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Annual report insights 2018

Surveying FTSE reporting

Contents

Overview	**01**
Introduction	**05**
1. Purpose and culture	**06**
2. Report structure and preliminary announcements	**08**
3. Strategy and business model	**12**
4. Stakeholders	**16**
5. Alternative performance measures and KPIs	**22**
6. Long term value creation	**26**
7. Risks and opportunities	**30**
8. Viability	**34**
9. Board and director stewardship	**38**
10. Succession and diversity	**42**
11. Accountability and internal control	**46**
12. Judgements and estimates, tax and pensions	**50**
13. Other financial statement disclosures	**54**
Appendix 1 – The preparation process	**58**
Appendix 2 – Timeline of key corporate reporting changes	**60**
Appendix 3 - Additional examples of disclosure	**61**
Appendix 4 – Regulatory overview	**76**
Contacts	**89**
Endnotes	**90**

Overview

Ever increasing scrutiny, constant change and a shortage of trust in business have been continuing features of the corporate reporting landscape. Once again our survey shows how companies have managed these challenges, where they are struggling to comply and areas of innovation and better practice.

As ever, we have scoured the annual reports of 100 listed UK companies, of various sizes and in various industries, in order to provide you with insight into FTSE reporting practices. We look at the whole report, including the strategic report, governance content and the financial statements.

Responsible capitalism and licence to operate

Responsible capitalism is a much-cited concept in recent years and there is an increasing acknowledgement that a company needs a societal licence to operate. It was therefore no surprise that 92% of companies surveyed referred to key inputs into their business model in the form of off-balance sheet resources and relationships, ranging from employee workforces to customer relationships and natural resources. The International Integrated Reporting Council's <IR> Framework can be helpful in this regard, with six companies referring to it or describing their report as 'integrated'.

Company purpose and culture

[illegible]% of reports gave a clear description of a company purpose that went beyond making profits for shareholders and, encouragingly, 76 companies discussed value created for at least one stakeholder other than shareholders.

The FRC has also stressed the importance of corporate culture in recent years, including the critical role of the board in holding management to account. An encouraging 58% of companies explained the values, behaviours and culture that they seek to uphold.

Section 172

Section 172 of the Companies Act 2006 (s172) already requires directors to consider broader non-financial matters, such as employee interests and the impact on the community and environment, whilst promoting the success of the company for its shareholders.

New laws will soon see all large UK companies having to describe in their annual reports how their directors have had regard to the matters set out in s172.

Corporate governance reforms have also seen the FRC publish a new UK Corporate Governance Code, incorporating the Prime Minister's broad social reform agenda and desire to restore trust in UK business. Effective in 2019, the 2018 Code will see numerous changes to the detailed public reporting on a company's corporate governance arrangements, driven by changes to the underlying governance processes for many companies.

Some companies are already acknowledging their broader responsibility within society. 29% of companies referred to the responsibilities required by s172 (2017:17), with 8% explaining how the directors had fulfilled those responsibilities and had regard to their duty under s172. The vast majority of companies (97%, 2017: 87%) evidenced consideration of their business' impact on the community and the environment. The fostering of relationships with suppliers was also acknowledged by 71% (2017: 38%).

Non-financial information

One of the few changes to the requirements for annual reports in 2017 was the implementation of the Non-Financial Reporting (NFR) Directive in the UK. 70 of the companies surveyed fell within its scope and compliance was mixed.

One NFR Directive requirement is to give the policies a company pursues in relation to environmental matters, its employees, social matters, human rights and anti-bribery and anti-corruption. 61 companies clearly mentioned anti-bribery and anti-corruption, but in many cases it was hard to identify whether companies had made disclosures designed to meet the NFR Directive, due to existing requirements touching on similar areas. Another recurring issue was ambiguity as to whether the information provided could really be regarded as constituting a 'policy'. For example, we felt that only 23 of the companies in scope had clearly named or described a policy in relation to social matters.

The new NFR Directive requirements may have contributed to an increase in the average length of reports, which rose from 155 to 164 pages. 13% discussed how they had regard to materiality in the context of their narrative reporting, typically within their corporate responsibility information.

Narrative reporting assurance

Despite investor focus on non-financial metrics, only a quarter of companies referred to internal or external assurance over non-financial or CSR information, in some cases covering more than just traditional sustainability information.

Use of APMs

The use of non-financial metrics remains relatively common in companies' key performance indicators (KPIs), with 71% (2017: 74%) having one or more such metric. Employee-related items were the most popular type of non-financial metric - 75% (2017: 53%) of those with non-financial KPIs had such a measure.

When it comes to financial metrics, alternative performance measures (APMs), being adjusted versions of IFRS measures, also remain popular, reflecting the widespread belief in the UK that when used appropriately they are useful. 96% presented such metrics in their up-front highlights section, with 91% of those including an adjusted profit APM.

Compliance with ESMA guidelines

An emerging trend observed, adopted by 46%, was for companies to have a dedicated section or appendix on APMs, providing much of the information required by ESMA's guidelines on APMs. Overall, compliance with ESMA's guidelines was mixed. 86% of those with an adjusted profit APM in their highlights section reconciled it back to the IFRS measure and 80% provided comparative balances.

Prominence of APMs

One of the more judgemental requirements of ESMA's guidelines is that APMs should not be given more prominence than the associated IFRS measures. It appeared that 20% of companies may have given undue prominence to adjusted profit measures by using bold font or graphs to emphasise APMs in their highlights. Looking further into the reports, almost a third of Chairmen's and CEOs' statements did not make any reference to IFRS profit measures when discussing adjusted profit measures, echoing findings from the FRC's recent thematic review on APMs.

In the financial statements themselves, 68% had APMs on the face of the income statement. In terms of the labels used, it appears that concerns over the use of misleading terms may be having an effect – the use of 'exceptional' items dropped from 20 companies to 11 companies and the use of 'non-recurring' from three to none. The use of 'adjusting items' as an umbrella term rose from six to ten.

Principal risks: cyber and technology

Against the backdrop of a fast-changing world, companies on average identified ten risks that could seriously affect their performance, future prospects or reputation. These principal risks covered a wide variety of issues, but in a business environment increasingly utilising technology it was unsurprising that, similar to the previous year's reports, they frequently included matters around cyber-crime (73%), data protection (54%) and systems' failures (46%). Many companies evidenced in their reports that their boards are taking cyber risks seriously, with 54% disclosing board attention on cyber risk/cyber security, including board training, presentations to the board or audit committee, cyber insurance and externally provided projects regarding cyber security.

Continuing with the technology theme, it was interesting that 19% set out a principal risk that they might not keep up with the pace of technological change and that a failure to do so would threaten the business. Another feature of the modern world, social media, was explicitly referred to by a small number of companies in the context of reputational risks and the need to monitor such publicity.

Principal risks: Brexit

Looking slightly further ahead, the UK's departure from the European Union was identified as a principal risk by 25 companies, with a further 34 explicitly referring to it in the context of a broader risk around marketplace and economic uncertainty. 27% disclosed board attention to the topic of Brexit, down from 44% in 2017. In terms of their business model and how it might or might not change following Brexit, the majority were either silent (46%) or stated that they were monitoring the situation (26%). 23% indicated that they did not expect any change and the remaining 5% that they had changed, would change or might change. The FRC is keen for companies to keep updating the information they provide on Brexit as the situation continues to evolve.

Principal risks: climate change

Surprisingly only one company identified climate change as a principal risk. A very small number mentioned compliance with regulation including that designed to tackle climate change and 18 companies identified environmental risks, ranging from availability of resources to extreme weather events (without linking these to climate change).

On a related note, only four companies asserted some level of compliance with the guidelines on climate-related disclosure published by the G20 Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD). Slightly more encouragingly, 15 companies in total described their board of directors' oversight of climate related risks.

Viability

Having considered a company's principal risks the directors are required to provide a statement regarding the company's longer term viability. 50% (2017: 34%) indicated which specific risks were considered in making their statement, with 54% disclosing qualifications or assumptions underlying their assessment – 29 companies mentioned the availability of financing or refinancing.

The FRC and investors have indicated that they expect to see directors undertaking an assessment of a company's prospects, including the resilience of the business model, over a longer time period than that over which they assess the company's viability. However, only 13% provided a clearly distinct discussion of the company's prospects in the viability statement.

Board evaluation

The performance of directors is often subject to considerable scrutiny nowadays, making board evaluation disclosures of particular interest. 35% of companies explained the findings and related action points from board evaluation processes (2017: 41%). A further 17% of companies just described the findings of their evaluation (2017: 9%). Discussing areas for improvement helps demonstrate transparency, openness to change and commitment to the running of an effective board.

Diversity

Boards can also benefit from having a suitably diverse make-up. New rules, stemming from the NFR Directive and implemented into the Disclosure Guidelines and Transparency Rules (DTR), became effective for periods commencing on or after 1 January 2017, requiring disclosure of boardroom diversity policies in the corporate governance statement, including aspects such as age, gender, geographical diversity and educational and professional background.

Although 80% (2017: 86%) of reports referred to aspects of diversity other than gender, only 29% were regarded as meeting the new DTR requirements. In order to meet the new requirements, boards should aim to describe the policy itself rather than the processes in place or actions taken during the year. Any cross-references to entity-wide diversity policies should also include information on how they specifically apply to the board.

Succession planning

After a significant improvement in our 2017 survey, standards had been maintained in this year's succession planning disclosures. 93% of boards disclosed activity around succession planning (2017: 89%, 2016: 69%). However, in our judgement only 33% (2017: 41%) of companies this year included disclosures that explained clearly the systems the board has in place to maintain good succession planning, for example use of a regularly updated skills matrix.

Audit committee reporting

The FRC's Audit and Assurance Lab published, in December 2017, investor feedback on what information is expected from audit committees on significant financial reporting issues. In our judgement, based on the FRC's findings, only 25% provided comprehensive disclosures adding substantially to the reader's understanding of issues and how the audit committee had considered and challenged them. In general, audit committees could have provided more detail on their actions and level of challenge and comparatively few explained the rationale underlying their conclusions regarding the significant issues.

The FRC's program of thematic reviews led, in part, to an increase in audit committee reports referring to engagement with the FRC's Corporate Reporting Review panel – a rise from 3% to 15%.

Judgements and estimates

In November 2017, the FRC published findings from its thematic review of financial statement disclosures on critical accounting judgements and key sources of estimation uncertainty under IAS 1. Consistent with the findings therein, it seemed to us that some progress had been made but that there is still room for improvement. For example, 66% (2017: 52%, 2016: 27%) distinguished between judgements and estimates, bearing in mind that different information is required for each, although 18 companies seemed to have misclassified items between these categories. Boilerplate also remains a concern - just under a third of companies we looked at only provided disclosures that were so generic they could have been applied equally to any other company.

Defined benefit pensions

Another area where the FRC completed a thematic review in 2017, and one that attracts significant attention, is in respect of defined benefit schemes run by companies. Albeit many are now closed to new entrants or future accrual, 67% of companies still had some form of defined benefit obligation. Encouragingly, on an accounting basis at least, 40 were in a surplus (where plan assets exceeded the liabilities) and 37 of those surpluses were recognised as assets by companies, although only 21 provided justifications for asset recognition.

New IFRSs

It was the final year for 81 companies surveyed before the mandatory implementation of significant new accounting standards on financial instruments and revenue, IFRS 9 and IFRS 15. Given this proximity, and perhaps thanks to regulatory pressure, it was pleasing that companies provided more information on these forthcoming standards than previously.

Six companies indicated that IFRS 15 might have a material impact and a further 20 stated that it would have an impact, which implied that it would be material. Of those 26 companies, 23 quantified the impact. Similarly, 19 companies indicated they expected IFRS 9 to have an impact, which again implied it would be material, with 14 quantifying it.

No companies had early adopted the new leasing standard, IFRS 16, which becomes effective for periods commencing on or after 1 January 2019 and brings most leases on balance sheet for lessees. Some companies appeared well advanced in their preparations, with eight companies quantifying the impact. A further 36 companies gave some idea of the impact through a cross-reference to their operating lease commitments. However, care should be taken in adopting such an approach, due to potential differences between IAS 17's disclosure and the amount to be recognised under IFRS 16. In the forthcoming reporting season expectations will only increase in terms of the information to be provided on the impact this significant new standard will have.

Final thoughts

Change abounds, both in terms of the business environment companies find themselves operating in and in terms of the information they are called upon to provide to investors. This publication provides valuable insight into how companies are responding to this challenge and how they are innovating when it comes to telling their story in their annual reports.

Veronica Poole
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Deloitte

Introduction

In this publication we aim to provide insight into practices in annual reporting, focusing on areas where requirements have changed, where regulators are focusing or where innovative practices are emerging.

The publication presents the findings of a survey of 100 annual reports of UK companies with a premium listing of their equity on the London Stock Exchange. 75 of the 100 companies are the same as those used in the previous survey. The population comprises 19 FTSE 100 companies (2017: 18), 38 FTSE 250 companies (2017: 39) and 43 companies outside the FTSE 350 (2017: 43). Investment trusts, other than real estate investment trusts, are excluded from the sample due to their specialised nature. The reports analysed are for financial years ended between 30 September 2017 and 31 March 2018.

Each section addresses a different aspect of a typical UK listed company's annual report, generally distinguishing between:

- areas where compliance has been relatively good or improved;
- areas where companies have struggled to comply with requirements; and
- areas where companies have gone beyond mere compliance and are innovating or voluntarily providing information.

The topic of integrated reporting impacts multiple parts of companies' annual reports and is discussed in multiple sections of our publication. To help identify this recurring topic we have used the following colour-coding:

Although our survey data uses only companies from our sample, when selecting examples of good practice we have used material from companies that, in our view, best illustrate a particular requirement or innovation, regardless of whether they are in our sample.

Many more example disclosures can be found in an appendix accompanying the electronic version of this publication, available at www.deloitte.co.uk/annualreportinsights. A more detailed discussion of the regulatory requirements UK companies with a premium listing are subject to is also provided as an appendix in the electronic version.

Each section also includes a short list of items to watch out for in the reporting season ahead, reflecting areas of changing requirements or practice and areas of regulatory focus.

Directors' remuneration

The length of the directors' remuneration report has remained above 10% of the whole annual report but has fallen, on average, by 1 page to 18 pages. Whilst FTSE 100 companies have the longest reports, on average, at 20 pages, surprisingly the longest 5 reports, all 30 pages or more, were from companies outside of the FTSE 100.

It was pleasing to see that companies are acknowledging the pay conditions of the wider workforce within their directors' remuneration reports with 69% of companies making reference, if only briefly, to their entire workforce. However, in line with 2017 no company has included a ratio comparing directors' to employees' pay. From 1 January 2019 quoted companies will need to provide certain ratios comparing CEO pay to employees.

In our sample, eight companies disclosed that more than 20% of shareholder votes had opposed approval of the previous 'Annual Report on Remuneration' at their most recent AGM, with one instance of the opposing proportion exceeding 50%. The Code requires companies to announce the actions they intend to take to understand a significant proportion of votes against a resolution; six of the above companies had followed up with explanations of the actions taken in their next directors' remuneration report. Section 4 provides further detail on stakeholder engagement.

Consistency

In reporting how the entity has developed and performed in the year, companies must ensure their analysis is fair, balanced and comprehensive. In assessing this, one of the things the FRC looks out for is consistency between information in the 'front half' and the financial statements. One indicator of this is whether the description of the entity's major products, services and markets and its competitive position in those markets in the front half is aligned with the segment analysis presented in the financial statements – for 92 companies it was.

What to watch out for

- [ ] Remember that the strategic report is only required to contain information material to shareholders.
- [ ] Consider the communication principles set out in the FRC's revised Guidance on the Strategic Report and the <IR> Framework's Guiding Principles, illustrated below.
- [ ] Consider investor views on whether to disclose the level of distributable profits and any associated recent FRC guidance.

<IR> Framework Guiding Principles

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

FRC's Communication Principles

- The strategic report should be fair, balanced and understandable.
- The strategic report should be clear and concise yet comprehensive.
- Where appropriate, information in the strategic report should have a forward-looking orientation.
- The strategic report should provide information that is entity-specific.
- The strategic report should highlight and explain linkages between pieces of information presented within the strategic report and in the annual report more broadly.
- The structure, presentation and content of the strategic report should be reviewed annually to ensure that it continues to meet its purpose and only contains information that is relevant.

Examples of disclosure

Mondi plc commented on materiality in the context of their report as a whole.

Mondi plc

Materiality

Mondi's Integrated report and financial statements 2017 aims to provide a fair, balanced and understandable assessment of our business model, strategy, performance and prospects in relation to material financial, economic, social, environmental and governance issues.

The material focus areas were determined considering the following:

→ Specific quantitative and qualitative criteria

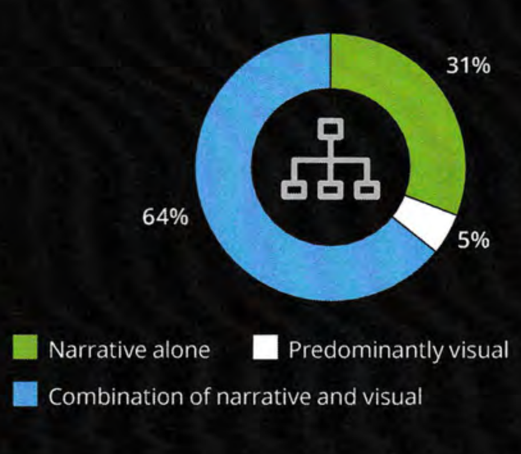
→ Matters critical in relation to achieving our strategic objectives

→ Principal risks identified through our risk management process

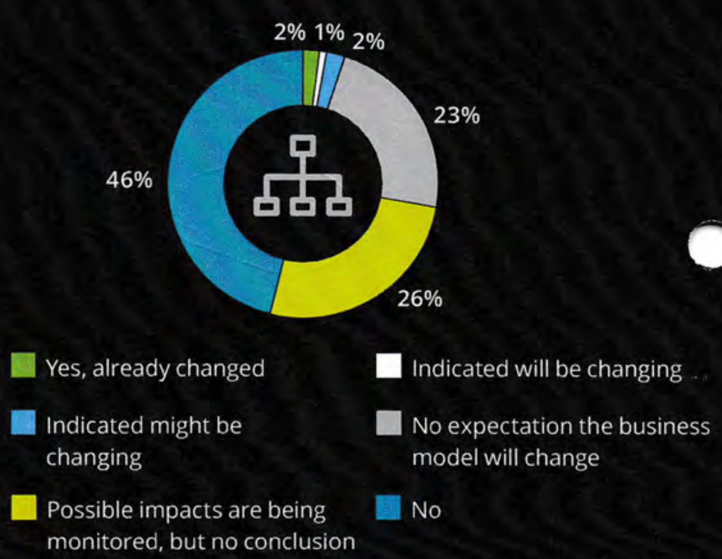
→ Feedback from key stakeholders during the course of the year

3. Strategy and business model

How is the business model presented?



Is there evidence of a change in business model because of Brexit?

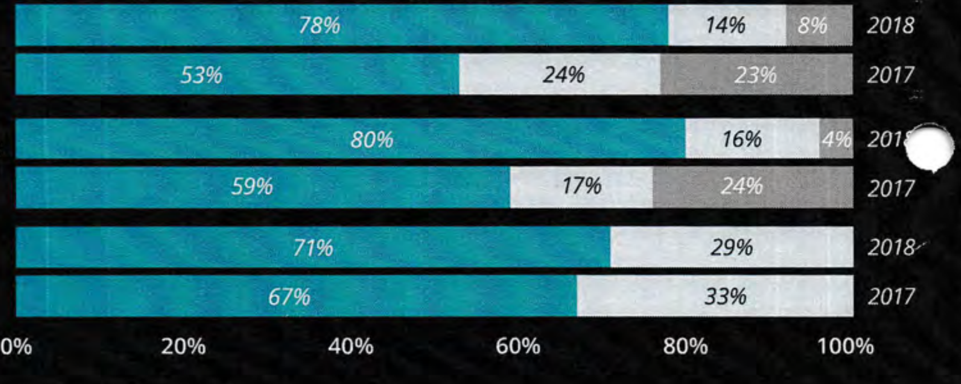


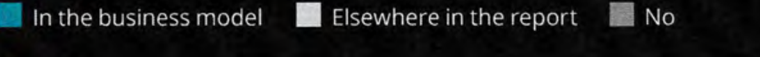
What information is provided in the business model?

Key inputs in the form of off-balance sheet resources and relationships?

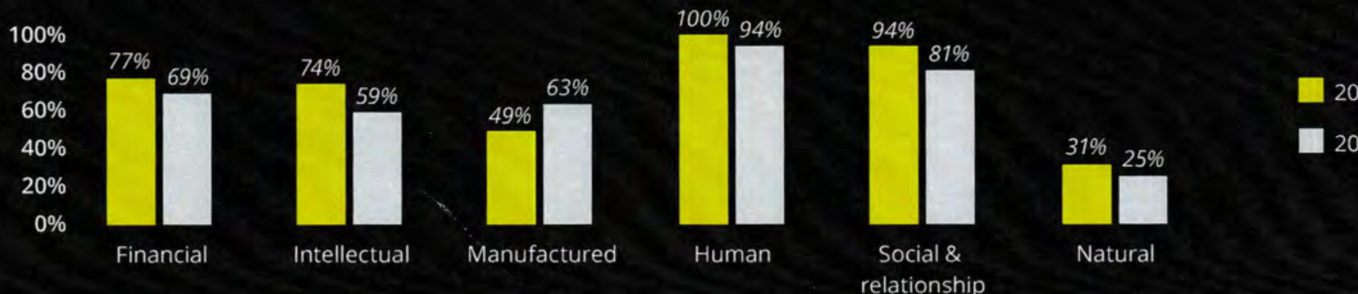
Key inputs in the form of assets and liabilities recognised on balance sheet?

An explanation of what the company does?





Of those identifying <IR> capitals, which ones are referred to?



Compliance – positive trends

An entity's purpose, its strategy, and its business model are inter-related concepts. The strategy sets out how the purpose will be fulfilled. But a key part of setting the strategy is understanding the organisation's business model, particularly the relevant levers available for directors to push and pull to be able to increase outputs and create long term value.

The business model disclosure is not only required [illegible] law, but is one of the first things investors look for [illegible] an annual report[4], so it should explain what the company does, how it does it, and the impact that the company's activities has. 94 companies clearly disclosed a business model, or information resembling such (2017: 95). Of the 6 companies that did not clearly disclose a business model, one of these conceded that their business model was being revised to reflect a new strategy and approach, along with a revised set of KPIs. The others all referred to the term "business model" within the standard boilerplate directors' responsibilities statement, but none provided any other clear disclosure in this regard.

Using a combination of words and diagrams remains the most popular means of articulating the business model, with 58 companies doing so (2017: 55). It was good to see that of those presenting some or all of the business model disclosure in a visual manner, [illegible]% of these visuals were deemed to have aided the discussion, compared to only half of those last year.

The graph opposite identifies certain elements considered useful by investors to be included within the business model disclosure, as highlighted in the FRC's Financial Reporting Lab project[5]. It is good to see an increase overall across all elements, although there still remains scope for improvement.

More companies are identifying and articulating in their business models those inputs which are key to the success of their business, as is suggested in the FRC's Guidance to the Strategic Report. In particular, over three quarters of companies are identifying those key sources of value in the form of off-balance sheet resources, relationships and other dependencies.

The identification of inputs is similar to the <IR> Framework's notion of 'capitals' within its value creation process. We were encouraged to see 35 companies (2017: 32) clearly considering the <IR> notion of 'capitals' in their business models, often demonstrating the outcomes of the business model on each capital, going beyond the FRC's recommendation of identifying just key inputs. Interestingly, these companies were spread fairly evenly across the FTSE, demonstrating that it is not only the largest of companies that see the benefit in understanding and articulating their business model in this way. On average, these companies identified a total of 6 capitals, with the most identified by one company being 12 different capitals.

Of those that identified key sources of value in the form of off-balance sheet resources, relationships and other dependencies, either in their business model or elsewhere in the report, 96% went on to provide an indication of how the key relationships and resources are being maintained and enhanced. For example, where a company's employees or its relationships with customers were identified, maintenance and enhancement of these relationships often focused around providing a supportive environment or a challenging or interesting job role for employees, and staying close to customers to understand their needs and adapting products or services accordingly.

The most useful disclosures regarding maintenance and enhancement of these key relationships then went on to provide either evidence or some sort of measurement of maintenance and how this impacted value creation. Examples include employee engagement scores, retention rates and details of internal progression for employees; when these increased (presumably as a result of the company's actions), employees would be happier and more motivated and thus productivity would increase, thus generating more value (see section 6). For customer relationships, Net Promotor Scores were often cited; again, as the company actively seeks to increase the score, the relationship strengthens and more value is created for the company, e.g. through repeat orders.

This issue of maintaining and enhancing key relationships highlights the importance of stakeholder engagement to understand stakeholder needs, and the close link between this and value creation (see section 4). It is expected that the renewed focus on directors' duties in s172 (including the requirement to "foster business relationships with suppliers, customers and others") and also on the NFR Directive, which either encourage or require disclosure on these non-financial sources of value, will increase the quality of disclosure about key off balance sheet resources, relationships and other dependencies.

Compliance – problem areas

Despite the vast majority disclosing a business model, it was disappointing to see only a small increase in the number of companies describing in their business model what their business actually does. Given many readers will turn straight to the business model, and that the business model lies at the heart of a company's strategy, this is something that we would expect companies to be addressing.

All but one company identified in their report the stakeholders it considers in how they do business, such as employees, customers and suppliers. For some companies this was obvious from their business model, for example by clearly identifying value created (or 'outcomes') for different stakeholder groups. An example of setting this out clearly is the business model presented by St James's Place plc. However, for a lot of companies this was less explicit and, in the absence of descriptions of clear stakeholder engagement activities (which would, in turn, inform the business model – see section 4) the identification of key stakeholder groups was hidden in the detail of the report. Disclosure of the value created for other stakeholders that supports economic value generation for the company itself is one of the desired attributes of a business model, as per the FRC's Lab report. For instance, investors want to understand the value to customers of the product / service that will likely result in future sales. But this is difficult to determine if it is not clear in the business model who the other stakeholders are.

Investors also need to know how successful directors have been in creating value. The FRC's revised Guidance on the Strategic Report[2] includes a paragraph stating that a company's strategy should be reflected in its key performance indicators (KPIs) i.e. the discussion of KPIs should allow an assessment of progress against the strategy. Only 46 companies linked all of their KPIs to their strategy in a meaningful way, as opposed to simply providing a cross-reference, an increase on the 37 which did so in 2017. A clear explanation of how the strategy and KPIs are related enables investors to ascertain how successful the directors have been in attaining what they set out to achieve. Brewin Dolphin Holdings PLC clearly linked its KPIs to each relevant strand of their strategy to facilitate measurement of their performance to date, as well as providing an indication, where applicable, of potential challenges to success.

Looking beyond compliance

Although an area of constant evolution, sustainability reporting is no longer a new concept, with many industries having reported on their environmental impact for over 30 years and the Global Reporting Initiative introducing broader sustainability reporting through their first framework of guidance in 1998. So it's not unreasonable to expect that the recent focus on s172 responsibilities and the NFR Directive disclosures would focus directors' minds on broader corporate social responsibility ('CSR') matters. Perhaps, then, it is a symptom of the corporate wheels moving slowly that for many companies there remains a lack of connection between the specific thinking around sustainability and broader strategic-level thinking.

Three companies were deemed not to include any significant CSR disclosures and 49 companies disclosed a separate CSR section with no reference to these matters within their strategy. More positively, 38 companies included some elements of CSR within their strategy, while the remaining ten companies fully integrated their CSR disclosures within their broader company strategy, thus avoiding the need for a separate full CSR section. G4S plc identified its key stakeholder groups upfront and linked each to the relevant strand of its strategy. The strategic review discussion then incorporated all material CSR disclosures, without the need for a separate section.

16 companies (2017: 12) made reference to the UN's Sustainable Development Goals[6] ("SDGs"), a set of 17 goals which were signed up to in 2015 by 193 world leaders with an aim to end extreme poverty, inequality and address climate change by 2030. Although most of the companies making reference were from the FTSE 100, they were from a number of industries, including telecoms, financial services, media and oil & gas. Most of the references to SDGs were where companies had mapped their sustainability strategy to the SDGs, with two companies bringing in the SDGs within their wider group strategy.

Linked to this, five companies made reference to the Task Force on Climate-related Financial Disclosures' Guidelines ('TCFD') which encourage consideration of climate risk, while another four indicated that they had complied with them. A further six companies did otherwise describe the Board's oversight of climate related risks and opportunities, albeit with no reference to TCFD.

The FRC has referred to both the SDGs and the TCFD, among others, as sources of guidance to Boards[7] when considering the impact on environment with respect to their s172 responsibilities (see section 4).

Linkage to principal risks, particularly those which are new or have changed, is valuable in demonstrating the resilience of the business model and how it can react to changes in the market environment. The issue of Brexit was widely discussed, with half of all companies discussing within their principal risks how it may specifically impact them. As shown in the graph, 54 companies (2017: 31) discussed, to varying extents, whether Brexit might impact their business model. While uncertainty may abound, directors' assessment of Brexit and its possible impact on the business' ability to create value in the long term provides deeper insight into the business and how directors are carrying out their s172 duties to promote the success of the company.

What to watch out for

- [ ] Review your business model disclosure and challenge whether it describes what the company does and identifies who the key stakeholders are.
- [ ] Of those key resources, relationships and other off-balance sheet sources of value creation identified in the business model, consider how these are maintained and enhanced. Useful disclosure includes evidence and measurement of maintenance and a description of how this impacted value creation.
- [ ] Challenge whether these key stakeholders and the value created for them by the company are being reflected in the strategy. Incorporating strands of a separate sustainability strategy into the main company strategy breaks down organisational silos and leads to a more coherent, comprehensive and connected strategy.
- [ ] Consider how progress against your strategy will be measured. One helpful way is through clearly linking the strategy to the relevant KPIs.

Examples of disclosure

The Weir Group PLC clearly articulated in its business model what it does, what the key resources it relies upon are and who their key stakeholders are and the value created for them.

The Weir Group PLC

See more examples of disclosure in the electronic version of this publication.

Compliance – positive trends

Over the past year there has continued to be a focus by government and in the media around directors' responsibilities under s172, specifically their duty to promote the long term success of the company taking into regard the impact on a broad group of stakeholders such as employees, customers, suppliers and the environment. It is therefore no surprise that more companies are referring to this duty in their annual report, with 29 doing so (2017: 17). However, only 8 companies (2017: 8) went on to provide a further comment to allow shareholders to assess how the directors have performed their duty. New regulations are applicable to periods commencing on or after 1 January 2019, which requires companies of a significant size (both public and private) to explain how they have complied with s172[8]. This is clearly an area which companies will need to consider further.

But how do directors carry out this s172 duty? First steps are to identify relevant stakeholder groups to the company, aside from shareholders. As the graphic opposite demonstrates, and in line with those key sources of value identified in the business model (see section 3), most commonly these are customers and employees.

Next, directors must engage with and listen to those other stakeholders. Although there is no legal requirement to disclose detail around engagement activities specifically, encouragingly 94 companies (2017: 90) described, to varying levels of detail, how they engaged with their stakeholders. Of these, 13% (2017:23%) focused only on their engagement with investors, while the remainder covered how they engaged with at least one non-investor stakeholder group. Most commonly this included conducting employee engagement surveys or getting customer feedback. Often the discussion covered only one or two stakeholder groups and frequently was dotted about the annual report. The most useful disclosures around engagement were those that presented the full picture, identifying each main stakeholder group, describing their engagement with each, what the subject of engagement was (e.g. customer service or quality) and explaining why this was relevant.

Stakeholder relationships and the capacity of an organisation to respond to key stakeholders' legitimate needs and interests are at the heart of integrated thinking, which underpins integrated reporting. An integrated report should provide insight into the nature and quality of the organisation's relationships with its key stakeholders, including how and to what extent the organisation understands, takes into account and responds to their legitimate needs and interests. The <IR> Framework states that by doing so, the integrated report enhances transparency and accountability.

Insight from engagement activities then needs to feed its way back to the boardroom, the board needs to react to this feedback, develop high level intentions and translate them into more precise policies for the company (see below regarding NFR Directive disclosures). However, as noted in section 9, there is little insight around this currently, with only 10 companies indicating that stakeholder feedback has any impact on board decision making.

Despite this missing link to the boardroom, almost half of those engaging with stakeholders (2017: 36%) went on to describe an outcome of some engagement and what they have done differently as a result. 8 companies provided outcomes solely relating to investor engagement, all of which related to directors' remuneration. 30 provided outcomes solely relating to engagement with other stakeholders, while the remaining 7 provided examples relating to engagement with both investors and at least one other stakeholder group. Nearly all of the descriptions of change were in response to employee or customer feedback. One related to changes made following feedback from regulators, and one mining company provided outcomes of engaging with local communities.

The focus on employees and customers mirrors the common identification of these groups as inputs into value creation in the business model disclosures (see section 3). It seems that companies find these engagement activities and disclosures easier for some stakeholders than others. Possibly this reflects an underlying current of short-termism: a company may adversely impact the local environment for a while before it becomes visible, whereas it would immediately feel the pinch if customer or employee relationships worsened, so companies need to keep a closer eye on them. Perhaps because of a more direct and more observable impact of employees or customers on cash flows, companies are more readily paying attention to those stakeholders and measuring the business' impact on them. In turn it is simply more difficult to measure interactions with local communities and other stakeholders, not just because of indirect financial implications but also because of difficulties gathering data and knowing what data to gather.

Compliance – problem areas

70 companies fell within the scope of the newly effective NFR Directive (19 companies had financial years beginning prior to 1 January 2017, while 11 companies had fewer than 500 employees). The legal requirement refers to a "non-financial information statement" to be included within the strategic report. In December 2017 the FRC published some FAQs[9] to accompany the NFR Directive, one of which confirms that the disclosures required do not have to be either a discrete element within the strategic report or a separate statement. Instead, companies are encouraged to consider how this information relates to other information in the strategic report and incorporate it therein. This view has been updated in the FRC's revised Guidance on the Strategic Report[2] to make clear that there must be a separate statement within the strategic report, but that this can include cross-references to where the required information can be found in the main body of the strategic report.

Only one company presented a standalone non-financial information statement, which took the form of a table detailing the disclosure requirements and cross-referring to where the information could be found. A handful of companies clearly identified the elements of the NFR Directive (environmental matters, employees, social matters, respect for human rights, and anti-corruption and anti-bribery matters) and provided some cross-references to where some of the information was located. One company was explicit in stating that the required NFR Directive information had been integrated into the strategic report, thus "promoting cohesive reporting of non-financial matters". In many cases the individual policies were named within the principal risks disclosures as an example of a mitigating activity, where relevant, and then further information was included within the CSR disclosures. 19 companies, spread fairly evenly across the FTSE, included some or all of the required disclosures outside of the strategic report (for example in the corporate governance statement) without cross referring to it from the strategic report. Given the non-financial information is required to be included in the strategic report the placement of these new disclosures within it (or cross referenced from it) is important.

Given the overlap with existing disclosure requirements, it was in many cases actually quite difficult to find some of the NFR Directive disclosures. For example, quoted companies are already required to include information about the company's employees, to the extent necessary for an understanding of the development, performance or position of the company. The NFR Directive requires a description of the policies pursued in relation to employees, along with any due diligence and outcomes of those policies. While many companies described their aims (such as focusing on the diversity of the workforce, or to achieve zero-level accidents) or specific actions (such as carrying out engagement surveys or investment in training and progression), it was often not clear whether this was a description of a specific underlying policy. Similarly, some companies named some specific policies but then did not link them to any other text to demonstrate how they had been applied.

If a company does not pursue policies in relation to one or more of the NFR Directive matters, it must provide a clear and reasoned explanation for the company's not doing so. This was very rare in practice, with only four companies doing so in relation to the environment and two for social matters.

In contrast, the NFR Directive disclosures around anti-bribery and anti-corruption were new, with no previous requirements in these areas. It was therefore much easier to identify the disclosures. 61 of those in scope and 15 outside scope discussed both anti-bribery and anti-corruption in their report, even if briefly. A further four companies in scope of the regulations discussed either bribery or corruption, but not both, leaving the remaining five companies in scope not discussing the matter at all.

Many companies enhanced their disclosures around human rights with information regarding slavery and human trafficking, linking to their other reporting requirements under the Modern Slavery Act. 24 companies disclosed in their annual report some or all of the detail required under their reporting duty on modern slavery with 38 others providing a cross-reference to their modern slavery reporting.

The area of most difficulty appeared to be disclosure of social matters. Albeit 'social' matters are not defined, we felt that only 23 of the 70 companies in scope had clearly named or described a policy in relation to social matters, although a further two did indicate that they do not pursue policies in this area. Some others may have felt that they had also provided relevant information, based on a broader interpretation of 'social'. While many companies include a lot of information about their interaction with local communities, most commonly their charitable fundraising efforts, for some it was to the point where it is questionable as to whether this information is truly material to the annual report. For others it raises the question of whether they have missed the mark a little, too, by providing information which does not give any meaningful insight into the impact of the company's activities on social matters. Anglo American plc provided a good example of a social matters policy, their "Social Way", which included details of due diligence and discussed the outcomes as well.

The requirement to disclose any due diligence processes implemented by the company in pursuance of the relevant policies was addressed in relation to about half of those policies disclosed. Overall the level of detail provided varied from vague to extensive, and the extent of the due diligence ranged from internal reviews and internal audit to external assurance. What was particularly refreshing was that the information disclosed seemed to be specific to each company, rather than reeling off a new boilerplate disclosure. Moreover, in many cases the due diligence resulted in a report to the Board, or at least a sub-committee. This supports the upcoming s172 disclosures (see below) by demonstrating how directors fulfil their responsibilities in practice.

Where outcomes of policies are measurable such as environmental emissions or employee accident rate, these were clearly disclosed. For other outcomes, such as for human rights policies, it was notable that these are more difficult to determine or articulate.

Looking beyond compliance

The new requirements of the government's package of corporate governance reforms (being the new regulations cited above, along with a new Corporate Governance Code[10]) are not applicable until periods commencing 1 January 2019. However, as shown in the graph opposite, perhaps unsurprisingly given the renewed focus, more companies are disclosing information this year around how directors have considered their responsibilities under s172 in all of those areas noted. A few of these areas also overlap with the new disclosure requirements under the NFR Directive and therefore the same disclosures may be meeting both requirements.

Almost all companies are providing information around how they have had regard to the interests of employees. Reference to the new gender pay gap reporting, and other employee performance metrics (see section 6) also evidenced how directors are taking employees' interests into account. This focus on employees is reflected in the number of companies including employees as key sources of value within their business model (see section 3).

Many more companies are indicating how they have fostered their relationships with their suppliers. Often this was through linking in to their human rights policies, and how they worked with their suppliers to ensure that their standards were being adhered to throughout the supply chain. Four companies disclosed some or all of the detail required under the reporting duty on payment practices and performance (which is otherwise required outside of the annual report for periods commencing on or after 6 April 2017), with two others providing a cross-reference to their reporting.

Acting fairly between members was usually demonstrated through the description of shareholder engagement whereby private shareholders were given opportunity for engagement and feedback outside of merely attending the AGM. Most companies disclosed this information within their corporate governance report, with 57 doing so. A good example of this disclosure is Barclays PLC which detailed engagement throughout the year with institutional investors and private investors.

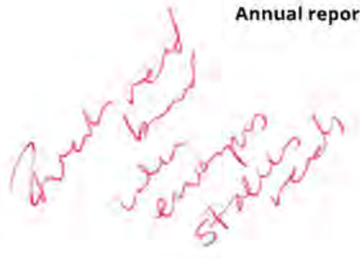
A number of companies provided examples of how the directors had taken into account broader factors in their decision making process. Britvic plc explained how, as part of their business capability programme, they had consulted with stakeholders and demonstrated how they had taken into account the interests of employees when relocating their manufacturing plants. Mears Group PLC developed a portal that provides detailed insight into local demographics, helping to identify areas of deprivation, which now drives their decision making by enabling them to target intervention and outreach to the most disadvantaged groups and focus on the right outcomes. Such examples may assist directors in articulating how they have performed their duty under s172.

Essentially, s172's requirement to take into account the impacts of decisions made upon key stakeholders is akin to "integrated thinking" under the <IR> Framework, which encourages this multi-capital approach to decision-making. Hilton Food Group plc explained how they factor into their decision making their customers' desire for reducing waste and minimising the environmental impact of their operations. As such the company has been working with suppliers to reduce the amount of packaging which, in turn, reduces cost and environmental impact.

There is no current requirement to disclose in the annual report any details of stakeholder feedback when reporting on major events during the year. It was pleasing, therefore, that a handful of companies discussed the mechanism for gathering stakeholder feedback in such circumstances. Marks and Spencer Group plc highlighted how their Business Involvement Group (where elected employees feedback to a national committee, the chair of which attends board meetings twice a year) helped to manage significant changes in the company, resulting in employee involvement being at the centre of the Board process.

What to watch out for

- ☐ New regulations applicable to accounting periods beginning on or after 1 January 2019 require all large companies to describe in their strategic report how they have complied with the requirements of section 172.
- ☐ Ensure Board processes are in place to enable the new s172 statement and meaningful NFR Disclosure statement to be made.
- ☐ Note that recent amendments made to the FRC's Guidance on the Strategic Report encourage companies to include a separate non-financial information statement within their strategic report, which includes clear cross references to where the required content is covered in the strategic report, if not in the statement itself. This is consistent with the approach required for the s172 statement.
- ☐ Both the SDGs (which can be incorporated into the company's strategy) and TCFD guidance (which can be used as a tool for considering climate risk) are recommended as sources of guidance by the FRC. These can be referred to when demonstrating how the board is considering environmental impact.
- ☐ An engagement programme for all relevant stakeholders should target not just those who are more vocal or easy to engage with, and should be supported by a process for feedback to the board.
- ☐ In particular, the new Corporate Governance Code provides a choice of three workforce engagement mechanisms (a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director).
- ☐ Challenge whether your NFR Directive disclosures are clear, with policies identified and described, and due diligence over and outcomes from those policies discussed. Where there is no policy in place, this must be clearly disclosed.



The use of alternative performance measures (APMs), often referred to as non-GAAP measures, continues to be a common feature across UK annual reports. These measures are intended to offer investors additional information on the reporting company's performance, in addition to the statutory GAAP measures. ESMA's Guidelines[19] on the use of APMs, together with the FRC's recent publication of their corporate reporting thematic review findings[11], provide the framework and key guidance to be applied when using APMs in corporate reporting. This area continues to be a hot topic for regulators and while there have been high level improvements where more companies appear to be applying the basic principles of ESMA's Guidelines, the pace of change has been slow.

In terms of where APMs are to be found in reports, 96 companies presented financial APMs within an up-front financial highlights section, and 91% of these included adjusted profit measures. Only 32% of companies presenting APMs in their financial highlights included adjusted sales measures. It seems that adjusted sales measures feature more commonly in detailed performance analyses, for example in the Chief Financial Officer's statement.

81% (2017: 81%) of companies had a Chairman's statement containing APMs and 82% (2017: 89%) a CEO's statement with APMs. The majority of these statements included adjusted profit measures. For example, 60% and 66% of companies surveyed presented a Chairman's and CEO's statement, respectively, which contained adjusted profit measures.

A continuing trend is that APMs, within the scope of the ESMA Guidelines, are being used by companies in their key performance indicators (KPIs). Of the 90 companies (2017:92) that clearly identified their KPIs only one did not include an APM, in 2017 all 92 companies included at least one APM.

Carrying on through the annual report, 68 companies (2017: 68) presented APMs on the face of their income statements (excluding unadjusted 'operating profit' lines). These measures would be considered APMs under the ESMA Guidelines were it not for the fact that the ESMA Guidelines apply only outside of the financial statements.

Whilst APMs can be both financial and non-financial, the ESMA Guidelines only apply to financial APMs. We consider the use of non-financial metrics, which did feature in a number of companies' operational highlights, in our discussion of KPIs below.

Compliance – positive trends

According to the ESMA Guidelines, APMs should be reconciled to the most directly reconcilable line item, subtotal or total presented in the financial statements. It is positive to see that 86% of companies reporting an alternative profit measure within the highlights section did reconcile back to an IFRS profit measure for all profit measures reported. In contrast, it was disappointing that only 29% of companies reporting an alternative sales measure provided a reconciliation albeit that this was driven by a lack of reconciliation for companies reporting a like-for-like or constant currency sales movement.

The Guidelines require the provision of comparatives for all APMs and we have seen that approximately 80% of companies with alternative profit measures in their highlights section provided this information.

Looking at KPIs, in an improvement from 2017, 46 companies (2017:37) linked all of their KPIs to the company's strategy in a meaningful way, as opposed to simply providing a cross-reference. This is a step in the right direction for linking together each area of the strategic report, although clearly there is still room for improvement by many. 71 reports evidenced, in some form, linkage between companies' KPIs and their directors' remuneration, demonstrating alignment of reward with success of the company.

Endnotes

1. https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter
2. https://www.frc.org.uk/getattachment/fb05dd7b-c76c-424e-9daf-4293c9fa2d6a/Guidance-on-the-Strategic-Report-31-7-18.pdf
3. https://www.frc.org.uk/getattachment/3851b9c5-92d3-4695-aeb2-87c9052dc8c1/Corporate-Culture-and-the-Role-of-Boards-Report-of-Observations.pdf
4. See page 4 of FRC's Lab project report: Business model reporting, October 2016 at https://www.frc.org.uk/getattachment/4b73803d-1604-42cc-ab37-968d29f9814c/FRC-Lab-Business-model-reporting-v2.pdf
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7. https://www.frc.org.uk/getattachment/61232f60-a338-471b-ba5a-bfed25219147/2018-Guidance-on-Board-Effectiveness-FINAL.PDF
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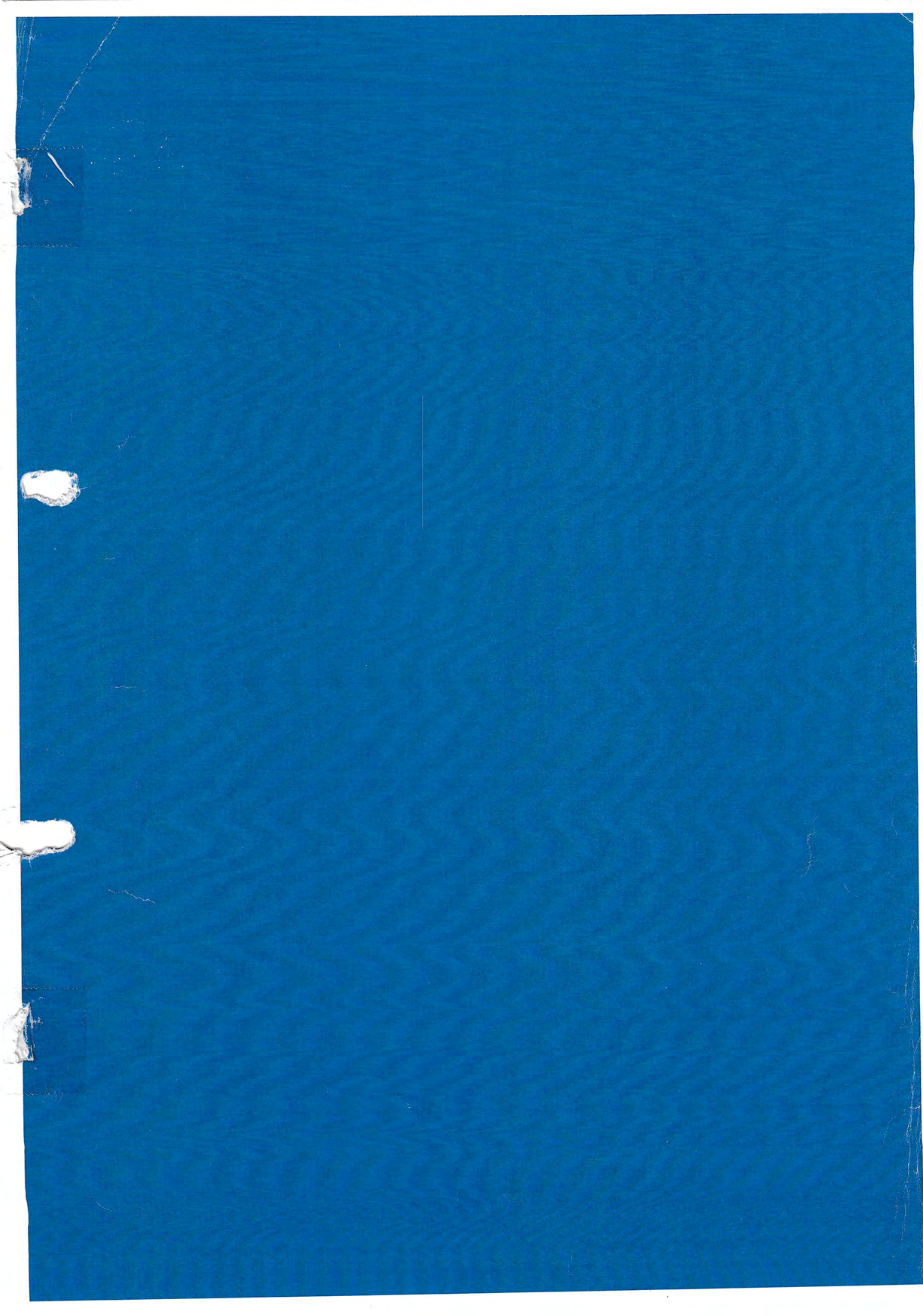
14. https://www.frc.org.uk/getattachment/76e21dee-2be2-415f-b326-932e8a3fc1e6/Risk-and-Viability-Reporting.pdf
15. https://www.frc.org.uk/getattachment/61232f60-a338-471b-ba5a-bfed25219147/2018-Guidance-on-Board-Effectiveness-FINAL.PDF
16. We determined the ratio either by taking the ratio as reported by the audit committee or, if no ratio was provided, calculating it ourselves from information in the audit committee report or financial statement notes.
17. https://www.frc.org.uk/getattachment/7f97f065-d912-4ca0-a96b-1f2fd4b0a565/LAB_Final.pdf
18. https://www.frc.org.uk/news/november-2017/frc-shares-better-practice-examples-from-thematic
19. https://www.esma.europa.eu/press-news/esma-news/esma-publishes-final-guidelines-alternative-performance-measures
20. https://www.weforum.org/reports/the-global-risks-report-2018
21. https://www.frc.org.uk/getattachment/d672c107-b1fb-4051-84b0-f5b83a1b93f6/Guidance-on-Risk-Management-Internal-Control-and-Related-Reporting.pdf



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