Annual reporting in 2014:
reflections on the past, direction for the future

September 2015

EY
Building a better working world

Foreword

Welcome to our review of 2014 annual reporting in the FTSE350. In last year's report entitled *Out with the old, in with the new,* we concluded that following significant developments in the annual reporting landscape, those tasked with preparing and writing annual reports and accounts (ARAs) had responded well, but there was still work to do. This year, in contrast, was relatively calm as preparers had very little or no change to contend with. This offered, we felt, a year for consolidation in which companies had the opportunity both to let the changes they had made bed in and to innovate.

Having conducted our review this year, we found that companies have again made progress and throughout this report we highlight those demonstrating leading practice. However, in some areas we were unable to find examples of a company meeting all elements of leading practice. Business model reporting seems to be a particularly tricky area.

The 'fair, balanced and understandable' (FBU) requirement has led to some companies making changes to the look and feel of their ARAs, which was one of the requirement's key objectives. We were pleased to see some companies referring to FBU when making improvements to their reports.

In other areas there was less progress. Companies continue to struggle to make linkages throughout their reports. This is connected to the fact that many are unable to clearly articulate their business model and strategy and these should form the basis of everything else they report and disclose.

In governance reporting terms, nomination committee reporting lags behind that of the other board committees. It is perhaps no surprise that the Financial Reporting Council (FRC) plans to focus on the role of this committee in the coming months, and we hope our recommendations support companies in making improvements in this area.

The updated 2014 UK Corporate Governance Code (the 'Code') will soon impact the 2015 ARAs of companies and disclosures on risk management and the viability statement are top of mind for preparers. With these new changes, amongst others coming into force next year, managing the tension between being clear and concise and meeting regulatory standards and leading practice can be a struggle.

However this tension needs to be addressed and ARAs improved. While many companies believe that investors do not read ARAs, those we have spoken to re-affirm their usefulness.

We are delighted that Sacha Sadan, Legal and General Investment Management's (LGIM) Director of Corporate Governance, has contributed to this report by sharing some frank insights on why annual reporting is important to LGIM and the wider investor community and how they are used. We would like to thank him for his time.

Consistent with the many good ARAs we read and analysed, we too have taken steps to make our report more usable and digestible this year. It has a new design, case studies including extracts from ARAs and a more interactive PDF version to help readers navigate the report more easily. We hope that the key reporting developments and hallmarks of leading practice that we have identified will help you in improving your own ARA.

We look forward to hearing your feedback and views.

Ken Williamson
Head of Corporate Governance,
EY UK & Ireland

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This is the interactive version of the report which contains navigation aids, click-throughs and external links. Access the print version from the report home page or get in touch with one of the EY contacts in Appendix E for a hard copy.

01. Q&A with Sacha Sadan

Director of Corporate Governance, LGIM

Those who prepare annual reports often wonder how they are used by investors. We interviewed Sacha Sadan to find out why annual reports are important to LGIM and what improvements they would like to see as investors.

Why are annual reports important to you/investors?

Many companies think that no one reads or cares about ARAs. We care passionately about them. We provide the capital and therefore require reliable reporting and accountability on how such capital is used. While there are many sources of reporting, the ARA is still 'king'. Many teams within LGIM use the different sections of the ARA, including the equity, fixed income and corporate governance teams. Having something written down means that companies have to think very carefully about what they are doing and we see what is written in the ARA as a sign of commitment. The very act of crystallising and writing down information about the company succinctly is a good experience. We use these commitments to hold companies to account. In reality having this written down means that companies rarely go back on such commitments, if they did we would engage with them.

Annual report disclosures are a good way for companies to show they are considering the risks to the business. Then if something goes wrong at a company we look at the ARA to see if it has been identified as a risk previously. We are not perfect, nobody is, and so we understand things don't always go to plan. But when something goes wrong we will give a company much more kudos if it was signalled in the ARA either as an emerging area or something they'd tried to devote attention to, so we do also use ARAs in a backward looking manner.

> ***"While there are many sources of reporting, the ARA is still king".***

Sacha Sadan,
Director of Corporate Governance, LGIM

Sacha is Director of Corporate Governance at LGIM and has overall responsibility for the corporate governance team which includes all Environment, Social and Governance (ESG) areas. The team performs a highly active role in engaging with the companies in which LGIM invests, seeking to deliver the best-possible long-term value for shareholders. The team also regularly collaborate with other investors, governments and regulators.

Sacha is a member of The Investment Association, Governance and Engagement Committee. Sacha also helped in the formation of the new UK Investor Forum and is a founding member of their Board.

Prior to joining LGIM, Sacha worked for Gartmore where he was a Senior UK Equity Fund Manager and co-managed a range of UK equity hedge, retail and institutional funds. Sacha was the top-rated Pan European Fund Manager in the Thomson Reuters Extel Awards in 2010 and rated third in 2009 as voted by UK companies and key sell-side participants.

Prior to Gartmore, Sacha was the lead UK Equity Fund Manager of a £4bn pension fund for the Universities Superannuation Scheme PLC. Sacha is a member of the CFA Institute and holds a BA in Accounting and Finance from Manchester University.

What do you like to see in annual reports?
Investors are encouraged when companies write about what didn't go well. Honesty is a key thing we look for. We do not like to be surprised when we look at the numbers or share price after reading a wholly positive narrative about the year. We also like to see how issues are being addressed and dealt with by the board during the year. This level of transparency is key to understanding the company from the outside looking in.

Some companies see their ARA as a legal document, but it is more than that. We want to see the ambition of the company. The safe harbour rules should mean that companies can talk about what they want to do, not just reflect on the past. However, we do not want the ARA to become a marketing document. Boards therefore need to play a part in sense-checking them and making sure that they are of the right quality and are balanced.

How do you use annual reports?
When our corporate governance team meets with a company, the first port of call for our preparation is the ARA. We will use that first and foremost before looking at any other document or source including the website. It is a great starting point for engagement with a company. Often the ARA provides us with hooks which we can follow up on at the meeting to get into the detail. The Chairman's statement, the disclosures on the board evaluation and the diversity statement are great indicators of how a company is working.

As investors, we will understandably never have a full picture because to some extent we are 'outsiders', but honest, balanced ARAs give us some pieces of the jigsaw.

Are there any issues or areas in particular that you look for and want improvements to be made in?
Diversity is an issue which is important to us and we want to see targets and details disclosed, not just boilerplate information. This is because a diverse board with directors who can offer truly fresh insights from a variety of perspectives enhances debate which in turn improves decision making. Board evaluations can help companies identify these gaps and be constructive in improving board processes. This is why we would like to see more detail about the findings of these reviews and the action plan on the areas of improvements disclosed.

We are also concerned that when it comes to cyber security not enough companies are talking about it or reporting on how the board is managing this key risk. It is surprising that in this review only 17% of companies list cyber security as a principal risk.

Annual reporting is important in order to provide investors with **assurance** on actions taken to **promote long-term success.**

77% of institutional investors considered the annual report to be an 'essential' or 'important' source of non-financial information when making an investment decision according to EY's report *Tomorrow's Investment Rules: global survey of institutional investors on non-financial performance*[1].

[1] EY, *Tomorrow's Investment Rules: global survey of institutional investors on non-financial performance*, 2014.

02. Our 'acid test'

In our 2014 report, we introduced the idea of an 'acid test', that is, the key questions a reader should be able to answer having read the narrative report. We have now extended this set of questions in light of the 2014 UK Corporate Governance Code:

Business model:

- How does the company make its money?
- What are the key inputs, processes and outputs in the value chain, and how are the company's key assets (including its physical assets, IP, people, technology, etc.) engaged in the value chain?

Strategy:

- What is the company's competitive advantage?
- How does the business model help deliver and sustain this over time?

Risk appetite:

- What levels of risk are the board willing to take in pursuit of its strategy?

Key performance indicators (KPIs):

- What are the key metrics the board uses to measure progress against its strategic objectives?
- How has the company performed against these metrics and how are these linked to the remuneration of key executives?

Principal risks:

- What are the risks to the successful delivery of the strategy and operation of the business model?
- In addition, given the latest changes to the Code, what are the risks that pose the greatest threat to the viability of the company i.e. solvency and liquidity risks?

Risk management and internal control disclosures:

- How are the principal risks mitigated and controlled by the company's systems of internal controls and risk management?
- How does the board monitor material controls on an ongoing basis to gain assurance that principal risks are being effectively managed and to take corrective action if they are not?
- What did the board's review of the effectiveness of these systems encompass?
- Has the board identified significant failings or weaknesses?
- What was the basis for determining what is 'significant'?
- Is it clear what actions have been or will be taken to address significant failings or weaknesses?

Viability statement:

- Over what timeframe has the board considered the viability of the company and why?
- What process did the board use to assess viability?
- What assurance did the board obtain over relevant elements (e.g., stress testing)?
- What assumptions did the board use in reaching their conclusion?

Governance:

- What did the board and its committees actually do in the year to govern the company?
- What, if any, changes were made to governance arrangements during the year and why?
- What areas for improvement were identified from the board evaluation and what progress was made against actions from the previous evaluation?
- How is board composition and succession planning being managed, giving due regard to skills, experience and diversity?
- How did the board seek to understand the views of shareholders during the year and what, if any, action was taken as a result of feedback?

03. Quick read

Our review of 2014 Annual Report and Accounts (ARAs) has found that broad improvements have been made but the difference is in the detail.

01

Key areas for improvement

1.
*Creating **linkages** between a clearly articulated **business model, strategy, key performance indicators, risk** and **remuneration** (page 12)*

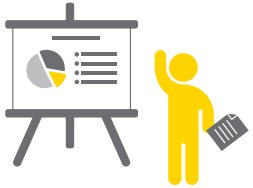
2.
***Clear and concise** reporting with an emphasis on **relevant, specific details** (page 9)*

3.
*Nomination committee reporting on **board composition and broader succession planning** (page 30)*

4.
*Governance reporting on **shareholder engagement** and **board evaluations** (pages 26 and 32)*

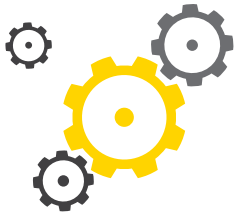
02

Why is annual reporting important?



1.
*Providing investors with **assurance** on actions taken to **promote long-term success and hooks for further engagement** (page 4)*

2.
*Strengthening accountability by demonstrating **commitments for the future** (page 4)*

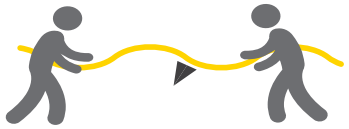


3.
*Driving better **governance outcomes***

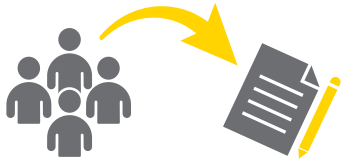
4.
*Meeting **regulatory requirements** (page 53)*

03

What are the key challenges?



1.
*Managing the tension between increasing **required disclosures** and the need to be **clear and concise** (page 9)*



2.
*Coordinating the production of the ARA between a **variety of authors** across the business while **maintaining a cohesive narrative***

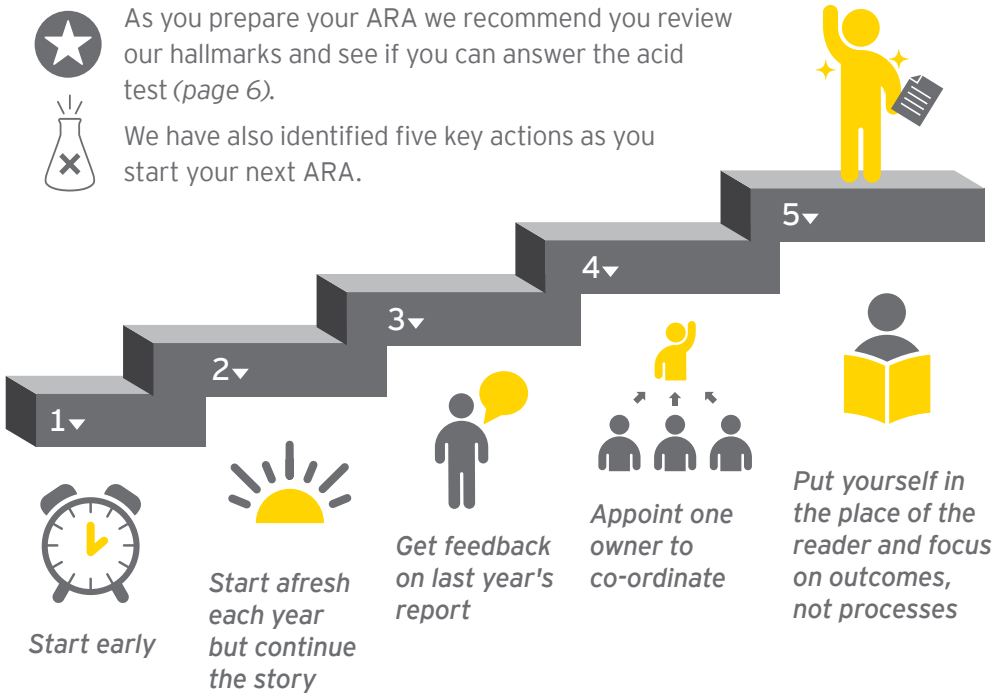
3.
*Keeping up with current, ongoing and future changes to **regulation, recommendations and leading practice** (page 53)*

04

The 5 priority actions for your next report

As you prepare your ARA we recommend you review our hallmarks and see if you can answer the acid test *(page 6)*.

We have also identified five key actions as you start your next ARA.



04. Clear and concise reporting

Whilst there has been limited change in regulatory requirements this year, looking back over the last five years we have seen a huge increase in requirements relating to the ARA. With new changes coming in next year, as part of the Code and other sources Δ, this trend is continuing. Therefore, companies continue to have to deal with a tension between an increasing number of regulatory requirements, which generally call for information to be added to the ARA, and the pressure to report clearly and concisely. The average length of ARAs is continuing to creep up, with a 2% increase between 2013 and 2014.

It is often the case that the inclusion of less relevant information can cloud a report's overall narrative. A company's attempt to be clear and concise should go hand-in-hand with making sound disclosures that link together effectively, as well as ensuring the report meets the FBU test.

One way of making reports more concise is to move to the back, annexe or remove (regulation permitting), standing information that does not change from year to year. The same applies to large amounts of detail that are only required for reference. Organising in this way also helps focus clearly on actions that have been taken during the year and their outcomes, rather than general processes, roles and responsibilities. It is important that the ARA remains a living document which makes it easy for readers to pull out the most relevant and up to date information.

Case study:

Anglo American plc

Anglo American has reduced their front half disclosures by 42 pages compared with last year. Our analysis found that changes to achieve this included:

- Removing the review of the industry
- Reducing the performance, portfolio and people reviews as well as the detailed analysis of each material mined by the company
- Moving the Directors' Report to the back

Average length of ARAs

167 pages

(2014)

163 pages

(2013)

148 pages

(2012)

This symbol (Δ) denotes a reference to changes in regulation which are explained in detail in Appendix B 'A look ahead: upcoming regulatory developments'.

Some companies have taken steps to significantly reduce the length of the front half of their ARA. This should lead to companies being able to tell a clearer, more concise story. 37% of companies in our review adopted a supplementary approach in order to achieve this. Examples of content moved to the back of the ARA in, for example, an 'Additional Information' section were:

- Specific details relating to products in certain sectors e.g., details of mines, properties owned, IP licences, geographical overview
- The Directors' Report
- The remuneration policy
- A five-year review
- Details of non-GAAP measures and glossaries/technical terms

We have also seen increasing numbers of companies improving the experience of reading their ARAs through interactive digital media. The Financial Reporting Lab has recently published *Digital Present* from its project *Corporate reporting in a digital world* covering investors' views on digital communication used by companies in their corporate reporting.

We will continue to monitor innovations in digital corporate reporting and hope that communication with investors will be enhanced by developments in this area.

Fair, balanced and understandable (FBU)

This was the second year that boards have been required to assert that they consider the entire ARA to be FBU. This has continued to have an impact on ARAs, with 19% of the companies within our sample making significant changes to make their reports more FBU this year. They have done this in various ways, including:

- Providing clearer explanations of business model and strategy
- Introducing more transparent summaries of principal risks
- Reducing jargon and technical language
- Providing definitions when technical language is used
- Creating clearer links between sections of the ARA
- Making the ARA more user-friendly and accessible e.g., by using graphs, diagrams and other visual aids

Even though it is not a requirement of the Code, our research found that 54% of ARAs also included a description of the process undertaken to help the board make its FBU assertion. Investors have told us, however, that it is not the FBU process that interests them as much as the outcomes of the FBU assessment. What changes have been made to the ARA as a result of the review?

Although it is difficult to judge the 'balance' of a report as an outsider, it seems there is still room for improvement in this area. Many reports fail to transparently disclose the challenges and difficulties faced during the year, alongside achievements.

> ***"Despite the huge volumes of available data in the market, the statutory accounts remain the most popular source of financial information on a company. It is slightly concerning however, that they are seen to include more and more irrelevant information, while often omitting more pertinent detail."***
>
> **Will Goodhart,** Chief Executive of CFA UK, cited in *Annual report is now a "corporate brochure"* by **Raymond Doherty,** Economia, 13 July 2015

Non-GAAP or alternative performance measures (APM)

In terms of balance, the other pertinent area for consideration is the disclosure of non-GAAP or alternative performance measures. ESMA published *Guidelines on Alternative Performance Measures* in June 2015. The Guidelines apply broadly to all regulated information. This would include management reports such as the Strategic Report[2].

These Guidelines apply to documents issued on or after 3 July 2016. They include that APMs should not be displayed with more prominence, emphasis or authority than measures directly stemming from financial statements. However, in this report we argue that companies should focus on the KPIs that really measure the delivery of the strategic objectives; these may not be GAAP measures in some cases. This requirement has the potential to create a degree of tension with the directors' desire to place appropriate focus on their KPIs and avoid clutter in the drafting of the Strategic Report. Directors will, accordingly, need to review the report carefully to ensure balance.

Case Studies:

Aggreko plc (Page 5)

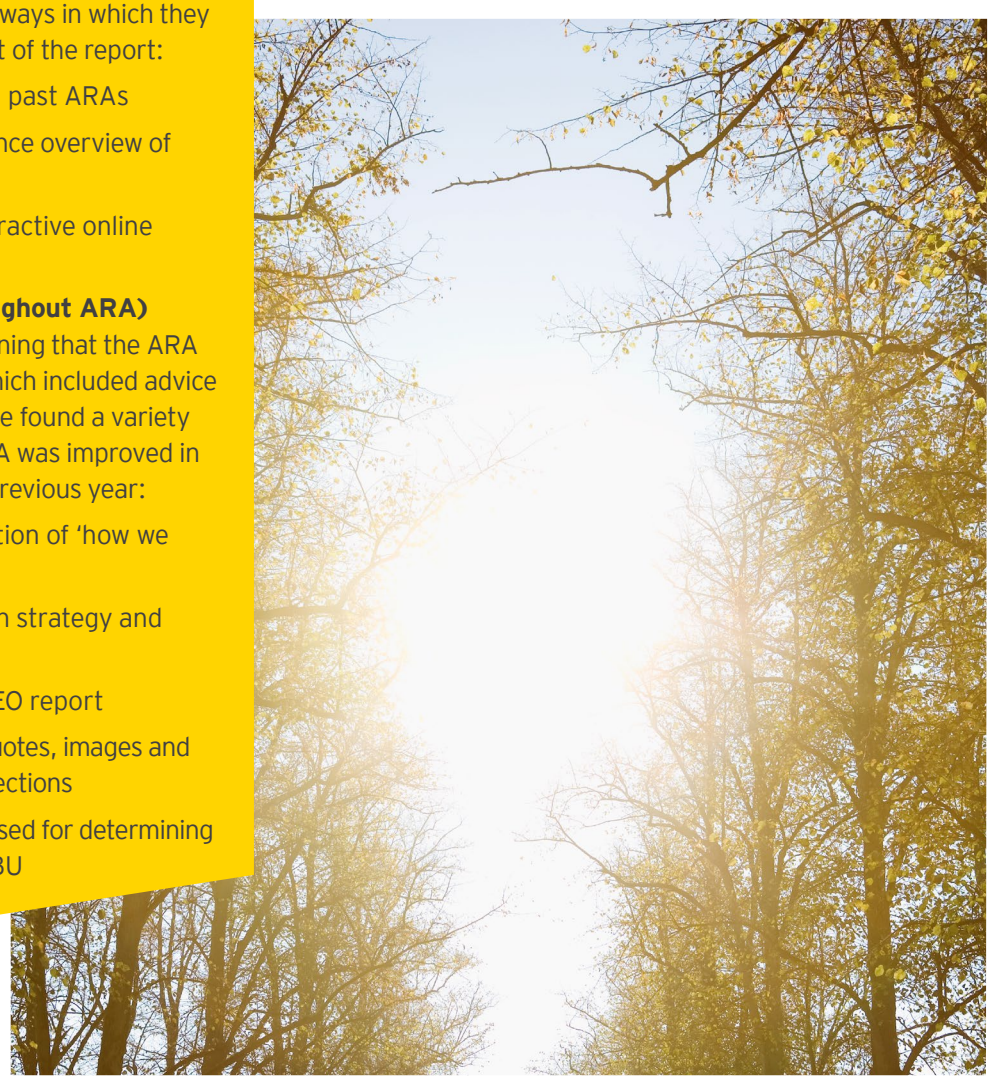
A call out box describes ways in which they have updated the format of the report:

- Collected feedback on past ARAs
- Introduced an at-a-glance overview of the company
- Published a more interactive online version of the report

Hammerson plc (throughout ARA)

The process for determining that the ARA was FBU is disclosed, which included advice from external parties. We found a variety of ways in which the ARA was improved in terms of FBU from the previous year:

- Simplified the description of 'how we create value'
- Created a link between strategy and sustainability
- Used a Q&A for the CEO report
- Increased the use of quotes, images and signposting between sections
- Disclosed the criteria used for determining that the report was FBU



[2] The Guidelines do not apply to financial statements. However, they do apply to other sections that make annual and half yearly financial reports, in particular management reports.

05. The Strategic Report

The Strategic Report was introduced to communicate to investors how directors have promoted the success of the company during the year. This key section is an opportunity for companies to provide critical strategic information on performance and future prospects. It should be cohesive with the financial statements and increase transparency. We encourage companies to take the opportunity to tell a clearly articulated story and to be innovative in how they tell the story of their business.

The quality of the Strategic Report depends on a variety of factors. The most important are:

- The clarity of the narrative explaining developments and performance during the year
- The effectiveness of connections between the business model, strategy, key performance indicators (KPIs), risks, and remuneration
- The degree of insight into the company's future plans

Less than 10% of ARAs provide linkages from strategy, to KPIs, risks and remuneration. However, links from strategy to KPIs are more common, with 50% of reports creating some connection. 33% of reports linked strategy to principal risks and 20% made clear links from the strategy and strategic objectives to remuneration.

Making precise linkages between key elements such as the business model, strategy, KPIs, risk and remuneration, can be a challenge. These links are often made using a key or table to show how different performance indicators, risks or variable remuneration measures are relevant to each element of the strategy. While these methods are effective, they are not the only way to create links and we would encourage companies to think creatively about how connections can be clearly articulated. Examples include: risk sections which provide explicit explanations as to how each particular risk impacts the strategy, or 'at-a-glance' sections which give an overall picture of the connected elements with signposts to further detail in each section.

Business model

Asking a simple question - how does the company make money? - can help to assess if a business model description is informative and useful.

Based on this test, we found that 42% of business model descriptions fail to give the reader a full understanding of what the business does and how it makes money. Many reports continue to describe the business model as a set of values or statements of intent rather than a practical explanation of how the business works.

The Financial Reporting Lab's 2014 stakeholder survey showed that business model reporting was one of the respondents' top priorities and we welcome the Lab's upcoming research on this topic[3].

9% of ARAs

had a clear link all the way from **strategy,** to **KPIs**, to **principal risks** through to **remuneration.**

[3] For more information read: *Lab Project Call for Participants: Business model reporting,* July 2015.

Case studies:

Antofagasta plc (page 12–13)

- The business model (see Figure 1) explains the inputs, processes and outputs of the business.
- It also shows which stages in the business model require varying levels of investment and those which create varying levels of income.
- The estimated number of years for which investment is required for each of the stages is also shown.

InterContinental Hotels Group plc (page 10–13)

- The business model description is preceded by an explanation of the different business models within the hotel industry for comparison.

Moneysupermarket Group plc (page 15)

- The business model is described in simple terms, without any jargon, and clearly explains how the business makes money.

Taylor Wimpey plc (page 18–23)

- The business model is linked clearly to strategy, strategic objectives and KPIs.
- The sustainability report and operating review are also structured around the business model.

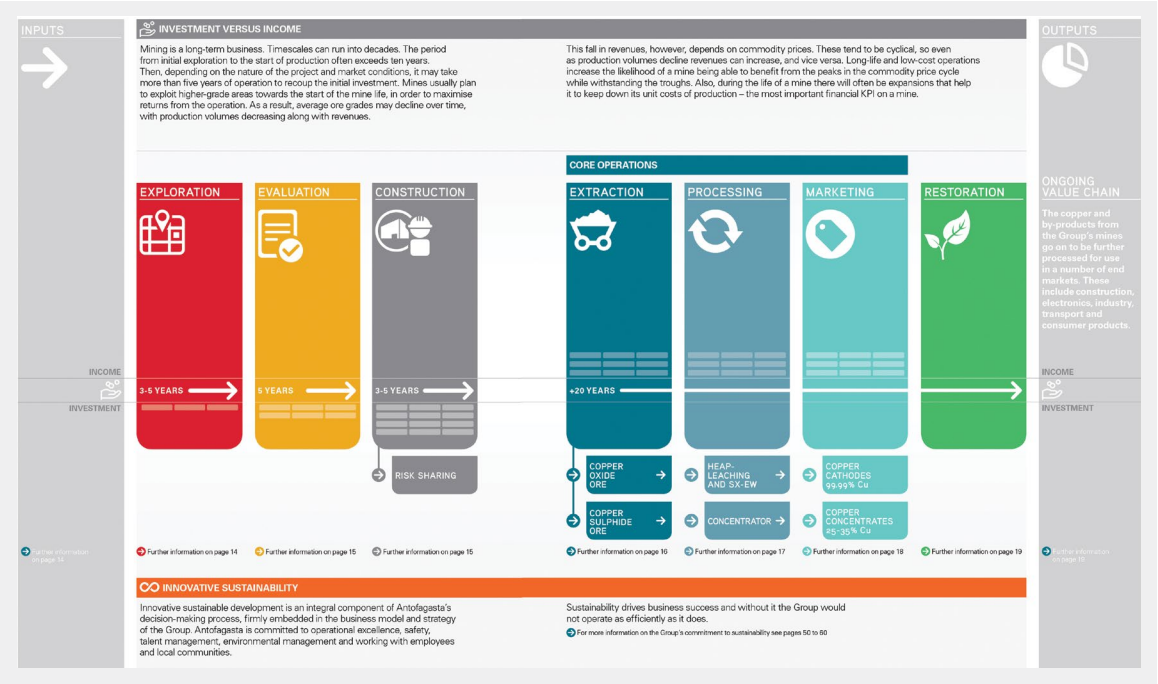


Figure 1. Antofagasta plc (page 12–13)

Hallmarks of leading practice business model reporting:

- Clear, simple language describing how the company makes its money
- An overview of the business' inputs, processes and outputs
- An explanation of how the key assets (including physical assets, intellectual property, people, technology, etc.) are engaged in the value chain
- Insight into investment and revenue streams in relation to different parts of the business
- Connection from the business model to the strategy and KPIs
- A comparison of the business model used by the company to those typically used in the sector and why management believe their model is most effective

"Annual reports are an important source of information for investors. They provide us with a real understanding of a business and its drivers, its financial strength, and the quality of management. We look to the report to provide us with the building blocks on which we make our investment decisions. The quality of these reports really matters. My message to companies is that improving the quality of your reporting will make you more attractive to investors."

Jessica Ground, Global Head of Stewardship, Schroders, cited in FRC Consultation: Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies, June 2015[4]

[4] *Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies: Discussion paper on the FRC's findings and proposals,* June 2015, pg. 10.

Strategy and strategic objectives

While the business model should demonstrate how the business creates value, the strategy should explain the approach taken to sustain this value over time. It is important that companies disclose a clear strategy linked to a set of strategic objectives. These are more granular expressions of how the strategy will be achieved and implemented. We have found that companies with well communicated strategies and clear strategic objectives are most likely to offer better overall reporting in terms of telling a story of the year with clear links from strategy to performance measures, through to risks and remuneration.

In addition, some companies use several different but related concepts, for example: values, differentiators, goals, purpose, vision and mission. Through our review, we found that these concepts are sometimes used inconsistently or interchangeably which can create confusion for the reader. Where companies choose to disclose these connected aspects of their strategy, they need to ensure that it creates clarity rather than confusion.

Finally, linking sustainability and strategy continues to be an area of evolving thought and practice. Last year, we suggested that companies could do better in articulating the aspects of sustainability that are critical to the success of their business.

Our research this year highlights that significant improvement is still required. Most ARAs do not make an effective link between sustainability and the company's strategy, KPIs or risks. If it does not make these connections clearly, reporting will do little more than tick the compliance box and add to the boilerplate.

The Companies Act 2006 requires quoted companies – to the extent necessary for an understanding of the development, performance or position of the company's business – to provide information on environmental matters, the company's employees, social, community and human rights issues, including information about any relevant policies and their effectiveness. We recommend that companies make use of this inbuilt 'materiality test' – i.e. these disclosures are required "to the extent necessary..." and hence where sustainability matters are relevant, we recommend companies clearly explain how they link and integrate with strategy. Companies that wish to present their sustainability activities in more depth can do so by perhaps producing a separate report, placing disclosures on a website or providing information in an appendix.

Hallmarks of leading practice reporting on strategy:

- Well-defined, company-specific strategy linked to clear expressions of how strategy will be achieved and implemented
- Short and long-term objectives disclosed
- Explanation of how the business model supports the achievement of strategy through competitive advantage
- Clear links between strategic objectives, KPIs, principal risks and remuneration
- Cohesion and clarity between varying "concepts" such as purpose, vision, mission or values
- Description of how the global environment, market trends or industry context impact the strategy and each of its objectives
- An explanation of what makes and sustains the competitive advantage of the business in relation to others in the industry

Case studies:

Moneysupermarket Group plc (page 2–3)

- The 'At-a-Glance' section provides a clear overview of the linkages between the strategic priorities, KPIs and risks.
- The report explains that the KPIs are new this year following evolution of the strategy.

GlaxoSmithKline plc (page 12–13)

- The strategic priorities are outlined with reference to progress since 2008, as well as progress in 2014.
- Key challenges in 2014 in relation to each of the strategic priorities are also explained.

Smith & Nephew plc (page 14–15)

- The 'How we performed' section shows clearly defined strategic priorities linked to an explanation of the global outlook for the industry.
- Related KPIs are also shown for each of the strategic priorities.

Key performance indicators (KPIs)

KPI disclosures should enable users of ARAs to see how the company is progressing towards achieving its strategy and strategic objectives. Investors we have spoken to express their frustration at being presented with numerous different sets of KPIs – in the Strategic Report, remuneration report and at investor presentations. They would like KPI sets to be consistent or, at the very least, to see an explanation of what links the different sets.

The Companies Act 2006 stipulates that the Strategic Report must: "to the extent necessary for an understanding of the development, performance or position of the company's business, include:

- Analysis using financial key performance indicators, and
- Where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters."

While most companies present a balance of financial and non-financial KPIs, 16% of Strategic Reports we reviewed did not include any non-financial KPIs. This minority of companies tend to limit themselves to standard financial KPIs, without any additional company-specific KPIs that are tailored to the strategy. Recent guidance, *Towards Transparency* published by ICAS[5], explains the importance of tracking non-financial measures in today's highly dynamic and complex business environment and provides guidance on the KPI selection process as well as sources of assurance.

It is also important to explain the relevance of each KPI. Why has each KPI been selected as a performance measure for this company? This step is often overlooked, yet it is a key aid to understanding. Finally, the narrative in the performance review section and the KPIs are often divorced from one another. In our view, the performance review section should primarily detail the achievement (or not) of KPIs against targets, rather than discussing performance using a different set of measures. However, companies do face a challenge as there is a regulatory expectation to include GAAP measures in the performance section which are not always the measures used for KPIs.

There has been an increase in the number of reports showing KPI trend data going back more than two years, with 37% of companies disclosing five-year performance trends and 26% disclosing trends over three years. We encourage companies to disclose KPI trend data over a period that allows a meaningful comparison between years, as this significantly enhances shareholders' ability to contextualise and assess performance during the specific year under review.

Hallmarks of leading practice reporting of KPIs:

- A broad set of KPIs, including financial and non-financial measures that are specific to the company
- Links from KPIs to strategic objectives, as well as principal risks and remuneration, where applicable
- Explanation of why each KPI has been chosen as a useful measure for the company
- Transparency and balance in reporting performance against targets including whether the targets have been met and if so an indication of future targets
- Statement on whether KPIs have changed from the previous year and, if so, why
- KPI trend data over a series of years, where relevant
- Narrative in the performance review section provides context for the actual performance in respect of the KPIs

[5] ICAS, *Towards Transparency: Assurance on KPIs – A practical guide for audit committees and boards*, June 2015.

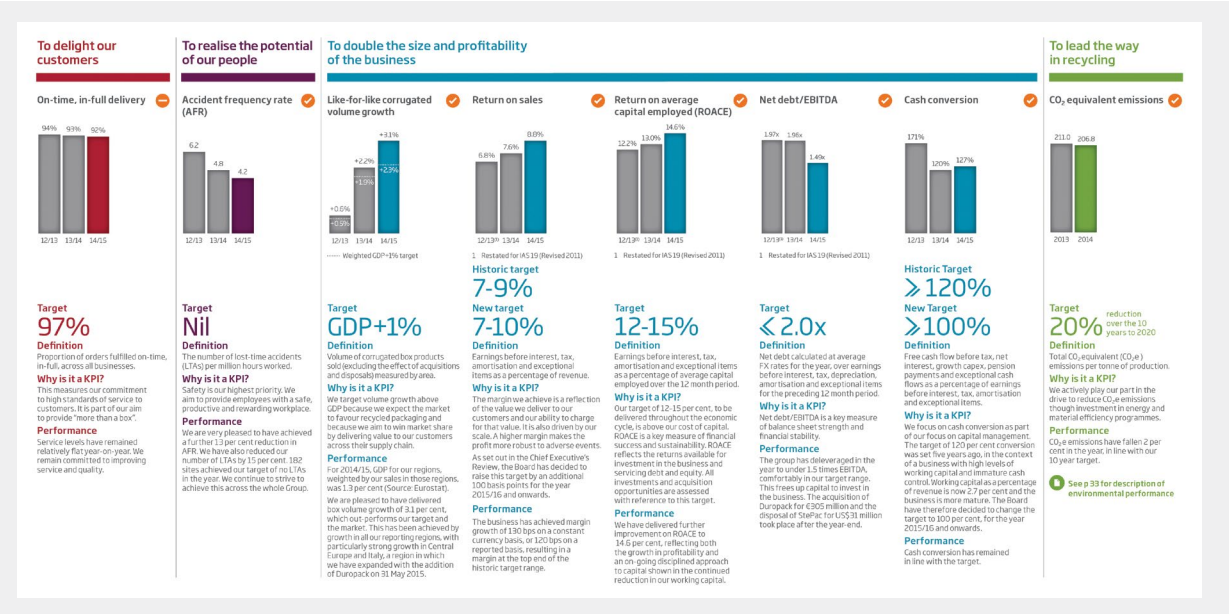


Figure 2. DS Smith plc (page 20–21)

Case studies:

DS Smith plc (page 20–21)

- KPIs are shown in categories according to the strategic priorities that they are intended to measure (see Figure 2).
- New and historic targets are disclosed.
- A definition of each KPI, an explanation of why each has been selected as a KPI and related narrative on performance are also provided.

Vodafone Group plc (page 16–17)

- A range of company specific KPIs have been set.
- Clear indicators show whether the target for each KPI has been 'Achieved' or there is 'More work to do'.
- Definitions and narrative on the performance of each KPI are also included.

Meggitt plc (page 27–30)

- KPIs are linked to the strategic objectives through a key.
- Specific targets are set and progress against these is reported.
- The link between each KPI and directors' incentive plans is explained in detail.

Risk disclosures and the viability statement

Principal risks

The average number of risks disclosed has increased from eight in 2013 to 11 in 2014. The highest number of risks disclosed in our sample was 31, by a bank[6]. The highest number of risks disclosed by a non-U.S. Securities and Exchange Commission (SEC) registrant, non-bank, was 18 and, the lowest, five. The risks rightly vary owing to the size, sector, and geographic spread of operations but the five most common categories of risk we noted from our review are shown in Figure 3.

The number of companies reporting cyber security as a risk is notably low at 17%. This is especially surprising as the *FT-ICSA Boardroom Bellwether*[7] survey found that 77% of company secretaries surveyed said that their board considers exposure to cyber security to be on the increase. Investors and independent directors also tell us that they are concerned about cyber security.

Challenges remain in disclosing risks that are sufficiently company specific and in describing the nature of the risks and mitigation activities in more depth. In addition, over half the reports we reviewed struggled to clearly articulate the link between principal risks and strategy and/or business model.

Before they consider disclosure, we expect that boards will spend time discussing and debating principal risks, their relevance and mitigation. In our view, boards and risk functions must begin to think more about the risks to solvency and liquidity as these directly impact a company's viability. Once they have had this debate, we would encourage companies to 'benchmark' their resulting principal risk disclosures against the hallmarks we have identified.

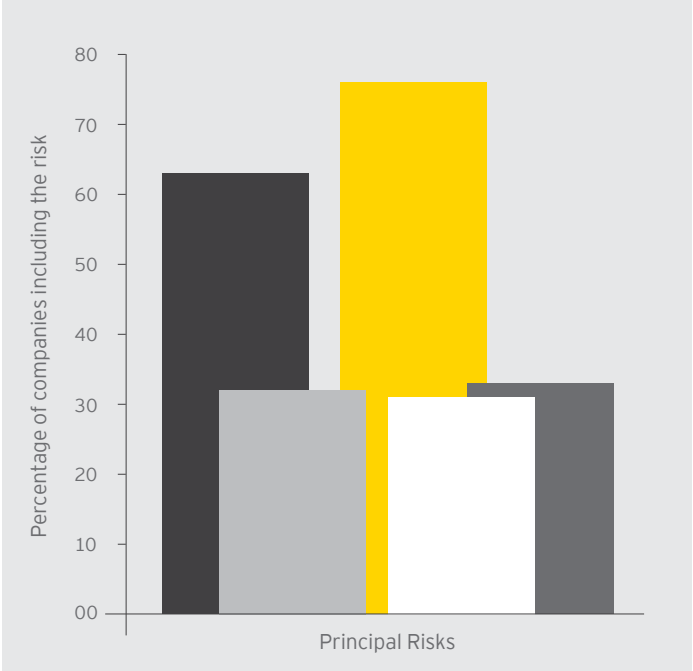


Figure 3. Most commonly disclosed risks

- 76% Legal and compliance
- 63% HR-related risks including staff & skills retention
- 33% Security (HSE 16%: Cyber 17%)
- 32% Political factors
- 31% Programme delivery, quality and timing

[6] Banks are subject to further disclosure requirements on risk (most notably the Enhanced Disclosure Task Force and Basel III).

[7] FT-ICSA, *Boardroom Bellwether: Insights into what boards are thinking from the survey of FTSE 350 company secretaries,* July 2015.

Hallmarks of leading practice principal risk disclosures:

- A description of how a particular risk is relevant to the company, for example, in relation to regulatory issues, which laws and regulations are of particular relevance or which part of the business is most affected
- An articulation of which risks have the most 'severe' potential impact which may be in the form of a heat map
- An indication of whether the risk has changed compared with prior year (e.g., increase/decrease) or is new
- Detail on risk appetite broken down for each area or particular risk

"The area of the annual report that shows greatest need for improvement is – by a considerable margin according to our respondents –the disclosure of principal risks and uncertainties. Given that over 90% think this is a useful disclosure this is clearly an area which deserves more attention from companies, and perhaps also from regulators."

CFA UK annual survey on Financial Reporting and Analysis[8]

[8] CFA Society United Kingdom, *CFA UK annual survey on Financial Reporting and Analysis*, 2015, pg. 1.

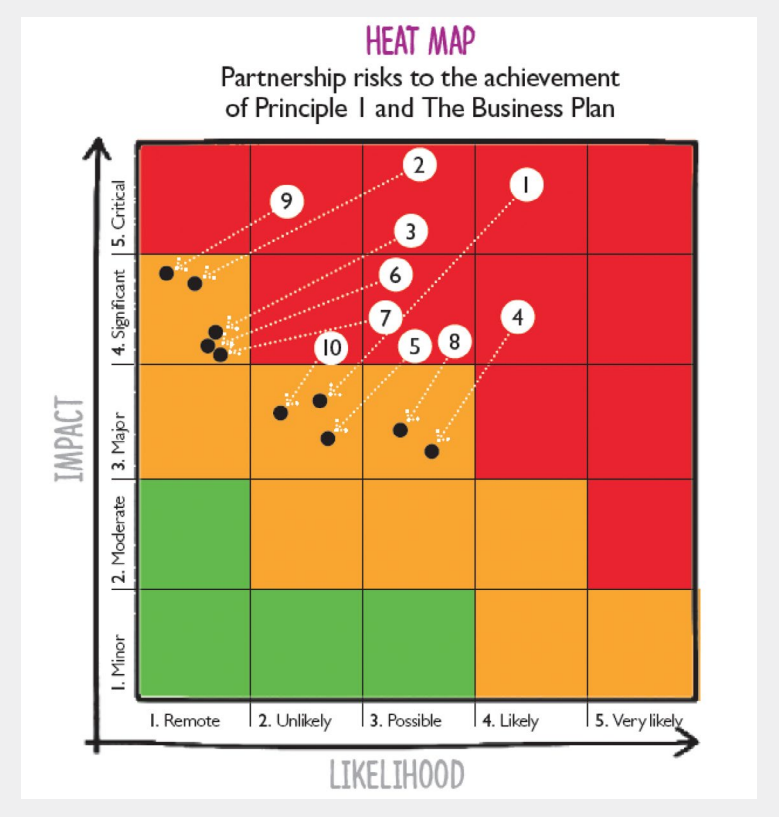


Figure 4. John Lewis Partnership (page 43)

Case studies:

RSA Insurance Group plc (page 46–47)

- The Group Strategic Risk Profile displays each of the principal risks on a graph showing the impact (measured by specific pound sterling amounts) and likelihood (measured by specific probabilities) of each.
- New risks are highlighted and when there has been a change to an existing risk, the direction of travel is also made clear.
- The responsible person/owner of each risk is disclosed.

Weir Group plc (page 25)

- A full risk appetite statement is disclosed including details of the parameters of the company's risk appetite in specific areas.

John Lewis Partnership (page 42–47)

- The section on managing risks describes each risk and mitigating actions without jargon. A comprehensive overview of the risk management governance structure is also provided.
- A heat map shows potential impact and likelihood of each risk before and after mitigating actions (see Figure 4).
- 'Did you know?' pop-ups clearly highlight key information.
- Changes from the previous year are clearly highlighted.

Fresnillo plc (page 42–53)

- The link from each principal risk to strategy is shown and a heat map shows changes in impact and likelihood from the previous year.
- The key risk indicators for each principal risk are shown alongside significant detail on the nature of the risks and mitigating actions undertaken.
- A rating of the risk appetite for each of the principal risks is disclosed.

Enhanced requirements under the 2014 Code: risk management and the viability statement

The 2014 Code, introduced the viability statement and enhanced requirements for risk management. The relevant updated Code provisions and related guidance are summarised here in so far as they relate to disclosure:

UK Corporate Governance Code

Relevant overarching Code Principles

C1. The board should present a fair, balanced and understandable assessment of the company's position and prospects.

C2. The board is responsible for determining the nature and extent of principal risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.

Relevant Code Provisions relating to disclosure

C1.3 In annual and half-yearly financial statements, the directors should state whether they considered it appropriate to adopt the going concern basis of accounting in preparing them, and identify any material uncertainties to the company's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements. (Underlined is new)

C.2.1 The directors should 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**. (New, emphasis added)

C2.1 The directors should describe those risks and explain how they are being managed or mitigated. (New in Code, but previously required under the Strategic Report Guidance)

C.2.2 Taking account of the company's position and principal risks, the directors should explain in the annual report **how** they have assessed the prospects of the company, over **what period** they have done so and **why** they consider that period to be appropriate. The directors should state whether they have 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, drawing attention to any **qualifications or assumptions** as necessary. (New, emphasis added)

C.2.3 The board should monitor the company's risk management and internal control systems and, at least annually, carry out a review of their effectiveness, and report on that review in the annual report. (Underlined is new)

FRC's *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* (September 2014)

Para 58: Guidance on Provision C2.3

- The board should summarise the process it applied in reviewing the effectiveness of the systems of risk management and internal control.
- The board should explain what actions have been or are being taken to remedy any significant failings or weaknesses.

Para 57: Guidance on Provision C2.3

In its statement, the board should, as a minimum acknowledge that it is responsible for risk management and internal control systems (and for reviewing their effectiveness) and disclose:

- That there is an on-going process for identifying, evaluating and managing principal risks
- That the systems have been in place for the year under review and up to the date of approval of Annual Report and Accounts
- That they are regularly reviewed by the board
- The extent to which the systems accord with the guidance in this document (Section 5 Para 39-43)

The changes to the 2014 Code concerning risk management, internal control and viability are, in essence, all about running companies well for long-term success, consistent with the ethos of the Strategic Report. It is important that these disclosures are FBU in order to provide investors with useful insight into how the board is discharging its responsibilities. This should include how risks are assessed and managed, and how directors have reached their conclusions about the company's viability. We encourage the board to view this statement in isolation to ensure it meets the FBU test.

The changes to the Code also mean that risk disclosures are likely to face greater scrutiny in the coming years. In fact, our review found that around two in 10 companies sought to improve their risk processes and reporting in their 2014 ARAs, with some stating that these actions were in preparation for complying with the 2014 Code. The Financial Reporting Lab has also indicated that it intends to run two projects – one on principal risk reporting and one on the viability statement.

Viability statement

A very small number of companies were early adopters of certain disclosure requirements of the 2014 Code – primarily the viability statement. However, their restricted numbers are insufficient to provide a basis for commentary on any emerging trends. In addition, a small number of companies provided some directional messages on how they were preparing for these changes. We expect over time, and with market practice, that disclosures in this area will improve.

For now, here are some questions that an investor may wish to see addressed as part of the viability statement:

- What timeframe have the board considered the viability of the company over and why?
- What process did the board use to assess viability?
- What assurance did the board obtain over relevant elements (e.g., stress testing)?
- What assumptions did the board use in reaching their conclusion and what should be disclosed in relation to those assumptions?

Risk management

Good risk reporting is, more often than not, underpinned by sound risk management processes and systems. From our review of ARAs, we noted that companies tend to explain the process and structures for managing risk including the frameworks they have in place. Particular aspects of this that are often less clear are:

- The processes to identify and/or validate principal risks
- A clear articulation of risk appetite
- The specific risk management measures and internal controls in place to manage and mitigate principal risks
- The role of the board in all of the above
- How the process described has led to the specific list of principal risks disclosed, providing a sense of the size, financial impact, likelihood and consequences of each risk

This symbol ( ) denotes a reference to changes in regulation which are explained in detail in Appendix B 'A look ahead: upcoming regulatory developments'.

The disclosures on risk management and internal controls should enable a reader to answer the following questions:

- How are the principal risks mitigated and controlled via the company's systems of internal controls and risk management?
- How does the board monitor material controls on an ongoing basis to get assurance that principal risks are being effectively managed and to take corrective action if not?
- What did the board's review of the effectiveness of these systems encompass?
- Has the board identified significant failings or weaknesses?
- What is the basis for determining what is 'significant'?
- Is it clear what actions have been or will be taken to address significant failings or weaknesses?

What the board actually does to discharge the responsibilities to which the disclosures relate is paramount. Companies must therefore first give their attention to establishing and putting into practice the requisite processes and methodology. Good disclosures should simply describe how the board has discharged its responsibilities and what conclusions it has reached. For further views on this, please see our report, *The viability statement: finding opportunities in the new regulatory challenge, published in* March 2015[9].

Disclosures: other considerations

Additionally, we suggest that the board and management bear in mind the following points as they prepare their disclosures:

- Companies must avoid boilerplate disclosures. Rather than repeating words from the Code, the emphasis should be on companies explaining why they feel that they can make the required assertions, and how they reached their conclusions. Specifically:
  - Explaining how directors assessed the company's prospects, not simply stating that they carried out an assessment. The disclosure should provide some colour on what the 'robust assessment of principal risks' consisted of so as to allow the board to reach its conclusion on the company's viability.
- The review of internal control and risk management systems should go beyond just stating that a review was performed. It should provide insight into the process/activities undertaken as part of the board's review and should also explain any outcomes.
- Any principal solvency or liquidity risks should be included in the principal risk disclosures either by explicit designation or by clearly describing the relevant qualifications/assumptions in the viability statement.
- In the spirit of FBU reporting, there should be a clear flow of linked disclosures i.e. those relating to principal risks, going concern and the viability statement. Companies should consider positioning these disclosures together - ideally in the same section (e.g., the Strategic Report).
- Disclosure should specifically cross-reference any related financial statement disclosures e.g., capital management disclosures under IFRS.

[9] EY, *The viability statement: finding opportunities in the new regulatory challenge*, March 2015.

06. Governance report

Based on feedback from investors, good governance reporting is useful because it provides confidence that the board is governing the company effectively. It also allows investors to better exercise their stewardship responsibilities by providing hooks for higher quality conversations with the board about how the company is governed.

A shortcoming of the current rules, in particular the *Disclosure and Transparency Rules*, is that they drive governance reports to include largely boilerplate information that focuses on governance processes rather than what the board and its committees did in any given year. Where the latter information is disclosed, it is often lost within the boilerplate disclosures. To overcome this, and to achieve a more focused and informative governance report, we endorse the approach of putting information that remains the same each year into an appendix or towards the back of the governance report and referring users to it, if needed.

This year we found that some companies have sought to improve their governance reports by disclosing the highlights of what the board and each of the committees did during the year and what their focus will be for the next year. This approach provides hooks for investors to ask further questions and provides insights into how the board spent its time. Some companies have also continued the look and feel of the Strategic Report through to the governance report, which helps the reader navigate this section and some have moved the Directors' Report to the back of the governance report or even the back of the ARA, which helps the governance report focus on actions during the year, and avoids breaking up the flow of the narrative with a set of statutory disclosures.

A good governance report should, in a clear and concise way, include:

- A description of any changes to governance arrangements during the year
- Reports from those charged with governance describing what the board and its committees did in the year and providing insight into decisions and outcomes
- A statement of compliance with the Code
- Explanations as to why any aspects of the Code were not followed, if applicable

Governance reporting on **shareholder engagement** and **board evaluations** is a **key area for improvement.**

Shareholder engagement

Shareholder engagement is a key board responsibility. Yet the content in ARAs on this topic is often uninformative. We encourage companies to make this section more focused and insightful. They can do this by touching on the areas of discussion, actions and outcomes arising from shareholder engagement. This is far more helpful than simply using annually repeated descriptions of the engagement process generally followed.

The Investment Association recently published a report, *Adherence to the FRC's Stewardship Code*[10] summarising the results of a survey of 288 signatories to the Stewardship Code on how they monitored and engaged with investee companies during the year. The report includes case studies of instances where a significant number of investors engaged with a company on a particular issue during the year. It is pleasing to note that there is some symmetry between these case studies and the relevant companies' disclosures on engagement within their ARAs.

We have found, however, that the majority of reports focus solely on the processes in place to engage with shareholders and do not provide details on topics covered or feedback received. The 2014 Code also now stipulates that a company should explain, when announcing voting results, actions it intends to take to understand the reasons behind the result when a significant proportion of votes have been cast against a given resolution at a general meeting. This comply-or-explain requirement will be in force for 2015 ARAs and should encourage more detail in shareholder engagement disclosures.

Hallmarks of leading practice shareholder engagement disclosures:

- An indication of whether the company has been proactive in reaching out to and engaging with shareholders in the year
- An explanation of what matters were discussed with shareholders and the feedback received
- Details on the actions, if any, that have been taken as a result of engagement
- Specific information on board members who met with shareholders over the year
- In addition to meetings and presentations, disclosure on any other methods of shareholder engagement, such as surveys or written feedback
- Additional context such as a description of the shareholder base in terms of size and geography or the voting record from the last AGM
- (For 2015 ARAs) A clear description of the actions the company intends to take to understand the reasons behind a voting result where there has been a significant proportion of votes cast against a resolution at a general meeting

[10] The Investment Association, *Adherence to the FRC's Stewardship, at 30 September, 2014,* June 2015.

Key themes discussed with shareholders in 2014

Home credit

- Rationale for the repositioning of the home credit business.
- Drivers of the improvement in performance in home credit.

Satsuma

- Impact of payday regulation on the online instalment market.
- Progress in building capability of Satsuma and competition.

Moneybarn

- Background on the Moneybarn business and growth potential.
- Reasons for the Moneybarn acquisition being funded by an equity placing.
- Progress with the transition to the new FCA regulatory regime.

Vanquis Bank

- Potential for Vanquis Bank UK to exceed its medium-term growth targets.
- Potential impact of forthcoming FCA credit card review on Vanquis Bank.
- Update on the potential Polish pilot operation and timescales for any growth targets.

Figure 5. Provident Financial plc (page 88)

Case studies:

Provident Financial plc (page 88)

- Key themes discussed with shareholders during the year are disclosed (see Figure 5).
- A calendar of investor relations events during the year is included.

AstraZeneca plc (page 90-91)

- The Investment Association's report referenced found that significant engagement took place with shareholders on approaches from Pfizer. The company's report on shareholder engagement includes a significant amount of information on this topic.

Standard Chartered plc (page 145-146 and 177)

- In response to a disappointing vote on the remuneration policy, the way in which the board engaged with shareholders to understand their views has been clearly explained, including a table with 'shareholder concerns' and 'action taken' in response.

Code compliance

Our research showed that 59% of companies complied with every provision of the Code and 85% complied with all or all but one provision. Only 3% of companies reported non-compliance with more than two provisions. While, in cases of non-compliance, all companies reviewed offered explanations, the quality of those explanations varied.

The Code[11] sets out recommended components of explanations for non-compliance. In our sample we found that one or more of these components were often missing from explanations.

Of the 41% of companies in our sample who provided explanations, the graph in Figure 6 shows how many included each of the components of a comprehensive explanation.

Explanations of non-compliance provide an opportunity for the board to explain how it operates in practice and why that approach works for the company. However, some companies miss this opportunity. They only state which provision they have not complied with rather than explaining the benefits to the company of their preferred practice in cases of permanent non-compliance.

As shown in Figure 6, the element most commonly absent from explanations is the description of actions to mitigate risks arising from non-compliance. This part of the statement is important for communicating how, despite divergence from the Code, shareholder interests continue to be protected.

In some cases, non-compliance is a clear and permanent choice because the board considers an alternative approach to be more effective for the company. However, in cases where non-compliance is only intended to be temporary, or where compliance has already been resumed, including the time period of non-compliance is important for assessing the significance or potential impact of the board's practice on the company.

We encourage companies to take the opportunity to provide explanations that are in the spirit of good governance and are 'fair, balanced and understandable'.

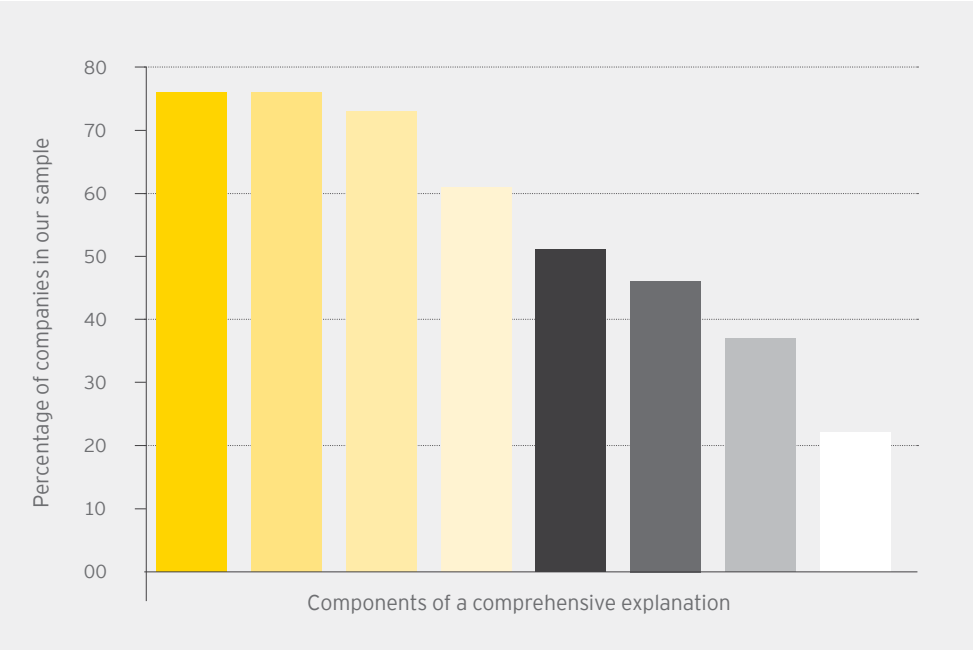


Figure 6. Comprehensiveness of Code compliance explanations

- 76% Provision not complied with
- 76% Rationale for actual practice
- 73% Background/history of actual practice
- 61% Time period of non-compliance
- 51% If intention to comply, expected timing of compliance
- 46% Contribution to good governance and business objectives
- 37% Consistency with over-arching Code principle
- 22% Description of mitigating actions for any related risk

[11] FRC, *UK Corporate Governance Code 2014, Section on Comply or Explain,* pg. 4.

As one investor put it, ***"Boards should have the courage of their convictions – if they believe they have good reasons for diverging from a Corporate Governance Code requirement, they should explain them clearly."***

EY, Shareholder engagement and corporate reporting at a crossroads[12]

Hallmarks of leading practice explanations of non-compliance:

- Specific details about which element of the Code is subject to non-compliance
- An illustration of how the actual practice is consistent with the underlying spirit of the relevant provision
- An illustration of how the actual practice contributes to good governance and the delivery of business objectives
- A description of any mitigating actions taken to address any additional risk that may have arisen
- Where non-compliance is intended to be time limited, a clear indication of by when the company expects to be in compliance with the provision

[12] EY, *Shareholder engagement and corporate reporting at a crossroads*, February 2014, pg. 1.

Nomination committee report

The nomination committee plays a vital role in helping to determine the board's composition and leadership of the company. As such, the committee is critical to a company's future success, yet investors have little insight into its activities.

Last year we predicted that nomination committees would be 'coming out the shadows'. However, nomination committee reporting continues to lag significantly behind audit and remuneration committee reporting. This is now likely to change as the FRC is conducting a project on succession planning and the effective execution of the nomination committee's role – with a view to highlighting best practice rather than regulating. We have also seen a few recent high-profile examples of shareholder engagement on succession planning. While the focus of the FRC's project may not be on reporting, the nomination committee report will be the most effective way to communicate how the committee properly carries out its role.

Our review found broad range in the quality of nomination committee reporting. 7% failed to produce a standalone report with an introduction from the committee Chairman. Some reports also lacked basic information such as which executive search firm had been used when appointing a new director.

Succession planning

It is essential that the board takes a long-term view of succession planning that links to the strategy of the business. Investors recognise that there are sensitivities when it comes to succession plans; few would expect – or want – companies to disclose detailed plans for the potential successor to the CEO. However, it is important to strike a balance so that disclosure provides investors with the comfort that succession is under control. Currently, most disclosures relate to the succession of non-executive directors. Succession is just as, if not more, important for executive directors which means that reports should also indicate the steps that are being taken with regard to the executive pipeline. This should include reference to the degree of oversight the nomination committee has of the company's talent pipeline; something which is important for the future supply of both executive and, ultimately the pool of non-executive directors.

Diversity

Investors continue to take a strong interest in diversity, both in the boardroom and across the business. They see diversity as a means to ensure that a wide range of perspectives are considered, with the result being better decision making. However, it is still rare for companies to provide meaningful connections between diversity and business strategy.

The Davies Review Annual Report 2015[13] reported that '85% of FTSE100 companies now disclose their boardroom diversity policy and over 58% have set clear measurable objectives'. This is certainly moving in the right direction and, coupled with the narrative reporting regulations, most companies now disclose information on gender diversity below board level across their businesses. We encourage all companies to include information on the policy and targets that they are working towards and how these link to business strategy.

Hallmarks of leading practice nomination committee reporting:

- Skills and experience of each board member and how they will help the company/board, as opposed to a list of previous roles held
- Specific details on board recruitment processes including whether a search firm was used, the skills and experience that were sought and why the successful candidate met the criteria set
- An overview of when directors are due to leave the board, and identification of the resultant skills gaps to fill
- A clear explanation of how the board defines and approaches diversity in practice
- A description of initiatives that are in place to develop the next cadre of senior management and an indication of whether emergency succession plans are also in hand

[13] *Women on Boards, Davies Review Annual Report 2015*, March 2015, pg. 17.

Case studies:

Hammerson plc (page 68–70)

- Board balance and mix of skills is explained and visually represented.
- Skills sought for future appointments are outlined.
- The process for appointing a new non-executive director during the year is explained and key information is provided such as how the search firm was appointed, what criteria were used, how the shortlist was determined, how many interviews were held and with whom.
- The extent of board oversight of executive succession plans is described.
- The company's approach to diversity in practice is stated.

Pearson plc (page 65)

- Evidence is provided of board oversight of executive succession planning through the Rising Star Programme.

Experian plc (page 50)

- Significant detail is provided on succession planning including the percentage of senior leadership roles with successors ready to provide emergency cover, the number with at least two successors who are 'ready now' or 'within two years'. The number of senior leadership team members in developmental roles outside of their home country is also disclosed.
- Details of preparation for meeting growth targets on staffing in certain business lines are included and it is explained that the nomination and corporate governance committee regularly reviews the senior leadership succession plans.

Cobham plc (page 51)

- Graphs and tables are used effectively to show board composition in terms of skills and experience and the tenure of each director (see Figures 7 and 8).
- This allows the reader to see when directors are due to leave the board and therefore which skills and experience gaps may emerge that will need to be addressed.

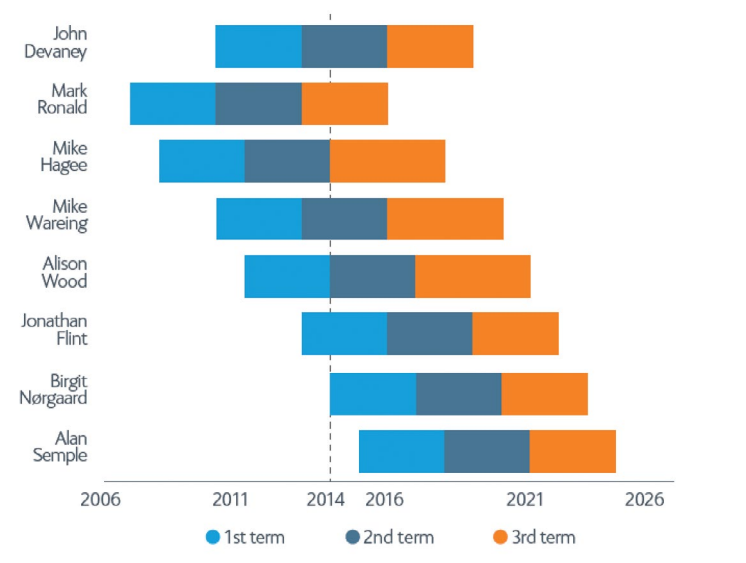


Figure 7. Cobham plc (page 51)

Skills and experience

The table below identifies the skills and experience of the Board members.

	Independence	Years with Cobham	Skills			Experience						
			Leadership	Strategy and Risk	UK Corporate Governance	Corporate	Engineering	Defence	Finance	US Market	UK Listings	HR
John Devaney		4	•	•	•	•	•	•	•	•	•	
Bob Murphy		2	•	•	•	•		•	•	•	•	•
Simon Nicholls		1	•	•	•	•		•	•	•	•	
Jonathan Flint	•	1	•	•	•	•	•	•	•	•	•	
Mike Hagee	•	6	•	•				•		•		
Birgit Nørgaard	•	0	•	•	•	•	•		•			•
Mark Ronald	•	8	•	•		•	•	•		•	•	
Alan Semple	•	0	•	•	•	•	•		•	•	•	•
Mike Wareing	•	4	•	•	•	•		•	•	•	•	•
Alison Wood	•	3	•	•	•	•		•		•	•	•

Figure 8. Cobham plc (page 51)

Board evaluations

As part of our joint project with The Investment Association on board effectiveness[14] we heard that investors gain comfort from the knowledge that a company has undertaken an external board evaluation. While investors recognise the sensitivities around disclosing the full conclusions of the evaluation, they see a definite benefit in companies disclosing the highlights along with any resultant actions.

A company with an effective board will naturally want to reassure investors about its effectiveness. Disclosing what was found as part of the board evaluation is a great way of achieving that goal. Equally, admitting that a board is taking steps to improve its effectiveness can be reassuring for investors. In our review, 56% of companies signposted some high-level actions to which they were committed, but it is unusual for companies to disclose areas of weakness in the current board.

> ***"In addition to the methodology, companies should provide a summary of findings and an action plan to address areas of improvements in the annual report and accounts."***
>
> *LGIM,*
> *2014 Corporate Governance Report*[15]

Hallmarks of leading practice board evaluation disclosures:

- An explanation of the strategy spanning the three-year evaluation cycle, including external evaluations
- Clear disclosures that explain the performance evaluation process, any significant recommendations or actions taken and changes or improvements that the board has committed to following a review
- Transparent and balanced narrative when describing areas for improvement

[14] The Investment Association and EY, *Board effectiveness – continuing the journey,* April 2015.

[15] LGIM, *2014 Corporate Governance Report: Active Ownership,* pg 9.

Case studies:

Lonmin plc (page 57-58)

- Significant detail is provided on actions from the previous evaluation, progress against these during the year and actions from the 2014 review.
- A degree of fairness and balance is shown in reporting areas in which progress was not made as expected as well as areas in which progress was achieved.

Melrose Industries plc (page 69-70)

- Stages of the board evaluation process are explained as well as action points from 2013 and progress in 2014.
- Agreements made by the board for the year ahead are disclosed.

Marks and Spencer plc (page 41)

- The board evaluation strategy and process are clearly outlined.

Audit committee report

The aim of the audit committee report is to provide assurance to investors that the audit committee has effectively carried out its oversight duties with a sufficient degree of rigour and challenge. A leading practice audit committee report will give the reader a flavour of the audit committee's culture, how it operates and how it uses various sources of assurance to ensure the integrity of the financial statements and efficacy of internal and external audit processes as well as risk management systems.

Last year, based on our findings and feedback from investors, we said that audit committee reporting should reveal more of the committee's activities during the year rather than focusing on general processes. If information about the roles and responsibilities of the committee has not changed from the previous year, companies should consider placing this in an appendix or on the company website and providing a signpost to this standard information.

Significant issues considered by the committee in relation to the financial statements

The average number of significant issues considered by the audit committee in relation to the financial statements, five, is unchanged from last year. These issues tally with the risk areas listed in the auditor's report in less than half of reports. Whilst there could be a clear rationale for this apparent discrepancy, we encourage audit committees to give reasons for the differences.

A key area for improvement is better clarity on how the committee addressed the significant issues it considered in relation to the financial statements. Many reports state only that the committee reviewed reports from management and were satisfied. They do not provide any detail about how assurance was obtained or if, and how, management was challenged. The audit committee report, taken with the auditor's report, should provide investors with an insight into the whole financial statement challenge process.

In 2013, one-third of audit committee reports in our sample cross-referenced issues with the relevant notes in the accounts. In a positive development, this practice has now increased to approximately two-thirds of companies.

In some sectors there are recurring issues that the audit committee considers annually. These could include, for example, revenue recognition in an industry where contract accounting is used. For these recurring issues, audit committees should consider making it clear what the specific areas of focus were over the year or what in particular was challenged by the audit committee.

Assessing the effectiveness of the audit process

Audit committees still struggle to describe how they assessed the effectiveness of the external audit process. This disclosure remains largely boilerplate, with the same text used each year. We encourage companies to disclose not only the process but also the outcomes of each review as well as any actions taken during the year. While the methodology or process might stay relatively consistent from year to year, the areas of focus may change. For example, if the company undertook a large acquisition, the committee could pay more attention to how the audit process considered the transaction, whether the auditor demonstrated the relevant skills, and whether management's papers on the acquisition were sufficiently well researched to facilitate the external audit. Companies should also consider describing how the roles of management and audit committee were assessed, as these parties also have significant influence on the effectiveness of the external audit process.

Hallmarks of leading practice audit committee reporting:

- Audit committee report as a separate section within the governance report, introduced by the committee Chairman
- Use of active, rather than passive, language to describe actions carried out during the year rather than covering only general roles, responsibilities and processes
- In relation to significant issues considered by the committee:
  - A clear and specific explanation of what the issue is and how it is relevant to the company and its circumstances (including an amount where relevant)
  - Insight into the audit committee's specific actions in addressing the issues including, for example, specific concepts that were challenged and debated, resources or points of reference that were used and/or areas in which further information was requested
  - Insight as to whether any third-party evidence or assurance was received by the audit committee to address a significant issue
  - Explanation of how the significant issues considered by the committee align with those listed in the auditor's report, or if they do not, explanation of the reasons for the differences
- Explanation of how the effectiveness of the audit process was assessed, outlining clearly the methodology, criteria and evidence used and any changes/focus areas compared with the prior year(s)
- (For 2015 ARAs) In cases where the audit committee has been asked to support the board in producing the viability statement, an explanation of how the committee supported the board in making the statement

Case studies:

ITV plc (page 75-81)

- The committee's focus areas for the year are listed.
- The report distinguishes between the significant issues that are particular to the year under review and recurring issues.
- A clear description of how the audit committee assesses the effectiveness of the audit process is included.

Travis Perkins plc (page 94-97)

- A good level of detail is provided on how the committee considered and challenged management on the significant issues including specifics on information received and how it was analysed.
- The report includes a comprehensive overview of what the committee did during the year, broken down by month, rather than a description of general processes.
- The policy for awarding non-audit work is clearly explained.

Remuneration committee report

Companies have now reported on their executives' remuneration for a second time under the revised directors' remuneration reporting (DRR) regulations. 20% of companies in our analysis sought shareholder approval of a revised remuneration policy in 2015[16]. Instances when policies were put back to a vote were typically the result of a number of changes to bring policies in line with investor guidelines and corporate governance leading practice.

The majority of companies in our analysis group, who did not seek re-approval of their remuneration policies in 2015, have utilised the flexibility within their policies to make minor changes under the Implementation Report without seeking a new binding vote. This is particularly pronounced in cases where malus and clawback provisions have been adopted early by companies in response to the 2014 Code**Δ**. Where the introduction of malus and clawback provisions are the only change companies are intending, the majority have decided that shareholders would not consider this issue to require a binding vote.

Of those disclosing the period over which malus and clawback will operate, nearly half stated that malus will apply during a three-year deferral period and clawback would remain applicable for three years after the vesting/payment of awards. These figures correspond with the percentage of companies introducing post-holding vesting periods. We expect that shareholder pressure in this area, together with the introduction of clawback policies, will mean that more and more organisations will be looking to introduce post-holding vesting periods as part of their remuneration policies.

75% Introduced a malus and clawback policy

10% Stated their intention to review their malus and clawback policy or implement such a policy in 2015

15% Have no stated policy on either or both malus and clawback

This symbol (**Δ**) denotes a reference to changes in regulation which are explained in detail in Appendix B 'A look ahead: upcoming regulatory developments'.

[16] We anticipate that the number of companies putting their remuneration policies back to the shareholder vote will be broadly consistent year on year. Therefore, we would expect that by 2020 any spikes caused by the three-year policy cycle will be ironed out.

Reports slightly shorter

One of the intentions of the new reporting regulations was to increase transparency of remuneration disclosures, but without unduly increasing the length of remuneration reports. Having addressed the primary aim, the focus, as with other areas of reporting, is now on reducing the length to ensure reports are clear and concise.

Our research shows that while the average length of remuneration reports has reduced to 17 pages (from 20 in 2014), this reduction is arguably not as sizeable as some may have hoped for.

The relatively minor reduction is due in part to the number of companies that opted to include their full policy table (see Figure 9) despite no legislative requirement to do so. While the regulations set out that the policy report only needs to be included when a shareholder vote is required, a number of institutional investors have indicated that the inclusion of the policy, in one form or another, is useful when interpreting the annual report on the implementation of policy.

Where companies continue to have longer reports, they have included page references and tables of contents to help users navigate to specific areas of interest.

Restraint shown in CEO salary increases

The revised remuneration regulations asked remuneration committees to consider the remuneration of other employees when determining CEO remuneration. Our analysis shows that this request has been taken on board, alongside continued shareholder pressure on pay. Executive pay reflects conditions in the wider workforce where salary increases are more restrained. Of the companies in our analysis group, over half of CEOs received a salary increase which was either in line with or lower than the group of comparator employees used in reports. A further 25% of CEOs did not receive a salary increase at all.

We expect policy around base salaries to continue to be under the spotlight following a research paper published by the Department for Business, Innovation & Skills (BIS) in March 2015[17].

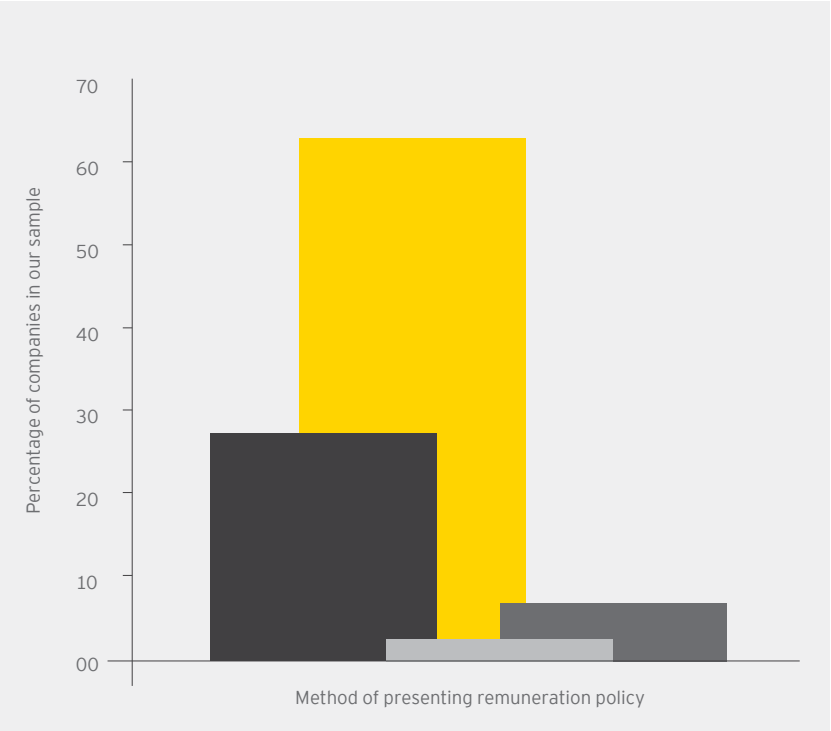


Figure 9. Presentation of remuneration policies

- 63% Included their remuneration policy in full
- 27% Included an abridged table and policy
- 7% Included only the table
- 3% No reference to table or policy

[17] Department for Business Innovation and Skills, *BIS Research Paper 208: How companies and shareholders have responded to new requirements on the reporting and governance of directors' remuneration*, March 2015.

Increased transparency in annual bonus target disclosure

From our research last year, only 39% of companies provided a 'quantitative'[18] level of disclosure in their reporting of retrospective bonus targets. In our latest research, we have seen an increase in this percentage to 50%.

In our analysis, 64% of companies withheld information for reasons of commercial sensitivity (up from 51% last year) although more than half of those companies stated when information would be disclosed (up from one third last year). Non-financial targets are less likely to be disclosed than financial targets, given the greater commercial sensitivity in these areas (e.g., where non-financial targets relate to specific M&A activity). However, additional narrative can contextualise the use of commercially sensitive exemptions.

Despite improvements, shareholder pressure on executive pay and media focus continue to shape the directors' remuneration landscape. Whether this leads to further intervention (for example, additional guidance being issued as a result of the BIS research paper) is yet to be seen.

In the short term at least, companies will be looking for a period of relative consistency so that they can manage executive pay under their existing remuneration policies.

Looking ahead, we encourage companies to be prepared to evolve and adapt remuneration reporting as shareholders continue to scrutinise reporting under the DRR regulations. Seeking feedback from shareholders on maximums expressed in the policy table and considering whether more could be done to disclose performance measures is also advisable. If it is not possible to disclose performance targets, companies should consider providing additional narrative for context.

In 2014 annual reporting, there remained ***"a lack of explanation on how the performance metrics selected to drive remuneration would also drive their long-term strategy."***

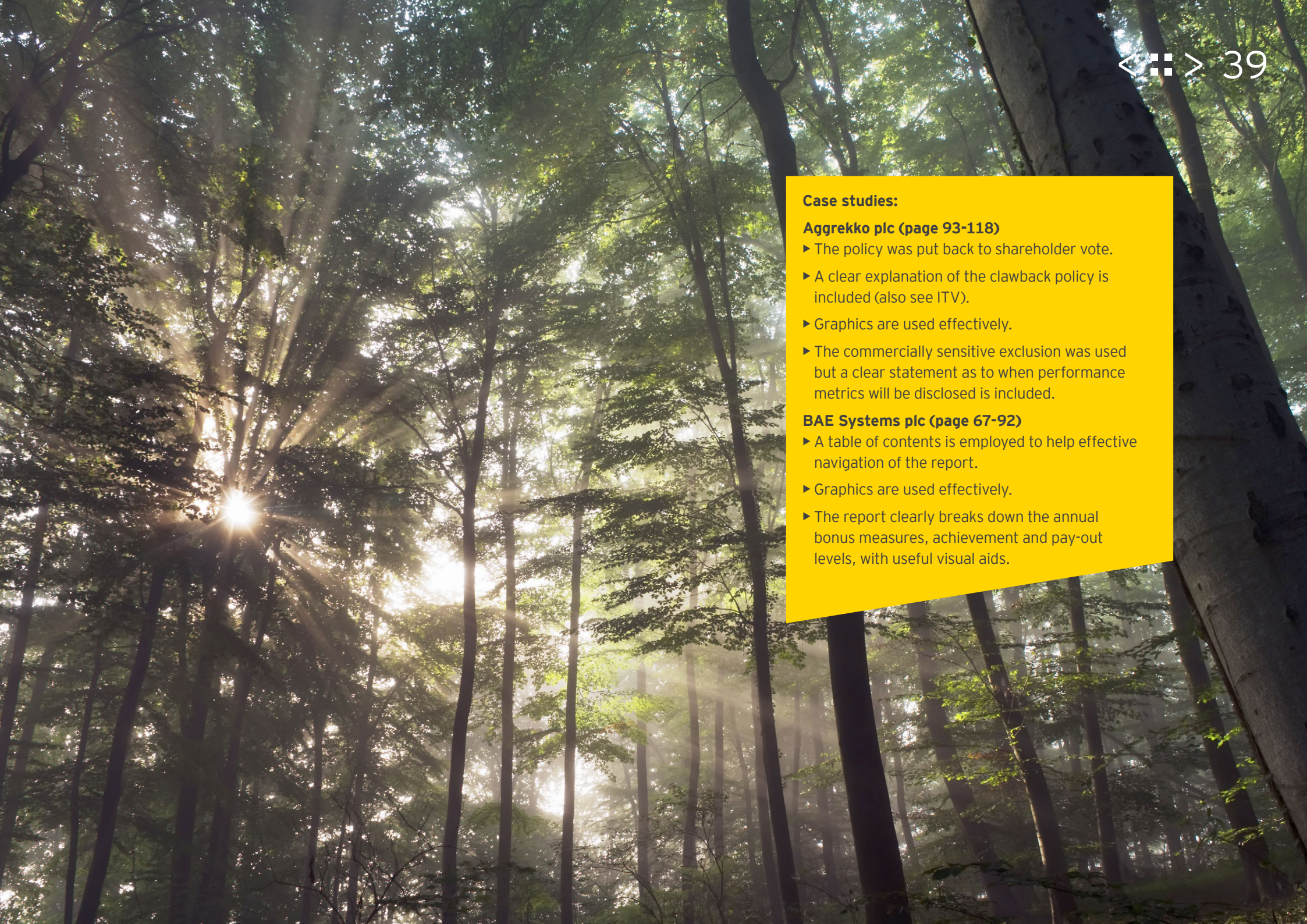
LGIM,
2014 Corporate Governance Report[19]

Hallmarks of leading practice remuneration committee reporting:

- The KPIs used to incentivise executive directors are the same as those used to measure the delivery of the strategic objectives
- The use of graphics is maximised to demonstrate link between remuneration and execution of business strategy
- An insightful and impactful introduction from the remuneration committee chair including whether bonuses were paid during the year and, if so, which targets were met
- All details are explained as clearly as possible, with key information highlighted and without the need for significant amounts of cross referencing to various different tables and notes to pull out basic information
- The overall context for variable remuneration rewards in the year is described and it is made clear whether targets were met and what was paid
- Any changes to remuneration arrangements are explained

[18] 'Quantitative' is defined to be the highest level of disclosure (i.e. actual targets (financial) disclosed together with performance against them).

[19] LGIM, *2014 Corporate Governance Report: Active Ownership*, pg 26.



Case studies:

Aggrekko plc (page 93-118)

- The policy was put back to shareholder vote.
- A clear explanation of the clawback policy is included (also see ITV).
- Graphics are used effectively.
- The commercially sensitive exclusion was used but a clear statement as to when performance metrics will be disclosed is included.

BAE Systems plc (page 67-92)

- A table of contents is employed to help effective navigation of the report.
- Graphics are used effectively.
- The report clearly breaks down the annual bonus measures, achievement and pay-out levels, with useful visual aids.

07. Auditor's report

After the first two years of implementation, feedback from the FRC and investors on the enhanced auditor's report has been extensive, both in terms of commendations and suggestions for further improvements. **On a more fundamental level, the enhanced reports have highlighted the degree of auditor judgement involved in all areas of the audit, and have begun to shed some light on the so-called 'black box' of the audit process.**

Overview of the changes made to the auditors' reports in the 2nd year of reporting

Our review has highlighted that a significant proportion of auditors' reports go beyond the minimum requirements set by the FRC in the auditing standards. A large number were innovative in layout and presentation and also included additional non-required information. We identified several key themes:

- The audit opinion is located at the beginning rather than at the end, thereby giving investors the fundamental conclusion upfront.
- The rationale for the chosen materiality benchmark is explained, thus enabling readers to see how audit materiality is chosen and calculated with key users in mind.
- Presentation of key concepts using tables, diagrams and graphs has created a clearer picture of the audit process that is more easily digestible for non-technical readers.
- The reported risks have been refined to be more company-specific. 'Standard' risks (as defined in auditing standards) of fraud in revenue recognition and the risk of management override of controls were only retained where specifically appropriate, thus enabling investors to home in on the actual key risks of material misstatement and providing them with hooks for debate with those charged with governance.
- Cross-references have often been added to the audit committee report and the notes to the financial statements. These cross-references help link the various components together and enable users to compare against audit materiality and other financial statement measures.

Audit firms have adopted varying degrees of reporting findings and/or observations from their work in significant risk areas. Although not a requirement, investors have welcomed greater disclosure in this area and we expect to see practices develop further.

Key metrics

In our sample, we observed that 86% of audits used a profit before tax measure to calculate materiality (see Figure 10). Nearly half of those made adjustments to reported profit before tax for one-off or non-recurring items such as impairments or exceptional items.

As in the previous year, the majority (55%) of audits use 5% as the benchmark for calculating materiality on profit before tax. Another 30% were within one percentage point of the average with outliers observed of 3.0% and 7.6% at either end of the range.

Auditors have adopted different approaches to attempt to explain the extent to which the audit scope they've applied covers the underlying revenue, costs, assets and liabilities. A common approach is to disclose the proportion of key metrics accounted for by units/components subject to the different audit scopes: full, specific and other. Key metrics included revenue (disclosed in 85% of auditor reports), profit before tax (75%), net assets (46%) and total assets (20%). Other measures such as gross profit, operating profit and EBITDA accounted for less than 5% of reports. Interestingly, 21% of auditor reports did not illustrate audit coverage over the measure in which the audit materiality was calculated. We expect practice will develop in this area over time.

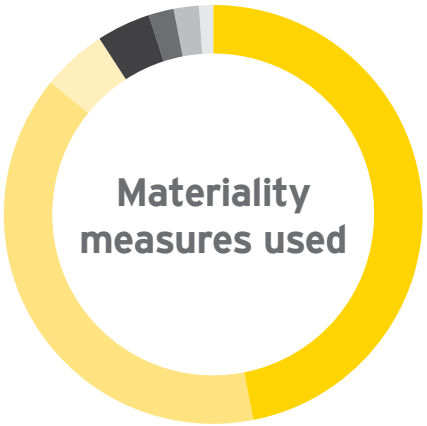


Figure 10. Materiality measures

- 47% Profit before tax
- 39% Adjusted profit before tax
- 5% Equity / net assets
- 4% Total assets
- 2% Revenue
- 2% EBITDA
- 1% Other

Future developments for the auditor's report

As a result of our reviews, the FRC's reviews and discussions with investors, we have identified a number of opportunities for continuous improvement in the next round of auditor reports. We highlight these below:

General	Risks
▸ More disclosure of comparative information and explanations of changes from one period to another ▸ Improvements in the value of the auditor's observations for the user	▸ Explanation of the circumstances where risks have changed since the last reporting period ▸ Improvement in the granularity of the reporting of risks, being as entity-specific as possible
Scoping	**Materiality**
▸ Better transparency as to how the scope of the audit responded to the specific risks identified	▸ Explanation of why the selected basis for materiality is most relevant for investors ▸ Where not evident, making clear numerically how materiality was calculated

Δ For details on upcoming changes that will impact audit reports please see Appendix B.

08. Financial statements

While not the main focus of our review, the interest in financial statement disclosures continues – with several initiatives and projects underway. Encouragingly, these are no longer the sole preserve of standard setters and regulators as more and more companies are taking part. A good example of this is the *Financial Reporting Lab's case study looking at William Hill* which explores the views of investors and analysts on presentation, position and content of accounting policies[20].

Only a few companies present their financial statements in a different manner. Most of the changes revolve around structuring, formatting and editorial improvements. Some examples of alternative ways of presenting financial statements can be found in the ARAs of Cairn Energy plc, William Hill plc and Mondi plc.

However, a key question in our minds is whether the issue is one of disclosure overload or disclosure effectiveness.

Many preparers hope to be able to reduce disclosures in the notes to the financial statements. However, it is even more important, in our view, that companies think about effectiveness (e.g., the relevance and specificity) of the disclosures that remain. While it may seem counter-intuitive, companies might need to add information to some current disclosures in order to aid understanding.

Structural changes are slightly easier to implement compared to, for example, tailoring, which may require the removal of immaterial information ('clutter') and the exercise of significant judgement. There is also a tendency towards a 'more is good' approach as companies remain cautious about regulatory enforcement.

Case studies:

Cairn Energy plc
- Accounting policies, related to a specific note, are included with that note.
- Notes are grouped by nature.
- Notes are ordered by importance.

William Hill plc
- Significant accounting policies are identified and disclosed in the Notes section.
- A complete list of accounting policies is provided in the appendix.

Mondi plc
- Key accounting judgements and estimates are disclosed and a complete list of accounting policies is included at the end of the report.

[20] Financial Reporting Lab, *Lab case study report: William Hill – accounting policies*, February 2015.

Recommendations for next year:

1. Companies should review 2014 financial statements for opportunities to tailor, cut clutter and improve relevance. This could include:
   - Removing unnecessary policies
   - Re-drafting policy notes to make them company specific
   - Highlighting changes in significant accounting policies
   - Re-visiting the materiality assessments relied on in the notes
   - Innovating how financial statements and disclosure notes are presented to make for an easier read
   - Presenting the CFO's review or performance summaries within the financial statements section

EY's publication *Applying IFRS: Improving Disclosure Effectiveness*[21] provides some useful suggestions, e.g., disclosing accounting policies, judgements, estimates and assumptions together with specific and quantitative disclosures or grouping disclosures by nature. A report by the Financial Reporting Lab, *Towards Clear and Concise Reporting*[22], also suggests that companies reflect on the purpose and value to investors of each note and consider removing notes where there is no overriding disclosure requirement or where they are judged to be immaterial.

2. Companies should ensure consistency and balance between financial statements and narrative, for example:
   - Between segmental analysis within the financial statements and the Strategic Report
   - Between the APMs/non-GAAP measures in the narrative part of the ARA and the reconciliation of APMs with IFRS performance measures in the financial statements
   - Between the financial review/highlights and the financial statements and notes

[21] EY, *Applying IFRS: Improving disclosure effectiveness*, July 2014.

[22] Financial Reporting Lab. *Lab Insight Report: Towards Clear and Concise Reporting*, August 2014.

09. Tax reporting

Level of tax contingencies was mentioned as a significant issue in **46%** of reports reviewed

Deferred tax recognition or calculation was mentioned as a significant issue in **28%** of reports reviewed

Taxation remains top of mind

Taxation remains the most commonly cited issue in audit committee reports. 65% of audit committee reports mention an aspect of taxation as a significant issue in relation to the financial statements, an increase on the 45% from our review last year.

This is perhaps not surprising given the continued development of the OECD's Base Erosion and Profit Shifting (BEPS) project Δ, which is changing the global tax environment to an unprecedented extent. When the impact of BEPS and other international tax initiatives (e.g., EU State Aid investigations into the use of tax rulings) are combined with a UK domestic tax environment that is increasingly focused on tax governance, risk and the disclosure of tax strategies, we expect references to taxation in audit committee or Strategic Reports to increase. Indeed, looking only at the FTSE 100 companies in our samples, approximately 80% of audit committee reports mention tax in some form.

Notwithstanding the significant changes that BEPS signals, it is interesting to note that only 4% of the groups we reviewed refer specifically to BEPS, or an aspect of it, in the front half of their ARAs. Most disclosures offer a fairly generic reference to the changing tax environment with little indication of the impact that the changes may have on the organisation.

Given the wide ranging effects that both the BEPS initiative and other international tax reforms may have on international businesses, stakeholders could well benefit from a clearer narrative explaining the impact that the changes will have on an organisation. We have seen more specific references emerging from US SEC registrants on this point. Based on our sample, an example of more focussed narrative is provided in Aggreko plc's ARA on page 51.

In terms of broader tax disclosures, a topic we have been tracking for several years now[23], there have been a number of significant developments. From this year's review, we continue to see more groups publicly describing their tax policy. 60% of the FTSE 100 now publicly disclose this information, either in their ARAs or in separately available public documents. Of particular interest from this year's review is that an increasing number of groups outside the FTSE 100 are also now including these disclosures, with 37% of FTSE250 companies within our sample making public tax policy disclosures.

This symbol (Δ) denotes a reference to changes in regulation which are explained in detail in Appendix B 'A look ahead: upcoming regulatory developments'.

[23] Primarily through EY's previous reports *Tax transparency – Seizing the initiative* (2013) and *Tax transparency – Building confidence* (2013)

What we mean by Tax Policy:

- The Tax Policy is a board approved document that sets out expected standards of conduct in relation to carrying out tax related activities across all areas of the business globally.
- It defines the scope of tax activities undertaken throughout the organisation, whether by the tax function, the business, or by the finance function.

What we mean by Tax Strategy:

- A Tax Strategy sets out the activities that will be undertaken to deliver on specific objectives. For example, this could be management of effective tax rate or tax controversy strategy.

Case study

Provident Financial (page 96)

- The way its tax policy is aligned to its specific tax risks is demonstrated.
- A detailed explanation of mitigation is provided.
- An explanation is included on what was done in the year to stay on top of regulatory changes that may impact the company.

This trend will be welcomed by HM Revenue & Customs (HMRC) which is consulting on a proposed mandatory requirement Δ for large businesses to publish their UK tax strategy as well as signing up to a voluntary Code of Practice. This means that it is possible that all large companies will need to provide tax policy information publicly within the next couple of years. Groups should, therefore, consider whether they have an appropriate tax policy in place and the implications of this being made public. Importantly, groups should make sure they are confident that the policy is applied in practice.

We noted in last year's report that there are clear themes amongst the tax governance principles that groups publicly disclose. The need to avoid disclosures becoming seen as mere boilerplate wording remains, although the proposed Code of Practice mentioned above may well exert some influence on future disclosures.

Against the regulatory backdrop Δ, ensuring that groups make appropriate disclosures, which both inform stakeholders and manage the associated reputational risk, can be a complex undertaking. However, preparing for increased transparency is key to continuing to build trust in, and understanding of, the global tax system and its effects on companies' financial results and risk profiles.

Three key issues to consider when forming a tax reporting and communication strategy, which will also help to mitigate reputational tax risk, are:

1. **Is the company actively monitoring the changing tax landscape?**
   - The UK's implementation of the OECD's requirement for country-by-country reporting to tax authorities is now well advanced.
   - The European Commission's published 'Action plan for a fairer corporate tax system' includes consultation on public country-by-country reporting.
2. **What do external tax communications say about the organisation?**
   - Changing tax regulation is often a principal risk in the Strategic Report, or a significant issue in audit committee reports.
   - Taxation can often get conflated with other corporate responsibility issues on social media and in the press.
3. **Can the company draw upon global tax footprint information to ensure it tells a consistent story to all its stakeholders?**
   Consideration and understanding of the global tax footprint should include:
   - Total taxes borne and collected
   - Governance over tax matters
   - Why the company operates as it does
   - Benefits to the wider economy

10. Appendices

Appendix A

Aide Mémoire

This aide mémoire will help you address key considerations and challenges as you start planning and drafting your 2015 ARA. It contains both the ✪hallmarks that are referred to in the various sections of this report as well as other recommendations we make throughout the report.

ARA content	Notes and actions
Fair, Balanced and Understandable	
▸ Structure your ARA to aid effective communication of key messages, reduce repetition and tell a story. Innovate the structure to achieve this ▸ Create meaningful links between the business model, strategy, KPIs, principal risks and remuneration ▸ Disclose the processes or measures used by the board to conclude that the ARA is FBU and the outcomes from that process, e.g., resultant changes made to the ARA ▸ Ensure consistency and balance between narrative reporting and financial statements, as well as across different sections of the narrative report ▸ Move "standing" information in the narrative to the back of the ARA or to the website (regulation and law permitting) ▸ Consider whether the Directors' Report could be placed at the back of the ARA ▸ Ensure that alternative performance/non-GAAP measures are clearly reconciled to GAAP measures and there is balance in how performance is described using these two measures	

ARA content	Notes and actions
Strategic Report	
Business model Ensure that the business model description: ▸ Explains in simple and clear language how the company makes money ▸ Clearly explains the key inputs, processes and outputs in the value chain, and how key assets (including its people, technology, etc.) are engaged in the value chain ▸ Provides insight into investment and revenue streams in relation to different parts of the business or different phases of development ▸ Provides a comparison between the company's business model and those typically used in the sector and articulates why management believe their model is most effective ▸ Articulates how the business model will help deliver the strategy	
Strategy ▸ Be company-specific and provide clear expression of how strategy will be achieved and implemented (strategic objectives) ▸ Articulate both short and long-term strategic objectives ▸ Clearly link strategic objectives, KPIs, principal risks and remuneration ▸ Describe how the global environment, market trends or industry context impact the strategy and the strategic objectives ▸ Explain what makes and sustains the competitive advantage of the business in relation to others in the industry ▸ Create cohesion and clarity between varying "concepts" such as purpose, vision, mission or values	

ARA content	Notes and actions
Key performance indicators (KPIs) ▸ Ensure KPIs are company specific and are based on a broad set of financial and non-financial measures ▸ Explain how the KPIs specifically help measure progress against the strategic objectives as well as why each one was chosen ▸ Show which KPIs are linked to executive variable remuneration ▸ Disclose targets for each KPI and report performance against those targets in a balanced and transparent manner ▸ Disclose KPI performance data over a number of years (e.g., 3-5 years) in order to show trends ▸ Explain changes to KPIs or their calculation if relevant ▸ Ensure that the performance review section (i.e. the narrative) provides context for actual performance in respect of KPIs	
Principal risks ▸ Ensure that the principal risks disclosed are specific to the company (e.g., by providing detail on which specific areas of the business are most affected) ▸ Indicate whether the risk has changed from prior year (e.g., increased or decreased) or is new ▸ Prioritise principal risks, e.g., by reference to severity of impact ▸ Clearly explain the principal risks that may affect the ongoing business model, solvency and liquidity of the company and how they are being mitigated ▸ Provide detail on risk appetite for each risk	
Risk management and internal controls ▸ Explain how the principal risks are mitigated and controlled by the company's systems of internal controls and risk management ▸ Describe how the board monitors material controls on an ongoing basis to get assurance that principal risks are being effectively managed and to take corrective action if not ▸ Explain what the board's review of the effectiveness of these systems encompassed ▸ Disclose whether the board identified any significant failings or weaknesses ▸ Define the basis used for determining what is 'significant' ▸ Explain the actions that have been or will be taken to address significant failings or weaknesses	

ARA content	Notes and actions

Viability statement
▸ Avoid boilerplate. Disclosures should be clear on the:
  ▸ Timeframe that the board considered the viability of the company over and why
  ▸ Process the board developed and implemented to assess viability
  ▸ Assurance board obtained over relevant elements (e.g., stress testing)
  ▸ Assumptions the board used in reaching their conclusion
▸ Explain how directors assessed the company's prospects, i.e. what the robust assessment of principal risks consisted of not simply that an assessment was carried out
▸ Consider positioning and flow of linked disclosures i.e. those relating to principal risks, going concern and the viability statement
▸ Cross-reference disclosures which are related, e.g., financial statement disclosures on capital management required under IFRS	

Governance report	
Explanations for non-compliance ▸ Be specific as to which element of the Code has not been complied with ▸ Illustrate how actual practice is consistent with the underlying spirit of the relevant Code provision and contributes to good governance and the delivery of business objectives ▸ Describe mitigating actions taken to address any additional risks that may have arisen as a result of non-compliance ▸ Be clear on when the company expects to be in compliance with the Code Provision (where non-compliance is intended to be time limited)	
Board evaluations ▸ Describe the board evaluation strategy spanning the three-year evaluation cycle, including external evaluations ▸ Explain the performance evaluation process, any significant recommendations or actions taken and changes or improvements that the board has committed to following an evaluation ▸ Provide transparent and balanced disclosure on areas for improvement identified in an evaluation	

ARA content	Notes and actions
Shareholder engagement ▸ Provide context, e.g., a description of the shareholder base in terms of size and geography or the voting record from the last AGM ▸ Indicate whether the company has been proactive in reaching out to and engaging with shareholders in the year ▸ Explain what matters were discussed with shareholders and the feedback received ▸ Detail the actions, if any, that have been taken as a result of engagement ▸ Specify who (e.g., which board members) met with shareholders during the year ▸ Describe other methods of shareholder engagement (e.g., surveys or written feedback) in addition to meetings and presentations ▸ Clearly describe the actions the company intends to take to understand the views of shareholders when there have been a significant percentage of votes against a given resolution at a general meeting	
Nomination committee report	
▸ Provide sufficient disclosure on board composition and board succession planning to provide assurance that they are being managed to deliver the long term strategy ▸ Consider providing an overview of when directors are due to leave the board, and the resultant skills gaps that will need to filled ▸ Provide insight on the robustness of board level recruitment and selection processes including whether a search firm was used, the skills and experience that were sought and why the successful candidate met the criteria set ▸ Explain how the committee creates and supports board diversity in practice ▸ Articulate the skills and experience of each board member and how they will help the company/board, as opposed to a list of previous roles held ▸ Describe the initiatives that are in place to develop the next cadre of senior management and an indication of whether emergency succession plans are also in hand	

ARA content	Notes and actions
Audit committee report	

▸ Consider a separate report within the governance section introduced by the audit committee chairman
▸ Use active language throughout focussing on activities in the year, actions and outcomes rather than generic process and role descriptions
▸ In relation to significant issues considered by the committee:
  ▸ Clearly explain what the issue is and how it is relevant to the company and its circumstances (including an amount where relevant)
  ▸ Articulate the audit committee's specific actions in addressing the issues including, e.g., specific concepts that were challenged and debated, resources or points of reference that were used and/or areas in which further information was requested
  ▸ Provide insight as to whether any third-party evidence or assurance was received by the audit committee to address a significant issue
  ▸ Be prepared to explain why the significant issues considered by the committee do not align with the risk areas identified in the auditor's report
  ▸ Consider separating issues which are recurring in nature from those that are specific to the year in question
▸ In relation to describing how the committee assessed the effectiveness of the audit process:
  ▸ Disclose both how the assessment was undertaken (i.e. the process) as well as the criteria and evidence considered in making the assessment
  ▸ Ensure disclosure describes the how the effectiveness of the audit process was assessed holistically and not just in relation to the auditor
  ▸ Explain any changes in the assessment compared to prior years e.g., new areas of focus	

ARA content	Notes and actions
Remuneration committee report	
▸ Ensure that the remuneration committee chairman's introduction is impactful, insightful and linked to the narrative on performance throughout the rest of report ▸ Ensure that there is a clear link (e.g., by use of graphics) between the KPIs that drive variable executive pay and those that are used to measure the delivery of the strategic objectives ▸ Clearly articulate how the remuneration policy is designed to drive execution of business strategy and long-term performance ▸ Provide context for the variable remuneration rewards in the year - clearly describe whether targets were met and what was paid ▸ Highlight key information clearly to minimise excessive cross-referencing to various tables and notes ▸ Ensure any changes to remuneration arrangements are clearly described ▸ If not subject to vote at the AGM, reference where a copy of the remuneration policy can be obtained (e.g., company website) so DRR can focus on performance and remuneration outcomes during the year	
Financial statements	
▸ Highlight any changes in significant accounting policies ▸ Ensure consistency of judgements and estimates and segmental analysis notes within the financial statements with the Strategic Report ▸ Ensure consistency and balance between the financial statements and the narrative of the rest of the report ▸ In the spirit of FBU, consider re-ordering and/or grouping of disclosure notes ▸ Consider presenting the CFO's review or performance summaries within the financial statements ▸ Review the financial statements for opportunities to cut clutter, e.g., by removing unnecessary policies, or conducting an assessment of materiality ▸ Where judgement is exercised to remove immaterial disclosure items briefly explain the basis for doing so (unless rationale is clear)	
Tax	
▸ Explain how the company is monitoring the changing regulatory landscape in relation to tax ▸ Consider explaining the company's attitude and approach to tax ▸ Consider drawing upon global tax footprint information to ensure a consistent story is given to all stakeholders	

Appendix B

A look ahead: upcoming regulatory developments

As the regulatory environment shifts, new required disclosures in annual reporting emerge. Here is an overview of recent and upcoming regulatory changes that will impact 2015 ARAs:

Keeping up with current, ongoing and future changes to **regulation, recommendations and leading practice**

This symbol (Δ) denotes a reference to changes in regulation which are explained in detail in this appendix.

Regulatory development	Source	Timing	Detail
2014 UK Corporate Governance Code	Financial Reporting Council	Accounting periods beginning on or after 1 October 2014	Following changes to the risk management provisions of the Code (see page 22 for full details), companies will now be expected, on a 'comply or explain' basis, to state that the company is viable for a period significantly in excess of 12 months. Provision C.2.2 states that the board must explain how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate.
			Provision E.2.2 of the Code has been amended to add that when, in the opinion of the board, a significant proportion of votes have been cast against a resolution at any general meeting, the company should explain when announcing the results of voting what actions it intends to take to understand the reasons behind the vote result. This is on a 'comply or explain' basis.
			Section D on remuneration within the UK Corporate Governance Code has been amended to increase emphasis on structuring remuneration for long-term performance. Remuneration policies will need to, on a 'comply or explain' basis, include provisions enabling the company to recover or withhold variable remuneration when appropriate.

Regulatory development	Source	Timing	Detail
Modern Slavery Act	UK Government	From October 2015	Companies with a turnover of £36 million or more will be required to publish an annual slavery and human trafficking statement. This statement must describe the steps the company has taken to ensure that slavery and human trafficking is not taking place in any of its supply chains or its own business, or it must disclose that the company has taken no such steps. The statement must be published on the website and may be published in the ARA and be approved by the board and signed by a director. There will be transitional provisions (to be published in due course) so that statements will not be required where a business's financial year end is very close to October 2015. In addition, the Government will be producing more detailed guidance on the statement.
Base Erosion and Profit Shifting (BEPS) Action Plan	OECD	Financial years commencing on or after 1 January 2016	The Base Erosion and Profit Shifting (BEPS) Action Plan, comprises 15 actions which aim to ensure alignment between taxation and the relevant substance that creates economic value. The initiative is moving towards finalisation, although many countries, including the UK, have already introduced unilateral measures to address BEPS activity. Significantly, country-by-country reporting is due to be implemented by the OECD and G20 nations.
IAS 1 – Presentation of Financial Statements	International Accounting Standards Board (IASB)	Financial years commencing on or after 1 January 2017	The IASB issued amendments to IAS 1 in December 2014. The amendments clarify, rather than significantly change, existing IAS 1 requirements. Notably, IAS 1 makes it clear that entities can exercise flexibility about the order in which they present the notes to financial statements. Preparers should note that in the IASB's view there must be a system or reason behind the ordering of the notes and companies need to consider the ease with which their financial statements can be understood and compared when deciding the systematic order for the notes (paragraph 113 of IAS 1). We expect more variety in reporting structures in the future as companies may start considering alternative ways of presenting notes. The IASB also continues to work on the materiality project as part of the disclosure initiative. The Practice Statement on materiality will be a significant next step in this process - more clarity around materiality would help preparers in making better judgements on what disclosures they can remove or reduce.

Regulatory development	Source	Timing	Detail
Changes to auditor reporting standards	International Auditing and Assurance Standards Board (IAASB) and European Union	From 15 December 2016 for audits of all listed entities (for IAASB changes) and from 7 June 2016 on all PIE (public interest entities) audits (for EU changes)	The IAASB changes require auditor reporting of 'Key Audit Matters', those matters that the auditor views as most significant, with an explanation of how they were addressed in the audit. Auditing standards have also been amended to require auditors to give a statement in their auditor's report, based on the knowledge they have acquired during the audit, if they have anything material to add or draw attention to in relation to the rest of the annual report. In addition, the EU Regulation (537/2014) will require the auditor to provide a description of the most significant assessed risks of material misstatement and the auditor's response to these risks, and where relevant, key observations arising with respect to those risks. The FRC is expected to consider these changes in due course and decide what, if any, further revisions to the UK auditing standard on auditor reporting are required.
Prompt payment	UK Government	From 2016	As part of the Small Business, Enterprise and Employment Act, a requirement has been introduced for large companies to report semi-annually on their payment performance.
Gender pay gap	UK Government	From 2016	While this has not been debated in parliament yet, it is likely that companies with 250 or more employees will be required to conduct an equal pay review and publish information on their gender pay gap.
List of subsidiaries	UK Government	From 2016	Companies could previously only disclose their principal subsidiaries in the accounts if a full list of subsidiary and other related undertakings were disclosed in the annual return. This option is being removed.
Non-Financial Reporting Directive	European Union	Financial years commencing on or after 1 January 2017	Large public-interest entities and public-interest entities which are parent undertakings of a large group, with more than 500 employees, will be required to disclose information, as relevant, on policies, risks and outcomes as regards environmental matters, social and employee-related aspects, respect for human rights, anti-corruption, bribery and diversity issues. Most of these disclosures are already encompassed in the UK company law with the exception of reporting on anti-corruption and bribery issues. The Department for Business, Innovation and Skills is currently considering how this Directive will be implemented into UK law.

Regulatory development	Source	Timing	Detail
Shareholder Rights Directive	European Union	TBC	Amendments have been proposed to the Shareholder Rights Directive aimed at encouraging long-term investment and shareholder engagement. The proposal includes provisions on shareholder engagement policy/disclosure, vote on executive remuneration and proxy adviser guidelines. Agreement has not yet been reached by the EU Parliament and Council.
HMRC Consultation on Improving large business tax compliance,	UK Government	TBC	HMRC is consulting on a proposed mandatory requirement for large businesses to publish their UK tax strategy as well as signing up to a voluntary Code of Practice. The consultation document suggests that useful public disclosures could include: ▸ A business's attitude to tax risk ▸ Its appetite for tax planning ▸ Its approach to HMRC relationships ▸ Whether a business has a target effective tax rate and what measures it is taking to maintain or reach this target The consultation also includes a proposal for an executive director to be identified as responsible for owning and signing off the tax strategy. With the consultation closing in October 2015, legislation could appear as early as the 2016 Finance Bill.

Appendix C Further reading

EY publications	Other recent publications
▸ *Board effectiveness – continuing the journey (produced jointly with The Investment Association)* ▸ *Shareholder engagement and corporate reporting at a crossroads* ▸ *The viability statement – finding opportunities in the new regulatory challenge* ▸ *Assessing the effectiveness of the external audit process* ▸ *Applying IFRS: Improving disclosure effectiveness* ▸ *2014 Executive and Board Remuneration Report* ▸ *Tomorrow's Investment Rules: Global survey of institutional investors on non-financial performance* ▸ *A new mountain to climb – tax reputation risk, growing transparency demands and the importance of data readiness* ▸ *Tax transparency – Seizing the initiative* ▸ *Tax transparency – Building confidence*	▸ *CFA UK annual survey on Financial Reporting and Analysis*, CFA Society United Kingdom, 2015. ▸ *BIS Research Paper 208: How companies and shareholders have responded to new requirements on the reporting and governance of directors' remuneration*, Department for Business Innovation and Skills, March 2015. ▸ *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting*, FRC, September 2014. ▸ *Supplementary Guidance for Directors of Banks on Solvency and Liquidity Risk Management and the Going Concern Basis of Accounting*, FRC, September 2014. ▸ *Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies: Discussion paper on the FRC's findings and proposals*, FRC, June 2015. ▸ *Lab case study report: William Hill – accounting policies*, Financial Reporting Lab, February 2015. ▸ *Lab Insight Report: Towards Clear and Concise Reporting*, Financial Reporting Lab, August 2014. ▸ *Boardroom Bellwether survey: Insights into what boards are thinking from the survey of FTSE 350 company secretaries*, FT-ICSA, July 2015. ▸ *Towards Transparency: Assurance on KPIs - A practical guide for audit committees and boards*, ICAS, June 2015. ▸ *Adherence to the FRC's Stewardship Code, at 30 September 2014*, The Investment Association, June 2015. ▸ *Corporate Governance Report: Active Ownership*, Legal & General Investment Management, 2014. ▸ *Women on Boards, Davies Review Annual Report 2015*, March 2015.

Appendix D

Methodology

A team of approximately 15 EY professionals, led by the Corporate Governance team and with expertise in areas including remuneration, tax and risk reporting conducted a comprehensive review of ARAs.

The sample consisted of 100 ARAs of FTSE 350 companies with September-December 2014 year-ends. The sample was weighted: 38% FTSE 100 and 62% FTSE 250 companies. All investment trust and mutual funds were excluded from our sample as the applicability of the recent regulatory and legal changes is slightly reduced as compared to a corporate.

Our research compiled qualitative and quantitative findings on a broad range of measures and topic areas which we present throughout this report alongside recommendations for leading practice. Where we have seen examples of leading practice from outside our sample, we have also included reference to these.

Appendix E EY contacts

If you want to know more about..		EY Contacts
Corporate governance	▸ Perspectives and trends in governance including the views of investors ▸ Board composition and effectiveness ▸ Leading practices in annual reporting including narrative and governance reporting ▸ Future developments in governance and reporting	**Ken Williamson** kwilliamson@uk.ey.com + 44 20 7951 4641 **Andrew Hobbs** ahobbs@uk.ey.com + 44 20 7951 5485 **Mala Shah-Coulon** mshahcoulon@uk.ey.com + 44 20 7951 0355 **Natalie Bell** nbell1@uk.ey.com +44 20 07951 1316
Tax Accounting and Risk Advisory Services	▸ Design or review of tax risk management frameworks ▸ Developing or refreshing tax policy or strategy to enhance governance ▸ Design, review and implementation of tax data and technology strategies ▸ Assurance over Senior Accounting Officer certification ▸ Review of tax processes and controls, including over voluntary tax disclosures ▸ Tax accounting and reporting services	**Mandy Pachol** mpachol@uk.ey.com +44 20 7951 7092 **Kevin Honey** khoney@uk.ey.com +44 20 7951 3606 **James Egert** jegert@uk.ey.com +44 20 7951 0272

Appendix E EY contacts

If you want to know more about..		EY Contacts
Financial Accounting and Reporting	▸ Financial reporting benchmarking, including accounting policies ▸ GAAP conversions ▸ Corporate treasury ▸ Improving your financial statement close process ▸ Optimising your ARA to enhance communication	Andy Smyth asmyth@uk.ey.com + 44 20 7951 3747 Andrew Davies adavies@uk.ey.com + 44 20 7951 3237
Performance and Reward	▸ Executive remuneration including policy design, governance and reporting ▸ Incentive design for executive, management and all employee populations including equity incentives ▸ Share plan implementation in the UK and internationally, including addressing regulatory and tax matters ▸ Remuneration benchmarking and market surveys	Isobel Evans ievans@uk.ey.com +44 20 7951 3113

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EY Corporate Governance team

The team provides insights on:

- Perspectives and trends in governance
- Board composition and effectiveness
- Leading practices in corporate reporting
- Future developments in governance and reporting

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ED 0915

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