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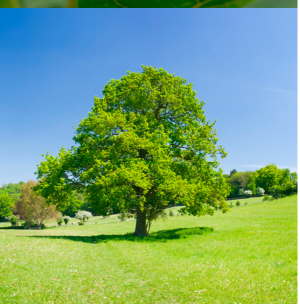

It has begun …
Early examples of reporting practice

In October 2013 we published 'A new beginning – Annual report insights 2013', a survey of company annual reports with accompanying tools to help preparers improve annual reports and implement the new strategic report, statutory greenhouse gas disclosures and the 2012 UK Corporate Governance Code (the Code). That publication set out some of the challenges listed companies face in dealing with the new requirements.

As the requirements were mandatory for companies with a year ending 30 September 2013, we have taken an initial look at how these companies dealt with these challenges. Whilst this may not be representative of the population as a whole, there are some useful insights into practice and some reminders of the challenges ahead for finance teams, boards and audit committees.

Strategic report – overall approach

Every annual report that we looked at included a strategic report, despite the Regulations only being published very shortly before the effective date of periods ending on or after 30 September 2013.

Explaining the change

The law does not require an explanation of the change, but signposting can be helpful.

It may be helpful to explain what the new requirements are:

- The Paragon Group of Companies PLC included a brief explanation of what the new strategic report is, welcomed feedback and noted that their disclosures would evolve over time as the FRC finalised its guidance.
- Aberdeen Asset Management PLC provided an overview of their strategic report, explaining what each component was and the key messages therein.

One report or two?

By law, the new strategic report should be separate from the directors' report with separate approval by the board. Matters can be elevated from the directors' report to the strategic report but this must be explained.

This has clearly caused some confusion, not least as to which information belongs in which report. Inclusion of a strategic report was approached in a variety of different ways, some of which did not appear to be fully compliant with the law:

- For some, the strategic report represented most of the front half narrative (excluding the directors', remuneration and corporate governance reports) and a few included a concise strategic report with separate detailed supporting information. However, others didn't seem to follow the spirit of the law stating that the directors' report comprised (among other things) the strategic report or that pages X to Y comprise the strategic report and directors' report. For a few, even when the actual content was presented and approved separately, their contents pages included both in a sub-section of the contents page headed 'Directors' Report'.
- In some reports only the directors' report had been clearly approved on behalf of the Board, though the law requires that each should be approved separately. Enterprise Inns PLC produced two distinct and separately approved reports.
- Several companies made use of the option to promote material of strategic importance from the directors' report to the strategic report. For example, Enterprise Inns PLC included a discussion of future developments in the strategic report instead of the directors' report, perhaps because it sat better alongside the review of the business in the strategic report; their directors' report cross referred to the fact they had done this.

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Linkage and cohesiveness

The FRC's draft Guidance on the strategic report calls for clearer flow of information with reduced duplication within the annual report as a whole.

It is promising to see that the annual reports that we looked at did generally suggest that management teams are giving greater consideration to linking the different components of the annual report and promoting cohesion within the document (a trend backed up by the survey findings in 'A New Beginning'). That said, there is still scope for companies to further improve their narrative 'flow' and useful areas for consideration will include the FRC's draft Guidance on the strategic report and the FRC's proposed changes to integrate risk management, internal control and going concern disclosures.

Strategic report – human rights

The human rights disclosure is arguably one of the most novel requirements in the Regulations and companies are finding it challenging. In many cases the discussion of human rights issues was bland and generic. Such disclosures typically appeared in the corporate and social responsibility (CSR) section of the strategic report and were often just mentioned in passing, as part of a broader discussion on ethical, employee or diversity issues. In some cases this disclosure seemed to have been omitted entirely.

Some companies justified light (or non-existent) discussion by stating that it was not considered necessary for an understanding of the business. Although this approach is certainly in the spirit of avoiding clutter, ensuring that only material disclosures are included, boards should take care to ensure that this is genuinely appropriate.

Where human rights issues might be expected to be significant to a company, substantial disclosures had been made. For example, Imperial Tobacco Group plc explained that they were guided by the UN Guiding Principles on Business and Human Rights and explained how they are working with suppliers to improve human rights. A few other companies also made references to UK, European or UN guidance and legislation, a good example being The Paragon Group of Companies PLC.

Strategic report and the Code – diversity

There are two sources of new reporting requirements in respect of diversity:

The Code – board diversity

All companies met the new requirement in the Code to discuss board diversity. Lonmin plc provided statistics around broader diversity areas at the board level, including industry sector experience, professional background and current country of primary residence

Strategic report – gender diversity

All companies provided statistics around gender balance of the workforce in their strategic report, as required by law. However, not all disclosure appeared to comply with the requirements of the law. The main issue arose in applying the definition of 'senior management', which must include directors of its subsidiaries. Terms such as 'executive committee', 'operating executive' and 'top leadership' were all used when disclosing the gender diversity of senior management, but could, in the absence of any clarification, suggest that directors of subsidiaries are being excluded. Some companies only gave a percentage split; the law requires absolute numbers of male and female employees. By contrast, though, other companies, such as Grainger plc, went above and beyond the legal requirements including age ranges and gender splits at more granular levels of seniority.

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Directors' report – carbon reporting

Although a handful of companies claimed exemption from the disclosure requirements on the grounds of impracticability, citing a lack of time to collate the required information, most companies provided full, thorough disclosures in this area. Perhaps surprisingly, many disclosures on carbon emissions were promoted from the directors' report into the strategic report, and included in the directors' report by way of cross-reference as the disclosures were considered to be of strategic importance. This might be because they sit more logically with the other CSR disclosures, most of which are required to be included in the strategic report. Good examples of disclosure in this area can be found in the annual reports of Sage Group PLC and Enterprise Inns PLC.

The Code – 'Fair, balanced and understandable'

The majority of companies included a statement that the annual report was fair, balanced and understandable (Code Provision C.1.1) within their directors' responsibility statement. Some explained more about the process which had been undertaken to support the board's conclusion. Half had asked the audit committee to advise them on their statement; those audit committees typically made some reference to 'fair, balanced and understandable' in the audit committee report. Companies that provided the most comprehensive disclosure in this area included:

- Imperial Tobacco Group plc referred to the use of a disclosure committee and internal audit plus internal and external legal advisers, acknowledging that sufficient time had been allowed to facilitate review and input.

- The audit committee of Enterprise Inns PLC explained that their focus had been on ensuring that the description of the business agreed with their own understanding, that the discussion of performance properly reflected the 'story' of the year, that appropriate weight had been given to good and bad news and that there were clear and well-articulated links between all areas of disclosure.

- Euromoney Institutional Investor plc referred to a training session covering corporate governance matters, a sub-committee of the directors reviewing the annual report and early preparation and review of new components of the annual report.

As expected, the audit committees list of significant issues was often close to the list of risks reported by the auditor.

The Code – significant issues considered by the audit committee

Audit committees now need to describe (Code Provision C.3.8) the significant issues they considered in relation to the financial statements and how they were addressed.

Number of issues discussed	Between one and nine, with an average of four.
Length of discussion	Significant variation. For example, Lonmin plc provided extensive discussion, whereas Shaftesbury plc selected one issue to discuss in detail and then referred to four others at a higher level.
Selection of issues	A minority of companies sought to explain why they had determined that the issues discussed were significant.
Linkage to the financial statements	Some companies cross-referred to other relevant disclosures on the significant issues set out elsewhere in the annual report as recommended by the Financial Reporting Lab.

Links to the auditor's report	Corresponding changes to auditing standards require the auditors to describe the risks of material misstatement that had most effect on the conduct of the audit. As expected, the audit committee's list of significant issues was often close to the list of risks reported by the auditor. • Around half of the companies omitted one of the issues discussed by the auditor – usually those where auditors are presumed to (risk of fraud in revenue recognition) or must (management override of internal control) have a significant risk. Grainger plc is an example of a company that identified management override as a significant issue in the Audit Committee report. • Around half of the companies included additional significant issues in the Audit Committee report compared to the auditor's risks. This was most commonly restricted to one additional issue but one company raised three additional issues and the greatest difference was in Imperial Tobacco Group plc where the Audit Committee raised seven additional issues. • Some companies provided greater detail in their disclosure – for example Euromoney Institutional Investor plc – this allowed the auditor to cross-refer to the audit committee's disclosure to reduce duplication in the auditor's report.

The Code – external audit tendering

With the new rules from the FRC and forthcoming rules from the Competition Commission (CC) and European Union (EU) it was no surprise that audit tendering was discussed in some detail:

- Several companies made reference to the CC rules and one to the EU proposals – sometimes in terms of impact and sometimes explaining that they would wait to decide on tendering once the position was clear. Other reasons cited for why a tender was not suitable at the present time included the board being occupied with critical strategic challenges and the cost and disruption of a tender process outweighing any benefit to shareholders from a more frequent change of auditor.
- Many companies disclosed that they were taking advantage of the FRC and CC transitional arrangements and were planning to go out to tender at the end of the current partner rotation cycle.
- Only one company, Victrex plc, overtly referred to not having undertaken a tender process as a non-compliance with the Code.

The Code – effectiveness of the external audit process

Many companies linked their disclosure around the effectiveness of the external auditor process with their discussion of tendering policy. The majority of disclosures in this area were relatively short and focussed on the effectiveness of the external auditors as opposed to the whole external audit process. A small number of companies made explicit reference to the wider audit process and management's role within it.

Certain companies made reference to the fact that the audit committee had used the relevant FRC Audit Quality Review Team report as part of their assessment; another referred to the audit firm's transparency report. ITE Group plc was the most comprehensive in describing the process they had undertaken to assess effectiveness of the external audit process.

Conclusion

Companies have taken note of the changes required to annual reports. They are working towards compliance with the strategic report and generally demonstrating a good level of compliance with the Code. This is rapidly evolving in practice and we will continue to assess the quality of disclosure as more companies publish their annual reports.

To find out more

If you would like more detailed information or advice, or would like to meet with us to discuss your reporting issues, please contact your local Deloitte partner or:

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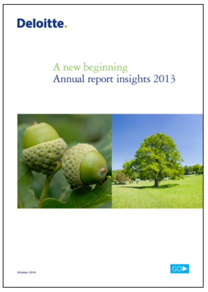

A new beginning – Annual report insights is available on www.ukaccountingplus.co.uk, your one stop shop for news and resources on UK accounting, reporting and corporate governance.

Other related Deloitte publications available on UK Accounting Plus include:

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

Useful external publications include:

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

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