with what the Board claims has been adopted.

## Keep an eye on

- Board evaluations, when completed properly, can identify areas of strengths and weakness, leading companies to make changes that positively impact performance and shareholder value.
- Ensure that you are managing and monitoring principal risks on a continuous basis; going forward, revised provision C.2.1 of the 2014 Code will require that the Board must confirm that they have undertaken a robust assessment of principal risks and explain how those risks are managed and mitigated.
- Make sure to include two distinct statements in the annual report relating to future prospects – a long-term viability statement (C.2.2) and a going concern statement (C.1.3).
- Be as clear as possible on the proactive nature of succession planning rather than focusing just on the process for Board appointments during the year.
- Take steps at Board level to put in place the appropriate governance to manage cyber risks.

## Introduction

The 2012 UK Corporate Governance Code aimed to contribute to the production of annual reports that provide shareholders with a more dynamic statement on the activities of the Board and its committees, for example through enhanced reporting by audit committees and encouraging more meaningful explanations for any non-compliance with the Code.

The latest revisions to the Code, which apply to financial years beginning on or after 1 October 2014, cover three principal areas: going concern and longer term viability, risk management and internal control and remuneration and shareholder engagement.

**Going concern and statement of longer term viability:** The annual report will include two distinct statements — the Board's confirmation of the appropriateness of the going concern basis of accounting and a broader, longer term assessment by the Board of the company's ongoing viability. (See chapter 10 'Going concern').

**Risk management and internal control:** Boards will have to monitor risk management and internal control systems on an ongoing basis, rather than reviewing effectiveness once a year. They should also undertake a robust assessment of the principal risks that might threaten the company's business model, future performance, solvency or liquidity. (See chapter 9 'Risks').

**Remuneration and shareholder engagement:** Boards should focus on the long-term success of the company when setting remuneration policy and include clawback and malus provisions. There is also a new provision requiring companies to explain what action they intend to take in response to situations where a significant proportion of votes have been cast against a resolution at any general meeting. This is particularly likely to be relevant where there is a significant vote against accepting the directors' remuneration report.

For the purposes of this section of our survey we felt it was important to analyse the results between FTSE 100, FTSE 250 and other listed companies separately to allow trends within those categories to be identified.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## <IR> governance

The <IR> Framework requires an integrated report to provide insight about how its governance arrangements contribute to its ability to create value. What a company chooses to disclose can be substantially affected by a company's understanding of the focus its stakeholder groups have on its governance arrangements.

Areas of focus could include the following.

- The corporate governance statement, for example:
  - the way that regulatory requirements influence the design of the governance structure and whether the structure put in place meets or exceeds regulatory requirements;
  - processes used by the company to make strategic decisions and to establish and monitor the company's culture, especially with regard to risk management;
  - actions those charged with governance have taken to influence the strategic direction of the company; or
  - how the board promotes and enables innovation.
- The nomination committee report – the skills and diversity of those charged with governance.
- The remuneration committee report – how remuneration and incentives are linked to value creation and the effects on the capitals.

In the UK environment, many of the goals set out in the <IR> Framework coincide with the goals of the FRC to provide sufficient insight to stakeholders in the company. As such, a genuine focus on applying both the spirit and the letter of the 2014 UK Corporate Governance Code and its guidance, together with some additional cross-referencing, will lead to a company's report meeting the requirements of the <IR> Framework.

## Compliance with the Code

The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that will contribute to the long-term success of the company.

All companies in our sample included a statement of compliance or partial compliance with the 2012 Code. The number of companies reporting full compliance with the 2012 Code decreased from 57% last year to 51%. This could be as a result of the FRC's continued focus on the importance of the effective operation of the 'comply or explain' principle and the push for meaningful explanations of non-compliances. This could be perceived as an inherent acceptance that, as long as a meaningful explanation is provided, non-compliance is better than blindly following the Code and just ticking a box.

Full compliance tends to diminish with the size of the corporation with full compliance for 40% (2014: 52%) of the companies outside the FTSE 350 compared with 51% (2014: 50%) of FTSE 250 companies and 78% (2014: 83%) of the FTSE 100 companies surveyed. Even though the Code has some relaxations for small companies, the compliance rate was still lowest amongst smaller companies.

Vodafone Group Plc presented their compliance with the Code in an effective way using the structure of the UK Corporate Governance Code to provide an easy to follow explanation of how they had complied.



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Compliance with the 2012 UK Corporate Governance Code

Throughout the year ended 31 March 2015 and to the date of this document, we complied with the provisions and applied the main principles of the 2012 version of the UK Corporate Governance Code (the 'Code'). The Code can be found on the FRC website ([frc.org.uk](http://frc.org.uk)).

We note that the 2014 version of the UK Corporate Governance Code will apply to us for the first time in the 2016 financial year and we intend to be in compliance.

We describe how we have applied the main principles of the 2012 Code in this table, cross referring to other parts of this Annual Report for further information on internal control and risk management and Directors' remuneration.

This table is intended to assist with the evaluation of our compliance during the year and should be read in conjunction with the Governance section as a whole.

Headings in the table correspond to the headings in the Code.

A. Leadership

**A.1 – The role of the Board**  
The Board's responsibilities are set out in the governance framework outlined on page 51. The Board held seven scheduled meetings during the year and holds additional meetings, as required. All Directors are expected, wherever possible, to attend all Board and relevant Committee meetings, and the annual general meeting. Details of Board meetings attendance for the year are set out on page 53.

**A.2 – Division of responsibilities**  
The roles of the Chairman and Chief Executive are separate and the key responsibilities of each are set out on page 51.

**A.3 – The Chairman**  
The role of the Chairman is set out on page 51. Board meetings are arranged to ensure sufficient time is available for the discussion of all items. In accordance with the Code, the Chairman was independent on appointment.

B. Effectiveness

**B.1 – The composition of the Board**  
Our Board consisted of 13 Directors, ten of whom served throughout the year. There are nine Non-Executive Directors, in addition to the Chairman and three Executive Directors on the Board. Changes made to the composition of the Board and Committees during the year are set out in the Nominations and Governance Committee Report. The balance and independence of our Board is kept under review by our Nominations and Governance Committee. Luc Vandeveldt will be stepping down from the Board at the annual general meeting in July 2015, having served 11 years as a Non-Executive Director. Philip Yee will have served on the Board for nine years and, in accordance with the Code, the Board has determined that Philip continues to demonstrate qualities of independence and judgement in carrying out his role, supporting the Executive Directors and senior management in an objective manner. His length of service and resulting experience of great benefit to the Board. Nick Lund and Samuel Jonah have served on the Board for eight and six years respectively. The Board considers that all of the Non-Executive Directors bring strong independent oversight and continue to demonstrate independence.

**B.2 – Appointments to the Board**  
Nick Reed was appointed as Chief Financial Officer in April 2014 and Sir Crispin Davis and Dame Clara Furze were appointed as Non-Executive Directors in July and September 2014 respectively. Dr Mathias Dopfer was appointed as a Non-Executive Director with effect from 1 April 2015. Further details on the process leading to their appointments are set out in the Nominations and Governance Report on pages 69 and 70.

**B.3 – Commitment**  
During the year, the Board considered the external commitments of its Chairman, Senior Independent Director and other Non-Executive Directors and is satisfied that these do not conflict with their duties and time commitments as Directors of the Company. Details of our Directors' other commitments are set out in their biographies on pages 52 and 53. Omid Kordelani stood down as a Non-Executive Director when he took on an executive role at Google. Changes to the commitments of all Directors are reported to the Board. Directors complete an annual conflicts questionnaire. Any conflicts identified would be submitted to the Board for consideration and, as appropriate, authorisation in accordance with our articles of association and the Companies Act

2006. Where authorisation is granted, it would be recorded in a register of potential conflicts and reviewed periodically. Directors are responsible for notifying the Company Secretary if they become aware of actual or potential conflicts or a change in circumstances relating to an existing contract and Non-Executive appointment letters are available for inspection at our registered office and will be available for inspection at our annual general meeting.

**B.4 – Development**  
Details of Board induction and training and development is set out on page 59.

**B.5 – Information and support**  
The Board recognises that there may be occasions when one or more of the Directors feels it is necessary to take independent legal and/or financial advice at the Company's expense. There is an agreed procedure to enable them to do so which is managed by the Company Secretary. No such independent advice was sought in the 2015 financial year. The Company Secretary also assists the Chairman by organising induction and training programmes, is responsible for ensuring that the correct Board procedures are followed, assists the Chairman in ensuring that all Directors have full and timely access to all relevant information and advises the Board on corporate governance matters. The removal of the Company Secretary is a matter for the Board as a whole.

**B.6 – Evaluation**  
Information on Board evaluation is set out on page 58.

**B.7 – Election/Re-election**  
All Directors have submitted themselves for re-election at the annual general meeting to be held on 28 July 2015 with the exception of Stephen Pusey and Luc Vandeveldt who will step down from the Board at the annual general meeting. The Nominations and Governance Committee confirmed to the Board that the contributions made by the Directors in offering themselves for re-election at the annual general meeting in July 2015 continue to be effective and that the Company should support their re-election. The biographies for our Directors can be found on pages 52 and 53.

**A.4 – Non-Executive Directors**  
Luc Vandeveldt was Senior Independent Director during the year. The responsibilities of the Senior Independent Director include acting as a sounding board for the Chairman, serving as an intermediary for the other Directors, being available to shareholders if they have concerns which they have not been able to resolve through the normal channels, conducting an annual review of the performance of the Chairman, and in the event it should be necessary, convening a meeting of the Non-Executive Directors.

In particular, Non-Executive Directors are responsible for bringing a wide range of skills and experience, including independent judgement on issues of strategy, performance and risk management, constructively challenging the strategy proposed by the Executive Directors, scrutinising and challenging performance across the Group's business, assessing the risk and integrity of the financial information and controls and determining the Company's policy for executive remuneration and the remuneration packages for the Executive Directors and the

Chairman. The Chairman met with the Non-Executive Directors without the Executive Directors being present at every Board meeting during the year and individually with each Non-Executive Director as part of the Board effectiveness review process.

C. Accountability

**C.1 – Financial and business reporting**  
The Directors' statement of responsibility regarding the financial statements, including the going concern assessment, is set out on pages 94 and 95. A further statement is provided on page 94 confirming that the Board considers 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. The responsibility of our auditor is set out in the Audit Report on pages 97 to 104.

**C.2 – Risk management and internal control**  
An overview of the Group's framework for identifying and managing risk is set out on pages 32 to 37. The Board has overall responsibility for the system of internal control. A sound system of internal control is designed to manage rather than eliminate the risk of failure to achieve business objectives and can only provide reasonable and not absolute assurance against material misstatement or loss. The Board has established procedures that implement in full the Turnbull Guidance "Internal Control: Revised Guidance for Directors on the Combined Code" for the year under review and to the date of this Annual Report. These procedures, which are subject to regular review provide an ongoing process for identifying, evaluating and managing the significant risks we face. Further information on the Board's responsibility for system of internal control and risk management can be found in the Director's statement of responsibility on page 95 and further information on the oversight of the Group's system of internal control and the monitoring of the Group's risk management system and its effectiveness can be found in the Audit and Risk Committee report on pages 63 to 68.

**C.3 – Audit Committee and auditor**  
The Board has delegated a number of responsibilities to the Audit and Risk Committee including governance over the appropriateness of the performance of both the internal audit function and external auditor and oversight of the Group's systems of internal controls. Further details of the composition of the Audit and Risk Committee and its activities are set out in the Audit and Risk Committee Report on pages 65 to 68 and the terms of reference for the Audit and Risk Committee can be found at [vodafone.com/governance](http://vodafone.com/governance).

D. Remuneration

**D.1 – The level and components of remuneration**  
The Remuneration Committee assesses and makes recommendations to the Board on the policies for the executive remuneration and packages for the individual Directors. For more information, see the Remuneration Committee Report on page 70 and Directors' Remuneration on pages 75 to 91.

**D.2 – Procedure**  
The Board has delegated a number of responsibilities to the Remuneration Committee, including determining the policy on remuneration of the Chairman, executives and senior management team. Full details are set out in the terms of reference for the Committee published at [vodafone.com/governance](http://vodafone.com/governance).

E. Relations with shareholders

**E.1 – Dialogue with shareholders**  
The Chairman has overall responsibility for ensuring that there is effective communication with investors and that the Board understands the views of major shareholders on matters such as governance and strategy. The Chairman makes himself available to meet shareholders for this purpose. The Senior Independent Director and other members of the Board are also available to meet major investors on request. Further information on how we engage with our shareholders can be found on page 62.

**E.2 – Constructive use of the annual general meeting**  
Our annual general meeting will be held on 28 July 2015 and is an opportunity for shareholders to vote on certain aspects of Group business and present questions to the Board. A summary presentation of the full year results is given before the Chairman deals with the formal business of the meeting. All shareholders can question any member of the Board both during the meeting and informally afterwards. The Board encourages participation of investors at the annual general meeting. The annual general meeting is also broadcast live and on demand on our website at [vodafone.com/agn](http://vodafone.com/agn). Voting on all resolutions at the annual general meeting is on a poll. The proxy votes cast, including details of the votes withheld are disclosed to those in attendance at the meeting and the results are published on our website and announced via the Regulatory News Service. A copy of our notice of meeting can be found at [vodafone.com/agn](http://vodafone.com/agn).

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Compliance with new requirements

83% of FTSE 100 companies surveyed made reference to forthcoming changes arising from the 2014 Code compared with 56% of FTSE 250 companies and 35% of other companies. For details regarding companies that early-adopted the new requirements regarding viability statements, see Chapter 10. One company in our sample stated that they had early adopted parts of the 2014 Code specifically in relation to their remuneration arrangements.

In addition to the new code, FTSE 350 companies also need to consider Part 5 of the Competition and Markets Authority Order on statutory audit services, which mandates particular responsibilities for the audit committee, effective for financial years starting on or after 1 January 2015. Although many audit committees will already comply with most, if not all, of the responsibilities described, these may not all be reflected in the committee's terms of reference.

The audit committee of Vodafone Group plc noted that they have changed their terms of reference to reflect the new Code requirements and the chairmen of both National Grid plc and Chesnara plc provided a good discussion of the impact of the Code changes. If not already considered, audit committees should be assessing whether any update to their terms of reference will be required to bring these in line with the 2014 Code changes and the requirements of the CMA Order.

Following the publication of the revised UK Corporate Governance Code, which will be adopted in the 2016 financial year, the Board has approved amendments to the Committee's terms of reference to include:

- providing advice to the Board on the assessment performed of the principal risks facing the Group including their management and mitigation;
- monitoring the Group's risk management system and reviewing its effectiveness; and
- providing advice to the Board on the form and basis underlying the longer term viability statement and going concern statement to be contained in future Annual Reports.

[Vodafone Group Plc Annual report 2015 \(p. 63\)](#)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

The changes introduced in 2014 to the UK Corporate Governance Code and the Financial Reporting Council guidance on risk management have highlighted the need for the Board to consider if the current risk management and internal control practices and culture of the Company support the spirit of the changes, not just the letter.

The updates to the New Code have been considered by the Board and refinements approved so we can report on compliance next year as required. It is the intention of the Board that any changes to the frequency and level of reporting received by the Board and Audit Committee in relation to risk management, compliance and internal control as a result of these updates, will also add value to the business.

[National Grid Plc Annual Report & Accounts 2014/15 \(p. 42\)](#)

2014 saw the introduction of an updated version of the Code which applies to accounting periods beginning on or after 1 October 2014 so is not applicable to these financial statements.

The updated version of the Code brings greater focus on the importance of the Board in setting the correct tone on corporate governance and emphasises the benefits of diversity on a Board.

Reporting on going concern status will be strengthened under the new provisions. Going concern statements will continue to evidence that going concern is an appropriate basis of accounting but a broader assessment of viability over a longer period will also be required.

The provision on Remuneration has been amended to make clear that remuneration policies must be designed to promote the long-term success of the company and that the performance-related elements of remuneration must be transparent.

The revised Code also includes a requirement to explain how a company intends to engage with shareholders where a significant percentage of them have voted against an AGM resolution.

None of the changes are expected to be an issue for the Company.

[Chesnara Plc Annual Report & Accounts 2014 \(p. 52\)](#)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Comply or explain

Companies should clearly explain why certain Code provisions have not been followed so that investors can identify whether the departure is appropriate in the particular context.

In 2012, the FRC issued 'What constitutes an explanation under comply or explain',\* where the FRC indicated that explanation sometimes is rather perfunctory. There was general agreement that the quality of explanation could be improved and three elements were proposed for a meaningful explanation; an explanation should set the context and historical background, give a convincing rationale for the action taken, and describe mitigating action to address any additional risk and to maintain conformity with the relevant principle. Sometimes, an alternative to following a provision of the Code may be justified in particular circumstances by a good explanation.

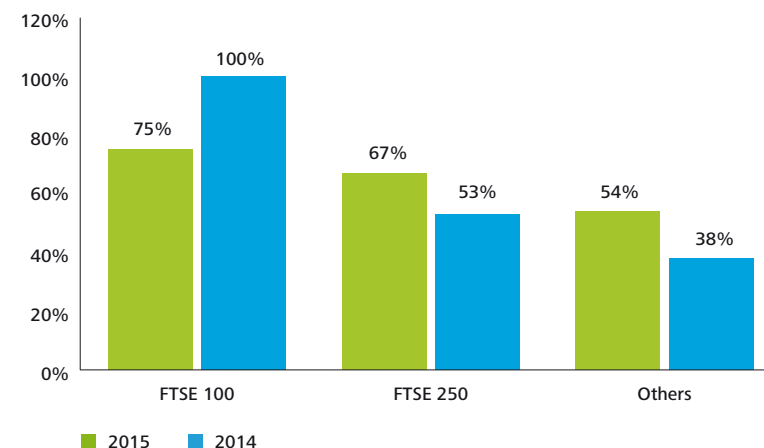
67% of companies that did not fully comply with the Code failed to provide a description of how the company remains compliant with the overriding Code principle, or how any resulting risks have been mitigated. Companies should clearly explain the context for non-compliance so that a clear link can be drawn between the action taken by the company and shareholders' interests.

Of those companies reporting partial compliance with the Code an increased proportion of smaller listed companies stated that their non-compliance was temporary – see Figure 11.1. Conversely there was a decrease in the FTSE100 companies surveyed that reported temporary non-compliance - this is due to a new company that was added to our sample this year that reported a permanent non-compliance.

82% (2014: 95%) of the companies who mentioned that non-compliance is temporary also provided an indication of when compliance might be achieved. Temporary non-compliance was most commonly caused by the sudden departure of a Board member with actions then being underway to address the issue. In this second year of companies applying the 2012 Code, it is encouraging to see that the percentage of companies that, in our view, provided a meaningful explanation for non-compliance with the Code has increased from 60% to 76%.

\* <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/What-constitutes-an-explanation-under-comply-or-ex.pdf>

Figure 11.1. Companies reporting temporary non-compliance with the code



Figures 11.2 and 11.3 show the most common areas of non-compliance with the Code amongst the FTSE 250 and smaller companies respectively, showing all provisions with three or more instances of non-compliance reported. As indicated above, 75% of non-compliances in the FTSE 100 companies were said to be temporary and there was no commonality in the areas of non-compliance.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Figure 11.2. Most common areas of non-compliance in FTSE 250 companies

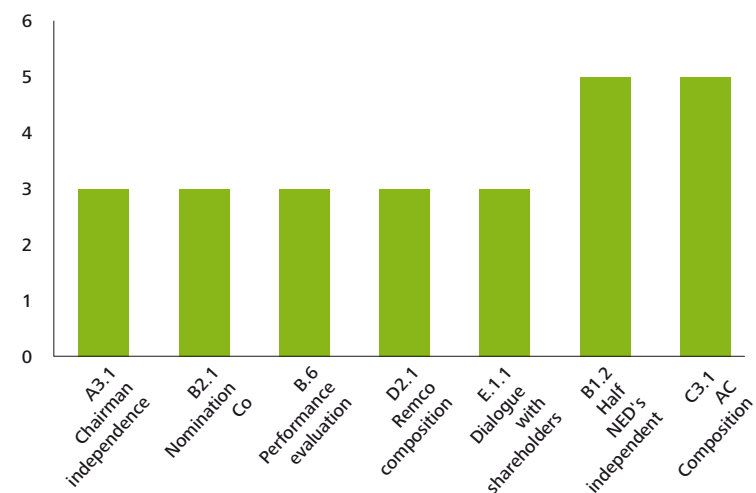
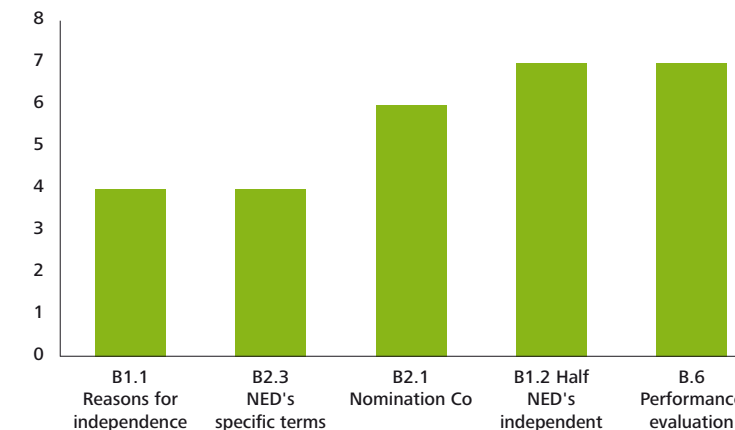


Figure 11.3. Most common areas of non-compliance in other companies\*



\*for one of the companies in our sample it has not been possible to identify which code provisions they do not comply with.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## Areas of non-compliance

The figures above indicate that the majority of instances of non-compliance arise from the provision in relation to composition of the board and its committees.

Johnson Matthey Plc, Bodycote Plc and Mothercare Plc provided the following explanations for their non-compliance(s) which give details of why the non-compliance arose, its impact and how its effects have been mitigated.

### Compliance with the UK Corporate Governance Code

During the period following Michael Roney's retirement on 23rd July 2014 up to Neil Carson's retirement on 30th September 2014, the board comprised five executive directors and four independent non-executive directors (excluding the Chairman). Whilst this was not in compliance with the Code (Provision B.1.2, which states that at least half the board excluding the chairman should comprise non-executive directors determined by the board to be independent), the board was comfortable with its composition for this brief period knowing that the executive and independent non-executive balance would be restored following Neil's retirement. The board believes that its balance of skills, experience and independence was not compromised during this period and that no one individual, or group of individuals, were able to dominate the board's decision taking. Following Chris Mottershead's appointment on 27th January 2015, the board comprises the Chairman, four executive directors and five independent non-executive directors, which means that more than half of our board, excluding the Chairman, now comprises independent non-executive directors.

[Johnson Matthey Plc Annual report & Accounts 2015 \(p. 90\)](#)

### Compliance reporting

In respect of the financial year 2014, Bodycote's obligation under the Disclosure and Transparency Rules is to prepare a corporate governance statement with reference to the UK Corporate Governance Code issued by the FRC in September 2012 ("the Code").

In respect of the year ended 31 December 2014, Bodycote has complied with the provisions of the Code with the exception of provision E1.1. As in previous years, the Board has taken the view that generally it is the responsibility of the Group Chief Executive and the Group Finance Director to manage relationships with institutional investors. The Chairman also meets institutional investors to discuss overall strategy, governance and any concerns that shareholders may have. Only where these more usual channels of communication have failed would the Board expect the Senior Independent Non-Executive Director (SID) or other non-executive directors to become involved, notwithstanding that the Code specifies attendance of the SID at meetings with major shareholders. The SID has contacted major shareholders and offered to facilitate meetings with them should they have any concerns they wish to discuss. Regular feedback by the Group's advisers on investor meetings and results presentations is circulated to all directors. During the year the Chairman and the SID met with shareholders to discuss governance matters.

Apart from this distinct area, Bodycote was in compliance with the provisions of the Code throughout 2014.

In September 2014 the FRC issued the updated UK Corporate Governance Code and areas of non-compliance will be reviewed by the Board during 2015.

### General

The Company considers that, with one exception, it has complied throughout the 52-week period ended on 28 March 2015 with the relevant provisions set out in the UK Corporate Governance Code published by the Financial Reporting Council (FRC) in 2012, having applied the main and supporting principles set out in Sections A to E of the Code. The exception is that the Board did not conduct an externally facilitated board evaluation during the year, the previous such evaluation having taken place in March 2012. The Board believes that it would be more valuable to review its performance thoroughly in a way that would properly take account of its role in overseeing the significant events during the year, and there was not sufficient time to complete this in the final quarter of the year following the rights issue. The Board has committed to an externally facilitated Board evaluation in FY2016.

[Mothercare Plc Annual report and accounts 2015 \(p. 40\)](#)

[Bodycote Plc annual report for the year ended 31 December 2014 \(p.40\)](#)



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

**Ownership of corporate governance**

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. The most common approach from Chairmen was to provide a Chairman's introductory letter to shareholders at the start of the corporate governance section and also to explain how the main principles of the Code have been applied or not applied, either in that letter or by including a cross reference to the relevant part of the corporate governance statement. 81% of Chairmen (2014: 67%) clearly took ownership of the corporate governance section of the annual report, with 48% (2014: 35%) also including some discussion of corporate governance in their Chairman's statement in the Strategic Report.

A good example of a Chairman's introduction was provided by Pearson Plc – this included clear signposting to the rest of the corporate governance section.

Marks and Spencer Plc also provided a good high level summary of the key features of their corporate governance report.

58 Pearson plc Annual report and accounts 2014

Governance overview  
from Glen Moreno, Chairman



Clear board roles and governance processes offer balance and experience to our strong, focused executive team, helping to drive strategic and performance progress.

**Governance principles**  
Our role and activities As a board we organise our work around four major themes where we believe we can add value: governance, strategy, business performance and people. Our board calendar and agenda provide ample time to focus on these themes and we have set out some examples of the business considered by the board, as well as the governance practices to which we adhere, on the pages that follow. [Learn more about Board meetings and activities on p63](#)

**UK Corporate Governance Code** This year, as is required, we are reporting against the 2012 edition of the UK Corporate Governance Code (the Code). The board believes that during 2014 the company was in full compliance with the Code. See page 73 for our position on audit tendering and rotation. A detailed account of the provisions of the Code can be found on the FRC's website at [www.frc.org.uk](http://www.frc.org.uk) and we encourage readers to view our compliance schedule on the company website at [www.pearson.com/governance](http://www.pearson.com/governance)

**Board and management**  
The Pearson board consists of senior executive management alongside a strong team of non-executive directors drawn from successful international businesses and education institutions with experience of corporate strategy, education, emerging markets, technology and consumer marketing.

**Board changes** As is best practice, we continually assess and refresh the board to ensure we maintain an appropriate balance and diversity of skills and experience. We will soon bid farewell to two trusted advisors, David Arculus and Ken Hydon, who have signalled their intentions to stand down from the board at the upcoming Annual General Meeting (AGM), having each served the company for nine years. We will miss their wise counsel and rigour as chairmen of the remuneration and audit committees respectively, and we thank them for their service to Pearson.

During the past year we have also welcomed two new non-executive directors to our board. Elizabeth Corley joined us in May 2014 and in January 2015 we welcomed Tim Score. I am delighted to say that Elizabeth and Tim are to be appointed as our new remuneration and audit committees chairmen respectively, following the AGM in April 2015. Between them, Elizabeth and Tim bring a wealth of business, finance and technology experience to Pearson's board, and will no doubt contribute fresh perspectives to the board's deliberations. [Learn more about our Board of directors on p60-61](#)

**Board and executive structure and balance** Our board consists primarily of non-executive directors, who bring a strong independent viewpoint, complementing the executive perspectives of John Fallon and Robin Freestone. In addition, we invite the Pearson executive to attend a number of the board's sessions to bring insights and thoughts from across the business. [Learn more about the Pearson executive on p6](#)

**Board evaluation** During 2014 we undertook an externally-facilitated board evaluation process. As always, this assists us in identifying opportunities to refine our processes, but the overall findings reflected a board which functions well, is fit for purpose and which has a strong sense of collegiality and support – something which has served us well through our two-year transformation. [Learn more about the Board evaluation on p68](#)

**Accountability** [See full section on p70-77](#)  
Throughout our transformation, our audit committee has played a vital role in overseeing both risk and reporting matters. Our refocused business has seen the introduction of a new financial reporting structure along the lines of our primary geographic markets, and our shift towards digital, services and emerging markets has brought new opportunities and risks – strategic, operational and financial. [Learn more about our Principal risks and uncertainties on p34](#)

**Engagement** [See full section on p78-81](#)  
Engagement with shareholders and society as a whole is key to Pearson's mission to help people make progress in their lives through learning. During the year, recognising this, we formalised our reputation & responsibility committee, headed by Vivienne Cox, whose focus includes our reputation with stakeholders (including investors) and the education community and oversight of Pearson's public commitments to society. We also welcomed a number of shareholders to our Annual General Meeting which, as always, was a valuable opportunity for our board and senior management to respond to shareholders' views and questions.

**Remuneration** [See full section on p82-106](#)  
Our remuneration policy was reviewed last year to align with the company's strategy and organisation and was approved by shareholders at the 2014 AGM. We continue to operate executive remuneration in line with the approved policy and at present do not anticipate seeking shareholder approval for our policy again until required to do so at the 2017 AGM.

This year's report on directors' remuneration refers to the changes we made in line with policy in 2014 to better align executive director compensation with the interests of our shareholders and, to put our report into context, contains a summary of the approved directors' remuneration policy report from 2013 which is not subject to a vote. The report also deals with the significant minority vote against the 2013 annual remuneration report which the company received at the 2014 AGM.

**Conclusion**  
I hope this report clearly sets out how your company is run, and how we align governance and our board agenda with the strategic direction of Pearson. We always welcome questions or comments from shareholders, either via our website ([www.pearson.com](http://www.pearson.com)) or in person at our Annual General Meeting.

*Glen Moreno*  
Glen Moreno Chairman

[Pearson Plc Annual report and accounts 2014 \(p. 58 – 59\)](#)

**THIS YEAR'S REPORT – KEY FEATURES**

**The structure of the Annual Report has been updated this year, providing greater focus to the key strategic messages within the Strategic Report, whilst still including the broader information on later pages for those that find it interesting.**

These changes have been made to promote clear and concise reporting, focusing the report on those factors that are most important to the long-term prospects of the business and ensuring key messages are clear, concise and easy to locate.

We have again focused on ensuring this report is fair, balanced and understandable. It is a reflection of how we have done business and how the Board has served its stakeholders. We believe this practical approach will support our performance for the long term and should protect the trust and integrity of our values, and the M&S brand.

**The Governance report provides:**

- A clear and honest review of the year;
- The outcome of our externally facilitated Board Evaluation;
- Greater disclosure around Board discussions and associated actions; and
- Information on our progress towards understanding our risk appetite.

**As a Board we regularly discuss and debate:**

→ Strategy and Company performance	→ The M&S brand
→ Culture and behaviour	→ International
→ Succession planning	→ Supply chain
→ Ecommerce	→ Risk
	→ Property
	→ Plan A 2020

**UK CORPORATE GOVERNANCE CODE**

**The UK Corporate Governance Code 2012 (the 'Code') is the standard against which we were required to measure ourselves in 2014/15.**

We are pleased to confirm that we complied with all of the provisions set out in the Code for the period under review.

A summary of our governance profile, outlining our compliance with key areas of the Code, has been set out on page 5 of the Strategic Report.

To keep this report interesting and engaging we continue to focus on the key insights from the business; however, further detail on how we comply with the Code can be found in our Corporate Governance Statement, available at [marksandspencer.com/thecompany](http://marksandspencer.com/thecompany)

[Marks and Spencer Plc Annual report and financial statements 2015 \(p. 33\)](#)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## Culture

Corporate culture is the new hot topic for 2015 and the FRC has confirmed the importance of good corporate culture<sup>53</sup> and embedding sound governance behaviours throughout the company. During 2015 the FRC has been reviewing how best to assess culture and practices and embed good corporate behaviour throughout companies and will consider whether there is a need for promoting best practice. The FRC's 'Guidance on Risk Management, Internal Control and Related Financial and Business Reporting'<sup>54</sup>, published in 2014, highlighted the need for Boards to think hard about assessing whether the culture practised within the company is actually in line with what Boards espouse. In particular, the FRC believes Boards should consider the following.

- What assurance does a Board receive around culture?
- Are performance drivers and values consistent?
- How can culture be maintained under pressure and through change?
- Are leaders role models for the values and culture of the business?

With this in mind, we reviewed our sample companies to determine how much evidence there was that the Board was taking ownership of corporate culture with a clear discussion in the governance section of the annual report. We found that 51 companies made no reference to culture anywhere in their annual report and a further 14 companies made no reference to it in the corporate governance section but had talked about corporate culture in the strategic report. 20 companies made a purely boilerplate reference to the Board's responsibility for the culture of the business in their corporate governance statement. This means that there were just 15 companies (seven FTSE 100, seven FTSE 250 and one other) who provided a meaningful discussion of the Board's responsibilities around corporate culture. The Boards of both St James's Place plc and Howden Joinery Group plc provided examples of such a discussion.

53. <https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2015/January/FRC-reports-on-better-compliance-with-UK-Corporate.aspx>

54. <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Risk-Management,-Internal-Control-and.pdf>

## Corporate Governance

Finally, there are many rather strongly held views about the role of the Board and Corporate Governance. St. James's Place has an unusual position in these debates, as both a listed company itself, seeking to meet the requirements of our shareholders, and also as custodian of our clients' assets. We are both the subject and object of corporate governance activity. In promoting a culture of 'doing the right thing' we are clear about our responsibility to our shareholders. It has always been important to us that our fund managers should engage with the companies in which they invest by voting their stock, but this is a topical area in which we will be further developing our thinking in 2015. I am, of course, available to talk to shareholders and can always be contacted via our Company Secretary (details on page 176)

## Culture

The Board exercises oversight over the Company's culture and regularly considers how both employees and Partners adhere to it and reviews measures to retain the Group's culture. The manner in which employees and Partners can adhere to the culture is set out in a series of "Our Approach" documents, including The Spirit of the Partnership.

I have stated previously that, as a locally empowered, entrepreneurial business, Howden Joinery is dependent on a strong, effective and consistent governance culture throughout the business, and this remains the case. Howdens has a distinctive and clearly defined culture which has been a principal cause of its success. Our core values are based around personal accountability, fair dealing, respect for others and recognition of effort. We insist on the importance of keeping our promises and we put direct, personal relationships at the heart of our business. Safeguarding and sharing the culture and values of the business is a primary function of the Board.

The Board reviews the performance of and provides counsel to the senior management in their day to day running of the business, and is ultimately responsible for the safeguarding of shareholders' interests and ensuring its own effectiveness. The Board is also responsible for protecting the culture and values of the business, a role particularly pertinent to Howdens where integrity, respect and recognition are fundamental tenets of the business.

[St James's Place plc Annual Report and Accounts 2014 \(p. 53 and 58\)](#)

[Howden Joinery Group Plc Annual Report & Accounts 2014 \(p. 49\)](#)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

[Serco Group plc](#) were the only company to refer to any assurance being undertaken around culture within the organisation. They noted that they had undertaken independent culture and ethics reviews during the year to measure the progress of changes in attitude throughout the organisation as part of their Corporate Renewal Programme.

### Board diversity

Diversity continues to be a hot topic, in the context of Board composition as well as the wider staff population (as discussed in chapter 7). A 2014 amendment to the preface of the Code provides a clear indication of the FRC's views on this matter and the significance they place on them. The preface now states 'Diversity is as much about differences of approach and experience, and it is very important to ensure effective engagement with key stakeholders in order to deliver the business strategy'. We are seeing some improvements in this from companies as explained below.

Reflecting on Lord Davies' recommendation that the number of women on FTSE 100 Boards should be 25% by 2015, and that FTSE 350 companies should set out the percentage of women they aim to have on their Boards, gender diversity receives significant focus in disclosures around Board composition. The average proportion of female directors on the Boards of FTSE 100 companies in our sample surveyed has increased from 21% last year to 24% this year. We are expecting to see the target 25% reached in our next year's survey which will capture a greater proportion of 2015 year-ends. In July 2015, the Secretary of State for Education, and Minister for Women and Equalities, Nicky Morgan said this when launching the consultation on gender pay gap reporting<sup>55</sup>:

"I am delighted that we have hit the Lord Davies target so that women now make up 25% of all FTSE 100 company Boards. But while I am proud of the progress made, there can be no room for complacency when it comes to securing equality for women."

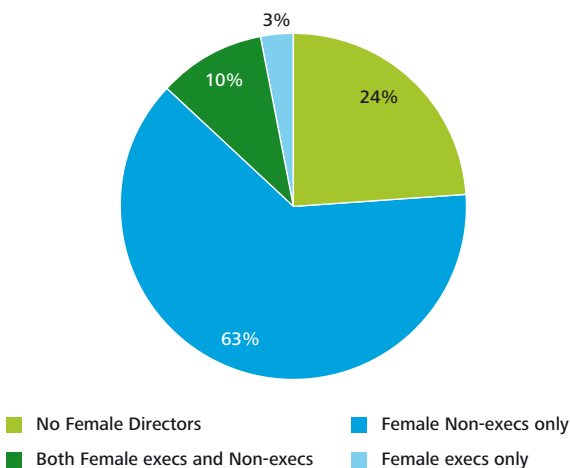
55. <https://www.gov.uk/government/news/prime-minister-my-one-nation-government-will-close-the-gender-pay-gap>

Only 17 of the 57 FTSE 350 companies surveyed made specific reference to Lord Davies' recommendations, with 13 providing a target for the percentage of women on the Board by a future date. Interestingly, four of the other companies in our sample also referred to the recommendations.

- 44% (2014: 33%) of the FTSE 100 companies surveyed provided a target, with 22% claiming to have already met the Lord Davies target of 25% of women on the Board by 2015.
- Only 13% (2014: 8%) of the FTSE 250 companies surveyed provided a target, with 8% claiming to have already met the Lord Davies target of 25% of women on the Board by 2015.
- Just one of the smaller listed companies in our sample provided a target for the number of women on Boards and also claimed to have met the Davies target.

Figure 11.4 shows the distribution of female directors amongst our sample companies. The overall percentage of companies with female directors has risen from 73% last year to 76% this year.

Figure 11.4. How many companies have female directors?



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

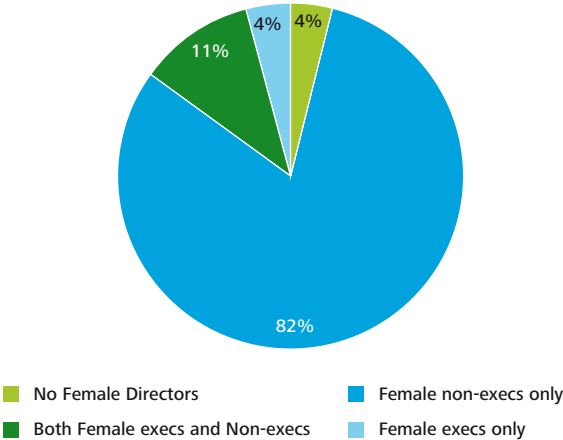
15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Larger companies in particular are gaining the value of a female perspective, with 96% of FTSE 350 companies surveyed and 100% of FTSE 100 companies surveyed having at least one woman on the Board – see figure 11.5 below. This compared to only 49% of smaller companies in our survey. The highest proportion of women on a single Board was 44% being three Non-executives and one Executive out of a total of nine directors (2014: 38%).

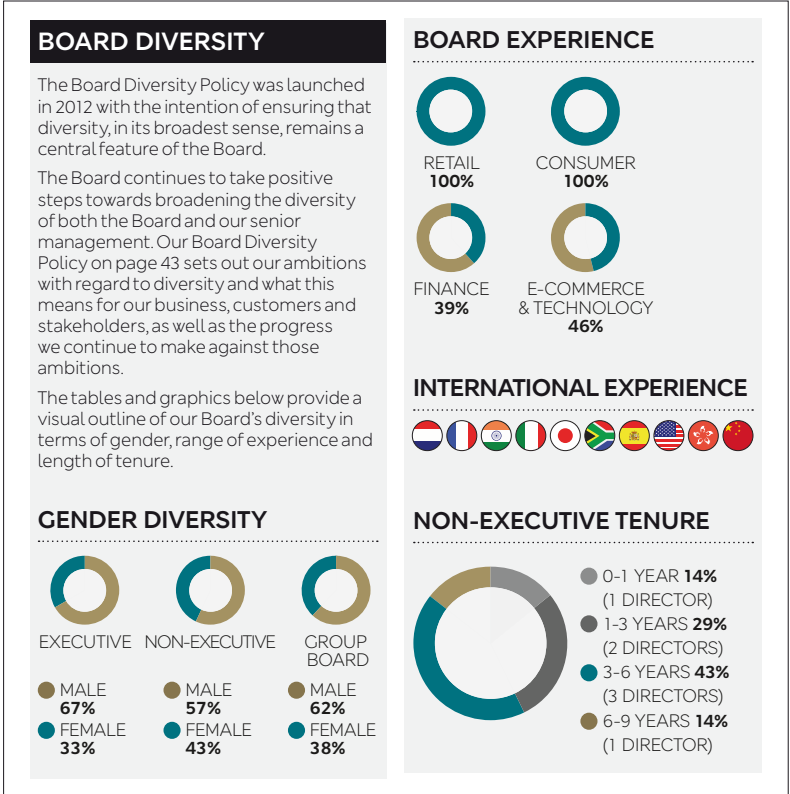
Figure 11.5. How many FTSE 350 companies have female directors?



The overall percentage of female directors as a percentage of total directors on the Boards of the 100 companies surveyed has risen to 18% (2014: 15%).

It is important to remember that when the Code talks of Board diversity, it is diversity in its broadest sense. It was encouraging to see that 63% (2014: 52%) of companies surveyed made reference to the wider aspects of diversity in their disclosures. It is good to see an increase, showing that more and more companies are placing increased importance on Board diversity. A variety of backgrounds and experience can make the company more adaptable to its ever changing environment. Divergent cultural backgrounds mean different ideas and perspectives. The most common areas mentioned were skills, knowledge and experience but other areas referred to include nationality, disability, personal attributes, age and regional and international experience.

Marks and Spencer Group Plc and Vodafone Group Plc provided good graphic/tabular presentations of the gender diversity on their Boards.



[Marks and Spencer Group Plc Annual report and financial statements 2015 \(p. 35\)](#)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

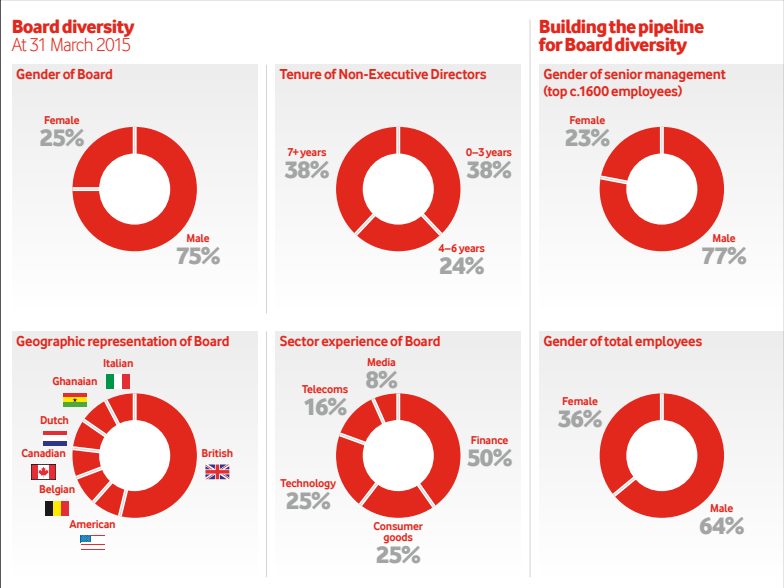
13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available



[Vodafone Group Plc Annual report and accounts 2015 \(p. 61\)](#)

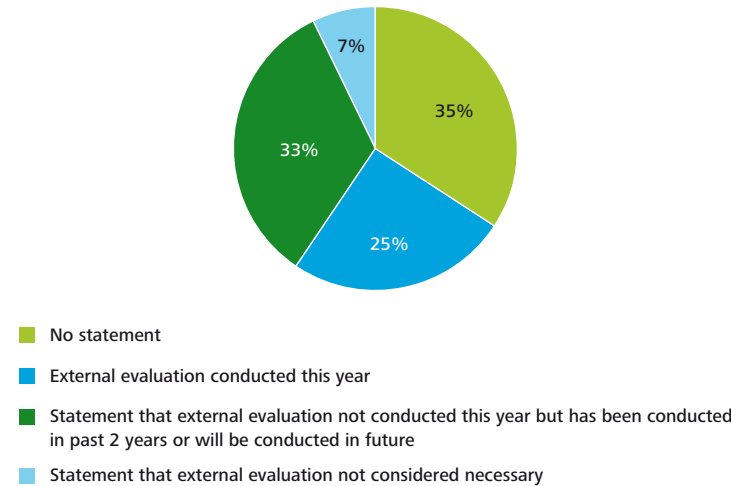
### Board performance evaluation

In accordance with Code principle B.6, the Board should undertake a formal and rigorous annual evaluation of its own performance. The Code recommends that companies in the FTSE 350 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 with 23% of the smaller listed companies providing some statement on whether an external evaluation was conducted in the current year or last three years or if not why this was not deemed necessary.

While in the prior year 53% of the companies surveyed indicated that they had undertaken an external performance evaluation or would do so in the next two years, in 2015 this figure increased to 58% of companies as per figure 11.6 below. This is much more prevalent in FTSE 350 companies, with 84% (2014: 86%) of them doing so as per figure 11.7 below.

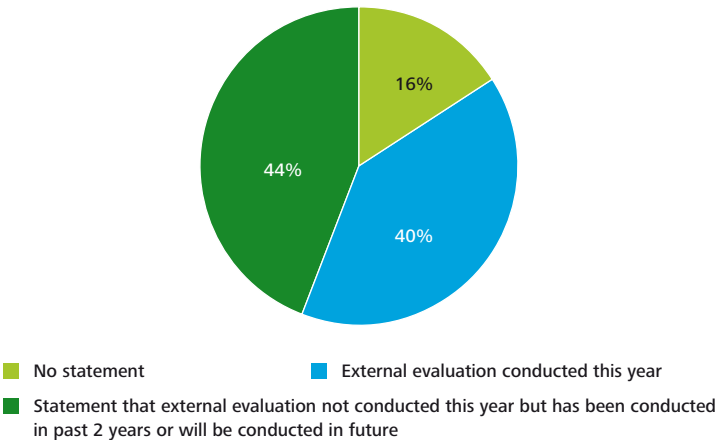
External facilitation once every three years has a role as it helps to gain a view on how a Board is doing compared to other comparator Boards. A good external facilitator can add much external perspective which a Board would otherwise not be able to access.

**Figure 11.6. Board performance evaluation for all companies**



1. Executive summary
2. How to use this document
3. Regulatory overview
4. Survey objectives and methodology
5. Overall impressions
6. Summary material
7. The strategic report
8. Key performance indicators
9. Principal risks and uncertainties
10. Going concern and viability
11. Corporate governance
12. The work of the audit committee
13. The auditor's report
14. Primary statements
15. Notes to the financial statements
Appendix 1 – Glossary of terms and abbreviations
Other resources available

Figure 11.7. Board performance evaluation for FTSE 350



Cobham Plc showed detail of the evaluation of the performance of the Board in 2014 and 2013 and the actions taken.

Board and committees performance evaluation		
Evaluation year	Observations	Actions taken
2013	Members of the Group Executive should be provided with opportunities to present to the Board on their areas of the business to provide more exposure to the Board members.	Presentations from the Group Executive were built in to the Board Work Plan for 2014 (and going forward). Various opportunities have also been taken for the Board to meet members of the senior management team both professionally and socially.
	Continued development of the strategic planning process.	The connectivity strategy was agreed during the first part of the year during a scheduled Board meeting, following which the Aeroflex transaction was identified. A Board meeting dedicated to strategic discussion was held during late 2014. Although this was delayed by the acquisition of the Aeroflex Group, the Board felt there had been a big improvement in strategic materials and subsequent Board discussions. Ongoing strategic updates form part of the rolling Board agenda.
2014	PV investment.	The continued investment in the products of the business to ensure currency of technology is recognised as key and more emphasis should be placed on pursuing (and monitoring) strategic opportunities through such investment.
	Continued development of the strategic planning process.	The Board identified a number of additional pieces of work they would like to see as part of the 2015 Strategic Review. These have now been scheduled into the work cycle for the Strategic team and the business, where appropriate, for delivery during 2015 Board strategy discussions.

Cobham Plc Annual Report and Accounts 2014 (p. 50)

Pearson Plc presented a step by step explanation of their Board evaluation process.

EVALUATION PROCESS

On JCA Group's recommendation, the process for the evaluation was as follows:

1

**Initial briefing** An initial briefing on the company to provide context and insights into the strategic priorities for the business as well as any issues or concerns to address more specifically

2

**Discussion guideline** Development of a 'discussion guideline' which was shared with the participants ahead of one-to-one meetings, to address key topics but not limit the discussion to only these; such topics included the organisation of the board, board and chair succession, judgement of the strategy and business performance, the dynamics and composition of the board and feedback on the committees and individual directors

3

**One-to-one meetings** One-to-one meetings with each board member, both executive and non-executive; these conversations were conducted on a confidential, un-attributable basis

4

**Effectiveness report** A full report was presented to the board, containing the key findings, recommendations for actions and suggested next steps

Pearson Plc Annual report and accounts 2014 (p. 66)



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Marks and Spencer Group Plc provided a comprehensive disclosure of the review process insights arising and action plan for 2015/16.



[Marks and Spencer Group Plc Annual report and Financial statements 2015 \(p. 41\)](#)

Evraz Plc provided a good example of its areas of evaluation and action points which is in line with the the purpose of the Code.

Lintstock subsequently produced a report which addressed the following areas of Board performance.	
Areas	Findings and action points
The composition of the Board, and the key changes that should be made to the Board's profile to match the strategic goals	The Board's composition was rated highly, with planned changes including additional mining expertise and North American knowledge, and increased female representation
The Board's understanding of the markets in which the Group operates, and of the views of major investors and shareholders	The rating was positive
The relationships between the members of the Board and between the Board and management, and the involvement of non-executives in the affairs of the Company outside Board meetings	Board dynamics and relationships with senior management were rated highly. The programme of site visits for Board members, and the discussion of Board and Company matters during these visits, is to be expanded and formalised
The management of time at the Board, including the annual cycle of work and the Board's agenda	The Board commits considerable time and effort to its monthly meetings and Board effectiveness was rated highly. Further thought is to be given to managing the time devoted to individual agenda items and to the organisation of papers circulated prior to Board meetings
The quality of advisers that support the Board and its committees, and directors' training needs	Performance was rated as adequate. Further thought is to be given to the provision of training for directors
The data provided to support the Board's analysis of the performance of the business, and the Board's knowledge of the performance of the Group relative to its main competitors	This was considered to be good. Information about the Group's competitors is to be brought together in a specific presentation
The Board's testing and development of the Company's strategy, and the involvement of the Board in determining strategic direction	Performance was rated as good, with strategy considered specifically by the Board on three occasions during the year. The linking of annual planning and budgeting to the strategy is to be brought out more clearly
The Board's management of the main risks facing the Group, and risk appetite	Performance was rated positively
The structure of the company at senior levels, and succession planning for the Chief Executive and other key management	The structure of the Group at senior levels was rated positively. The Board, in addition to the Nominations Committee, is to devote more time to considering succession planning
The composition and performance of the committees of the Board, the performance of the Chairman and the individual performance of directors	The contribution of the Chairman was rated highly and the performance of the Board's subcommittees was considered good, with the Audit Committee's contribution commented on particularly favourably
While there are areas for improvement, which will be addressed, in overall terms the review was encouraging and useful.	

[Evraz Plc Annual Report and Accounts 2014 \(p. 76\)](#)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

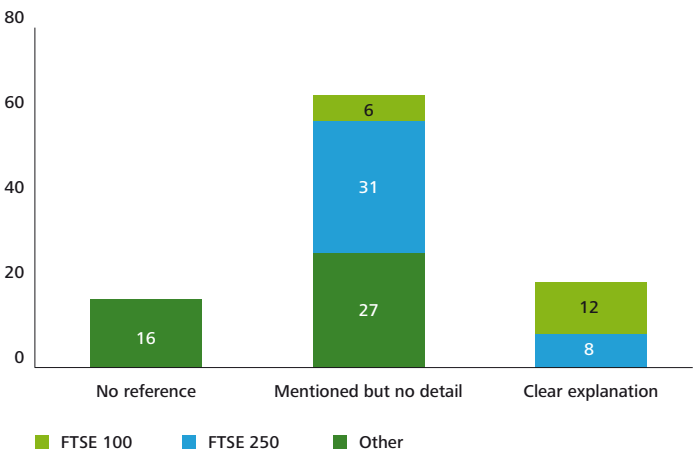
**Nomination committee and succession planning**

In accordance with Code provision B.2.1, there should be a nomination committee that leads the process for Board appointments and make recommendations to the Board. It is also likely to lead the efforts of the Board in succession planning, another current hot topic.

74% (2014: 71%) of the companies surveyed and 79% (2014: 79%) of those in the FTSE 350 mentioned the process used for Board appointments. However, succession planning involves more than just making new appointments when necessary.

The FRC's project on succession planning<sup>56</sup> is aimed at identifying and promulgating good practice and, more specifically, at how the nomination committee can play its role effectively. The FRC believes that unless Boards are planning over the medium to long-term, for both executive and non-executive positions, they will struggle to ensure that there is the right mix of skills and experience needed as the company evolves. Many companies still only talk about succession planning in terms of replacing individual Board directors – in other words, usually a short term tactical response that does not address the more strategic issue of longer term, forward-looking, succession planning.

Figure 11.8 How well did companies discuss succession planning?



Our survey examined whether there had been reference to succession planning, whether there was a note that it was dealt with but no further detail, or whether there was a clear explanation of the Board's activities in this area. The results are shown in Figure 11.8.

Johnson Matthey Plc, BT Group plc and Barclays PLC all provided good disclosures around their succession planning activities which demonstrated the proactive nature of their succession planning activities.

Nominating	Key areas	Actions
<b>Board membership and succession</b> At each meeting we considered succession planning and the composition of the Board. We had an extra meeting this year with the Chief Executive, to focus specifically on succession plans. We reviewed executive director succession. We also reviewed succession plans for the <i>Operating Committee</i> roles as well as for those other roles held by the Chief Executive's direct reports.  We have a skills matrix against which we evaluate candidates for the Board, whether those individuals are identified by the Board or external consultants. We reviewed our skills matrix during the year, assessing the relevant skills that the Board has against a set of criteria: the technical skills required for running a listed company; customer sectors; industry knowledge; stakeholder engagement; and regional experience. We believe the Board has strong technical expertise and a good range of experience across different customer and industry segments. We further strengthened our financial expertise with the appointment of Isabel Hudson.  We instructed external search consultants MWM Consulting to identify potential non-executive directors. MWM Consulting are instructed from time-to-time by BT for search assignments but otherwise have no connection with the company. Having considered potential candidates against our skills matrix, members of the committee and the Board met Isabel Hudson. Then, on behalf of the committee, I recommended her appointment to the Board. Isabel brings significant board experience, extensive experience in financial services in the life, non-life and pensions industries and has worked both in the UK and in Continental Europe.  We believe our Board composition is currently appropriate but we will continue to keep this under review.	<b>Succession planning for the Board and senior management</b>  • Review of the Board skills matrix  • Succession planning for executive board appointments and senior management positions  • Board would benefit from: i) greater financial expertise on key committees; ii) greater international diversity; iii) expertise in customer experience issues/management of major contracts	  • We reviewed the Board skills matrix at our September meeting, and the matrix was further updated following input from the Board.  • We reviewed with the Chief Executive his plans for executive director succession and other key senior management appointments at a specific additional meeting of the committee.  • Our appointments this year of Iain Conn and Isabel Hudson have provided additional expertise including in areas of finance and pensions and increased the range of customer, regulation and international experience on the Board. • Isabel has been appointed as a member of the <i>BT Pensions Committee</i> and will become chair of this committee and of the EAB on 1 February 2016. Iain Conn is a member of the <i>Audit &amp; Risk Committee</i> and <i>Nominating &amp; Governance Committee</i> .

[BT Group plc Annual Report & Form 20-F 2015 \(p. 105 – 106\)](#)

56. <https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2015/January/FRC-reports-on-better-compliance-with-UK-Corporate.aspx>

1. Executive summary
2. How to use this document
3. Regulatory overview
4. Survey objectives and methodology
5. Overall impressions
6. Summary material
7. The strategic report
8. Key performance indicators
9. Principal risks and uncertainties
10. Going concern and viability
11. Corporate governance
12. The work of the audit committee
13. The auditor's report
14. Primary statements
15. Notes to the financial statements
Appendix 1 – Glossary of terms and abbreviations
Other resources available

## Succession Planning

The board recognises that effective succession planning is not only a fundamental component of board effectiveness but is also integral to the delivery of Johnson Matthey's strategic plans. It is essential in ensuring a consistent level of quality in management, in avoiding instability by helping mitigate the risks which may be associated with any unforeseen events (such as the departure of a key individual), and in promoting diversity. The board, through the Nomination Committee, is actively engaged in succession planning to ensure plans are in place for the orderly and progressive refreshing of its membership and to identify and develop senior management with potential for board and GMC positions.

Below board level, there is a structured approach to succession planning designed to secure a pipeline of talented and capable individuals from within Johnson Matthey who will ultimately progress to board and GMC positions. Each of our divisions and corporate functions prepare and maintain succession plans, assisted by divisional and group Human Resources. The GMC rigorously reviews these plans each year.

A key aim is to ensure broad experience and encourage cross fertilisation across our divisions. The identification and development of high potential individuals is also considered by the GMC. The GMC's review of the succession plans generally leads to further refinement and changes, resulting in the final plans which are submitted to the Nomination Committee. Each year the Nomination Committee, with input from the Group Human Resources Director, reviews the management development and succession planning processes for the directors and senior executives, approves succession plans for the board and considers succession plans for senior executives.

Johnson Matthey has in place a range of ongoing talent management and development initiatives designed to further develop senior management. Many of these are well established, but new initiatives are being developed and introduced which are designed to support current strategic imperatives. Key initiatives continued this year are our executive development programme with London Business School, aimed at developing senior level talent and boosting their capabilities around strategy and leadership, and a global training curriculum to support the group's Manufacturing Excellence programme.

Succession planning at board and senior management level for Johnson Matthey encompasses potential succession to all senior roles, including that of Chief Executive, and considers the identification, development and readiness of potential internal successors. The board (through the Nomination Committee) will continue to focus during the coming year in particular on the key issues of active talent management, mobility across the group and diversity.

### Succession planning and talent management

The consolidation of the previously fragmented approach to succession planning and talent management of the Senior Leaders Group, focusing on gaps in succession plans for Group Executive Committee roles resulting from the rebuilding of the Group Executive Committee over the past two years.

- The Committee identified the leadership needs of the Company, assessed the overall bench strength of leadership of Barclays Senior Leaders Group and evaluated the adequacy of succession plans for members of the Group Executive Committee and the Board.
- Scrutinised progress reports relating to the Talent Management Programme, which identifies talented people within Barclays who are capable of development and promotion to senior levels, and the recruitment of individuals with appropriate values and culture.
- The Committee assured the strength and capability of the Senior Leaders Group, and supported a greater focus on values and culture in recruitment and talent assessments, with hiring decisions being made on the basis of fit with Barclays' Values.
- The Committee has also ensured the identification of potential succession candidates for Group Executive Committee roles on the basis of readiness within two years, from three to five years and emergency cover.

[Barclays PLC Annual Report 2014 \(p. 56\)](#)

[Johnson Matthey Plc Annual Report & Accounts 2015 \(p. 91\)](#)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Internal control and risk management

Code 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 and should report to shareholders that they have done so.

- 97% of companies surveyed provided an explanation of how the company has applied Code Principle C.2 Internal Control.
- 89% of companies provided a summary of the process which the Board applied in reviewing the effectiveness of the system of internal control.
- Only 2 companies of the 100 companies surveyed mentioned the process their Boards have applied to deal with any internal control aspects of problems disclosed in the annual report and financial statements.

Per the FRC's new 'Guidance on Risk Management, Internal Control and Related Financial and Business Reporting', Boards will have to monitor risk management and internal control systems on an ongoing basis, rather than once a year, and will need to explain actions taken to remedy any failings or weaknesses identified.

Persimmon Plc provide an example of such a disclosure.

Following review by the Risk Committee where minor weaknesses in internal controls were identified action has been taken to improve and strengthen procedures as part of the regular de-briefing of senior management by the Group Risk Department on conclusion of their work.

[Persimmon Plc Annual report – December 2014 \(p. 48\)](#)

Going forward, as mentioned in chapter 9 revised provision C.2.1 of the 2014 Code will require that the Board must confirm that they have undertaken a robust assessment of the principal risks facing the company and explain how these are managed and mitigated.

### Cyber governance

Organisations have never been more at risk from cyber-attacks. Recent high-profile attacks on companies in the retail, media and industrial sectors have highlighted the type of damage that can be done by hackers and cyber terrorists. This growing threat comes at a time when there is also increasing focus on how organisations manage risk. Regulators, investors and senior executives are putting companies under pressure to explain how they identify risks to their business and how they ensure these are being managed within an agreed risk appetite.

There is evidence that many organisations, while being aware of the cyber threat, have not grasped the severity of the risks they face themselves and have not put in place the governance to manage these. A UK Government survey of cyber governance<sup>57</sup> reported that while 88% of respondents from the FTSE 350 included cyber risk on their risk register, 75% of Boards seldom heard about cyber risk, only 24% based their discussions on robust or comprehensive management information, and less than 20% had a clearly set and understood appetite for cyber risk. As mentioned in chapter 9, 60% of companies included IT as one of their principal risks, although this figure encompasses all IT risks, not just cyber security.

We looked at our sample to determine how many companies were talking about the Board's involvement in activities around cyber risks and security within their corporate governance statements. Just 32% of companies had made such a reference, echoing the findings from the Government survey.

57. [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/399260/bis-15-37-ftse-350-cyber-governance-health-check-tracker-report-2014.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/399260/bis-15-37-ftse-350-cyber-governance-health-check-tracker-report-2014.pdf)

1. Executive summary	There was also a wide variety in the way cyber risk was being approached at Board level in the annual reports surveyed, with various companies classifying it as:
2. How to use this document	<ul style="list-style-type: none"> <li>• a key area of focus for internal audit;</li> </ul>
3. Regulatory overview	<ul style="list-style-type: none"> <li>• an area of review by the Audit Committee;</li> </ul>
4. Survey objectives and methodology	<ul style="list-style-type: none"> <li>• a topic on which the Audit Committee had received a presentation;</li> </ul>
5. Overall impressions	<ul style="list-style-type: none"> <li>• part of training for directors;</li> </ul>
6. Summary material	<ul style="list-style-type: none"> <li>• an action as part of the Board performance evaluation;</li> </ul>
7. The strategic report	<ul style="list-style-type: none"> <li>• an area of Board focus;</li> </ul>
8. Key performance indicators	<ul style="list-style-type: none"> <li>• part of the remit of a newly appointed Chief Information Officer;</li> </ul>
9. Principal risks and uncertainties	<ul style="list-style-type: none"> <li>• part of a specific review by the Risk Committee; or</li> </ul>
10. Going concern and viability	<ul style="list-style-type: none"> <li>• part of the Corporate Responsibility Committee's responsibilities.</li> </ul>
11. Corporate governance	National Grid plc provided the most comprehensive disclosures on this topic with the Chairman stating that responsibility for making sure National Grid plc has an effective process for managing cyber security risk should rest with the Audit Committee.
12. The work of the audit committee	
13. The auditor's report	
14. Primary statements	
15. Notes to the financial statements	
Appendix 1 – Glossary of terms and abbreviations	
Other resources available	

The Board received an in-depth presentation on security and cyber security which provided a framework for discussion around the threats we face and the effectiveness of our strategy to mitigate the inherent risks. We have made a significant investment over the last five years to improve our capabilities in this area so we can adapt to and address an ever-changing threat landscape. Following this session, we agreed that responsibility for making sure we have an effective process for managing cyber security risk should be delegated to the Audit Committee. You can read more about this on page 50. The Board will continue to receive an annual in-depth presentation on information systems and security, including cyber security.

**Cyber security risk management.** A paper from internal (corporate) audit on the status of our cyber security risk management and external good practice in September 2014. In setting the scope of its new responsibilities, the Committee considered the level of assurance currently provided by internal (corporate) audit and other assurance providers and the frequency and extent of information received. Subsequently, the Committee's terms of reference were amended to include this additional responsibility in relation to the review of the governance processes over cyber security risk and the Committee now receives a regular update from the Head of Corporate Audit.

[National Grid Annual Report & Accounts 2014/15 \(p. 42\)](#)



# 12. The work of the audit committee

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## Top tips

- Given the increased focus on the work of audit committees, consider presenting their work in a clear, separate report within the annual report – 83% (2014: 67%) of companies elected to do so this year. A personal introduction from the audit committee chair demonstrates clear ownership of the audit committee report.
- Make it clear how the significant issues considered in relation to the financial statements have changed from the previous year and why they remain relevant for the current year – we have provided two examples of companies which made it clear which issues were new for the current year and which were recurring items. This provides an added level of insight for the reader.
- Use the FRC's 'Audit Quality Practice Aid'<sup>58</sup> to assist in structuring your disclosure on the assessment of the effectiveness of the external audit process.

## Keep an eye on

- Take steps to understand differences between the audit committee's discussion of significant financial statement issues, the risks described by the auditors in their auditor's report and the financial statement critical accounting judgements and key sources of estimation uncertainty. There is no requirement for total alignment but audit committees should be able to explain where there are differences.
- Keep up to date on the developments around audit tendering and rotation – the final rules and transitional arrangements are now much clearer. Consider providing an indication of when you might next put your audit out to tender – 48 companies (2014: 35) did so this year.
- Make sure that the audit committee terms of reference have been updated to reflect the 2014 Code changes and the CMA Order<sup>59</sup>.

The 2012 Code significantly increased the reporting responsibilities of the audit committee, with more emphasis on presenting detail in the annual report about what the audit committee has done during the year under review to fulfil its responsibilities. Now in year two, this level of transparency gives shareholders a much clearer picture of what the key issues considered by the committee are and how they are addressed and what the audit committee does to oversee the external audit relationship.

## Presentation of the audit committee report

The Code requires there to be a separate section of the report which describes the work of the audit committee in discharging its responsibilities. 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 could be a subsection within the overall corporate governance report. However, reflecting the increasing profile of the audit committee's activities, the number of companies presenting a stand-alone audit committee report within the corporate governance section of the annual report has increased again this year, with 83 companies (2014: 67) presenting such a report. This separation is useful as it provides a clear definition between the work of the audit committee and the work of the board as a whole.

A similar number of companies had audit committee chairmen taking clear ownership of the audit committee report, 74 in 2015 compared to 71 in 2014. This was done usually either by the committee chairman signing the report or presenting an introductory summary.

58. <https://frc.org.uk/News-and-Events/FRC-Press/Press/2015/May/FRC-provides-aid-to-Audit-Committees-in-evaluating.aspx>

59. [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/364145/Audit\\_Order.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/364145/Audit_Order.pdf)



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

# <IR> ownership

The <IR> Framework has an emphasis on ownership and stewardship which echoes the good practice shown when the audit committee chairman takes clear ownership of the audit report (or, indeed, the chairman of the board takes ownership of corporate governance as a whole).

In the UK environment, the 2014 Corporate Governance Code provides that a separate section of the annual report should describe the work of the committee. As explained in the FRC's Guidance on Audit Committees, this "deliberately puts the spotlight on the audit committee and gives it an authority that it might otherwise lack."

How does this affect the production of an integrated report? The main impact is that a consistent narrative and message regarding the capitals of the company needs to carry through in a further separately presented report.

The reader should be able to see the business model and the principal risks and uncertainties carrying through and affecting the risk management and internal control reported on by the audit committee, as well as the significant issues the audit committee considered in relation to the financial statements.

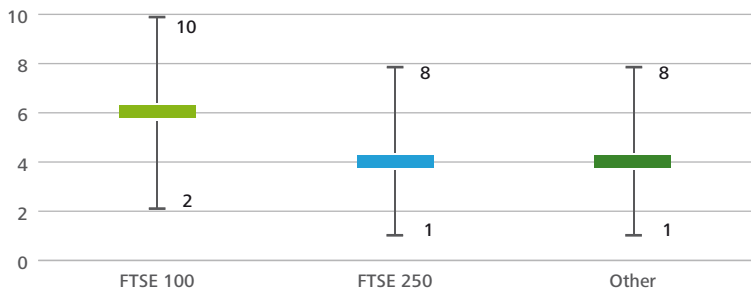
## Significant issues considered by the audit committee

The Code requires audit committees to describe the significant issues considered in relation to the financial statements and how those issues were addressed. In addition, auditors are required to report on the key risks of material misstatement which they focused on and which required the most audit effort. We examine the correlation between the significant issues discussed by the audit committee and the risks disclosed by the auditors below.

Only three of the companies we surveyed had failed to include disclosure of the significant issues considered by the audit committee – one from the FTSE 250 group and the others from the smaller listed company group.

The average number of issues disclosed across the three company size categories was identical to last year and is set out in figure 12.1.

**Figure 12.1. How many significant financial reporting issues were identified by the audit committee?**



Using our own judgement we rated the disclosures on the significant issues as brief, moderate or comprehensive. 23% were deemed to be brief, 52% moderate and only 22% comprehensive. This spread is not surprising given the range of size of companies included within this sample. But that is not to say that all the comprehensive disclosures were in the largest companies, there was a good spread throughout our sample of audit committees providing a more comprehensive disclosure of the significant issues considered. To achieve a rating of 'comprehensive' we would have seen a majority of the characteristics referred to below from the Financial Reporting Lab's report on 'Reporting of Audit Committees' in the disclosure.

1. Executive summary	<p>The FRC's Financial Reporting Lab suggests the following for the discussion of significant issues.</p> <ul style="list-style-type: none"> <li>• Reporting should be bespoke, company specific and tailored to the year under review.</li> <li>• Providing context to the issue helps to communicate the specific story, e.g. quantifying the issue, identifying the related business unit, geography, contract or transaction type, describing the nature of the issue as being related to a specific policy or involving a specific assumption or estimate.</li> <li>• Providing greater depth on how the audit committee fulfilled its role and the robustness of the steps it undertook to assess each significant issue and reach conclusions.</li> <li>• Using more descriptive, 'active' language stated in the past tense, as this provides assurance that the audit committee has positively taken specific steps to address the issue.</li> <li>• Disclosing ranges or scenarios taken into consideration, key assumptions, and whether reported amounts fall within an acceptable range.</li> </ul> <p>Good examples of disclosures on significant issues were given by Marks and Spencer Group plc and The Weir Group plc. In particular, both these companies make it clear which issues are recurring issues for the audit committee and which are one-off items for the particular year.</p>
2. How to use this document	
3. Regulatory overview	
4. Survey objectives and methodology	
5. Overall impressions	
6. Summary material	
7. The strategic report	
8. Key performance indicators	
9. Principal risks and uncertainties	
10. Going concern and viability	
11. Corporate governance	
12. The work of the audit committee	
13. The auditor's report	
14. Primary statements	
15. Notes to the financial statements	
Appendix 1 – Glossary of terms and abbreviations	
Other resources available	

#### REVENUE RECOGNITION IN RELATION TO REFUNDS, GIFT CARDS AND LOYALTY SCHEMES

Revenue accruals for sales returns and deferred income in relation to loyalty scheme redemptions and gift card and credit voucher redemptions are estimated based on historical returns and redemptions. The Committee has considered the basis of these accruals, along with analysis of historical returns and redemption rates and has agreed with the judgements reached by management.

#### SUPPLIER INCOME (NEW DISCLOSURE)

The Committee has considered the assessment made by management over the accounting for supplier rebate arrangements and has been actively involved in reviewing the Group's controls in place in this area. The Committee has reviewed in detail management's paper, which set out the nature and value of these arrangements and the timing of recognition in the financial statements, along with the related Internal Audit findings reported. The Committee is satisfied with management's conclusion that there is no risk of material misstatement in the current and previous period. In addition, the Committee decided to enhance the disclosures in relation to supplier income by publishing the accounting policy and disclosing the effects of supplier income on certain balance sheet accounts. ➕ See note 17 on p112

[Marks and Spencer Group plc Annual Report and Financial Statements 2015 \(p. 49\)](#)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

**Current period matters**

(1) Accounting for the acquisition of Trio Engineered Products ('Trio') – note 13  
The specific items we have discussed and reviewed with management and the external auditors, EY, in relation to the £146m acquisition of Trio were: (a) the Purchase Price Allocation (PPA) exercise to attribute provisional fair values to separately identifiable intangible assets and the related accounting for deferred tax; (b) the assessment of provisional acquisition fair values of other assets and liabilities, specifically property, plant & equipment, inventory and provisions; and (c) compliance of the disclosures in the financial statements with IFRS 3, 'Business Combinations'.

Management engaged with an independent external advisor to complete the PPA exercise and reported a summary of the underpinning assumptions and related results to us. We reviewed that summary and also compared the assumptions used to those for other recent acquisitions where appropriate. The accounting for deferred tax has included technical input from the Group Head of Tax. We examined the nature and extent of provisional fair value adjustments to other assets and liabilities noting a rigorous process was being undertaken and would be finalised, as required by IFRS 3, in 2015. Finally, we challenged management on the completeness of the related disclosures and satisfied ourselves that they were complete, accurate, understandable and compliant with IFRS 3.

(2) Exceptional items – Group-wide efficiency review – note 5

The Group announced in November 2014 that it had undertaken a Group-wide review in the third quarter to identify opportunities to reduce costs, increase customer responsiveness and efficiency while aligning resources globally to capture end market opportunities. This programme was extended towards the end of the fourth quarter in response to the very significant decline in the oil price. The financial impact of the initiatives underpinning the programme is a cost in 2014 of £49m, which has been reported as exceptional on the face of the Income Statement. This figure comprises asset impairments of £19m and reorganisation costs (which have or will result in a cash out flow for the Group) of £30m. Further detail in relation to the initiatives is provided in the Financial Review on page 46.

As well as being party to discussions at Board level on this subject, the Audit Committee has received detailed reporting from the Finance Director covering the following aspects: (i) costs by initiative, by division; (ii) accounting treatment adopted in relation to recognition of provisions and impairments; and (iii) disclosure of the amounts and related narrative reporting. The Committee has probed management to understand and confirm that the requirements of IAS 37 'Provisions, contingent liabilities and contingent assets' have been met in terms of recognising a provision at the end of the year and received reporting from EY that confirms management's treatment as appropriate. Furthermore, we considered the nature of these costs in light of the Group's accounting policy for exceptional items. The Committee agrees with the accounting treatment and disclosure of these items in the 2014 Annual Report.

**Recurring agenda items**

(1) Accounting for pensions – note 24

We have examined these disclosures and we are satisfied they are complete and accurate. In reaching this conclusion, we have challenged management on the key assumptions used underpinning the valuation, taking assurance from the fact that external advice is taken by them. During the current year, we gave specific consideration to the additional disclosure provided by management summarising the most recent actuarial funding valuation deficits under the two main UK plans as well as the agreed future contributions under the respective schedules of contributions. We consider that these disclosures enable users of the financial statements to better understand the risk and impact of the agreed future contributions on the Group.

(2) Tax charge and provisioning – note 7

The Audit Committee receives a detailed report from the Finance Director every six months, which covers the following key areas: (i) status of on-going enquiries and tax audits with local tax authorities; (ii) the Group's effective tax rate for the current year; and (iii) the level of provisioning for known and potential liabilities, including significant movements on the prior period. In addition, the Committee takes comfort from the presentation to the main Board on tax strategy and risk, given by the Group Head of Tax, every year. A summary of the Group's tax policy is provided in the Financial Review on page 48. Based on the work we have undertaken in the current year, we are satisfied that the position presented in these financial statements is reasonable and understandable.

[The Weir Group PLC Annual Report and Financial Statements 2014 \(p. 87 – 88\)](#)

Both these companies also provided clear cross references to where the relevant issues were also discussed in the financial statements, which helps to provide linkage between the various elements of the annual report and also provides further context for the reader. Overall only 41% of the companies in our sample provided similar cross references.

Correlation between the significant financial statements issues discussed in the audit committee report and the risks described in the auditor's report was interesting in the companies in our sample.

It is true that an audit committee might choose to spend time on a financial reporting issue which the auditors do not view as a significant risk of material misstatement, so there will be some differences in the lists of issues raised. However, without some level of consistency in the terminology used when discussing similar issues, readers are left to use their own judgement and analysis to determine if there are unexplained or unjustifiable differences between the issues noted by the audit committee and those being noted as areas of focus by the auditor.

Chapter 13 explains that there are fewer references this year in audit reports to the two 'standard' significant risks set out in auditing standards (revenue recognition and management override of internal controls) which has led to fewer differences between the audit risks in the audit report and the significant issues discussed by the audit committee. Another area where we expect a substantial degree of cross-over is between these two areas and the critical accounting judgements and key sources of estimation uncertainty in the financial statements.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

An example of a clear reference to the critical accounting judgements and key sources of estimation uncertainty from the audit committee report is below:

- the Committee reviewed the significant judgements relating to rebates, including the disclosures made in the critical accounting estimates and judgements section in Note 3 to the financial statements on page 96. Based on the reports received from the Group's finance function, the significant majority of the Group's supplier income relates to volume-based agreements, with the remainder representing other rebate income for which recognition is more judgemental. The Committee noted that volume-based income is largely based on calendar year purchases, therefore the risk of misstatement is reduced significantly for year-end reporting. The Committee reviewed the report from the Group finance and risk functions of the application of those key judgements and the related controls in place over all rebates, and is satisfied with the judgements taken and control environment in relation to the recognition of rebate income and financial statement reporting.

[Kingfisher plc Annual Report 2014/15 \(p. 43\)](#)

The matters covered in each area are not expected to be identical, but a close correlation would ordinarily be expected. The table below indicates some of the reasons we have identified through our survey this year where there might be a difference between the significant issues related to financial reporting discussed by the audit committee, the audit risks described in the auditor's report and the critical accounting judgements and key sources of estimation uncertainty disclosed in the financial statements. We would expect the audit committee to consider differences between these when determining whether they have adequately discussed and disclosed all the most significant issues related to financial reporting.

Issue discussed	Audit committee report?	Audit report?	Financial statements?
The most material judgements and key sources of estimation uncertainty relating to the financial statements	✓	✓	✓
Sometimes includes the 'standard' significant risks set out in auditing standards	X	✓	X
Less material judgements and key sources of estimation uncertainty – for instance historically material matters	X	X	✓
Items on the regulatory agenda – for instance exceptional items	✓	✓	X
Exercise judgement in deciding which of the issues ... are significant, but should include at least those matters that have informed the board's assessment of whether the company is a going concern (FRC Guidance on Audit Committees 5.3) – going concern and funding issues appear more often	✓	X	X
Only the risks with the <b>greatest effect</b> on the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team (ISA (UK & Ireland) 700.19)	X	✓	X
The audit committee may have spent time on a potential exposure that it becomes clear is not material to the financial statements	✓	X	X
Risks relating to internal controls over financial reporting, including IT risks	✓	✓	X
Risks relating to reported or potential fraud	✓	X	X
Significant issues relevant to audit committee reporting, for example the fair, balanced and understandable assertion	✓	X	X

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## Effectiveness of the external audit process

As last year, there has been a mixed response to the new requirement for the audit committee to explain how it has assessed the effectiveness of the external audit process. All of the FTSE 100 companies surveyed, included an explanation, as did 92% of the FTSE 250 companies (2014: 95%) and 73% of the smaller listed companies (2014: 61%). Again, we rated the disclosures on this assessment as brief, moderate or comprehensive. 64% were deemed to be brief, 27% moderate and only 9% comprehensive.

The FRC issued an 'Audit Quality Practice Aid'<sup>60</sup> for audit committees in May 2015. The aid focusses on assessing audit quality and has been developed from feedback from audit committee members, investors, financial management and auditors. As well as setting a framework for the committee's evaluation, the aid sets out practical suggestions on how audit committees might tailor their evaluation in the context of the company's business model and strategy; the business risks it faces; and the perception of the reasonable expectations of the company's investors and other stakeholders.

Good examples of comprehensive disclosures on the assessment of the effectiveness of the external audit process, which explain the process undertaken; the method of assessment; key parties involved and the particular aspects of the audit process assessed, were given by Halma plc and Weir Group plc.

### External audit effectiveness

The effectiveness of the external audit process is assessed by the Committee, which meets regularly throughout the year with the audit partner and senior audit managers. Key to the overall effectiveness of the process is a 'no surprises' approach adopted by both the Group and the Auditor under which each party makes the other aware of accounting and financial reporting issues as and when they arise, rather than limiting this exchange to the period in which formal audit and review engagements take place.

This general approach is supported by a formal annual survey process involving subsidiary and Group management as well as Audit Committee members and attendees.

Surveys are tailored and issued to three distinct groups of respondents:

- Subsidiary Finance Directors;
- Sector Chief Executives, Sector Vice Presidents and Sector Finance Directors; and
- Audit Committee members and attendees.

The survey completed by the first group is divided between questions focusing on audit quality and client service. As this group is involved primarily in the execution phase of the audit, the responses cover practical audit management issues as well as observations made of the integrity and quality of audit field teams. The second and particularly the third group interact mainly with senior audit management and the audit partner and so the survey covers more general audit planning and wider issues around the audit relationship.

In addition to assessing the effectiveness of the external Auditor the Committee recognises that Group management has an important role to play in the overall effectiveness of the external audit process and the Auditor is therefore asked to conduct its own survey of both subsidiary and head office companies with which Deloitte interacts. This survey addresses items such as the timeliness, quality and reliability of data provided to the Auditor.

Taken together, the Committee believes that sufficient and appropriate information is obtained to form an overall judgment on the effectiveness of the external audit process. The external audit effectiveness process findings from last year's review were also incorporated into our audit processes this year.

[Halma plc Annual Report and Accounts 2015 \(p. 68\)](#)

### Auditor effectiveness

The effectiveness of the external audit process is dependent on appropriate audit risk identification at the start of the audit cycle. EY present their detailed audit plan to us each year identifying their assessment of these key risks. For the current period, the significant risks identified were the carrying value of goodwill and intangible assets, valuation of inventory, adequacy of liability provisioning, including provisions for legal obligations, exceptional items and the exposure to significant tax risks due to the inherent management judgement required in all these areas. Our work in each of these areas has been covered in detail earlier in this report.

Our assessment of the effectiveness and quality of the audit process in addressing these matters is formed by, amongst other things, a review of the reporting from the auditors to the Committee and also by seeking feedback from management on the effectiveness of the audit process. During the first half of the year, management issued a detailed questionnaire to every Finance Manager/Director and Divisional Finance Director to collect feedback on the 2013 audit process. This covered resource and expertise of the audit teams, quality of planning, execution and deliverables as well as an assessment of overall performance.

Resultant themes and findings were discussed between ourselves, management and EY with both management and the auditors reporting to us on the actions being implemented in response. In addition, on a periodic basis, the Finance Director and Group Financial Controller meet with the overseas external audit teams.

[The Weir Group PLC Annual Report and Financial Statements 2014 \(p. 89 – 90\)](#)

60. <https://frc.org.uk/News-and-Events/FRC-Press/Press/2015/May/FRC-provides-aid-to-Audit-Committees-in-evaluating.aspx>

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

**Auditor effectiveness (continued)**

The Committee discussed the Audit Quality Inspection report on EY issued by the FRC in May 2014 at its meetings in July and September and I also had a separate meeting with the lead audit partner to discuss the report. Although the principal findings of the FRC report indicated a deterioration on the previous year, the Committee agreed that this report, in itself, did not have an impact on our assessment of audit effectiveness at Weir.

Overall management were satisfied that there had been appropriate focus and challenge on the primary areas of audit risk, although there are of course some areas where improvements can be made, and assessed the quality of the audit process to be good. Based on the input from management and discussions we have had with EY and key finance individuals, we also hold this view. This process will be repeated in respect of the 2014 audit in advance of the Committee's meeting in July 2015.

The Committee holds private meetings with the external auditor each year to provide additional opportunity for open dialogue and feedback from the Committee and the auditor without management being present. Matters typically discussed include the auditor's assessment of business risks and management activity thereon, the transparency and openness of interactions with management, confirmation that there has been no restriction in scope placed on them by management and how they have exercised professional scepticism. I also meet with the lead audit partner outside the formal committee process as necessary throughout the year.

[The Weir Group PLC Annual Report and Financial Statements 2014 \(p. 89 – 90\)](#)

As part of its investigation of the Statutory Audit Services Market, the Competition & Markets Authority (CMA) recommended that audit committees of FTSE 350 companies whose audit had been reviewed by the FRC's Audit Quality Review Team should disclose the principal findings and grade assigned to it in the annual report and accounts together with how they and the auditors were responding to the issues raised. In response to this, in November 2014, the FRC announced that it will consult on the CMA's recommendation in time for updates to the UK Corporate Governance Code to be made in 2016. In particular, the FRC cautioned audit committees to take care if they wished to mention that an Audit Quality Review inspection had taken place of the audit file of their company and recommended that the inspection grade should not be disclosed and that care must be taken not to imply that the FRC endorses their financial statement judgements.

From our sample we found just one example of an audit committee discussing an Audit Quality Review inspection of the audit file of their company. In line with the recommendation by the FRC, the final grade awarded is not referred to. The audit committee makes reference to having met with the FRC to discuss the findings.

The Audit Quality Review team of the Financial Reporting Council undertook a routine review of the 2013 external audit files following which the Audit Committee Chairman met the FRC to review its findings. The Committee is satisfied that these were adequately reflected in the 2014 audit approach adopted.

[Persimmon Plc Annual Report – December 2014 \(p. 47\)](#)

**Audit tendering**

The frequency of audit tendering and the length of the relationship between the external auditor and the companies they are auditing has been a key area of focus since the 2008 financial crisis. The 2012 Code introduced a requirement for FTSE 350 companies to put their audit out to tender at least once every ten years and to provide disclosures around the length of the existing audit relationship and details on tendering policy. In addition the European Union and the CMA have also introduced new rules around mandatory tendering and rotation. The new EU Audit Regulation will apply for financial years commencing on or after 17 June 2016. Subject to transitional provisions, it will require mandatory firm rotation for the audits of public interest entities every ten years but allows Member States the option to extend that period to twenty years as long as a tender is undertaken after ten years. The UK Government has confirmed that the UK will be taking the extension to twenty years for the mandatory rotation period. The CMA Order applies to FTSE 350 companies for periods commencing on or after 1 January 2015 and imposes ten year mandatory tendering, so this is compatible with the new EU requirements.

As expected, in light of the Code provision, the number of companies providing information on the tenure of the incumbent auditor continues to increase from 75% in 2014 to 85% in 2015. Across the companies surveyed the average length of tenure of the auditor was 13 years (FTSE 100: 22 years (2014: 28 years), FTSE 250: 12 years (2014: 11 years) and Other: 9 years (2014: 10 years)).

The number of companies committing to a tendering frequency has risen from 11% to 20% and all of these were every 10 years, as in the Code provision, with one exception in the smaller listed companies category where the tendering frequency was to be every 20 years. The number of companies providing an indication of when an audit tender would be undertaken has also increased from 35% to 48%, typically taking advantage of the transitional arrangements allowed for by the Code provision and/or coinciding with the rotation of the current engagement partner.



# 13. The auditor's report

## 1. Executive summary

## 2. How to use this document

## 3. Regulatory overview

## 4. Survey objectives and methodology

## 5. Overall impressions

## 6. Summary material

## 7. The strategic report

## 8. Key performance indicators

## 9. Principal risks and uncertainties

## 10. Going concern and viability

## 11. Corporate governance

## 12. The work of the audit committee

## 13. The auditor's report

## 14. Primary statements

## 15. Notes to the financial statements

## Appendix 1 – Glossary of terms and abbreviations

## Other resources available

### Keep an eye on

- All companies in our sample published an enhanced auditor's report. There were no qualified reports and one report that discussed a material uncertainty relating to going concern. For all companies, this was the second or third year that this enhanced report was produced by their auditor.
- Significant changes compared to the first year included:
  - auditor disclosures where the statutory auditor changed;
  - disclosure of changes to audit risks and materiality compared to the prior year; and
  - disclosure of details of the findings of the auditor's work on audit risks by 28% of auditors (2014: 0%).
- The average number of audit risks disclosed for FTSE 100 companies was five (2014: five), the average for FTSE 250 companies was four (2014: four) and the average for smaller companies was three (2014: four).
- Where the auditor uses component auditors to conduct all or part of the work, 61% provided a detailed description of ways the group auditor interacts with the component auditors (2014: 30%).
- There was an improved level of disclosure regarding the proportion of the company's results that had been subject to audit procedures, with 91% of audit reports explaining the level of audit coverage of key financial statement measures such as turnover (2014: 77%).

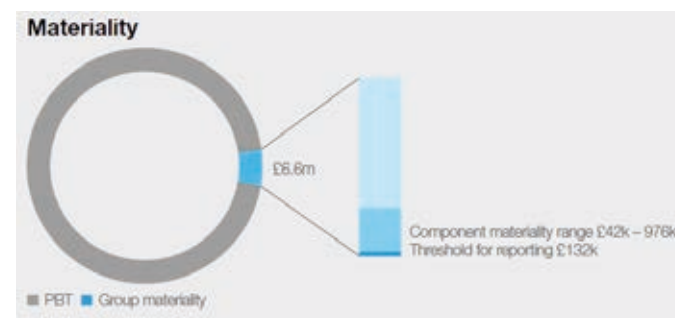
### The enhanced audit report

At the time of our last survey, the majority of companies affected by the 2013 revisions to audit reporting had already published an annual report including an 'enhanced' audit report (an audit report including the auditor's comments on risks, materiality and scope). This year the majority of companies affected are in the second year of enhanced reporting.

Although the audit report is written by the auditor, it is read in conjunction with the audit committee report and the financial statements. In order to present a clear picture to shareholders it is important that these are broadly consistent.

In addition, there are areas of presentation or content that audit committees and preparers may wish to discuss with their auditor to align the report more closely with the remainder of the annual report.

This year we have noticed more reports where presentation echoes the rest of the annual report, for instance the audit report is more likely to include diagrams, graphs and tables where the rest of the annual report takes a more visual approach to presenting information. An example is Halma plc.



[Halma plc Annual Report and Accounts 2015 \(p. 97\)](#)

The audit report is on a journey of ever-increasing transparency from the 'boilerplate' information we saw in 2013 to a future when almost all reports will include focused, entity-specific information that dovetails with the audit committee report and discloses details of the findings of the auditor's work on audit risks. This year is only the second year of that journey.

### Year 2 reporting

It is not a surprise to see that there have been changes since the first year of reporting. In particular, the auditors have now engaged with the need to explain changes in their approach from prior year, with regard both to audit risks and materiality.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Our assessment of risks of material misstatement

The assessed risks of material misstatement described below are those that had the greatest effect on our audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team. These risks are the same as those discussed in 2013 but with the addition of going concern on the grounds that there has been a significant drop in the oil price.

[Premier Oil plc 2014 Annual Report and Financial Statements \(p. 132\)](#)

### Materiality

We determined materiality for the Group to be £1,082,000 (2013: £377,000), which is approximately 5% (2013: 2%) of operating profit for the year and which would have a non-recurring impact on profit. Our materiality as a percentage of operating profit increased in the year, based on our assessment of the reduction in the risk over going concern from previous periods.

[Skyepharma PLC Annual Report and Accounts for the year ended 31 December 2014 \(p. 72\)](#)

Some companies in our sample have also changed auditor since the prior year. An example where there has been informative disclosure regarding how the auditor has managed this change is the Marks and Spencer Group Plc audit report.

### We visited all significant components during the year

The most significant component of the Group is its retail business in the United Kingdom, which accounts for 89% of the Group's revenue, 91% of the Group's operating profit and 50% of the Group's net assets. The Group audit team performs the audit of the UK business without the involvement of a component team. During the course of our audit, the Group audit team conducted 16 distribution centre and 27 retail store visits in the UK to understand the current trading performance and, at certain locations, perform tests of internal controls and validate levels of inventory held.

Since this was our first year as the Group's auditor, we visited each of the eight significant locations outlined above at

least once. Each component was visited during our transition, planning and risk assessment process, in order for a senior member of the Group audit team to obtain a thorough understanding of the operations, risks and control environments of each component. For more significant or complex components, we conducted a second visit during the audit to review the component auditor's working papers and attend key meetings with component management.

Going forward, we will follow a programme of planned visits that has been designed so that a senior member of the Group audit team visits each of the locations where the Group audit scope was focused at least once every two years, and the most significant of them at least once a year.

In years when we do not visit a significant component we will include the component audit team in our team briefing, discuss their risk assessment, and review documentation of the findings from their work.

In addition to our visits in these locations, senior members of each component audit team attended a two-day training programme hosted by the Group audit team covering topics which included understanding the business and its core strategy, a discussion of the significant risks and workshops on our planned audit approach.

[Marks and Spencer Group Plc Annual Report & Financial Statements 2015 \(p. 88\)](#)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

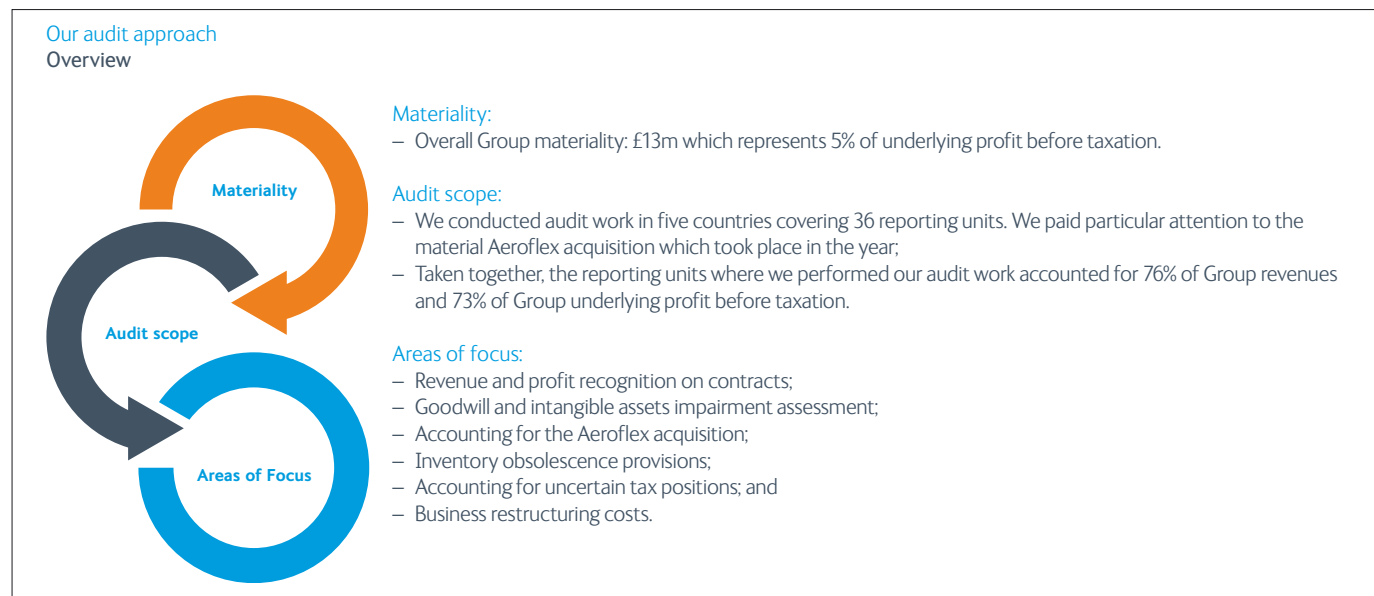
14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Another change is the introduction of an 'executive summary' with a few key details of one or more of materiality, scope and audit risks by a minority of our sample. We have noted a move towards the audit report becoming longer and more detailed (also see section on 'Significant issues and audit risks' below). The reader may therefore benefit from accessing highlights of the key statutory requirements. For instance, the audit report for Cobham plc provides the following summary.



[Cobham plc Annual Report and Accounts 2014 \(p. 70\)](#)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor’s report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

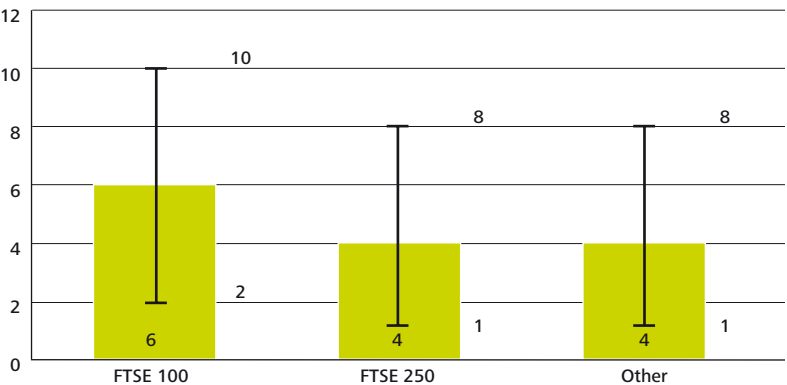
Significant issues and audit risks

As we would expect, there continues to be a high degree of cross-over between the significant issues relating to financial reporting disclosed by the audit committee and the risks disclosed by the auditor. There is also a correlation between these and the critical judgements and key sources of estimation uncertainty discussed in companies’ financial statements – this is discussed in chapter 12.

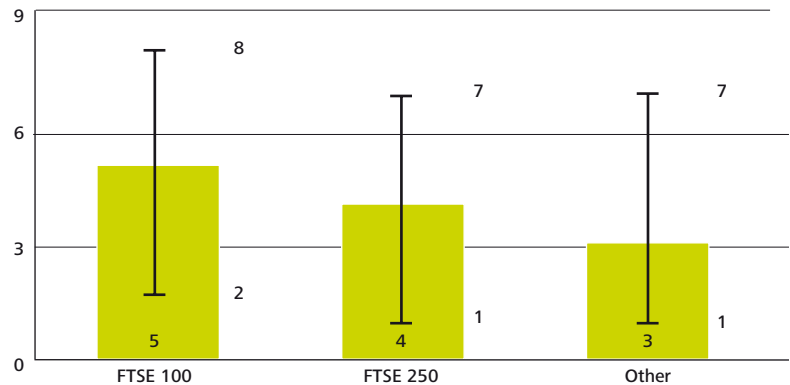
Figure 13.1 compares the number of significant issues disclosed in the audit committee report to the number of risks in the audit report. The variation in the number of risks in the audit report for FTSE 250 and smaller companies has increased this year at between one and seven (2014: FTSE 250 – two to six, smaller companies – one to six).

Figure 13.1 How many significant financial statement issues and audit risks were disclosed?

Number of financial statement issues discussed by the audit committee in their report



Number of audit risks discussed by the auditor in their report



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

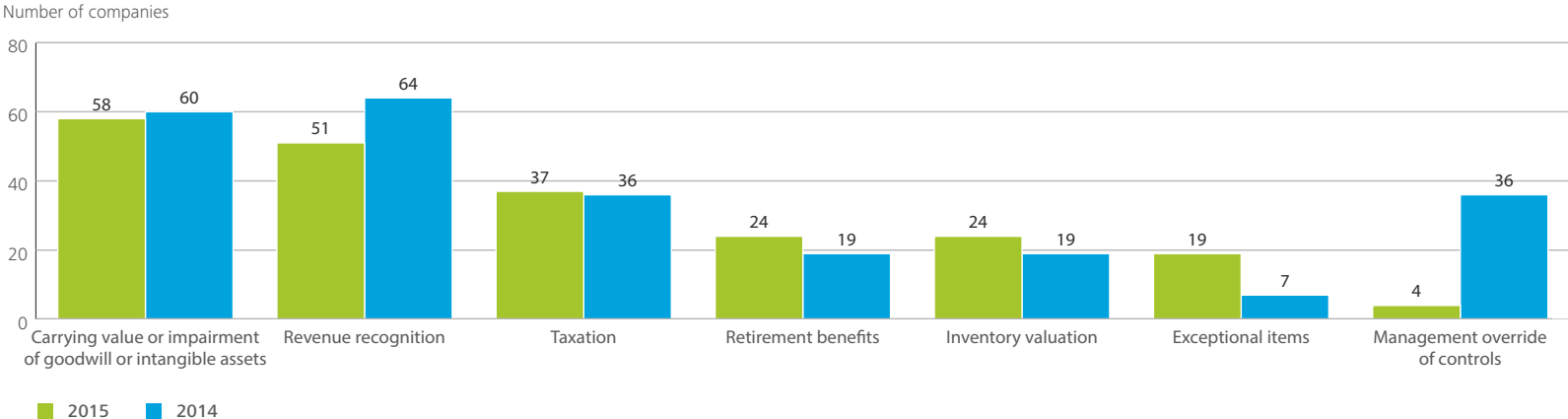
15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

The nature of the audit risks included in the audit report has changed in the second year, with a reduction in reporting of the two 'standard' significant risks set out in auditing standards – a rebuttable presumption that the risk of fraud in revenue recognition will be significant and a substantial reduction in reporting of the mandatory significant risk of management override of controls. Revenue recognition is still a common risk, although this is often included more broadly than the risk of fraud; management override of controls is more common in companies with complex control environments, dominant management and/or changes in the year. This is shown in the graph below.

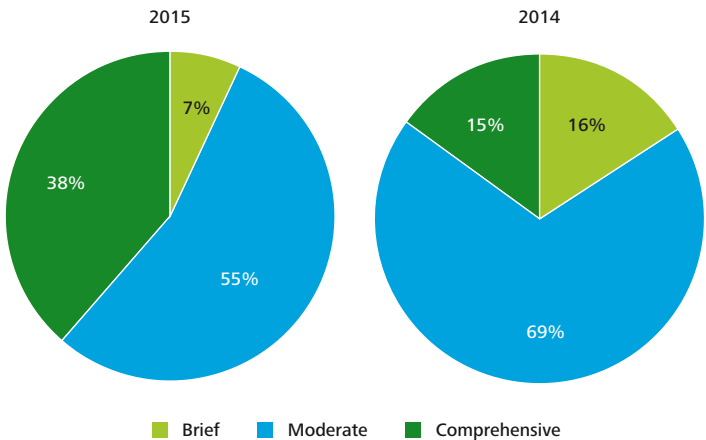
**Figure 13.2 What were the most common audit risks included in the audit report**



32 audit reports disclosed one or more risks (an average of two) that were not discussed as significant issues by the audit committee (2014: 55 audit reports, two risks). This reduction in number of audit reports which disclosed additional risks was largely attributable to the fall in disclosure of the risk of management override of controls. There were no consistent themes to the audit risks that were not discussed by the audit committee.

48 audit committees discussed significant issues that were not disclosed as risks by the auditor (2014: 43 audit committees). The most common of these were going concern (twelve companies, 2014: 13 companies), identification and disclosure of exceptional or non-recurring items (ten companies, 2014: eight companies) and provisions for a variety of exposures (ten companies, 2014: five companies). Using our own judgement we rated the auditors' disclosures on the risks as brief, moderate or comprehensive. The results were as set out in Figure 13.3

**Figure 13.3. How extensive were the auditors' disclosures on risks?**



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Last year, we expected that over time auditors' risk descriptions would become more concise as the quality of audit committee reporting improved, with increased use of cross-references. However, instead we have seen a substantial increase in the number of audit reports with a comprehensive level of description – a movement towards including all relevant information in the audit report so that it makes sense on a standalone basis. Related to this, we have also seen a reduction in the number of audit reports indicating that the reader should refer to the audit committee report (80% compared to 84% in 2014). Auditors' descriptions have also become more granular and tailored to the company's circumstances.

We have however seen some good examples of audit reports providing cross-references to relevant disclosures in the financial statements, a trend we expect to continue. Examples can be seen in both audit reports used to illustrate the Findings on audit risks section in next page.

## Findings on audit risks

Where relevant, key observations arising with regard to audit risks will be a required disclosure under the new EU Audit Regulation, which is currently the subject of government consultation and is due to be adopted in the UK during 2016. 28% of the audit reports in our sample disclosed findings on specific audit risks (2014: 0%). The approach to disclosure varies from a format with subheadings drawing the reader's attention to the findings to comments included in the text of the auditor's response to the risks. Extracts showing both approaches are below:

## 2 IMPAIRMENT OF STORE ASSETS

### Risk description

As described in the Accounting Policies in note 1 and in note 15 to the financial statements, the Group held £5,031.1m of property, plant and equipment at 28 March 2015. There is a risk that the carrying value of stores and related fixed assets may be higher than the recoverable amount. When a review for impairment is conducted, the recoverable amount is determined based on value in use calculations which rely on the directors' assumptions and estimates of future trading performance.

The key assumptions applied by the directors in the impairment reviews are:

- Country-specific discount rates.
- Future revenue growth.
- Trading margin.

→ Store costs, including rent, staff payroll costs and general operating costs.

The directors consider that each retail store constitutes its own cash generating unit ('CGU'), with the exception of the outlet stores which are used to clear old season

general merchandise stock at a discount, and certain strategic stores. The outlet stores are considered to represent one CGU in aggregate and strategic stores are evaluated as part of a country-wide impairment review.

The Group's accounting policy sets out a relevant shelter period for new stores to be taken into account when assessing indicators of impairment during initial years of trading to enable the store to establish itself in the market.

### How the scope of our audit responded to the risk

We considered the appropriateness of the methodology applied by the directors in calculating the impairment charges, and the judgements applied in determining the CGUs of the business.

We assessed the impairment models and calculations by:

- Checking the mechanical accuracy of the impairment models.
- Assessing the discount rates applied to the impairment reviews for each country and comparing the rates to our internal benchmark data.

→ Comparing forecast growth rates to economic data.

→ Evaluating the information included in the impairment models through our knowledge of the business gained through reviewing trading plans, strategic initiatives, and meeting with senior trading managers from key categories and our retail industry knowledge.

We assessed the appropriateness of the shelter period for each store opened within that time frame, and compared the original investment case for the store against its

current trading performance. Where stores were trading significantly below the original case, we considered the evidence available to support future improvements in performance, specifically by assessing the trading plans and actions being taken on an individual store basis.

**Findings** We concluded that the assumptions applied in the impairment models were appropriate, including those made around shelter periods and no additional impairments were identified from the work performed above.

[Marks and Spencer Group Plc Annual Report & Financial Statements 2015 \(p. 84\)](#)



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

**Accuracy of revenue due to complex billing systems**

Refer to page 150 (Note 3 – Significant accounting policies) and page 155 (Note 4 – Segment information)

The accuracy of revenue amounts recorded is an inherent industry risk. This is because telecoms billing systems are complex and process large volumes of data with a combination of different products sold and price changes in the year, through a number of different systems.

We evaluated the relevant IT systems and the design of controls, and tested the operating effectiveness of controls over the:

- capture and recording of revenue transactions;
- authorisation of rate changes and the input of this information to the billing systems; and
- calculation of amounts billed to customers.

We also tested a sample of customer bills and checked these to cash received from customers. Our testing included customer bills for consumers, corporate and wholesale customers.

We found no significant exceptions in our controls testing and no material misstatements in our substantive testing.

There is a level of variation in the information provided by the auditor, with many audit reports simply stating in a similar sentence for each audit risk that there were no issues identified in the work performed. Some include an additional level of detail which is appreciably more informative.

It is worth noting that both risks are written with a minimum of jargon, and the Marks and Spencer Group Plc audit report also includes quantification of the risk – both of which are helpful to the reader.

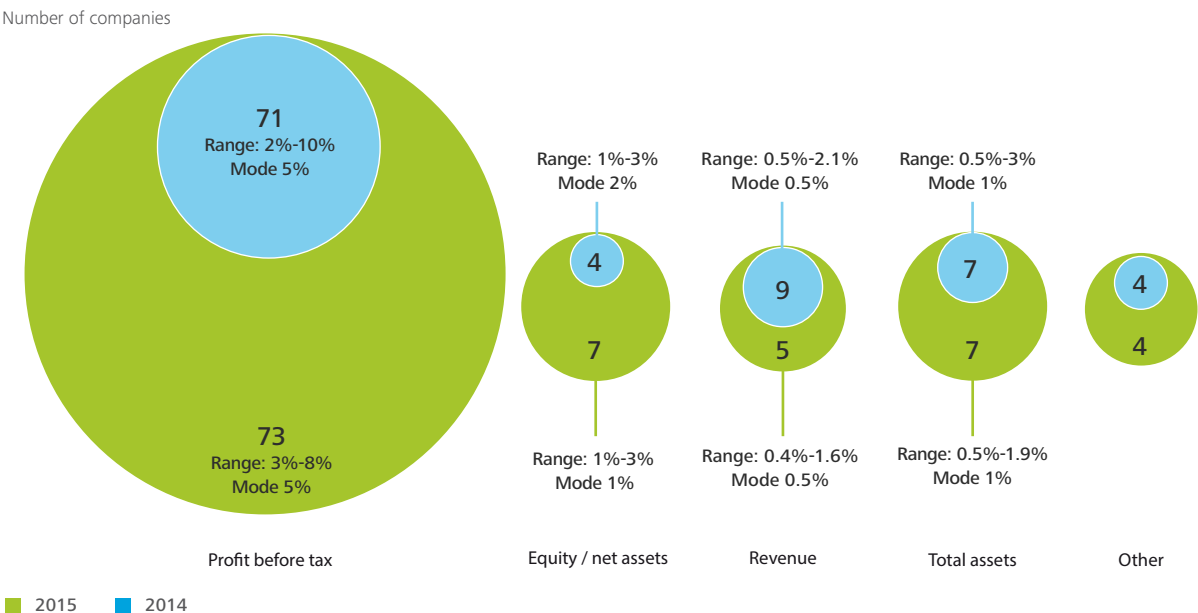
[BT Group Plc Annual Report and Form 20-F 2015 \(p. 139\)](#)

**Materiality**

The auditor is required to describe how they applied the concept of materiality in planning and performing the audit, including as a minimum the threshold used by the auditor as materiality for the financial statements as a whole.

Consistent with last year, almost all auditors explained the basis on which they had determined materiality. 91% (2014: 88%) also gave materiality as a percentage of a benchmark; a further 5% (2014: 7%) explained the benchmark used but without giving the percentage.

**Figure 13.4 What is the basis on which the auditor determined materiality?**



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

It is noticeable that the top end of almost all materiality ranges and in the case of net assets also the mode has decreased since our 2014 survey. For auditors using profit before tax as a benchmark, a pure average of the percentage given has dropped to 5.23% (2014: 5.6%).

We believe this is largely attributable to increased visibility of the way materiality is determined between audit firms and within industry sectors, driven both by the disclosure in the audit report and by the FRC's report (released December 2013).<sup>61</sup>

We determined planning materiality for the group to be US\$23 million (2013: US\$30 million), which is below 5 per cent (2013: 7.5 per cent) of normalised pre-tax profit. Pre-tax profit has been normalised through the exclusion of one-off items, including impairment charges, that are audited separately and would, if included, significantly distort the materiality calculation year-on-year. We have reduced the percentage applied to pre-tax profit in response to recent market and regulatory trends in this area.

[Premier Oil plc 2014 Annual Report and Financial Statements \(p. 135\)](#)

49 (2014: 44) of the auditors that used profit before tax as a basis used an adjusted measure and, of these, only 35% (2014: 50%) used a measure that was already discussed by the company in its financial statements, often as a non-GAAP profit measure. For 18 (2014: ten) of these companies, it was not possible to determine the same materiality figure based on the information provided in the audit report and financial statements.

We identified that 17 of the auditors using adjusted measures had adjusted amortisation of intangible assets out of the profit measure used to determine materiality (2014: 14). In four cases (2014: four) it was not possible to tell from the information provided.

We consider the disclosure more useful if the user can reproduce and reach their own conclusions on how the auditor approached the determination of materiality. Some auditors are improving the quality of disclosure in this area, including diagrams, figures and tables, or providing additional detail in the text, for instance this explanation of the use of an adjusted measure in the AO World Plc audit report which explains not only how the auditor had adjusted profit but why.

61. <https://www.frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Thematic-Review-Materiality.pdf>

**Our application of materiality**

We define materiality as the magnitude of misstatement in the financial statements that makes it probable that the economic decisions of a reasonably knowledgeable person would be changed or influenced. We use materiality both in planning the scope of our audit work and in evaluating the results of our work.

We determined materiality for the Group to be £603,000 (2014: £392,000), which is 5% (2014: 5%) of normalised pre-tax profit. Pre-tax loss has been normalised by adjusting for the start-up investment and losses incurred in the European operations as described in note 8 and for the costs incurred in relation to the Performance Share Plan (PSP), which was specific to the IPO in the previous financial year, as described in note 29.

The losses incurred in the European operations are considered to be part of an investment and start-up phase therefore not representative of the underlying pre-tax profit forecast in future periods. The charge in relation to the PSP relates specifically to an incentive plan to reward the management team for their successful IPO and accordingly reflect a much greater value compared to the other on-going share-based payment schemes in the Group. For these reasons, both items are considered to be required to be adjusted to give a true reflection of materiality relevant to the underlying trade of the Group.

[AO World Plc Annual Report and Accounts 2015 \(p. 76\)](#)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

7% of auditors have an additional, lower materiality level used to audit certain elements of the financial statements (2014: 3%). 10% disclosed performance materiality (2014: 14%) and all auditors disclosed the level at which differences identified were reported to the audit committee (2014: 97%).

**Scope of the audit**

This year there has been a notable increase in transparency in the area of audit scope and we hope this will lead to greater insight for investors and productive debate between auditors and audit committees regarding audit quality.

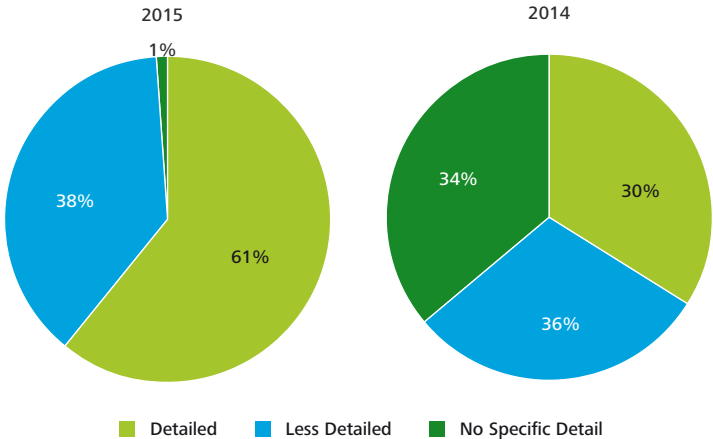
98% of companies (2014: 95%) presented audit reports where there was a description of how the auditor approached the overall engagement, in addition to the responses to specific audit risks. Of these, 91 audit reports (2014: 75 audit reports) provided sufficient information for the reader to understand how much of the group had been audited. The most common measure used to assist the reader in putting coverage into the context of the financial statements was profit before tax.

71 audit reports (2014: 70 audit reports) discussed component audits, with the remainder either not mentioning component audits or auditing the whole business centrally.

Using our own judgement we rated the auditors' disclosures on interaction with component auditors as detailed, less detailed or not containing any specific detail.

The audit reports in our sample have shown a substantial increase in relevant detail regarding the interaction of the group auditor with the component auditor. In some cases, the detail has gone even further into providing detailed explanations of the way the audit team has been set up, such as in this audit report on EVRAZ plc.

Figure 13.5. How comprehensive was the discussion on interaction with component auditors?



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Involvement with component teams

In establishing our overall approach to the Group audit we determined the type of work that needed to be undertaken at each of the components by us, as the Group audit team or by component auditors from other EY global network firms operating under our instruction. Of the 10 specific scope components selected audit procedures were performed on five of these directly by the Group audit team. For the components where the work was performed by component auditors, we determined the appropriate level of involvement to enable us to determine that sufficient audit evidence had been obtained as a basis for our opinion on the Group as a whole.

During the current year's audit cycle visits were undertaken by the Group audit team to component teams in Russia and Ukraine. These visits involved discussing the audit approach with the component team and any issues arising from the work. The Group audit team visited the component team in the USA in 2013 but not in the current year's audit cycle. For 2014 the main focus of the Group audit team was on the Russian and Ukrainian entities in response to the increased risk of the economic environment in those areas. The Group audit team interacted regularly with the component teams where appropriate during various stages of the audit, reviewed key working papers and were responsible for the scope and direction of the audit process. This, together with the additional procedures performed at group level, gave us appropriate audit evidence for our opinion on the Group Financial Statements.

### Integrated team structure

The overall audit strategy is determined by the senior statutory auditor, Ken Williamson. The senior statutory auditor is based in the UK but, since Group management and operations reside in Russia, the Group audit team includes members from both the UK and Russia. The senior statutory auditor visited Russia three times during the current year's audit and members of the Group audit team in both jurisdictions work together as an integrated team throughout the audit process. Whilst in Russia, he focused his time on the significant risks and judgemental areas of the audit. He attended management's going concern, impairment and significant estimates and judgements presentations to the Audit Committee where he challenged management on their assumptions. He met with Russian based members of the Group audit team including internal valuation specialists used in the audit. During the current year's audit he reviewed key working papers and met, or held conference calls, with representatives of the component audit team for all Russian based full scope components to discuss the audit approach and issues arising from their work.

# 14. Primary statements

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## Top tips

- Companies should continue to be careful when using non-GAAP measures as they remain a regulatory focus. 74% of the companies surveyed utilise such alternative performance measures.
- If you present non-GAAP information, make sure you explain why certain items are excluded. 12% of the companies utilising non-GAAP information failed to provide an explanation and only a little more than half of the explanations provided contained the detail requested by the FRC.
- If material, results from joint ventures or associates accounted for under the equity method should be presented separately in the income statement. Only 70% of all companies with investments in joint ventures or associates provided a separate line item.
- Consider reviewing your notes to find immaterial disclosures. If quantitatively and qualitatively immaterial disclosures should be deleted to help produce a 'clear and concise' report. 8% of all surveyed companies provided disclosures relating to balance sheet items that did not appear to give any material information.
- Consider the sufficiency of disclosures on restricted cash positions – the requirements are likely to be expanded soon under a new IASB proposition. Only 19% of the companies surveyed provided information on restricted cash.

## Keep an eye on

- The exclusion of fundamental reorganisations or restructuring results in several consecutive years contradicts the idea of 'exceptional items' – reconsider whether those are really exceptional.
- IAS 33 requires basic and diluted EPS figures when presenting an adjusted EPS. 9% of companies presenting such figures failed this requirement.
- Old UK GAAP cannot be continued for company financial statements for periods beginning on or after 1 January 2015. Companies must transition to either IFRS, FRS 101 or FRS 102 by then.

## Income Statements

Only 14 companies (2014: 17) presented a combined statement of profit or loss and other comprehensive income which five (2014: seven) were in the FTSE 350. The remaining 86 (2014: 83) companies preferred to present separate statements of profit or loss (frequently referred to as 'income statements') and statements of comprehensive income which includes other comprehensive income.

The organisation and presentation of information in the financial statements has moved back into the focus of the IASB in recent years, with various projects underway. In May 2015, the IASB published an exposure draft (ED) for a revised *Conceptual Framework*. The ED does not provide a definition of when an item of income or expense should be included in the statement of profit or loss or other comprehensive income (OCI). However, it includes a rebuttable presumption that all income and all expenses will be included in the statement of profit or loss. This presumption can only be rebutted by the IASB when setting standards and only if the income or expenses relate to assets or liabilities measured at current values, or if excluding those income or expenses from the statement of profit or loss would enhance the relevance of the information in the statement of profit or loss for the period. It will hence be interesting how the role of other comprehensive income will develop in the future.

## Operating Profit

Old UK GAAP effectively required presentation of a sub-total for operating profit but there is no such requirement in IFRSs. Nonetheless, our survey showed that 92 (2014: 91) companies present an operating profit row in their financial statements, in some cases describing it as 'net operating income', 'profit from operations' or 'results from operations'.

## Non-GAAP performance measures

Non-GAAP information encompasses additional subtotals or aggregation in the financial statements beyond those specified by IFRSs. For the purposes of this section of our survey, metrics such as profit before exceptional items were still regarded as non-GAAP measures even if they were presented as a measure of segment of profit or loss in accordance with IFRS 8 because that is what is reported internally.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

In December 2013, the FRC issued a reminder on the need to improve the reporting of additional and exceptional items by companies and ensure consistency in their presentation<sup>62</sup>. 63 (2014: 68) of the companies we surveyed provided non-GAAP measures on the face of their income statement whilst an additional eleven that did not present non-GAAP information on the face of their income statement provided non-GAAP performance measures somewhere else in the financial statements. There was no clear reason why these companies chose not to present their non-GAAP information on the face of the income statement – perhaps they felt that it did not merit this level of prominence. This means that overall only 26 companies did not provide any non-GAAP performance measures in their financial statements.

In February 2015 the IASB discussed principles of disclosure related to alternative performance measures during their deliberations on the Disclosure Initiative. The Board expressed mixed views on whether alternative performance measures should be allowed in the financial statements, especially their presentation on the face of the primary financial statements. There was also a demand amongst Board members for more rigour around the definition of alternative performance measures. The IASB staff is currently preparing a discussion paper on the principles of disclosure that is expected to be published in Q1 of 2016. This project may eventually impact the presentation of non-GAAP measures in the financial statements.

Other regulators have also started to pick up on this topic in recent years. For example, ESMA recently issued its 'Guidelines on Alternative Performance Measures'. Details on this paper can be found in the regulatory overview in chapter 3.

In their 2014 Corporate Reporting Review Annual Report, the FRC stated that they will continue to review the manner in which companies report exceptional items, especially regarding the associated accounting policies, the consistency, the terms used, the symmetry between debits and credits and the presentation of comparative information. In relation to this, 49% of the preparers in our survey who presented non-GAAP information provided the users of their financial statements with a detailed explanation of why certain items were excluded from the IFRS results. Such explanations included the objective and criteria for stripping out certain items as well as information regarding their comparability and their relation to IFRS figures.

62. <https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2013/December/FRC-seeks-consistency-in-the-reporting-of-exceptional-items.aspx>

Another 39% gave just a generic description, which did not clearly explain why specific items had been stripped out. Only 12% (2014: 21%) did not explain why they utilised a non-GAAP measure in their financial statements. For those that did give an explanation, this information could usually be found easily in the accounting policy note.

A good example of why certain items were excluded from IFRS results was provided by Kingfisher plc:

*Use of non-GAAP measures*

In the reporting of financial information, the Group uses certain measures that are not required under IFRS, the Generally Accepted Accounting Principles ('GAAP') under which the Group reports. Kingfisher believes that retail profit, adjusted pre-tax profit, effective tax rate, adjusted post-tax profit and adjusted earnings per share provide additional useful information on underlying trends to shareholders. These and other non-GAAP measures such as net debt/cash are used by Kingfisher for internal performance analysis and incentive compensation arrangements for employees. The terms 'retail profit', 'exceptional items', 'adjusted', 'effective tax rate' and 'net debt/cash' are not defined terms under IFRS and may therefore not be comparable with similarly titled measures reported by other companies. They are not intended to be a substitute for, or superior to, GAAP measures.

[Kingfisher plc Annual Report and Accounts 2014/2015 \(p. 90\)](#)



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

The identification of exceptional items is an area that can be very judgemental. It is therefore often a focus of the audit committee (see chapter 12) and will also often be disclosed under the significant accounting judgements in the notes (see chapter 15).

In our survey, 30% of the preparers who utilised non-GAAP performance measures broadly described them as 'before exceptional items', 21% used the term 'underlying performance' and 19% defined their non-GAAP performance measure as 'adjusted'. Examples for other descriptions used were 'profit before specific items', 'trading profit' or 'profit before non-recurring items'. Some preparers used industry-specific measures. Those figures are fairly consistent to our survey last year. The only notable difference is that none of the companies failed to describe the non-GAAP measures presented whilst in the prior year those were 10%. This might be a result of the FRC's efforts to improve disclosure around non-GAAP measures.

Figure 14.1. How are the non-GAAP performance measures broadly described?

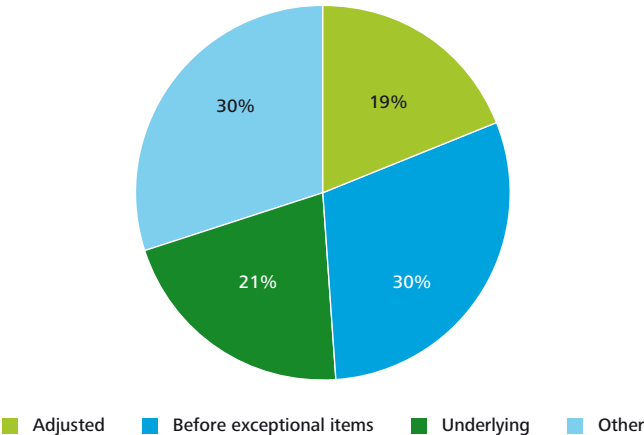
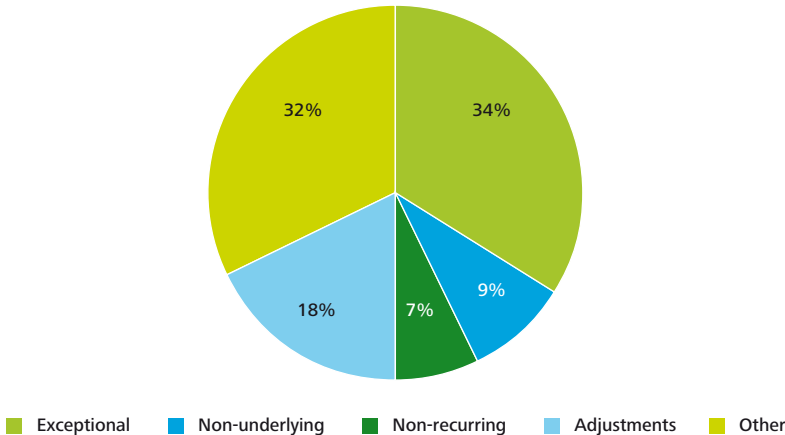


Figure 14.2. How are the excluded items broadly described?



Other descriptions included 'specific items', 'other items' or 'non-trading items'.

As shown by Figure 14.3, a majority of the companies that provided non-GAAP performance measures stripped out fundamental reorganisations or restructurings, which are often one-off items. However, the FRC highlighted restructuring costs in their press notice as an example of a category of material items that could potentially recur each year in similar amounts. The FRC therefore asked companies to consider whether such amounts should be included as part of underlying profit.

A significant number of preparers (albeit less than in our previous survey) stripped out amortisation in arriving at their non-GAAP measure of profitability. In doing this, amortisation was usually distinguished from exceptional or non-recurring items but still stripped out in the same way. Such an approach appears to follow the letter of the FRC's recommendations in terms of not labelling recurring amortisation as exceptional, but their identical treatment could call into question whether the spirit of the recommendations has been complied with.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

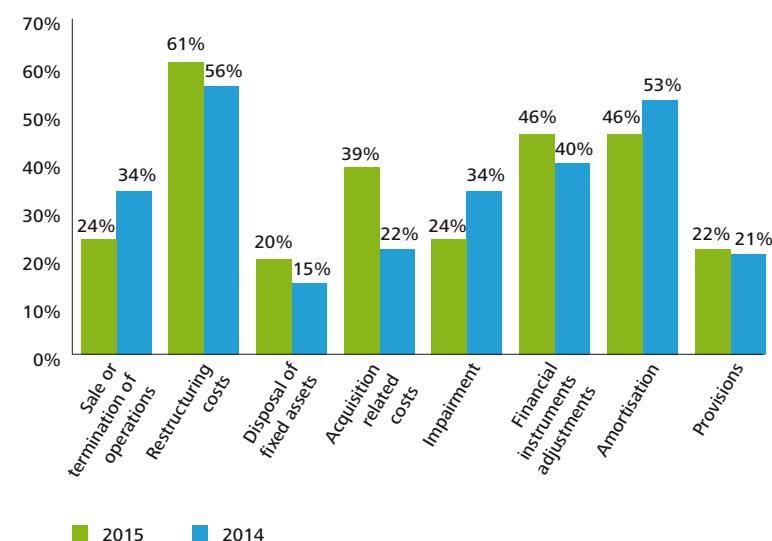
Appendix 1 – Glossary of terms and abbreviations

Other resources available

The figure also shows that other items that were frequently stripped out included items that were linked to financial instruments (46%), acquisition costs (39%) and results from the sale or termination of operations (not including discontinued operations) (24%). Examples of other items occasionally excluded but which aren't illustrated in Figure 14.3 were items relating to share-based payments or pension schemes, valuation gains or losses, tax-related income and expense, foreign currency adjustments and certain industry-specific items.

The survey showed that, compared to the prior year, less companies excluded impairment-related items. This is consistent with the decrease in the number of companies that recognised impairment losses, as discussed in Chapter 15, and could be a result of the improving economic conditions with less impairments arising. Other significant movements from our previous survey include an increase in numbers of companies that excluded acquisition-related costs and a decrease of excluding costs in relation to selling or terminating operations and amortisation.

Figure 14.3. What do non-GAAP measures strip out?



Those groups that presented non-GAAP measures on the face of the income statement preferred to include additional lines in the income statement (51%, 2014: 47%). Other preparers chose additional columns to the income statement (38%, 2014: 40%) or a combination of columns and lines (8%). Various IASB constituents have expressed concerns that additional information disclosed on the face of the financial statements may give undue prominence to that information and hence receive excessive attention by users. However, in its ongoing discussions on the principles of disclosure, the IASB has not indicated that they intend to entirely prohibit such a presentation. The FRC has stated that it supports this position which is also welcomed by us.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

A good example of how to present clearly distinguished non-GAAP information on the face of the income statement was provided by Compass Group PLC. They presented the non-GAAP information in a separate statement below the income statement.

## ANALYSIS OF OPERATING PROFIT

FOR THE YEAR ENDED 30 SEPTEMBER 2014

	Notes	Total 2014 £m	Total 2013 £m
<b>CONTINUING OPERATIONS</b>			
Underlying operating profit before share of profit of associates		<b>1,236</b>	1,255
Share of profit of associates		<b>9</b>	10
Underlying operating profit <sup>1</sup>		<b>1,245</b>	1,265
Amortisation of intangibles arising on acquisition	11	<b>(25)</b>	(25)
Acquisition transaction costs	26	<b>(3)</b>	(3)
Adjustment to contingent consideration on acquisition		<b>–</b>	1
Operating profit after costs relating to acquisitions and before exceptional items		<b>1,217</b>	1,238
European exceptional	2	<b>–</b>	(59)
Goodwill impairment	2, 10	<b>–</b>	(377)
<b>Total operating profit</b>		<b>1,217</b>	802

1 Underlying operating profit excludes European exceptional and goodwill impairment, amortisation of intangibles arising on acquisition, acquisition transaction costs and adjustment to contingent consideration on acquisition.

[Compass Group PLC Annual Report 2014 \(p. 81\)](#)

We expect that non-GAAP measures will continue to be used by preparers of financial statements to allow users to assess the entity's ability to create future cash flows. While we agree with the overall concept of using non-GAAP measures, our survey has showed that there is still room for improvement regarding transparency and appropriate presentation in that area.

### Discontinued Operations

IFRS 5 requires entities to present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations. Specifically, an entity should disclose the post-tax profit or loss of discontinued operations. Our survey showed that ten (2014: 16) companies presented discontinued operations on the face of their income statement, eight of which had sold operations whilst two had terminated operations.

IAS 33 requires entities that report a discontinued operation to disclose the basic and diluted amounts per share for the discontinued operation either in the statement of comprehensive income, or in the notes to the financial statements. Four of the companies that presented discontinued operations provided a reconciliation of their earnings per share figure for continuing operations and their earnings per share for discontinued operations to their total earnings per share on the face of the income statement. One company provided continuing and discontinued earnings per share in their income statement but did not provide a total number. Five of the companies that had discontinued operations did not provide earnings per share figures for their discontinued operations on the face of the income statement but provided figures that still met the requirements of IAS 33.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Share of joint ventures and associates

Although IAS 1.82(c) lists the presentation of the share of the profit or loss of associates and joint ventures accounted for under the equity method as one of the minimum requirements in the profit or loss section or the statement of profit or loss, only 42 of the 60 companies (70%, 2014: 88%) with investments in joint ventures or associates included that line item in their income statement. Some of the other 18 explicitly cited materiality reasons for not including a separate line. It is possible that the remainder also omitted the disclosure on the basis of materiality but did not include a statement to that effect. Regulators have indicated that they do not expect an explicit statement when such items have been excluded because of materiality reasons.

### Earnings per share

IAS 33 prescribes the principles for determining and presenting earnings per share (EPS) amounts in order to improve performance comparisons between different entities in the same period and between different accounting periods for the same entity.

Often, companies disclose an 'adjusted' EPS figure in addition to the EPS figure calculated in accordance with IAS 33. In our survey, 70 (2014: 63) preparers decided to present adjusted EPS figures in their financial statements. Within those, 39 (55%, 2014: 51%) presented the figures on the face of the income statement and 31 (44%, 2014: 49%) disclosed the adjusted figures in the notes only.

IAS 33 mandates that adjusted figures should be included in the notes to the financial statements and that basic and diluted adjusted measures be presented with equal prominence. It is not clear whether presentation of adjusted measures both in the notes and on the face of the income statement is permitted.

91% (2014: 81%) of those who included an adjusted EPS figure in their financial statements provided a basic and diluted adjusted EPS. Only 9% did not provide a diluted adjusted EPS. We welcome this improvement as it is in line with the FRC's call for improving the reporting of additional items and hope that more companies will follow the example in future years.

### Balance sheet

In 2007, the IASB amended IAS 1 to change (among other things) the term 'balance sheet' to 'statement of financial position'. After this amendment became effective on 1 January 2009, entities were allowed to use or retain alternative titles for the primary statements. However, all Standards and Interpretations were amended to reflect the new terminology.

Although the effective date for the new titles was more than five years ago and there have been more changes since then, 74 (2014: 75) of the companies surveyed still used the term 'balance sheet' in their financial statements. Only 26 companies had moved to the title suggested by the IASB.

In the FTSE 350 sector, 30% used the term 'statement of financial position' whilst amongst non-FTSE 350 companies only 21% used the new terminology.

75 (2014: 72) groups in the survey presented net assets in their statement of financial position while 25 (2014: 27) presented a total of equity and liabilities instead.

In July 2014, the FRC published a Lab insight report titled 'Towards Clear & Concise Reporting'<sup>63</sup>. The report highlighted progress that companies made towards clearer and more concise reporting. The concept of materiality in financial statements was one of the focus areas. The FRC found that some companies have removed immaterial disclosures from their financial statements and have thus improved the focus. The FRC recommended that companies should review the value of each note to an investor and that quantitatively and qualitatively immaterial information should be removed.

22 companies presented line items in their balance sheet (excluding equity items) that were below the amount that was agreed between the auditor and the audit committee as a reporting threshold for misstatements (sometimes also referred to as the 'clearly trivial misstatements threshold'). 16 (73%) of those presented specific notes relating to one or more of these items.

63. <https://www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/FRC-Lab-Towards-Clear-Concise-Reporting.pdf>

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Whilst half of those notes gave clearly material information, in our view the other half could have been omitted without withholding relevant information. We hope that companies will further reduce such immaterial disclosures under the FRC's 'Clear & Concise' initiative.

### Restricted cash

In December 2014 the IASB proposed amendments to IAS 7 *Statement of Cash Flows* that, if finalised, would require greater disclosure of restrictions that affect the decisions of an entity to use cash and cash equivalent balances. In our survey, only 19 companies disclosed restrictions around cash that they held. Four companies identified cash balances pledged as security whilst three identified cash held in escrow as restricted. One company identified cash held overseas in a jurisdiction with exchange restrictions as restricted. Other scenarios giving rise to restrictions included cash held to meet liquidity ratio requirements or amounts held by insurance companies to meet regulatory requirements. The remainder did not provide any specific information on the nature of the restrictions on the use of their cash.

Whilst the proposed amendment to IAS 7 does not include a net debt reconciliation, it would ensure that users have the necessary information to undertake a net debt reconciliation themselves. Our analysis of net debt reconciliations provided by companies can be found in Chapter 15.

### Parent company reporting

UK preparers have several options when preparing their parent company's separate financial statements. Of the 100 companies surveyed, 51 (2014: 50) adopted old UK GAAP for their parent company financial statements whilst 47 (2014: 49) of them chose IFRSs for the company financial statements. A majority of the companies applying old UK GAAP will be unable to continue to do so for their next annual financial statements. For periods beginning on or after 1 January 2015, three new Financial Reporting Standards (FRS 100, 101 and 102) will be in force, bringing with them a number of new options for many UK entities and groups. All previously effective FRSs will be withdrawn.

Twelve of the companies we surveyed stated an intention to move to FRS 101, the IFRS-based reduced disclosure framework. However, to be able to apply FRS 101, certain conditions must be met, for example the shareholders must have been notified in writing. Also, FRS 101 cannot be applied in consolidated financial statements. Two (2014: one) of the companies we surveyed had already adopted FRS 101 for their parent company financial statements.

Under section 408 of the UK Companies Act 2006, parent company financial statements that accompany consolidated accounts are exempt from presenting an income statement. With reference to that exemption, 94 (2014: 92) companies excluded their parent-only income statement. Three (2014: four) of those companies presented a statement of other comprehensive income, presumably because the exemption is not quite clear as to whether it extends to statements of other comprehensive income for IFRS adopters.

Under section 479A of the UK Companies Act 2006, subsidiaries are exempt from statutory audits provided the parent gives a guarantee in respect of all outstanding liabilities of the subsidiary. The parent must disclose in the notes to the consolidated accounts where the subsidiary has taken advantage of this exemption. Our survey showed that eight of the surveyed parent companies have disclosed that they took advantage of this audit exemption. The exempted subsidiaries were usually smaller UK subsidiaries with all principal subsidiaries audited.

# 15. Notes to the financial statements

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## Top tips

- Companies do seem to be getting to grips with making their financial statements more concise, with a two page reduction in average length this year. Think about how you can reduce immaterial disclosure, for example by cutting out boilerplate from accounting policies.
- Make sure you consider consistency of messaging between the financial statements and narrative reporting. 43% of companies included discussion of capital management in the front and back halves but without clear linkage between the two disclosures.
- Consider an alternative presentation for accounting policies – 5% of companies integrate some of their accounting policy disclosures alongside the related notes, something which investors have said they find useful.
- Use understandable language in note disclosures, avoid boilerplate information and ensure relevant disclosures are tailored to the company's circumstances and business. Where necessary, provide a glossary to assist readers where industry jargon is complex.

## Keep an eye on

- Disclosures around distributable reserves – 40 of the companies we surveyed are responding to investor demand for information in this area by providing some disclosure, despite the lack of any requirement to do so.
- The IASB's project on net debt reporting – only 48% of companies surveyed presented either a net debt reconciliation or a reconciliation of cash flows to movement in net debt, disclosures that investors have said they find useful.
- Disclosure of standards in issue but not yet effective – the FRC have said they expect meaningful disclosure around the impact of IFRS 15 in particular but only one company gave detailed information.
- Ensuring that accounting policies are company-specific – in particular revenue recognition, which is of significant interest to investors and regulators. Only 49 of the companies we surveyed gave a detailed explanation, with 11 giving little or no company-specific detail at all.

## Linkage to narrative reporting

Integration of the financial review (management's commentary on the company's financial performance, position and prospects) with the financial statements is of real importance to investors, as reflected by the findings of the FRC's Financial Reporting Lab ('the Lab') investigation into this very subject<sup>64</sup>. In terms of our findings, all companies surveyed, apart from one, limit management's commentary to the strategic report, but integrate financial information by including extracts from the primary statements and cross references to the financial statements. Only one company, National Grid plc, experimented with an alternative format where summary financial review information is included within the strategic report, with further detailed explanations embedded within the financial statements and clearly identified as 'unaudited' commentary. The Lab's report noted that most investors believed clear separation of the audited financial statements and management's commentary remained the most appropriate approach, although one company indicated that their retail shareholders (as opposed to their institutional investors) found the integration of the financial review within the financial statements helpful, providing better insight into the company's performance and position.

64. <https://www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/Accounting-policies-and-integration-of-related-fin.aspx>



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Unaudited commentary on the consolidated income statement

The consolidated income statement shows all revenue earned and costs incurred in the year, with the difference being the overall profit for the year.

Revenue

Revenue for the year ended 31 March 2015 increased by £392m to £15,201m. This increase was driven by higher revenues in our UK Electricity Transmission business, reflecting increases in allowed Transmission Owner revenues, and higher core allowances and pass-through costs in UK Gas Transmission. Revenues in our UK Gas Distribution business were slightly lower as a result of changes in allowed revenues for replacement expenditure (repex). Our US Regulated businesses revenues were also lower, as a result of the end of the LIPA Management Services Agreement (MSA) last year, partially offset by revenue increases from existing rate plans, including capex trackers, together with additional income from gas customer growth and the impact of the strengthening US dollar.

Operating costs

Operating costs for the year ended 31 March 2015 of £11,421m were £347m higher than the prior year. This increase in costs included a £154m year on year impact of changes in exceptional items, remeasurements and stranded cost recoveries, which is discussed below. Excluding exceptional items, remeasurements and stranded cost recoveries, operating costs were £193m higher, principally due to: increases in controllable costs, including the impact of inflation and additional costs incurred in the US to improve data quality and bring regulatory filings up to date; higher US bad debt costs following last year's exceptionally cold winter; and higher depreciation and amortisation as a result of continued investment programmes. These cost increases were partly offset by a reduction in spend on US financial systems implementation and stabilisation upgrades, with the project completing in the first half of this year.

Net finance costs

For the year ended 31 March 2015, net finance costs before exceptional items and remeasurements were £75m lower than 2013/14 at £1,033m, mainly as a result of lower average gross debt through the year, lower RPI in the UK and refinancing debt at lower rates.

Tax

The tax charge on profit before exceptional items, remeasurements and stranded cost recoveries was £114m higher than 2013/14. This was mainly due to higher profits before tax and the non-recurrence of one-off items that benefited the prior year.

Exceptional items, remeasurements and stranded cost recoveries

Operating profit for the year ended 31 March 2015 included an £83m loss (2013/14: £16m gain) on remeasurement of commodity contracts. The year ended 31 March 2014 also included a net £55m gain on exceptional items, including a net gain on the LIPA MSA transition in the US of £254m; restructuring costs of £136m, primarily in the UK as we reorganised certain parts of our business to deliver under the new RIIO price controls; and a £79m provision for the demolition of UK gas holders that are no longer required.

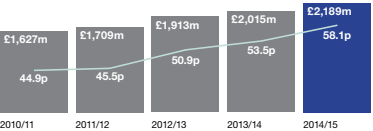
Finance costs for the year ended 31 March 2015 included exceptional debt redemption costs of £131m and a loss of £34m on financial remeasurements, relating to net losses on derivative financial instruments.

Exceptional tax for 2014/15 of £78m primarily represents tax credits on the exceptional items and remeasurements described above.

Adjusted earnings and EPS

The following chart shows the five year trend in adjusted profit attributable to equity shareholders of the parent (adjusted earnings) and adjusted earnings per share. See page 186 for a reconciliation of adjusted basic EPS to EPS.

Adjusted earnings and adjusted EPS<sup>1</sup>



1. Adjusted earnings and adjusted EPS are attributable to equity shareholders of the parent.

The above earnings performance translated into adjusted EPS growth in 2014/15 of 4.6p (9%).

In accordance with IAS 33, all earnings per share and adjusted earnings per share amounts for comparative periods have been restated for shares issued via scrip dividends.

Exchange rates

Our financial results are reported in sterling. Transactions for our US operations are denominated in dollars, so the related amounts that are reported in sterling depend on the dollar to sterling exchange rate.

	2014/15	2013/14	% change
Weighted average (income statement)	1.58	1.62	(2)%
Year end (balance sheet)	1.49	1.67	(11)%

If 2013/14 results had been translated at 2014/15 exchange rates, revenue, adjusted operating profit and operating profit reported in sterling would have been £212m, £25m and £32m higher respectively.

[National Grid plc Annual Report and Accounts 2014/15 \(p. 87\)](#)

Regulators continue to draw attention to the need to report both the good and bad reporting story in the annual report. The FRC highlighted the lack of symmetry between the 'bad' news and 'good' news in annual reports in its Corporate Reporting Review Annual Report 2014<sup>65</sup> ('CRR' Annual Report). The use of adjusted performance measures in both front and back halves of annual reports, such as 'profit before exceptional items' is another area of focus for regulators. ESMA have recently published their 'Guidelines on Alternative Performance Measures' (see Chapters 3 and 6 for more information), which will require companies to reconcile APMs used in the front half to information presented in the financial statements. The FRC also continue to highlight the identification of exceptional items as a common theme in investigations by their Conduct Committee.

One thing that can contribute to telling a balanced and integrated story is to ensure that there is clear discussion in the narrative reporting in the front of the annual report of significant items identified in the financial statements. During the period under review, 72 companies surveyed recognised significant restructuring costs, impairment losses (excluding bad debts) or other exceptional items (2014: 69). 15 of these companies did not discuss the business events relating to these with a reasonable degree of prominence in the narrative reporting, something which indicates a potential lack of cohesion in the report. Another is ensuring that the identification of business segments in the narrative report and operating segments in the financial statements is consistent – this is discussed further under 'Operating segments' later in this chapter.

Another area where information in the financial statements should link to the financial review within the narrative reporting relates to funding and capital management. Figure 15.1 illustrates the ways in which companies surveyed integrated this disclosure across the annual report. 43% of companies surveyed included disclosure about capital management within both the narrative report and the financial statements, but with no clear cross references from the front end to the detailed disclosures in the notes to the financial statements and/or vice versa. These were mostly from the FTSE 350 – among the smaller companies surveyed, 70% did not discuss capital management in the front half at all.

65. <https://www.frc.org.uk/Our-Work/Publications/Corporate-Reporting-Review/Corporate-Reporting-Review-Annual-Report-2014.pdf>

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

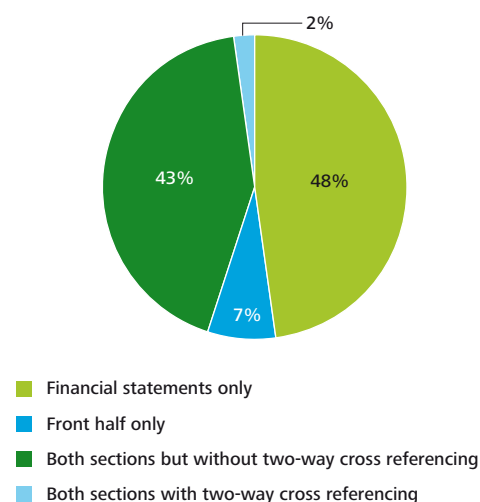
15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Further, in many cases the financial review within the strategic report contained information about funding and cash flows but this was not linked to detailed capital management disclosures in the notes to the financial statements. Companies should make efforts to present coherent and integrated information in this regard, which could also help improve messaging to investors about the management of capital and funding. Further discussion of capital management disclosures, together with an example, are provided later in this chapter.

**Figure 15.1. How are companies presenting information about capital management?**



**Structure of notes**

In relation to the structure of the notes, key areas highlighted by regulators and the IASB's ongoing Disclosure Initiative project<sup>66</sup> include the coherent integration of information across the financial statements, ensuring focus on key messages and reducing immaterial or unnecessary disclosures.

There has been a continued effort by companies to reduce clutter in their financial statements. Various suggestions have been made by the Lab to achieve this in their insight report 'Clear & Concise Reporting'<sup>67</sup>. These include removing accounting policies that are deemed not to be significant and including them in an appendix, reducing standing information to ensure the prominence of remaining information, omitting unnecessary disclosures and carefully considering materiality for the particular facts and circumstances. Companies should be asking what the purpose and value of each note is and how useful they are for investors, focusing disclosure on content that is most important to users. Of course, companies need to balance what they think users need with the requirements of the Standards. 16 companies clearly indicated that certain disclosures had been omitted on the grounds of materiality, with 13 of these being from the FTSE 350.

An example of an approach to remove immaterial disclosure is given by HSBC Holdings plc. The company presented a 'Disclosure philosophy' within the directors' report which provided an overview of the simplifications that HSBC had made to its financial statements and provided a cross reference to the notes to the financial statements where detailed information about this was included. HSBC explained in the notes on the basis of preparation that disclosures for immaterial items were no longer presented and that duplication of information was reduced where possible. For example, HSBC removed separate notes on property, plant and equipment and an analysis of financial assets and liabilities by measurement basis, instead including relevant information in other notes. They also rationalised notes on employee compensation and benefits and lease commitments.

66. <http://www.iasplus.com/en-gb/projects/iasb-and-ifs-projects/major/disclosure-initiative-overview>

67. <https://www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/FRC-Lab-Towards-Clear-Concise-Reporting.pdf>

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## Our disclosure philosophy

HSBC strives to maintain the highest standards of disclosure in our reporting.

It has long been our policy to provide disclosures that help investors and other stakeholders understand the Group's performance, financial position and changes thereto. In accordance with this policy:

- In order to make the financial statements and notes thereon easier to understand, we have undertaken an initiative to provide more focused information and to remove duplication where possible. As a result, we have changed the location and the wording used to describe certain accounting policies within the notes, removed certain immaterial disclosures and changed the order of certain sections. In applying materiality to financial statement disclosures, we consider both the amount and nature of each item. The main changes to the presentation of the financial statements and notes thereon in 2014 are described on pages 346 and 347.
- The information provided in the 'Notes on the Financial Statements' and the 'Report of the Directors' goes beyond the minimum levels required by accounting standards, statutory and regulatory requirements and listing rules. In particular, we provide additional disclosures having regard to the recommendations of the Enhanced Disclosures Task Force ('EDTF') report 'Enhancing the Risk Disclosures of Banks' issued in October 2012. The report aims to help financial institutions identify areas that investors had highlighted needed better and more transparent information about banks' risks, and how these risks relate to performance measurement and reporting. In addition, we continue to enhance our disclosures in line with good practice recommendations issued by relevant regulators and standard setters and in response to feedback received from users of our financial statements.

The Lab suggested improving layouts to improve clarity in reporting, using cross references to reduce duplication and tables instead of narrative explanation where possible to provide insight in a concise manner. The use of cross referencing and sign posting in the annual report, for example making use of a detailed index page for the financial statements, can significantly increase the usability of the information provided.

Another way of structuring notes chosen by some companies was to re-order the notes or group related notes to better present the 'story' of the company. In its project report on accounting policies<sup>68</sup>, the Lab notes that some investors preferred the 'standard' order following the line items of the primary statements while others preferred the company-specific ordering of notes. An index or list of contents can be very helpful especially if the disclosures are grouped under relevant headings for easier navigation, as shown by Unite Group plc.

[HSBC Holdings plc Annual Report and Accounts 2014 \(p. 107\)](#)

68. <https://www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/Accounting-policies-and-integration-of-related-fin.aspx>

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

## INTRODUCTION AND TABLE OF CONTENTS



Whilst these financial statements are prepared in accordance with IFRS, the Board of Directors manage the business based on EPRA earnings and EPRA net asset value (NAV) which can be found in section 2. These results are aligned with the European Public Real Estate Association (EPRA) best practice recommendations. We have grouped the notes to the financial statements under five main headings:

- Results for the year, including segmental information, EPRA earnings and EPRA NAV
- Asset management
- Funding
- Working capital
- Key management and employee benefits

Each section sets out the relevant accounting policies applied in these financial statements together with the key judgements and estimates used.

### Primary statements

Consolidated income statement  
Consolidated statement of comprehensive income  
Consolidated balance sheet  
Company balance sheet  
Consolidated statement of changes in shareholders' equity  
Company statement of changes in shareholders' equity  
Statements of cash flows

### Section 1: Basis of preparation

### Section 2: Results for the year

- 2.1 Segmental information
- 2.2 Earnings
- 2.3 Net assets
- 2.4 Revenue and costs
- 2.5 Tax
- 2.6 Audit fees

### Section 3: Asset management

- 3.1 Wholly owned property assets
- 3.2 Inventories
- 3.3 Other non-current assets
- 3.4 Investments in joint ventures
- 3.5 Investments in subsidiaries

### Section 4: Funding

- 4.1 Borrowings
- 4.2 Interest rate swaps
- 4.3 Net financing costs
- 4.4 Gearing
- 4.5 Financial risk factors
- 4.6 Operating leases
- 4.7 Capital management
- 4.8 Equity
- 4.9 Dividends

### Section 5: Working capital

- 5.1 Cash
- 5.2 Trade and other receivables
- 5.3 Credit risk
- 5.4 Trade and other payables
- 5.5 Transactions with other Group companies

### Section 6: Key management and employee benefits

- 6.1 Staff numbers and costs
- 6.2 Key management personnel
- 6.3 Share based compensation

There may be a time around the corner when users can have a customised experience where they can select the composition and ordering of notes according to preference using digital tools similar to IFRS eXtensible Business Reporting Language<sup>69</sup> (XBRL). XBRL provides a reporting language which authoritatively defines reporting terms to allow for clear extraction of financial information in a digital format. A report by the Lab on the use of digital media in corporate reporting<sup>70</sup> noted that most investors are not yet using XBRL, instead preferring PDF documents because these are considered to be more 'complete' and assured, have a clear boundary and are searchable. A number of companies do already give readers a chance to 'build' their own customised annual reports via their websites and companies should be on the lookout for digital opportunities to provide this flexibility for different users' preferences.

## Choices for Accounting policies

The Lab's project report on accounting policies acknowledges different views exist regarding the placement of the disclosure on accounting policies and that investors have experimented in that area. The report indicates that the accounting policies would normally be disclosed in a single note after the primary financial statements and the vast majority of companies we surveyed (see Figure 15.2.) adopted this approach. However, the Lab noted that presenting the accounting policies in another systematic order is also permitted by IAS 1 – a position clarified by the 2014 amendments to IAS 1 under the IASB's Disclosure Initiative. Our survey showed that some companies chose alternative ways to present their notes. It seems that slowly more companies (5% in 2015 as opposed to 4% in 2014) are beginning to present general accounting policies in a separate note and combine item-specific policies with the relevant note. An investor association was quoted by the Lab as saying that this approach was helpful. They liked that the relevant policy was presented together with the numbers.

One company presented almost all of their significant accounting policies in the final note of their financial statements.

69. <http://www.iasplus.com/en-gb/projects/iasb-and-ifs-projects/research/short-term/xbrl>

70. <https://frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/Lab-Project-Report-Digital-Present.pdf>

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

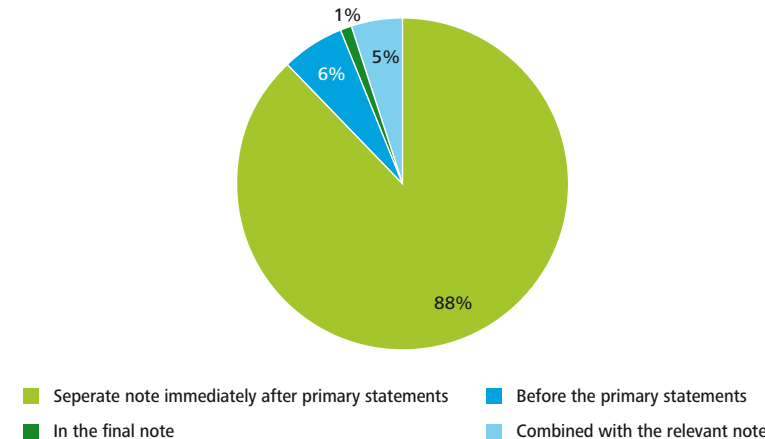
14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Figure 15.2. How are accounting policies presented?



The average length of policies provided in a separate note was six pages, in line with the prior year, indicating that the various initiatives to address Disclosure overload, including the FRC's 'Clear & Concise' project and the IASB's Disclosure Initiative, have yet to have a significant impact in this area. The shortest note in this year's survey was three (2014: two and a half) pages long whilst the longest had 17 (2014: 20) pages. However, the company which had the longest note provided extended disclosures due to a prior year restatement. Without the restatement, the note would only have had eleven pages.

### Changes to accounting policies

Where accounting policies change, for example due to new IFRS requirements or for voluntary changes in accounting policy, the Lab noted in their report on accounting policies that investors like clear IAS 8 disclosures on the impact of the change plus the reasons for any voluntary changes. 30 of the companies in our sample restated prior year figures either due to changes in accounting policies (14), corrections of prior period errors (four) or as required by specific standards, such as IFRS 8 *Operating Segments* (eleven).

Only four of these presented a restated balance sheet at the beginning of the comparative period, as required by IAS 1, although that standard does specifically mention that this is required only where the restatement has a material impact – eight companies specifically mentioned this as the reason for not presenting a third balance sheet, with the rest staying silent.

Where prior period amounts are restated the Lab noted that investors found that the use of a tabular format to illustrate the effect, with each adjustment clearly identified, best presented this information.

A good example of such a disclosure is given by Tate and Lyle below, describing the transition to IFRS 11 *Joint Arrangements* from IAS 31 *Joint Ventures*.

#### 42 Adoption of IFRS 11 'Joint Arrangements'

With effect from 1 April 2014, the Group adopted IFRS 11 'Joint Arrangements' which changed significantly the accounting for its interests in joint ventures. Before adoption of the standard, the Group's interests in joint ventures were accounted for by proportionate consolidation, whereby the Group's share of the income and expenses, assets and liabilities and cash flows of joint ventures were combined on a line-by-line basis with those of Tate & Lyle PLC and its subsidiaries. IFRS 11 prohibits the use of proportionate consolidation and requires that joint ventures are accounted for using the equity method of accounting. Under the equity method of accounting, the Group's share of the after tax profits and losses of the joint ventures has been shown on one line of the consolidated income statement, its share of their net assets has been shown on one line of the consolidated statement of financial position and the consolidated statement of cash flows reflects cash flows between the Group and the joint ventures within cash flows from investing activities. While these changes have not affected the Group's earnings or its net assets, they have affected many of the individual line items presented in the Group's financial statements. In accordance with IAS 1, the Group has also presented a third statement of financial position (as at 1 April 2013) following the adoption of this accounting policy.

Comparative financial information for 2014 has been restated to adopt the new standard. An analysis of the effect of the impact on the Group's results for 2015 and 2014 is presented below:

	Year ended 31 March 2015			
	Under previous policy £m	Elimination of proportionate consolidation £m	Adoption of equity accounting £m	As reported £m
<b>Consolidated profit or loss and comprehensive income</b>				
<b>Year ended 31 March 2015</b>				
<b>Continuing operations</b>				
Sales	2 694	(338)	–	2 356
Operating profit	96	(63)	–	33
Finance income	1	–	–	1
Finance expense	(32)	–	–	(32)
Share of profit after tax of joint ventures and associates	–	–	49	49
Profit before tax	65	(63)	49	51
Income tax expense	(35)	14	–	(21)
Profit from continuing operations	30	(49)	49	30
Profit from discontinued operations	–	–	–	–
Profit for the year	30	(49)	49	30
Other comprehensive expense	(2)	16	(16)	(2)
Total comprehensive income	28	(31)	31	28

[Tate & Lyle PLC | Annual Report 2015 \(p. 147\)](#)

If a company has not applied a new standard or interpretation that has been issued but is not yet effective, they must disclose that fact and any known or reasonably estimable information relevant to assessing the possible impact that the new pronouncement will have in the year it is applied. In our 2015 survey, seven (2014: nine) companies had adopted a pronouncement before its EU-effective date, although only one specifically mentioned it in their accounting policies note.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

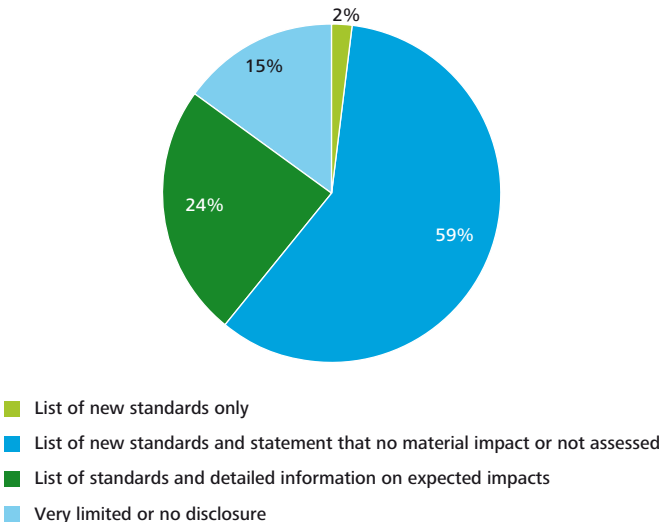
Appendix 1 – Glossary of terms and abbreviations

Other resources available

Six companies adopted the 'Package of five' new consolidation standards voluntarily, while IFRIC 21 *Levies* was adopted by one company, an SEC registrant. As an SEC registrant, this company was required to apply IFRSs as issued by the IASB and so it applied IFRIC 21 in line with the IASB effective date (1 January 2014) instead of the EU effective date (17 June 2014).

Figure 15.3 shows that a majority of companies in our survey did not give detailed information on the expected impacts of standards issued but not yet effective. Most companies either did not expect the new pronouncements to have a material impact, or stated that they were still assessing the impacts of new but not yet effective standards.

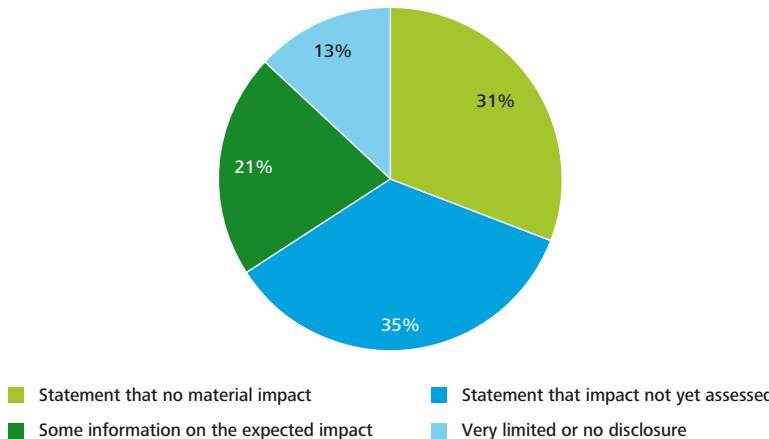
**Figure 15.3. How detailed are the disclosures regarding standards in issue but not yet effective? (excluding IFRS 15)**



A surprisingly high number of companies, 15% (2014: 10%) did not provide a clear disclosure on those standards or did not to give any information at all. Although this information may not seem that useful in understanding the current year financial statements, presenting meaningful disclosures in this area will help to give investors confidence that management have their eye on the ball in terms of future changes in accounting standards.

Although the effective date of IFRS 15, the new revenue recognition standard, is now expected to be 2018, the FRC stated in their 2014 CRR Annual Report that they would already expect to see company-specific disclosures on the likely impact of this new standard. However, our survey has revealed that the quality of disclosure on the expected effects of IFRS 15 is fairly similar to that provided for other standards. Only one company gave detailed information about the specific impacts, with a further 20 giving some limited insight. The rest was divided between 'no material impact expected' (31%) and 'impact not yet assessed' (35%). A significant minority listed the standard as 'new but not yet effective' but did not provide any further disclosure. Surprisingly, some companies did not mention IFRS 15 at all in their financial statements.

**Figure 15.4. How detailed are the disclosures on the adoption of IFRS 15?**



It seems like a majority of the companies surveyed had not had a chance to properly assess the impact of IFRS 15, with many providing no information on how it could potentially affect their financial statements – even at a high level in terms of broad areas that could be subject to change. The IASB has decided to defer the effective date of IFRS 15 to provide companies with more time to prepare for the transition. Nonetheless, we hope to see a shift in the answers in our 2016 survey towards more detailed information.



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

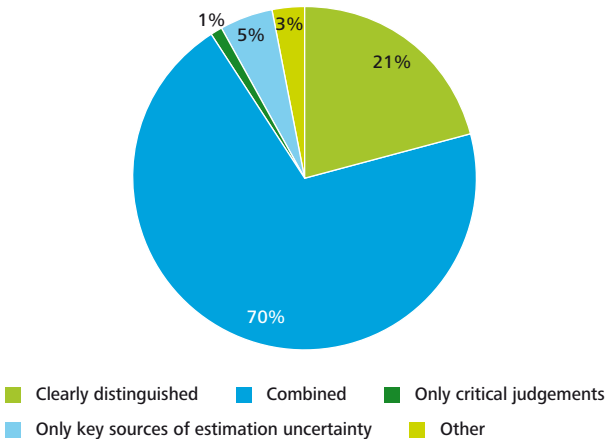
Other resources available

**Critical judgements and key sources of estimation uncertainty**

A company must disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations, that management has made in the process of applying the company's accounting policies that have the most significant effect on the amounts recognised in the financial statements. Information about the key assumptions concerning the future and other key sources of estimation uncertainty must also be disclosed at the end of the reporting period. IAS 1 restricts this disclosure requirement to items that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

According to the Lab's report on accounting policies, many investors do not differentiate between judgement and estimate disclosures in the way described above. This is consistent with the way those items are presented by the companies in our survey. As shown in figure 15.5, about two thirds of the preparers combined their disclosure on critical judgements and key sources of estimation uncertainty. Only about every fifth company provided a clearly distinguished disclosure. The remainder either only disclosed one of the two categories of items, or combined these disclosures with the relevant notes.

**Figure 15.5. How are critical judgements and key sources of estimation uncertainty disclosed?**

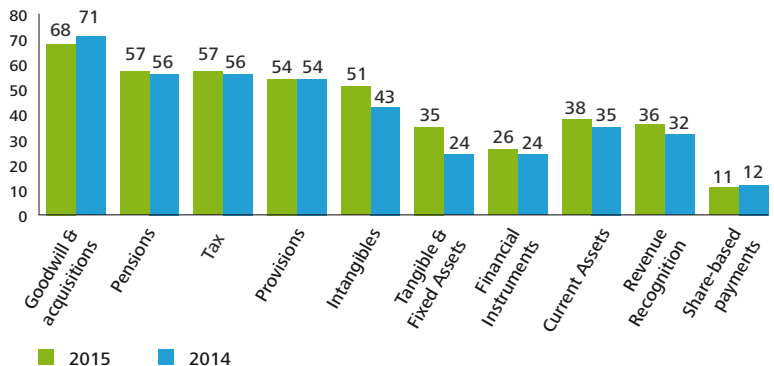


The Lab's report on accounting policies states that investors often highlight estimates when asked which accounting policies they refer to most. This demonstrates, in the view of the FRC, the importance to investors of the estimates and judgements made in choosing and applying accounting policies, and supports disclosure that provides a clear understanding of estimates and judgements in the context of the related accounting policy.

As many companies combine the critical judgements and the key sources of estimation uncertainty, we were unable to perform a separate analysis of both items. Therefore, the average number of critical judgements and key sources of estimation uncertainty was analysed together. On average, companies disclosed five and a half (2014: five) of these items in their annual reports with the largest number being 14 (2014: 14).

The items that have been included as critical judgements or key sources of estimation uncertainty remain consistent with the previous year (Figure 15.6). Goodwill and acquisitions, pensions, tax, provisions and intangibles remain a focus area of judgement and estimation uncertainty. As well as the categories listed below, 28 companies listed other items such as judgements on which items should be excluded from non-GAAP measures, assessments of control or significant influence, investment property valuations and industry-specific items. In particular the number of companies identifying a critical judgement around the items excluded from non-GAAP measures rose from 4 last year to 9 this year, potentially prompted by the FRC's press notice on the matter in late 2013 (see Chapter 14).

**Figure 15.6. How many companies include the following items as critical judgements or key sources of estimation uncertainty?**



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

A good example for the disclosure of critical judgements and key sources of estimation uncertainty was given by Skyepharma plc.

**Critical accounting estimates and judgements**

The preparation of the consolidated accounts requires the Group to make estimates and judgements that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. The Group bases its estimates and judgements on historic experience and on various other assumptions that it considers to be reasonable. Actual results may differ from these estimates under different assumptions or conditions.

**Judgements**

**Revenue recognition**

The Group's revenue comprises revenues from licencing agreements, including up-front payments, milestone payments and technology access fees, contract research and development revenue, royalty income and manufacturing and distribution revenue. The Group enters into a wide variety of collaborative arrangements with its partners from which it may earn all, or some of, these revenue streams. The application of the Group's revenue recognition policy to the complex collaboration agreements requires significant estimates and judgement.

**Non-current assets held for sale**

A vacant property in Switzerland previously classified under property, plant and equipment has been reclassified to non-current assets held for sale as at 31 December 2014. The property has been marketed for sale since January 2011, but following the lease of the property to the Aenova Group in October 2014, management believes that the marketability of the property to an investor is significantly improved and therefore a sale within the next 12 months is deemed highly probable. As such, it has been reclassified as at 31 December 2014 in accordance with IFRS 5.

**Deferred tax asset**

The Group has recognised a deferred tax asset as at 31 December 2014 to the extent that available tax losses can be carried forward and offset against future taxable profits. Management believes that the asset is fully recoverable and that the look-forward period is appropriate under IAS 12.

**Capital Raise and Bond Proposals**

Significant accounting judgements were necessary in respect of the repayment of the 2024 Bonds ("Bond Proposals") implemented on 30 April 2014 including the treatment of transaction costs and the internal rate of return used in calculating the discount on redemption.

Further details are set out in Note 24: Borrowings and Note 2(t): Accounting policies: Non-convertible Bonds.

**Estimates**

**Paul Capital Note**

The liabilities under the Paul Capital Note were treated as financial liabilities under IAS 39. The fixed amortisable note was recorded at the net present value of expected amortisation payments to be paid to Paul Capital. This amount is net of amounts forecast to be paid to Paul Capital by Pacira Pharmaceuticals which reduce the amount owing to Paul Capital by the Group. Further details are set out in Note 12: Finance costs and income, and Note 24: Borrowings.

**Shares in and loans to Group undertakings**

Each reporting period the Group makes an assessment for indications of any impairment in the carrying value of investments using estimated discounted cash flows. The Company also makes an assessment for indications of any impairment in the carrying value of shares in and loans to Group undertakings in view of the Company's market capitalisation and the implied enterprise value.

In assessing the implied enterprise value, significant estimates include:

- sales projections – based on management's projections, using partner information where available;
- cash flow projections – usually for ten years (or the expiry of relevant patents if shorter) based on expected product lives;
- income and costs for products under development;
- launch date of products utilising the Group's technologies; and
- discount rates.

The application of different estimates could materially affect the Company's balance sheet value of shares in and loans to Group undertakings.

**Impairment of intangible assets and property, plant and equipment**

An assessment was made in respect of indications of impairment in the carrying value of the Group's intangible assets and property, plant and equipment as at 31 December 2014. A formal impairment assessment would involve calculations which require the use of estimates. No impairment indicators were identified as at 31 December 2014 and therefore no formal impairment assessment was performed.

**Pensions**

The Group recognises actuarial gains and losses arising from experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred) and changes in actuarial assumptions directly in equity, in the period in which they have occurred. The costs are assessed in accordance with advice received from independent actuaries. These assumptions include inflation rate, rate of increase in salaries, discount rate and expected return on plan assets and are disclosed in Note 27: Retirement benefit obligations. The selection of different assumptions could affect the results of the Group.

**Share-based compensation**

Incentives in the form of shares are provided to employees under share option, share purchase and long term incentive plans. The fair value of the employee services received in exchange for the grant of the options and rewards is recognised as an expense. The expense is based upon a number of assumptions disclosed in Note 30: Share-based payments. The selection of different assumptions could affect the results of the Group.

**Amortisation lives**

Other intangible assets are recorded at their fair value at acquisition date and are amortised on a straight line basis over their estimated useful economic lives from the time they are available for use. Any change in the estimated useful economic lives could affect the future results of the Group.

**Taxation**

Current tax is the expected tax payable on the taxable income for the year using the tax rates and laws that have been enacted or substantially enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years. The Group has open tax assessments and queries with a number of revenue authorities and, on the basis of external professional advice, continues to believe that it has made adequate provision for any liabilities that may arise from these open assessments. The ultimate liability for such matters may vary from the amounts provided, and is dependent upon negotiations with the relevant tax authorities.

**Depreciation of flutiform® supply chain assets**

Assets relating to the flutiform® supply chain are recorded at cost and are depreciated on a units of production basis over their estimated useful lives from the time they are available for use. Depreciation rates are reviewed and adjusted as necessary when information indicating improvements or decreases in expected useful economic lives is received by the Group. Any change in the estimated useful economic lives could affect the future results of the Group.

[Skyepharma Annual Report and Accounts for the year ended 31 December 2014 \(p. 96\)](#)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Recognising the importance of revenue recognition

The Lab's report on accounting policies states that investors are particularly interested in policies that are unique or important to a business' operations. Therefore, revenue recognition policies are invariably considered to be significant and regulators tend to focus their attention on such matters. Our survey showed that 89 companies presented company-specific information in their description of revenue recognition. Of those, 40 gave high-level information whilst 49 gave detailed information. The remaining 11 companies only presented a very generic description, which is disappointing given the importance users tend to place on it.

The average number of words in the revenue policy description was 245 – ranging from 45 words up to 894 words. Whilst the number of words could, somewhat crudely, be seen as indicative of the quality of disclosures, for companies in certain industries a relatively short note may provide all the detail needed. An example of this is illustrated by Essentra plc.

#### P. Revenue

Revenue from the sale of goods is recognised in the income statement net of expected warranty claims when the significant risks and rewards of ownership have been transferred to the customer.

The majority of the Group's businesses sell goods on an ex-works basis, where the Group as seller makes its goods ready for collection at its premises on an agreed upon sales date and the buyer incurs all transportation and handling costs and bears the risks for bringing the goods to their chosen destination. The Group operates non ex-works terms with customers in some of its businesses, and in these businesses, revenue is recognised when the significant risks and rewards of ownership have been transferred to the customer. These terms include some consignment stock agreements, where revenue is recognised when the customer removes the goods from consignment stock.

[Essentra plc Annual Report 2014 \(p. 101\)](#)

Looking ahead, IFRS 15 Revenue from Contracts with Customers is set to become effective for periods commencing on or after 1 January 2018. The Standard introduces a number of new disclosure requirements compared to IAS 18 and will require, inter alia, information on when performance obligations are typically satisfied, determination of the transaction price and allocation to performance obligations. As alluded to above, companies would be well advised to consider the impact of IFRS 15 sooner rather than later.

### The package of five

The 'package of five' includes IFRS 10 *Consolidated financial statements*, IFRS 11 *Joint arrangements*, IFRS 12 *Disclosures of involvement with other entities*, IAS 27 *Separate financial statements* and IAS 28 *Investments in associates and joint ventures* and became effective in the EU for annual periods beginning on or after 1 January 2014. This set of standards was issued in response to financial crisis to give investors a more accurate picture of the nature and extent of a company's involvement with other entities.

For example, the package requires more information on special purpose vehicles and a classification of joint arrangements that reflects their substance rather than their legal form. As set out below, it appears that for some the impact of this package was significant, but for many it did not bring about significant change.

Only nine companies surveyed were yet to adopt the 'package of five', with six companies in our survey early adopting it. For most companies this was the first time they had had to contend with these sizeable new standards. However, only two companies surveyed reported that the adoption of IFRS 10 had impacted their financial statements, with one consolidating additional entities and the other reclassifying some investees as joint ventures rather than subsidiaries.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

The implementation of IFRS 11 *Joint Arrangements* requires a change in the classification and treatment of joint ventures. 42 companies surveyed recognised joint arrangements in their financial statements and explicitly stated that they had adopted IFRS 11, of which only five had joint arrangements that were classified as a joint operation. Of the six companies that were using proportional consolidation for joint ventures in the reports we looked at in last year's survey, only one has identified the joint arrangement as a joint operation. Two have yet to apply IFRS 11 and the other three are now equity accounting for these interests, having determined that they are joint ventures under the new standard.

The objective of IFRS 12 is to require the disclosure of information that enables users of financial statements to evaluate the nature of, and risks associated with, its interests in other entities, and the financial effects of those interests. IFRS 12 requires judgements on issues like 'de facto control' per IFRS 10 and the classification of arrangements as joint operations per IFRS 11 to be clearly explained in the notes, where relevant. Note that, as discussed earlier, IAS 1 also requires disclosure of critical judgements.

Only 12 of the companies surveyed included disclosure about judgements made when classifying interests in other entities. In particular, very few companies included disclosure of judgements relating to issues where IFRS 10 has introduced new guidance on particular topics. In its 2014 CRR Annual Report, the FRC specifically identified judgements around 'de facto control' as an area where companies should carefully consider the new guidance and disclose information around any judgements made clearly in their financial statements. Other disclosures that companies are specifically required to make by IFRS 12 include classifying joint arrangements as joint ventures or joint operations and whether they meet the definition of an investment entity.

An example of disclosures relating to some of the complex judgements around control and company-specific information are illustrated by Mitie Group plc and Evraz plc.

**Significant Accounting Judgements and Estimates**  
**Accounting Judgements**

In the process of applying the Group's accounting policies, management has made the following judgements, apart from those involving estimates, which have the most significant effect on the amounts recognised in the consolidated financial statements:

- The Group determined that it obtained control over Corber on 16 January 2013 (Note 11). As of 31 December 2012, certain conditions relating to acquisition of an additional 50% ownership interest in Corber were not met. As such, the Group did not consolidate Corber in 2012.
- The Group determined that the 51% ownership interest in Timir (Note 11) does not provide control over the entity. In April 2013, the Group concluded a joint venture agreement with Alrosa under which major operating and financial decisions are made by unanimous consent of the Group and Alrosa, it ensures that no single venturer is in a position to control the activity unilaterally. Consequently, the Group determined that Timir constitutes a joint venture under IFRS 11 "Joint Arrangements".

[EVRAZ plc Annual 130 Report and Accounts 2014 \(p. 131\)](#)

*Accounting for joint ventures and associates*

The group has interests in entities in which it considers that it does not have control and which are accounted for using the equity method. In the group accounts, consideration is given to the treatment that should be adopted for the results of those entities in which the group has a participation, taking into account the ownership of the entity and the group's influence over its control. Particular consideration was given to the group's interest in a special purpose company, O-Gen Plymtrek Limited ('O-Gen'). As a result of a number of factors, and in particular the combination of not having a majority of directors on the Board and having no veto rights over substantive matters, the group equity accounts for its interest in O-Gen (see Note 5).

[Mitie Group plc Annual Report and Accounts 2015 \(p. 103\)](#)

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Only 20 companies surveyed presented information that clearly stemmed from new requirements of IFRS 12. Most companies appeared to present the same or very similar disclosures relating to subsidiaries, joint ventures and associates as they would have done prior to application of IFRS 12, for example the listing of subsidiaries required by the Companies Act (for accounts approved on or after 1 July 2015 this listing will need to include all subsidiaries, rather than just the 'principal' ones). In many cases this was because group structures are relatively simple and no significant judgements have been required.

IFRS 12 introduces new disclosure requirements regarding the interest that material non-controlling interests have in the activities and cash flows of the group, requiring such items as summarised financial information to be presented.

### Operating segments

Twelve of the companies (2014: 14) surveyed, spread across various industries, identified just one reportable segment. Although a single reportable segment is justifiable where the chief operating decision maker is only presented with aggregated information in order to make decisions about the allocation of resources and review performance, a regulator will often approach such a conclusion with a degree of scepticism. A clear description of how such a conclusion was reached can help pre-empt challenge in this regard – on average the justification for a single reportable segment this year lasted 81 words (2014: 58 words), indicating that perhaps companies are responding to regulatory interest by improving their justification for such a situation.

Consistency of segmental reporting with information presented in the narrative reporting in the front half improved, with only 12% of companies displaying inconsistency between the segments discussed in the narrative and in the IFRS 8 note in 2015, down from 17% in 2014. This could be as a result of the emphasis by regulators and demands from investors for consistency between the financial review information in the Strategic Report and the financial statements. The Lab suggested in its insight report on clear and concise reporting<sup>71</sup> that key segmental performance information should be up front in the narrative reporting with more detailed disclosure in the financial statement notes, in accordance with IFRS 8 *Operating Segments*.

During the year under review, eleven companies restated their segmental analysis (2014: four). In most cases this was as a result of acquisitions or disposals of business units during the year and subsequent internal reorganisation.

71. FRC Lab insight report Towards Clear & Concise Reporting (August 2014) <https://www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/FRC-Lab-Towards-Clear-Concise-Reporting.pdf>

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Tax disclosures

In July 2015 HM Revenue & Customs (HMRC) published a consultation document<sup>72</sup> aimed at improving tax compliance by large businesses. One of the suggestions was to ask businesses to publish their tax strategy, potentially in the annual report.

For the year under review, disclosures about tax governance that went beyond existing requirements and provided information on tax governance, tax charges and/or tax payments to UK and/or global tax authorities in their annual report were made by nine companies (2014: seven companies). All companies making these additional tax disclosures were FTSE 350 companies. An example of such a disclosure was included in Weir Group PLC's annual report, as set out opposite.

### Tax policy

The Group's strategic tax objectives are to:

- comply with all applicable tax laws and regulations, including the timely submission of all tax returns and tax payments; and
- develop and maintain strong working relationships with local tax authorities and undertake all dealings with them in a professional and timely manner.

The Group has strong controls and clear policies and procedures covering tax, which must be followed by all finance personnel. We take a conservative approach to all tax planning with the overarching aim of paying the right amount of tax at the right time in each tax jurisdiction in which we operate. As a large multi-national, we conduct our business affairs in a way which is efficient from a tax perspective, for example by looking to take into account available global tax incentives and allowances, but we do not undertake tax planning for its own sake.

In terms of cash tax, the Group paid income tax of £94m in 2014 across all of its jurisdictions compared to £72m in 2013. Net cash tax paid in the UK in 2014 across corporation tax, VAT and payroll taxes was approximately £41m (2013: £45m).

72. <https://www.gov.uk/government/consultations/improving-large-business-tax-compliance>



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

### Defined benefit pensions

In their CRR Annual Report, the FRC raised concerns around pension accounting. The FRC specifically identified issues related to the assessment of whether a surplus calculated in accordance with IAS 19 represents a recognisable asset and, conversely, whether a minimum funding requirement exists that necessitates the recognition of an additional liability under IFRIC 14. Companies also need to ensure that the regulatory framework of the pension schemes, risks around defined benefits plans and funding arrangements have been described, and any amounts that the company has agreed to pay into the plan are quantified and the relevant maturity profile has been adequately disclosed.

66 companies surveyed operated a defined benefit pension scheme. Of these, 14 recognised a surplus as an asset, while only 3 explicitly stated that the recognition of plan surpluses as assets was limited due to IFRIC 14's requirements. Companies with such schemes should pay careful attention to impending changes to IFRIC 14, for example the clarification that when assessing the recoverability of a surplus, gradual settlement cannot be assumed where trustees have a unilateral right to wind up a scheme.

The number of pages dedicated to pension plan disclosures remain lengthy. On average companies surveyed presented IAS 19 *Employee Benefits* disclosures over five pages, an increase from four last year.

### Goodwill and business combinations

The number of business combinations reported by companies surveyed the year has remained consistent and in a similar proportion between the FTSE 350 and smaller companies. During the year 39 companies surveyed reported business combinations (2014: 36). Of the FTSE 350 companies surveyed, 30 (2014: 26) reported business combinations. This relatively stable number of mergers and acquisitions suggests that there has not been a marked change in the state of the economy to encourage additional acquisition activity.

82% of companies reporting business combinations appeared to present all or nearly all of the information required by IFRS 3 *Business Combinations*, in line with the prior year (2014: 81%). For those companies not presenting certain disclosures this could often be attributed to the acquisition not being significant either on its own or in combination with other business combinations during the period.

79% of companies which completed business combinations during the period recognised intangible assets other than goodwill. The recognition of intangible assets arising in business combinations and the associated deferred tax remains an area of focus for the FRC, as highlighted in their CRR Annual Report. One can expect challenge from the FRC if goodwill arising is significant, but few or no separate intangibles have been recognised. Of the companies surveyed that had business combinations, the value of intangible assets recognised (excluding goodwill) was, on average, 42% of the total difference between the consideration paid and the fair value of previously recognised assets of the acquiree.

Where companies surveyed recognised goodwill on acquisitions completed during the year, 16% of these companies did not identify why goodwill was recognised or what gave rise to the goodwill (2014: 10%) as required by IFRS 3. This leaves shareholders guessing as to why the company paid a premium for the acquisition.

### Testing times for goodwill

Impairment disclosures continue to be a hot topic for regulators and an area where companies can improve the quality of their disclosures. 82 companies surveyed (2014: 80) recognised goodwill at their respective reporting dates and 11 of these companies recognised an impairment loss specifically on goodwill during the year (2014: 15).

The FRC's CRR Annual Report featured asset impairment calculations and disclosures as a common area of challenge. Areas of weakness identified included the description of key assumptions, the use of a single discount rate applied to multiple cash generating units with different risk profiles, unclear or generic sensitivity disclosures and unrealistic assumptions around growth in forecasting cashflows.

Disclosures should clearly distinguish between cash-generating units and the level at which goodwill is monitored. 89% (2014: 70%) of companies with goodwill on their balance sheets disclosed their cash-generating units with significant goodwill balances as required by IAS 36, an improvement on the previous year. Different discount rates should be used for cash-generating units with different risk profiles, assuming the underlying cashflows are not risk adjusted. 77% (2014: 59%) of companies presenting goodwill impairment testing disclosure used CGU-specific discount rates, again an improvement on last year.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

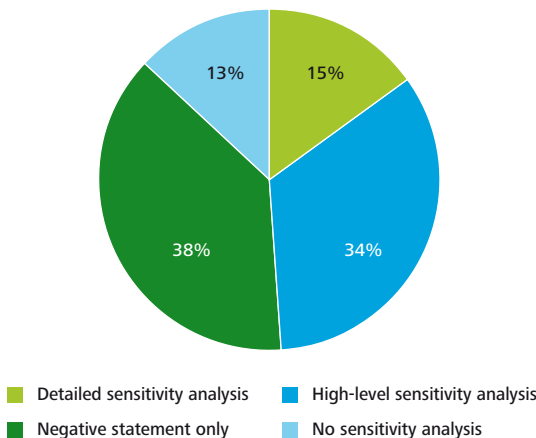
Appendix 1 – Glossary of terms and abbreviations

Other resources available

9% of companies with goodwill did not provide information about the period over which cash flow projections were based on budgets and forecasts (2014: 6%) – a requirement of IAS 36 where value in use is used as the recoverable amount of a CGU with significant goodwill.

Sensitivity disclosures, which should be provided where a reasonably possible change in a key assumption would cause an impairment, need to be clear and specific. Figure 15.7 illustrates how companies surveyed presented sensitivity disclosures for goodwill impairment testing. A good example of goodwill and impairment testing disclosure given by National Express Group PLC is provided below.

**Figure 15.7. Were additional sensitivity disclosures provided regarding goodwill impairment?**



73. Annual Study of Intangible Asset Market Value 2015, Ocean Tomo, [www.oceantomo.com/intellectual-capital-equity/](http://www.oceantomo.com/intellectual-capital-equity/)

The calculation of value in use for each group of cash-generating units is most sensitive to the assumptions over discount rates and the growth rate used to extrapolate cash flows beyond the three-year period of the management plan.

The key assumptions used for the cash-generating units are as follows:

	Pre-tax discount rate applied to cash flow projections		Growth rate used to extrapolate cash flows beyond five year period of management plan	
	2014	2013	2014	2013
UK Coach	8.5%	9.4%	2.0%	2.0%
North American Bus	8.6%	9.1%	2.5%	2.5%
Spanish Coach and Bus	8.5%	8.6%	2.0%	2.0%

The value in use of the North American Bus division exceeds its carrying amount by £160.4m (2013: £161.1m). Sensitivity analysis has been completed on each key assumption in isolation, and this indicates that the value in use of the division will be equal to its carrying amount following an increase in the pre-tax discount rate of 140 basis points (2013: 150 basis points) or a reduction in the growth rates used to extrapolate cash flows beyond the three-year period of the management plan of 160 basis points (2013: 150 basis points).

The value in use of the Spanish Coach and Bus division exceeds its carrying amount by £107.1m (2013: £212.9m). Sensitivity analysis has been completed on each key assumption in isolation, and this indicates that the value in use of the division will be equal to its carrying amount following an increase in the pre-tax discount rate of 70 basis points (2013: 140 basis points) or a reduction in growth rates used to extrapolate cash flows beyond the three-year period of the management plan of 70 basis points (2013: 150 basis points).

The headroom has decreased for Spanish Coach and Bus, reflecting a cautious approach in forecasting revenue and profit based on an assessment of the bidding and contract renewal environment, and the response to increased levels of competition. North America has improved headroom, as an increase in the asset base is more than offset by future profit projections.

It is believed that any reasonably possible movement on key assumptions will not lead to an impairment of goodwill allocated to UK Coach.

[National Express Group PLC Annual Report and Accounts \(p. 121\)](#)

### Other intangible assets

Intangible assets are increasingly making up a significant amount of a company's value, both in terms of those that are recognised on balance sheet and those that are not recognised by accounting standards. With regards to the former, 84 companies surveyed (2014: 84) recognised intangible assets other than goodwill.

### <IR> and the rise of the intangible

One of the main drivers of <IR> has been the shift in factors that make up a company's market value. Research in 2015 from Ocean Tomo<sup>73</sup> found that net assets of S&P 500 companies represented only 16% of their market capitalisation, compared to 83% in 1975. In other words, intangible factors, including trust, reputation, and long-term viability of the business model that are not necessarily captured by accounting records have become the material value drivers. As discussed in chapter 7, <IR> challenges companies to consider all relationships and resources which are material to the company, factoring these into the business model as well as when determining the company's strategy. Internally generated intangible assets such as brand and reputation continue to be important value drivers for quoted companies, but neither are permitted to be recognised on balance sheet by IFRSs.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

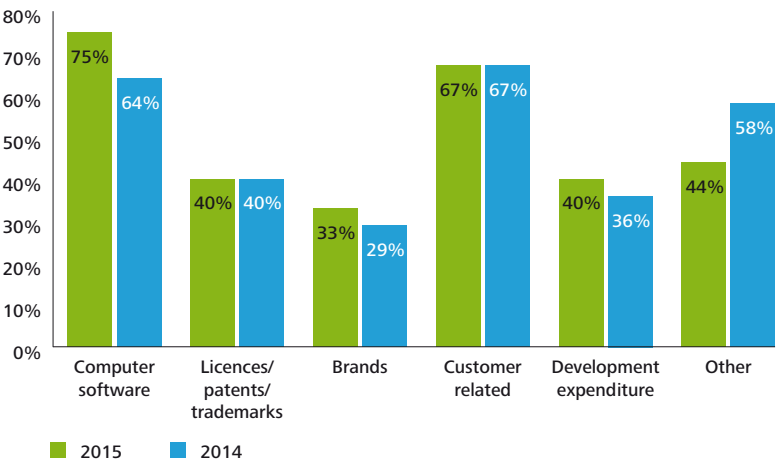
15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Figure 15.8 below analyses the classes of intangible assets (other than goodwill) recognised by companies. The two most commonly recognised classes of intangible assets are computer software and customer-related assets.

**Figure 15.8. Which classes of intangible assets (other than goodwill) are recognised?**



16% of those companies reporting intangible assets (other than goodwill) determined that those assets had indefinite useful lives (2014: 15%). The percentage of those companies disclosing a justification for the indefinite useful life, in accordance with IAS 38 *Intangible Assets*, decreased from 92% to 80% for the year reviewed. A good example of the justification for allocating an indefinite life to intangible assets is given by LSL Property Services plc.

Brand names are not amortised as the Directors are of the opinion that they each have an indefinite useful life. This is based on the expectation of the Directors that there is no foreseeable limit to the period over which each of the assets are expected to generate net cash inflows to the businesses and the Directors are confident that trademark registration renewals will be filed at the appropriate time and sufficient investment will be made in terms of marketing and communication to maintain the value inherent in the brands, without incurring significant cost. All brands recognised have been in existence for a number of years, and are not considered to be at risk of obsolescence from technical, technological nor commercial change. Whilst operating in competitive markets they have demonstrated that they can continue to operate in the face of such competition and that there is expected to remain an underlying market demand for the services offered. The lives of these brands are not dependent on the useful lives of other assets of the entity.

[LSL Property Services plc Annual Report and Accounts 2014 \(p. 96\)](#)

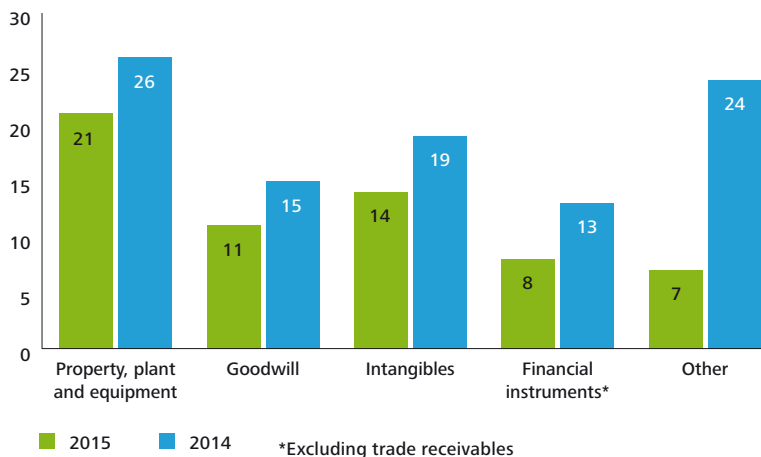
**Impairments**

The number of companies surveyed that recognised impairment losses, excluding impairments of trade receivables (given how common these are), decreased by 20% from 54 to 43 for the year under review. The groups of assets impaired by the companies surveyed, excluding trade receivables, are illustrated in Figure 15.9 below.

This decrease in the number of impairments recognised during the period under review demonstrates the continued economic recovery of the companies surveyed. However, the level of impairment reversals remained low. Only four companies recognised a reversal of impairment, suggesting that not all businesses (that had previously recognised impairments) are seeing the benefit just yet. Additionally, IAS 36 contains certain restrictions around reversals of impairments, for example an impairment of goodwill can never be reversed.

IAS 36 requires the events and circumstances that led to the recognition of the impairment loss to be disclosed for all material impairments. 65% of companies reporting impairment losses appeared to adequately report such information. It appeared that those companies that did not provide the required disclosure may often have omitted it on the grounds of materiality.

**Figure 15.9. What has been impaired during the year?**



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

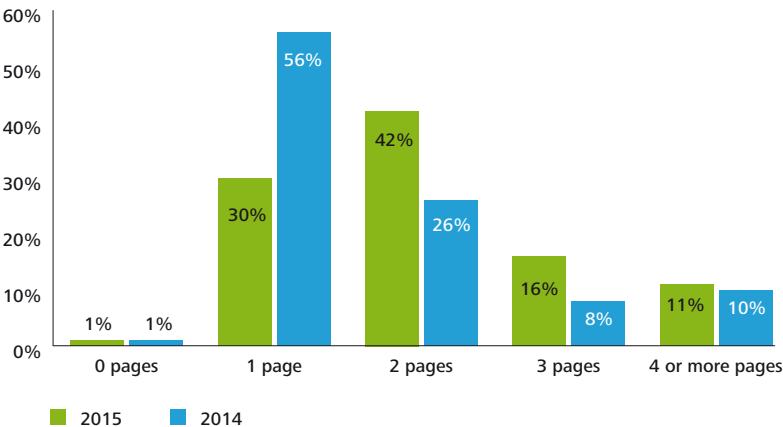
Other resources available

### Share-based payments

Share schemes are a very common part of remuneration packages for directors, senior management and other employees nowadays. 91 companies surveyed (2014: 86) had share based payment schemes.

IFRS 2 *Share-based Payment* contains extensive disclosure requirements. However, the vast majority of companies (71%) continue to limit disclosure to a maximum of two pages, in line with our prior year results. Figure 15.10 below illustrates the length of share-based payment disclosures for the companies surveyed. Only one company with a share-based payment charge omitted IFRS 2 disclosure, but this may have been due to materiality as the charge was relatively small. This remains an area of complex disclosure where companies can still make an effort towards presenting the key terms of the share schemes succinctly, making use of IFRS 2's aggregation provisions where appropriate.

Figure 15.10. How long are the share-based payment disclosures (to the nearest page)?

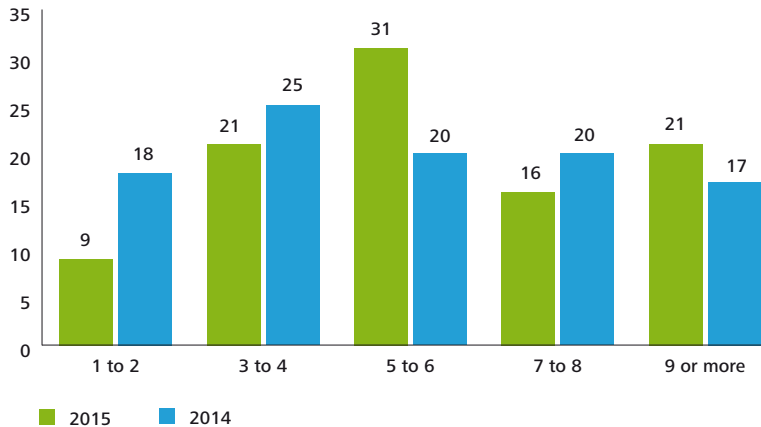


### Financial Instruments

The disclosures for IFRS 7 *Financial instruments: Disclosures* include broad quantitative and qualitative information. A handful of companies surveyed chose to present the required qualitative information about the nature and extent of risks arising from financial instruments together with the accounting policy notes rather than as a separate note, perhaps because they felt that the information was suitably significant that it should be given a greater degree of prominence.

The total IFRS 7 disclosure included in the financial statements of companies surveyed continued to be extensive. The most common length of IFRS 7 disclosure was six pages (2014: five) with 59% of companies presenting IFRS 7 disclosures over six or more pages (2014: 47%). Figure 15.11 below illustrates the range of IFRS 7 disclosure length.

Figure 15.11. How long are the IFRS 7 disclosure notes (to the nearest page)?



With certain exceptions, such as when carrying amounts approximate fair values, the fair value of financial assets and liabilities held at amortised cost should be disclosed under IFRS 7. Consistent with last year, 58% of the companies surveyed with non-current liabilities held at amortised cost presented the fair value of these liabilities (2014: 52%), while 38% provided a negative statement that the carrying value approximated fair value (2014: 43%). 4% failed to provide any information about the relevant fair value of these liabilities (2014: 5%).

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

IFRS 13 *Fair Value Measurement* has been effective since 1 January 2013 providing guidance on how fair value should be measured for most items required to be measured on that basis. The fair value hierarchy defined in IFRS 13 identifies three levels of valuation techniques depending on the inputs used, where level 3 makes use of unobservable inputs. 42 companies surveyed recognised financial instruments at fair value using level 3 inputs (2014: 46). Of these companies, only 12% did not appear to disclose information around the unobservable inputs and any quantitative factors required by IFRS 13, which is an improvement on the previous year (2014: 17%).

The classification of inputs to measure fair value for property as 'level 2' or 'level 3' in the IFRS 13 fair value hierarchy requires judgement and has resulted in much debate in the real estate industry. Illustrative guidance for property companies applying IFRS 13 is provided by the European Public Real Estate Association ('EPRA')<sup>74</sup> in their position paper on this topic. An example of IFRS 13 disclosure for investment property measured using level 3 inputs is given by Primary Health Properties PLC below.

**Fair value hierarchy**

All of the Group's properties are level 3, as defined by IFRS 13, in the fair value hierarchy as at 31 December 2014 and 2013. There were no transfers between levels during the year or for the year ended 31 December 2013. Level 3 inputs used in valuing the properties, are those which are unobservable, as opposed to level 1 (inputs from quoted prices) and level 2 (observable inputs either directly, i.e. as prices, or indirectly, i.e. derived from prices).

**Valuation techniques used to derive Level 3 fair values**

The valuations have been prepared on the basis of Fair Market Value (FMV) which is defined in the RICS Valuation Standards, as:

*"The estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion."*

**Valuation techniques: market comparable method**

Under the market comparable method (or market comparable approach), a property's fair value is estimated based on comparable transactions and using certain unobservable inputs. These inputs are detailed below.

**Unobservable input: estimated rental value (ERV) range**

ERV	ERV	The rent at which space could be let in the market conditions prevailing at the date of valuation.
<b>2014</b> £55,436-£1,158,011 per annum	<b>2013</b> £30,000-£1,157,725 per annum	

**Unobservable input: true equivalent yield range**

True equivalent yield	True equivalent yield	The equivalent yield is defined as the internal rate of return of the cash flow from the property, assuming a rise to ERV at the next review date, but with no further rental growth.
<b>2014</b> 4.83%-6.76%	<b>2013</b> 4.88%-6.85%	

[Primary Health Properties PLC Annual Report 31 December 2014 \(p. 69\)](#)

74. EPRA Position Paper on IFRS 13 Fair Value Measurement [http://www.epra.com/media/EPRA\\_Position\\_Paper\\_on\\_IFRS\\_13\\_February2013\\_1360061211090.pdf](http://www.epra.com/media/EPRA_Position_Paper_on_IFRS_13_February2013_1360061211090.pdf)

**Capital risk management**

Debt and cash flow remain high priority areas that investors want to understand, as highlighted by the FRC Lab. Investors want to know how much debt is owed and when is it due, according to the report. To meet these needs, clarity is required in disclosures around capital management, debt terms and maturity. Net debt reconciliations could also be volunteered, as discussed below.

Specific disclosures around the composition of capital and the objectives, policies and processes for the management of capital are required by IAS 1 *Presentation of Financial Statements*. In their CRR Annual Report the FRC identified capital management disclosures as an area of weakness, for example where companies failed to explain what is managed as capital and inconsistencies in the qualitative and quantitative disclosure on identified capital. An area for improvement remains the coherence and integration of information about funding, cash flows and capital management across the narrative report and financial statements.

While 97% (2014: 90%) of companies surveyed provided some disclosure regarding capital management, as required by IAS 1, in our view 56% of the companies surveyed presented disclosures that did not give a full, company-specific picture of the policies and processes for managing capital.

A good example of capital management disclosure is provided by Unite Group plc. The disclosure shows how other information about funding can be integrated to present a coherent message to users on capital management.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

SECTION 4: FUNDING CONTINUED

4.7 Capital management

The capital structure of the Group consists of shareholders' equity and adjusted net debt, including cash held on deposit. The Group's equity is analysed into its various components in the Statement of Changes in Equity. The components and calculation of adjusted net debt is set out in note 4.4. Capital is managed so as to continue as a going concern and to promote the long-term success of the business and to maintain sustainable returns for shareholders and joint venture partners.

The Group uses a number of key metrics to manage its capital structure:

- Adjusted net debt (4.4)
- Adjusted gearing (4.4)
- See-through LTV (2.3a)
- Weighted average cost of investment debt (4.5aii)

In order to manage levels of adjusted gearing over the medium term, the Group seeks to deliver NAV growth and to recycle capital invested in lower performing assets into new assets and property developments. £71 million of property assets were sold in 2014 and we plan to sell an average of £50 million – £100 million of property each year. The Group targets a yield on cost of approximately 7%. The Group does not commit to developing new sites until sufficient equity and funding to fulfil the full cost of the development is secure.

The Board monitors the ability of the Group to pay dividends out of available cash and distributable profits. The Operations segment generated cash of £35.0 million (2013: £23.2 million) during the year, thereby covering the proposed dividend of £22.5 million, 1.6 times (2013: £8.5 million, 2.7 times).

[The Unite Group plc Annual Report and Accounts 2014 \(p. 129\)](#)

The FRC Lab noted that investors want a better understanding of the link between profit or loss, cash generated and the amounts on the balance sheet. Overall 48% (2014: 44%) of companies presented disclosed a net debt (cash) reconciliation or a reconciliation of net cash flows to changes in net debt. However, of the 62% of our companies that had significant borrowings outstanding at the reporting date this figure was significantly higher, at 65%. Perhaps some companies in a strong net cash position or without significant borrowings feel that such a disclosure would be of limited usefulness to investors. There is currently no requirement to present a net debt reconciliation or a reconciliation of net cash flows to changes in net debt as part of the financial statements, although the IASB has an ongoing project to explore requirements in this area, having published an exposure draft in late 2014 proposing a requirement for information similar to a net debt reconciliation. Voluntary provision of net debt information is also slightly more prevalent among FTSE 350 companies, with 54% of them presenting it compared to 30% of the other companies.

An example of a net debt reconciliation is provided by Compass Group below.

	Cash and cash equivalents £m	Bank overdrafts £m	Bank and other borrowings £m	Total overdrafts and borrowings £m	Finance leases £m	Derivative financial instruments £m	Total gross debt £m	Net debt £m
<b>NET DEBT</b>								
At 1 October 2012	728	(58)	(1,699)	(1,757)	(28)	84	(1,701)	(973)
Net increase in cash and cash equivalents	297	–	–	–	–	–	–	297
Cash inflow from issue of bonds	–	–	(563)	(563)	–	–	(563)	(563)
Cash outflow/(inflow) from other changes in gross debt	–	40	11	51	–	(42)	9	9
Cash outflow from repayment of obligations under finance leases	–	–	–	–	9	–	9	9
Increase in net debt as a result of new finance leases taken out	–	–	–	–	(2)	–	(2)	(2)
Currency translation (losses)/gains	(19)	(2)	(19)	(21)	–	72	51	32
Other non-cash movements	–	–	46	46	–	(48)	(2)	(2)
At 30 September 2013	1,006	(20)	(2,224)	(2,244)	(21)	66	(2,199)	(1,193)
At 1 October 2013	1,006	(20)	(2,224)	(2,244)	(21)	66	(2,199)	(1,193)
Net decrease in cash and cash equivalents	(559)	–	–	–	–	–	–	(559)
Cash inflow from issue of bonds	–	–	(646)	(646)	–	–	(646)	(646)
Cash outflow from repayment of loan notes	–	–	74	74	–	–	74	74
Cash inflow from other changes in gross debt	–	(18)	(3)	(21)	–	(4)	(25)	(25)
Cash outflow from repayment of obligations under finance leases	–	–	–	–	5	–	5	5
Increase in net debt as a result of new finance leases taken out	–	–	–	–	(2)	–	(2)	(2)
Currency translation (losses)/gains	(16)	1	51	52	1	(24)	29	13
Other non-cash movements	–	–	(21)	(21)	–	23	2	2
At 30 September 2014	431	(37)	(2,769)	(2,806)	(17)	61	(2,762)	(2,331)

[Compass Group Annual report 2014 \(p. 131\)](#)

Distributable reserves

A letter from a group of long-term institutional investors and the UK Shareholders Association was sent in late 2014 to all FTSE 100 Audit Committee Chairs to convey their desire for clear and consistent disclosure of the accumulated distributable and non-distributable reserves in published financial statements, including greater clarity over the split between unrealised and realised income included in these reserves. The Lab is also currently undertaking a project on the 'Disclosure of Dividend Policy and Capacity'. Although there is no requirement under the law or accounting standards, 40 companies in our sample (25 from the FTSE 350 and 15 smaller companies presented some information about distributable reserves in their financial statements, predominantly together with disclosures about share capital or reserves. Figure 15.12 illustrates the ways in which companies chose to state this information: positive statement about amount of reserves available for distribution, a statement about amounts which are not distributable or no information about distributable reserves.



1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

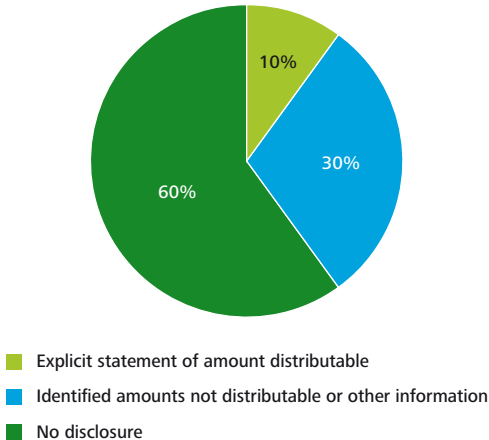
14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

Figure 15.12. How are companies disclosing information about distributable reserves?



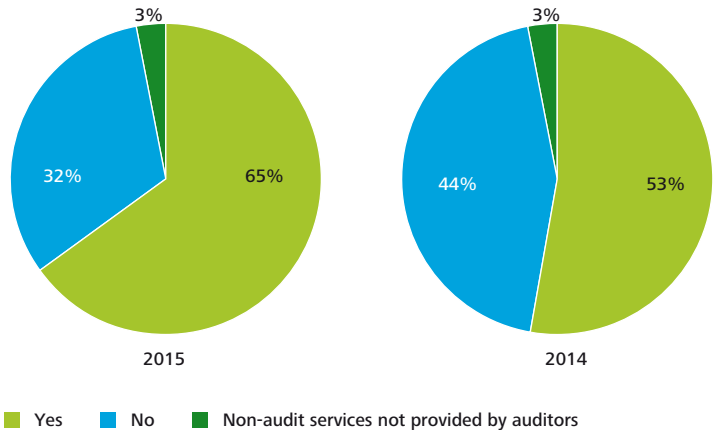
**Auditors' remuneration and independence**

The provision of non-audit services by auditors remains an area of focus and debate for regulators. The EU Audit Regulation which applies to public interest entities comes into force for periods commencing on or after 17 June 2016. The Regulation bans certain non-audit services over and above those already prohibited by existing FRC standards and imposes a cap on fees for non-audit services not required by law or regulation, limiting them to an amount not greater than 70% of audit fees. The FRC is in the process of implementing these in the UK and it will not be clear until late 2015/early 2016 the exact scope of the ban on tax services and whether the cap will apply just to the parent company's auditor or be extended to other component auditors who are part of the auditor's network. Notably, the analysis of non-audit services required by UK law does not currently align with the cap, and companies may want to consider further sub-totals to demonstrate compliance once the law comes into force.

Further, as part of their implementation study into 'Reporting of Audit Committees'<sup>75</sup>, the Lab suggested that many companies could improve their reporting of the nature of non-audit services received, together with information about the relevant fee. Figure 15.13 illustrates the number of companies surveyed that clearly identified non-audit services.

97 companies surveyed (2014: 97) received some non-audit services from their auditors. It was noted that 33% of companies receiving non-audit services did not clearly identify all the services received (2014: 45%). Where these services amounted to 20% or more of the value of the audit fee, 62% of companies provided disclosures explaining why it was in the interests of the company to purchase the non-audit services from the auditor rather than another supplier, although the information was frequently boilerplate in nature. This remains an area for improvement.

Figure 15.13. Are companies clearly identifying all non-audit services?



75. <https://frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/Implementation-Study-Reporting-of-audit-committee.pdf>

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

A significant proportion of companies provided the information around the provision of non-audit services either together with the note on auditor remuneration in the financial statements or within the audit committee report within the front-end narrative reporting. It would be useful for companies to improve the cross references between the audit committee report and the auditor remuneration disclosures. For more information on this see Chapter 12.

A good example of succinct disclosure of audit remuneration including non-audit services and a cross-reference to further information is presented by Vectura Group plc below.

Auditor's remuneration		
The analysis of auditor's remuneration is as follows:		
	2015 £000	2014 £000
Fees payable to the Company's auditor for the audit of the Company's annual accounts	20	20
Fees payable to the Company's auditor and its associates for other services to the Group: – the audit of the Company's subsidiaries	72	63
Total audit fees	92	83
Audit-related assurance services	17	15
Taxation compliance services	4	4
Other taxation advisory services	—	20
Other services	—	315
Total non-audit fees	21	354
<b>Total fees</b>	<b>113</b>	<b>437</b>
Details of the Group's policy on the use of the auditor for non-audit services, the reasons why the auditor was used rather than another supplier and how the auditor's independence and objectivity was safeguarded are set out in the Audit Committee report on page 56. No services were provided pursuant to contingent fee arrangements.		
In the prior year, other services included financial due diligence work to support the acquisition of Activaero GmbH.		

[Vectura Group plc Annual Report and Accounts 2014/15 \(p. 99\)](#)

# Appendix 1 – Glossary of terms and abbreviations

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

**Act Companies Act 2006**

**BIS The Department for Business, Innovation and Skills**

**CEO Chief Executive Officer**

**CGU Cash generating unit**

**CODM Chief Operating Decision Maker**

**Conduct Committee**

A body established by the FRC with legal authority to ensure that the annual accounts of public and large private companies comply with the Act and applicable accounting standards.

**CMA Competition and Markets Authority**

An independent public body which helps to ensure healthy competition between companies in the UK for the ultimate benefit of consumers and the economy.

**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**

**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**

The FCA acts as the UK 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.

**FRC Guidance**

Guidance on the Strategic Report, issued by the FRC, setting out recommendations on how to produce an effective strategic report.

**FTSE 100/250/350**

Indices ranking listed companies by size, published by the FTSE Group.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

**GAAP Generally accepted accounting practice**

**<IR> International Integrated Reporting Framework**

A framework produced by the IIRC to bring greater cohesion and efficiency to the reporting process, and help companies adopt 'integrated thinking' as a way of breaking down internal silos and reducing duplication.

**IAS International Accounting Standard**

**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**

A global coalition of regulators, investors, companies, standard setters, the accounting profession and NGOs, which maintains and updates the <IR> framework.

**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.

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

**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](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**

**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 premium 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.

# Other resources available

1. Executive summary

2. How to use this document

3. Regulatory overview

4. Survey objectives and methodology

5. Overall impressions

6. Summary material

7. The strategic report

8. Key performance indicators

9. Principal risks and uncertainties

10. Going concern and viability

11. Corporate governance

12. The work of the audit committee

13. The auditor's report

14. Primary statements

15. Notes to the financial statements

Appendix 1 – Glossary of terms and abbreviations

Other resources available

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Tracy Gordon  
[trgordon@deloitte.co.uk](mailto:trgordon@deloitte.co.uk)

James Rogers  
[jrogers@deloitte.co.uk](mailto:jrogers@deloitte.co.uk)

Corinne Sheriff  
[csheff@deloitte.co.uk](mailto:csheff@deloitte.co.uk)

Amanda Swaffield  
[aswaffield@deloitte.co.uk](mailto:aswaffield@deloitte.co.uk)

Peter Westaway  
[pwestaway@deloitte.co.uk](mailto:pwestaway@deloitte.co.uk)

## UK Accounting Plus

For the latest news and resources on UK accounting, reporting and corporate governance, go to [www.ukaccountingplus.co.uk](http://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.

## GAAP 2016 Model annual report and financial statements for UK listed groups (due out around the end of 2015)

This Deloitte publication illustrates the disclosures in force for December 2015 year ends, including material encompassing all of the revised reporting requirements discussed herein. If you would like to obtain a copy of this publication please speak to your Deloitte contact.

## Executive pay publications

Further information on directors' remuneration and directors' remuneration reports can be found at <http://www2.deloitte.com/uk/en/pages/tax/articles/executive-pay-publications.html>



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