Report

Financial Reporting Council

December 2015

Clear & Concise

Developments in Narrative Reporting

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries, and oversee the regulatory activities of the accountancy and actuarial professional bodies.

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Registered in England number 2486368.
Registered Office: 8th Floor, 125 London Wall, London EC2Y 5AS

Headlines

Companies are taking on board the objectives of the FRC's Clear & Concise initiative

- Investors highlight the importance of clear presentation of information.
- The introduction of the fair, balanced and understandable principle has resulted in greater engagement from Boards in the annual reporting process.
- Some real or perceived barriers to Clear & Concise reporting remain.

The overall quality of corporate reporting has improved since the introduction of the strategic report, although opportunities for further improvement still exist

- Companies are applying the principles in the FRC's *Guidance on the Strategic Report*.
- Some companies are leading the way in developing best practice.

Scope for companies to take a longer term view in their strategic reports

- Many companies provide information on expectations for the next 12 months, whilst other strategic reports look out over a longer period.

Opportunities to make further improvements in communication

- Good linkage of information in the annual report goes beyond highlighting the location of related disclosures and explains the nature of the linkage.
- Some boilerplate is still prevalent in risk reporting.

Opportunities for concise reporting through the application of materiality

- Specific areas for improvement include disclosures of principal risks and key performance indicators.

Business model reporting is still evolving

- There are some good examples of disclosures explaining how the company generates value but a need for better explanation on what makes the company different.

Enhanced focus on reporting of key performance indicators

- There is scope to improve reporting of key performance indicators, explaining relevance to the business and relationship to GAAP measures where appropriate.

Emerging developments

- An increasing focus on more effective regulation.
- Developments in non-financial reporting.
- Evolution of reporting in a digital environment.

1 Clear & Concise reporting: The current picture

What is Clear & Concise reporting?

An overarching principle for good communication in corporate reporting is that it should be Clear & Concise. The Financial Reporting Council's (FRC) mission is to promote high quality corporate governance and reporting to foster investment. With that in mind, the FRC's Clear & Concise initiative is a programme of activities aimed at ensuring that annual reports provide relevant and easily understandable information for investors.

The objectives of the Clear & Concise initiative are to encourage:

- **communication that is focused on the needs of the audience;**
- **greater emphasis on the application of materiality;**
- **improvement in the relevance and readability of annual reports; and**
- **consideration of other channels for reporting information.**

There are multiple regulators setting requirements for different parts of the annual report, and the initiative considers the role of regulation, influencing those setting disclosure requirements in the UK, Europe and internationally.

To bring about change, we believe that ongoing collaboration by all those involved in the corporate reporting chain is vital: investors, companies, auditors, regulators and other stakeholders. We all have a common goal of improving the quality of corporate reporting to foster investment.

Further details of the FRC's Clear & Concise initiative can be found at
https://www.frc.org.uk/Our-Work/Headline-projects/Clear-Concise.aspx.

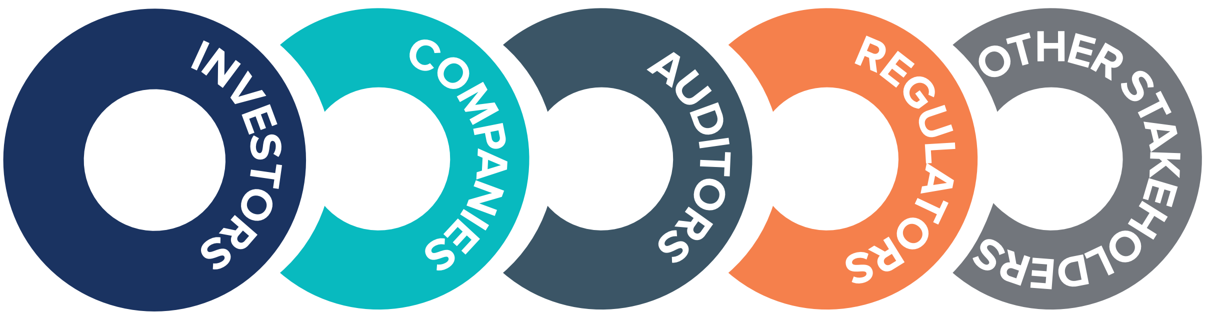
The FRC's review

This report examines the steps that companies have taken towards Clear & Concise reporting. It highlights emerging best practice in narrative reporting following the introduction of the strategic report and considers developments in the reporting framework. The report is in three sections:

1 Clear & Concise reporting: the current picture (page 1) provides an overview of the current reporting landscape. It considers feedback from investors and companies on the impact of recent developments. It examines how communication can be improved and some of the perceived barriers to Clear & Concise reporting can be overcome.

2 The study on the impact of the strategic report (page 7) examines developments in the usefulness and relevance of narrative reporting since the introduction of the strategic report and the FRC's *Guidance on the Strategic Report.*[1] It investigates how narrative reporting has evolved and how it can continue to evolve. The study consists of an analysis of recent research of quality of the strategic reports, supplemented with a detailed review of a small sample of strategic reports.

3 We consider emerging developments in reporting on page 24.



1 The FRC's *Guidance on the Strategic Report* is available at https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Strategic-Report.pdf.

Where are we now?

Over the last few years we have seen an increased emphasis on narrative reporting and this has been accompanied by changes to the regulatory framework. In September 2013, we saw the introduction of the strategic report and new regulations for remuneration reporting. The FRC published the *Guidance on the Strategic Report* in 2014 and we have also made complementary improvements to corporate governance reporting. These recent developments have led to more cohesive, communicative annual reports, with better linkage between related information and more focus on Clear & Concise reporting.

Investor and company perspectives

Investor perspective

Investors have welcomed the recent changes to annual reports and tell us that the quality of reporting has improved significantly since the introduction of the strategic report. Innovative UK companies are enhancing the usefulness and relevance of corporate reporting and developing best practice. Companies should look to continue this journey of improvement and evolution.

Investors highlight the importance of clear presentation of information. They generally find the use of diagrams and charts to summarise information helpful and stress the importance of clear cross-referencing. Some investors have highlighted specific areas where they would like to see further improvements, in particular the reporting of principal risks.

Many asset managers are now signatories to the FRC's *UK Stewardship Code*,[2] leading to increased engagement between institutional investors and companies. Investors increasingly say that they use the information in the strategic report to monitor investments and form a basis for engagement; forming views on the position, performance and prospects of a company. Many also form a view of the nature of the company's culture through reading the strategic report.

Company perspective

We have heard that the introduction of the fair, balanced and understandable principle in the *UK Corporate Governance Code*[3] has resulted in greater engagement from Boards in the annual reporting process and the introduction of the strategic report has resulted in a number of companies taking the opportunity to rethink their annual reports. Chairmen have told us that the changes to the 2014 *UK Corporate Governance Code* on risk reporting, internal controls and viability have provoked useful conversations in the boardroom, particularly over the nature of risks facing the company.

The FRC has spoken to companies about the processes they have employed in improving their annual reports and the Financial Reporting Lab has produced case studies on this topic in its report *Towards Clear & Concise Reporting*.[4] Some insights from this dialogue are set out overleaf.

2 The FRC's *UK Stewardship Code* aims to enhance the quality of engagement between asset managers and companies to help improve long-term risk-adjusted returns to shareholders. It is available at https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf.

3 The FRC's *UK Corporate Governance Code*, revised in September 2014, is available at https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf.

4 The Financial Reporting Lab's reports are available at https://www.frc.org.uk/Lab/Reports.

Achieving Clear & Concise reporting

Starting early – some companies are starting their annual reporting process earlier. This allows time for discussions on the content of the annual report with internal teams.

Page count – a number of companies used a reduction in page count as a benchmark in order to streamline their annual report. Whilst Clear & Concise is about relevant reporting rather than shorter reports, we can see that a reduction in the number of pages could be a useful indicator.

Innovation – some companies tell us that it helps to start the planning process with a blank sheet of paper. This enables them to be less constrained by how the annual report has been structured in previous years, enabling a fresh and more innovative approach.

Materiality – the application of materiality is crucial for Clear & Concise communication in the annual report. Our Study on the Impact of the Strategic Report examines the application of materiality in more detail.

Considering the audience – the annual report is primarily a document for investors which in itself can be a broad group. Some companies considered the composition of their investors (e.g. retail vs. institutional) in order to ensure their communication is targeted.

Collaboration between internal teams – the introduction of the strategic report has been seen by some companies as an opportunity to bring together teams across the organisation with responsibility for different parts of the annual report. This facilitates identification of linkages between different areas, can help reduce duplication and result in a more 'joined-up' annual report.

Board-level engagement – it is critical to engage with the Board early in the process of planning the annual report. Board support for driving innovative improvements in the annual report is key to the evolution and improvement of structure and content.

Culture – a company culture[5] that fosters continuous improvement and collaboration between internal teams is seen as a driver for making changes to the annual report. The annual reporting process is seen as a continuous improvement cycle rather than a one-off exercise.

5 The FRC has recently launched a Culture project, further information can be found at https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/Culture-Project.aspx.

Breaking down the barriers

We frequently hear about some of the real or perceived barriers to Clear & Concise reporting. These all create pressure on the annual report.

Four years on from *Cutting clutter*,[6] companies are proceeding with caution when it comes to removing immaterial information from the annual report. In this section we address some of the common misconceptions that could be seen as preventing companies from moving forward on the journey.

Application of disclosure requirements

? Do companies need to provide every disclosure set out in standards or other regulation?

Not in all cases.[7] Company law and accounting standards both include concepts of materiality although the language used may be different.

Strategic Report	The Companies Act 2006 (the Act) uses terms such as 'to the extent necessary', 'key' (e.g. key performance indicators), 'principal' (e.g. principal risks and uncertainties'). This means that only information that is material to shareholders should be included in the strategic report.[8]
Corporate Governance	There are certain mandatory disclosures in the Disclosure and Transparency Rules and the *UK Corporate Governance Code*. However, there are others in the Listing Rules and the *UK Corporate Governance Code* that apply on a 'comply or explain' basis.[9]
Financial Statements	Accounting standards[10] do not require disclosure when the information is not material.

Regulatory approach

? Does Corporate Reporting Review take the same approach to materiality as set out in accounting standards or other regulation?

Yes. Corporate Reporting Review letters of enquiry discourage Boards from including immaterial matters in their reports and explain that only disclosures that are material or relevant should be included.

6 A copy of *Cutting clutter* is available at https://www.frc.org.uk/getattachment/8eabd1e6-d892-4be5-b261-b30cece894cc/Cutting-Clutter-Combating-clutter-in-annual-reports.aspx.
7 There are some disclosures (e.g. most of those in the directors' report) that are required irrespective of materiality, therefore a company will need to consider the application of materiality based on the regulation that applies to the specific component of the annual report.
8 See section 5 of the *Guidance on the Strategic Report* for further information on materiality.
9 See Schedule B of the *UK Corporate Governance Code*.
10 IAS 1 *Presentation of Financial Statements*, paragraph 31; FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, paragraph 3.16A.

Placement of information

Can some of the information that is currently in the annual report be placed on a company's website (e.g. standing data)?

Yes. Complementary information that is not required (by law or regulation) to be included in the annual report can be published separately.

Does company law require the annual report to be a printed document?

If the company's articles allow and members agree, there is nothing to prevent companies sending information electronically to their members. Companies will, for example, still be required to provide a paper copy of their annual report to all members that have requested one.[11] However, this should not constrain companies from innovation. While the annual report must be capable of being provided on paper, there are opportunities to move away from thinking about the annual report primarily as a paper document.

Audit approach

Is the auditor's view of the application of materiality to disclosure in the financial statements the same as in accounting standards?

The concept of materiality in ISA (UK and Ireland) 320 is based on the accounting standards. Early engagement by companies with auditors on materiality for disclosures could be helpful.

Internal teams

How can a company get buy-in across internal teams to remove information from the annual report?

There are a number of questions internal teams can consider when deciding whether information can be removed or moved from the annual report:

Is the information still relevant for the current year? For example, it may relate to an issue that was important in previous years, such as during the financial crisis, but is not applicable to the current year.

Is the information relevant to investors? For example, it is an area where the investor relations team gets frequent questions?

Is the information only relevant to a subset of users?

If regulation permits, is it more appropriate for it to be reported outside the annual report?

Is the information not material (and not required by the Act to be disclosed irrespective of materiality) and can it therefore be omitted?

11 For further details on the electronic communication provisions see sections 1143–1148 of the Companies Act 2006.

2 Study on the impact of the strategic report

The introduction of the strategic report was a catalyst for change and provided an opportunity for companies to rethink their reporting. In this section, we consider the findings of our study on the impact of the strategic report two years on.

Our study consisted of collating the findings of reports produced by a number of organisations on the quality of UK corporate reporting, supplemented with a detailed review of a sample of 2013/14 and 2014/15 strategic reports of FTSE 350 companies. We thank the organisations whose research contributed to this study for the use of and references made to their reports. Appendix B explains the design of our study in more detail.

The aims of our study are to:

- consider how companies are applying the principles in the FRC's Guidance on the Strategic Report;
- set out observations on best practice reporting;
- share the experiences of investors and companies; and
- provide practical assistance to facilitate further improvements.

Our findings are organised under the four key themes which underpin the *Guidance on the Strategic Report:* communication, placement of information, content elements and materiality. Although this study focuses on the strategic report,[12] we recognise that the strategic report does not exist in isolation from the annual report as a whole and we refer to other components of the annual report where relevant.

The *Guidance on the Strategic Report* sets out best practice for all companies preparing a strategic report. While performing our study, we have kept the objectives of the guidance in mind. These are to:

- ensure that relevant information that meets the needs of shareholders is presented in the strategic report;
- encourage companies to experiment and be innovative in the drafting of their annual reports, presenting narrative information in a way that enables them to best 'tell their story' while remaining within the regulatory framework; and
- promote greater cohesiveness in the annual report through improved linkage between information within the strategic report and in the rest of the annual report.

12 A review of Developments in Corporate Governance and Stewardship is available on the FRC website.

The observations and analysis in the study are supported by highlighted text as follows:

Principles from the FRC's *Guidance on the Strategic Report*

Key focus areas

Investor observations

Communication

The introduction of the strategic report regulations provided a catalyst for companies to move away from a purely compliance driven approach to reporting and to focus more on communication.

The *Guidance on the Strategic Report* sets out communication principles for the strategic report that are also relevant to the annual report as a whole. Our study found that many companies have made improvements to how they communicate in their annual reports—particularly in their strategic reports—by making important information more accessible.

Investor focus

Companies are using the strategic report to highlight key changes during the year, helping investors[13] to identify important new information. Giving sufficient prominence to changes in strategy, significant acquisitions or disposals and key developments for each segment, market or core product range is particularly helpful. Investors tell us that they value entity-specific information and our study found that some companies have embraced the strategic report as an opportunity to 'tell their story' and present a clear picture of their investment proposition.

Investing time and resources in producing high quality corporate reporting can result in significant benefits for companies, in particular for smaller listed and AIM quoted companies. Companies are more likely to attract investors and lenders if the quality of reporting is good, thereby improving a company's access to, and cost of, capital. Similarly the quality of a company's reporting has an impact on its credit rating.[14]

Fair, balanced and understandable

The strategic report and the annual report as a whole should be fair, balanced and understandable.

A fair, balanced and understandable strategic report:

- truly reflects the business;
- is comprehensive but concise;
- strikes an appropriate balance between positive and negative aspects;
- is cohesive, with different components of the annual report being consistent; and
- is written in clear language.

13 In this study, references to 'investors' include institutional investors, retail investors and analysts unless specifically stated otherwise.
14 The FRC's recent research *Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies* is available at https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Consultation-Improving-the-Quality-of-Reporting-b-File.pdf.

The best strategic reports communicate to investors the effectiveness of the Board's stewardship both in terms of capitalising on opportunities and managing the impact of less favourable events, trends and conditions. We found it helpful when companies explained clearly and concisely the potential impact of such unfavourable circumstances and the steps the company is taking to mitigate this.

In a recent interview with EY, an investor highlighted that 'investors are encouraged when companies write about what didn't go well. Honesty is the key thing we look for.'[15]

High quality reports avoided jargon, and explained acronyms and industry specific terms to ensure they were understandable to non-expert users.

Forward-looking orientation

A key objective of the strategic report is to enable investors to assess the company's future prospects. Where appropriate, the strategic report should have a forward-looking orientation and give due regard to the factors that may affect the company over the short, medium and long term.

Our study found that almost all strategic reports contained some forward-looking information. An understanding of medium- to long-term expectations provides the broader context needed for longer-term investment decisions.

A recent survey by CFA UK found that nearly 80% of investors forecast financial performance for 3 years or more.[16]

A few companies provided quantitative targets so that performance against their strategic objectives could be measured over time, which helps investors to design appropriate forecasting models.[17] Other examples of useful forward-looking information include information about new products under development, information on whether the company plans to expand (either organically or through acquisition) or to dispose of a segment of its business, whether the company intends to enter any new markets, information on succession planning, plans for capital expenditure, and expectations for the company's key products and markets over future years.

15 EY's report *Annual Reporting in 2014: reflections on the past, direction for the future*.
16 2015 *CFA UK annual survey on Financial Reporting and Analysis*.
17 PwC's report *Searching for buried treasure: A review of 2015 strategic reporting practices in the FTSE 350 noted that only 8% of FTSE 350* companies use KPIs supported by clear targets.
18 The PwC report noted an investor's observation that while nobody has a 'crystal ball', forward-looking information is essential for analysts to be able to construct meaningful forecasting models.

Summary of legal requirements – 'safe harbour' provisions

We understand that Boards may be reluctant to include forward-looking information in the strategic report because they are concerned about unpredictable circumstances that may impact the business. However, section 463 of the Companies Act 2006 limits the liability of directors for any loss as a result of any untrue or misleading statements in the strategic report: Directors are only liable to the company, and only if they knew that the statements were untrue or misleading or if they knew that an omission was a dishonest concealment of a material fact. This protection is sometimes known as 'safe harbour'.

Accordingly, provided directors do not issue a deliberately or recklessly untrue or misleading statement or dishonestly conceal a material fact by way of an omission, they will not be liable to compensate the company for any loss incurred by it in reliance on the report. This 'safe harbour' protection applies to the strategic report, the directors' report and the directors' remuneration report.

Further information on the application of the 'safe harbour' provisions is included on page 12 of the *Guidance on the Strategic Report* and provided in a letter from BIS which can be found on the FRC's website at **https://www.frc.org.uk/Narrative-Reporting**.

We believe that there is scope for companies to go further in providing a longer-term forward-looking analysis.[18] Companies may wish to consider the alignment between the time-horizons applied to their forward-looking information, strategic plan, impairment reviews and viability statement and/or clarify why it is appropriate to consider different time periods in each context.

Linkage

Good linkage is essential for the annual report to communicate a holistic story to investors, demonstrating that the Board has a coherent vision for the company and that the reporting reflects how the business is managed.

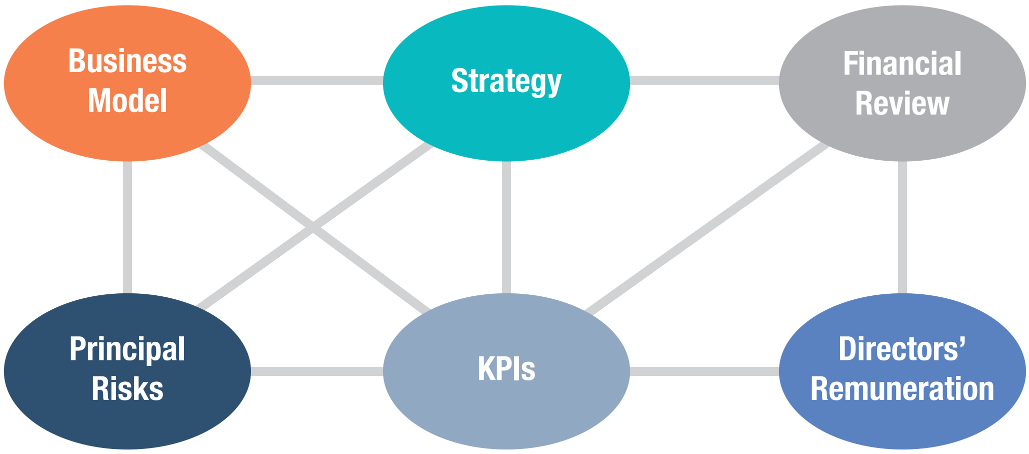
The majority of strategic reports in our detailed review drew attention to the existence of relationships between disclosures. This was most useful when it explained the nature of the linkage rather than simply highlighting the location of related information.

Insufficient linkage between different sections of the annual report can make it appear disjointed. While our study found that there was good linkage in some annual reports, we believe there is scope to further strengthen links and better explain how information is interrelated.[19] Cross-referencing and signposting are useful techniques that can assist companies in highlighting linkages.

19 Deloitte's report *Annual report insights 2015: building a better report* highlights that linkage remains weak, with only 10% of listed companies demonstrating comprehensively how all of the various elements of the report linked together.

Examples where companies used linkage effectively included:

- explanations of how the principal risks may affect the company's ability to achieve its strategic objectives and how the strategy may need to be adapted if certain risks crystallise;
- clarification of how the key performance indicators (KPIs) measure progress against the strategic objectives and how these relate to the business model;
- reconciliations, where relevant, of KPIs to related GAAP measures in the financial statements;[20] and
- explanations of the relationships between directors' remuneration, the financial performance for the year per the financial statements and the KPIs to aid understanding of the remuneration policy disclosed in the remuneration report.



Boilerplate disclosures

Investors are unlikely to find boilerplate disclosures informative and note that they can obscure useful information.

Our study found that the introduction of the strategic report has resulted in more entity-specific disclosure as companies focus on communicating the company's position in the market, its strategic objectives and the Board's plans for the development of the business.

That said, there are still some areas where boilerplate disclosures are prevalent. For example, some companies' principal risk disclosures and reporting on environmental, employee, social, community and human rights matters (EESCH) were generic rather than company specific.

20 See ESMA's *Guidelines on Alternative Performance Measures* for further information.

Placement of information

Many companies have embraced the introduction of the strategic report as an opportunity to rethink the structure of their annual report and have developed innovative ways of 'telling their story'. Appropriate placement of information is a crucial aspect of communicating the company's key messages effectively.

Innovation with structure and presentation

Structure

Most companies in our detailed review included a clear and sufficiently detailed contents page to help investors to locate specific components of the annual report and pieces of information that they wish to review.

Companies relocated detailed information that was not necessary to the understanding of the development, performance and position of the business towards the back of the annual report so it does not detract from the key messages in the strategic report. As a general principle, information that is not material need not be included in the annual report. However, we acknowledge that determining whether information is immaterial and can be removed is challenging, therefore moving information can be a useful first step.

Some companies combine all of the narrative information in their annual report into a strategic report and a corporate governance report (including the directors' report and directors' remuneration report), whilst others produce a strategic report and several smaller reports.

Some companies moved the directors' report to the end of the annual report because they now use the directors' report primarily to meet various statutory disclosure requirements, rather than communicate material information to investors.

Most annual reports include several separate reports from different Board members and committees. Investors are interested in the Board's perspective and these reports can provide useful insight, although companies should be careful to avoid the duplication of information in different sections or confused messaging.

Presentation

Companies use diagrams, tables, graphics and pictures to present information in their strategic reports in a clear and understandable format. Information presented in this way can be easier to navigate and absorb at a glance. Our study found that companies are generally striking a good balance in the proportions of summarised information and more detailed narrative explanation providing analysis and context.

Some annual reports in our detailed sample contained a combination of portrait and landscape oriented pages. This can make a report difficult to read, particularly in the PDF format favoured by most investors. One option companies may wish to consider is producing their entire annual report in landscape format so that it is easier to read on a screen.[21] It is important for the content of a PDF to be accessible; restrictions on content copying, page extraction and commenting can be frustrating for investors.

A recent survey by Comprend UK found that 88% of investors prefer PDF documents and 98% read the annual report on screen rather than in paper format.[22]

The most readable reports break up dense areas of text, use font sizes and styles that are easy to read and avoid printing text on a background that is a similar colour to the font. We noted that some companies have taken these messages on board and are producing more reader-friendly reports.

Cross-referencing

An item of required information set out in one component of the annual report can be included in another by cross-reference. This can lead to clearer communication, whilst ensuring statutory disclosure requirements are met and duplication is avoided.

Cross-referencing is a useful tool for reducing duplication in the strategic report and the annual report as a whole because it enables a company to group related information together. Where law or regulation specifies a particular location for a disclosure a company may provide that disclosure in a different component of the annual report if it considers that this will result in more effective communication of the information. Cross-referencing can improve the narrative flow of the strategic report because information that is material but not of strategic importance can be provided elsewhere, for example in an appendix to the annual report.

Most companies in our detailed review used cross-referencing to some extent. However, we believe that companies can be more ambitious in their use of cross-referencing and this flexibility will enable them to innovate with structure as annual reports continue to evolve.

Companies should be mindful that when information satisfying a disclosure requirement that applies to the strategic report is provided elsewhere in the annual report, a cross-reference to the disclosure must be included in the strategic report for the disclosure requirement to be met.

21 The Financial Reporting Lab's recent project *Digital present* explored the current use of digital media in corporate reporting.
22 Comprend UK's *Capital Market Report 2015*.

Signposting

Signposting can be used to direct users to complementary information that is not required to meet the disclosure requirements for the particular component of the annual report. Signposted information can be located elsewhere in the annual report (for example, an appendix) or outside the annual report (for example, on the company website).

While some companies are not yet using signposting, others used the technique to produce clearer and more concise reports while enabling users to locate further detail they may find interesting and useful. Companies used signposting to direct users to a wide variety of information outside the strategic report including detail on policies, separate detailed reports on market outlook and technological development, corporate responsibility videos, codes of conduct, press releases, investor presentations, and other regulatory information.

Increased use of signposting would enable companies to streamline their strategic reports further and communicated more clearly and succinctly. We encourage companies to consider whether there is information in their strategic reports that is not of strategic relevance and may be better reported elsewhere.

Content elements

The legislation underpinning the strategic report specifies certain disclosure requirements. The Guidance on the Strategic Report highlights that the strategic report should outline what the company does, how it generates value, its strategy and its objectives, and how performance against these is measured. It should include an analysis of the company's development, performance and position for the year and key trends and factors in the markets in which the company operates.

Business model

Quoted companies are required to disclose their business model and strategy. Our study observed that companies take different approaches to reporting this information. Many use diagrams to depict their business model.[23] However, it is also important to provide sufficient narrative explanation of the business model to enable investors to understand what the company does. During our detailed review we noted some good examples of clear business model disclosures that explained how the company generates long-term value, identifying its main revenue streams and highlighting the company's key relationships, resources and other inputs that enable its successful operation.

In our view, business model disclosures that focused on the main drivers of value generation were more informative than those that primarily focused on describing the company's broad objectives or mission statement. The clearest disclosures explained explicitly how the business model will achieve the strategic objectives and how it is linked to the principal risks.[24]

Our study observed that a few companies used their strategic reports to differentiate their business model from those of their competitors. This provides an opportunity to explain to investors how the business model is intended to create the competitive advantages which may be critical to the long-term success of the company.

Business model reporting is still evolving and the Financial Reporting Lab is currently working with investors and companies to develop best practice in this area.[25]

Most companies in our detailed review sample located their business model disclosures near the front of their strategic reports, followed by their strategy disclosures. We found this logical because the business model and strategy disclosures underpin the other information in the strategic report. Locating these disclosures near the beginning of the strategic report provides context for the information that follows. When the business model was located towards the middle of the strategic report there was generally a less clear narrative flow to the document.

23 The PwC report noted that 64% of FTSE 350 companies use a diagram to depict their business model.
24 Black Sun's report *The Complete 100: Living the story, 2014 analysis of FTSE 100 corporate reporting trends* noted that only 12% of FTSE 100 companies linked their business model to their principal risks.
25 More information is available at https://www.frc.org.uk/Lab/Current-projects.

Strategy

Our study observed a variety of approaches to disclosure of strategy. Some companies provided very informative disclosures which set out strategic objectives for both the short and longer term,[26] summarised the actions that will be taken to implement the strategy and explained how progress will be measured over time. The most cohesive strategic reports linked their strategy to the company's business model, KPIs, principal risks, market trends and financial performance for the year.

Best practice reporters explained the relationship between their strategy and their principal risks, for example by outlining how the strategy could be adjusted in the event of particular principal risks crystallising. In our view, such information is very useful for understanding the adaptability of the business.

The less informative strategy disclosures outlined only high-level strategic objectives and in some cases there was insufficient explanation of how these will be achieved. Generally, we found that progress against the strategy to date was more clearly articulated than the Board's key priorities looking forward or how the company intends to implement its strategy over future years.

Our study found that some companies provided context for their strategy by setting out quantitative and qualitative targets for the following year and highlighting divisions or products that are anticipated to be core growth areas for the business. However, few companies explained or quantified the expected impact of their strategy over the medium to long term.[27]

Many companies linked their KPIs to specific strategic objectives. The clearest reports also explained why these KPIs had been selected as the most appropriate measures for quantifying progress towards those strategic objectives.

Some companies linked their strategy to their market overview to highlight the evolution of their strategy in response to economic and market changes. When strategy disclosures remain relatively unchanged year-on-year this can create the impression of a disconnection between the Board's approach to managing the business and the reality of a constantly evolving business environment.

Our detailed review found that companies which were undertaking major restructuring tended to provide more detailed strategy disclosures outlining the Board's approach to managing this process, and more forward-looking information on how the business is expected to change over the period of time during which the restructuring will take place.

26 The Black Sun report noted that 29% of FTSE 100 companies discussed both short and long term strategic objectives.

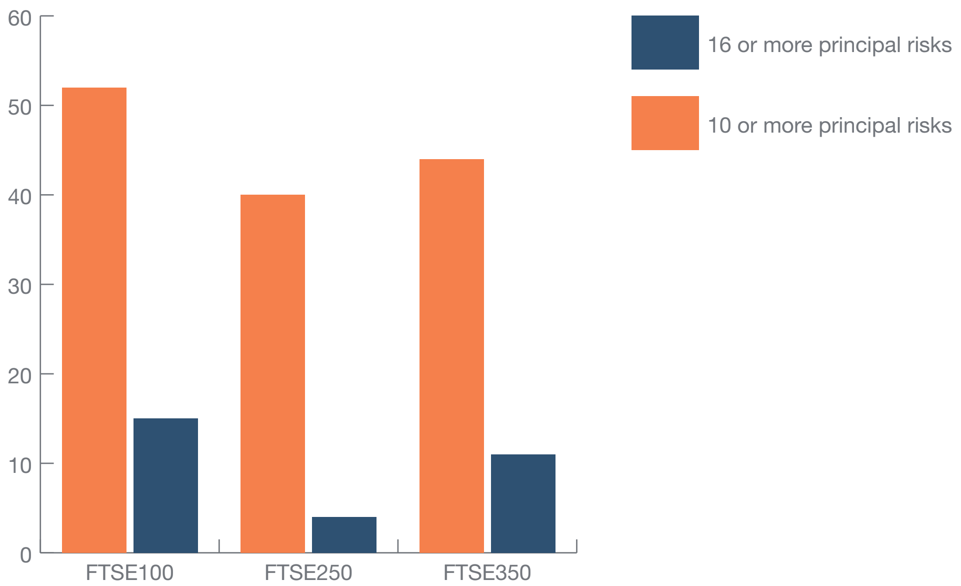
27 The Black Sun report noted that only 16% of FTSE 100 companies set out both quantitative and qualitative targets for long-term strategic objectives.

Principal risks and uncertainties

High quality information about principal risks and uncertainties is important to investors' analysis of a company and some investors believe this is the area of the annual report that requires the most improvement.[28] It remains an area where companies are developing their reporting.

Some companies have improved their reporting of principal risks since the introduction of the strategic report. However, other companies in our detailed review sample disclosed more than ten principal risks and one company disclosed 35. Our study noted that the FTSE 100 companies generally disclose more principal risks than FTSE 250 or FTSE 350 companies.

% of companies [29]



Reporting a large number of principal risks can make it difficult for investors to identify and understand which risks are the most significant for the business. This point was also highlighted by the Financial Reporting Review Panel (FRRP) in a press notice in 2011.[30]

The principal risks and uncertainties included in the strategic report should be limited to those that the Board considers to be material to the development, performance, position or future prospects of the company. These are likely to be the risks that are discussed by the Board on a regular basis.

The clearest reports identified as principal risks only those risks that have a high likelihood of occurrence, or have the potential to have an effect on the entity of high magnitude, or both. We found the 'heat maps' that some companies used to depict this very helpful for understanding the Board's assessment of each risk and its significance to the company.

28 The 2015 *CFA UK annual survey on Financial Reporting and Analysis* emphasised this point.
29 The data in the graph comes from the Black Sun and PwC reports.
30 A copy of the press notice is available at https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2011/February/The-Financial-Reporting-Review-Panel-highlights-ch.aspx

Companies applying the *UK Corporate Governance Code* (provision C2.1) should explain how principal risks are being managed or mitigated. It is helpful when companies highlight how the risk profile has changed and whether the Board has evolved its approach to mitigation during the year.[31] A few companies also explain how certain principal risks may interact and we believe that investors find such information very useful.

Some reports still contain generic descriptions of risks and mitigation activities, with little explanation of why each one was considered to be a principal risk relevant to that particular business. This issue seemed to be more prevalent in those reports that contained a high number of principal risks.

Key performance indicators

KPIs are the measures that the Board uses to monitor the development, performance or position of the business. Our study noted that many companies used KPIs targeted at their business model and strategic objectives. KPIs can also provide a link between the performance of the business and the decisions taken by the remuneration committee. We noted that in some cases there was limited explanation when the measures used to assess the performance of Board were different to the KPIs.

Our study found that some companies linked their KPIs to their strategy and the most informative reports explained *how* the KPIs measure the company's progress against the strategy[32] and relate to its principal risks. Linkage between these disclosures helps investors to understand why the KPIs selected are the most relevant for measuring progress against the strategic objectives and identifying trends and factors that may impact this progress so that the
Board can take appropriate and timely mitigation action.

If KPIs have changed year-on-year it is useful for companies to explain why the method of calculation has been altered or different KPIs have been selected. We also found it helpful when trends in KPIs were explained and this analysis was linked to the information on general trends in the markets in which the company operates.

Our detailed review included companies that disclosed from four to 17 financial KPIs and from zero to 15 non-financial KPIs. While the appropriate number will be dependent upon the size, complexity and particular circumstances of the company, in our view the strategic reports containing a limited number of KPIs that were clearly linked to the company's strategy were the most informative.

Our detailed review noted variation in the type of non-financial KPIs reported. Some companies used KPIs related to environmental, employee, social, community and human rights matters. Measures of employee engagement were particularly common. Other companies used KPIs such as the number of new products brought to market, volume of products sold, retail space or market share. Similarly to financial KPIs, it is helpful when companies explain why the non-financial KPIs selected are the most appropriate for assessing the performance of their business.

31 The PwC report noted that risk disclosures 'seem quite static, with little reference to how risks change during the year or what mitigating activities have been taken in that period to respond.'

32 The PwC report states that 'some companies create an impression of alignment between strategic priorities and KPIs… but if you look closer, the link is artificial – there's little consistency between measure and priority.'

Focus on alternative performance measures

Investors find alternative performance measures (e.g. non-GAAP measures) to be useful and companies make use of these in their strategic reports.

Our study found that it was common for alternative performance measures to include adjusted profit figures that exclude certain items that the Board does not expect to recur or believes are not relevant to the underlying performance of the business. Where alternative measures have been calculated by adjusting the GAAP numbers in the financial statements, it is very important to provide a clear reconciliation and explanation of adjustments to IFRS results, including why certain items have been excluded.

A lack of sufficient reconciliation between non-GAAP measures and the financial statements is a common issue noted by the FRC's Corporate Reporting Review.[33] As an extreme example, it may be misleading to refer to 'underlying profit' that excludes certain expenses if the financial statements show that the business is loss making, unless prominent reconciliation is given.

The European Securities and Markets Authority (ESMA) recently published ***Guidelines on Alternative Performance Measures*** (see page 26 for further information).

Financial review and market trends

Our study found that companies generally provided a good analysis of the financial performance and position of the business, usually in the form of a report from the Chief Financial Officer.

In most of the strategic reports in our detailed review, the financial review referred to the company's KPIs as well as figures from the financial statements, although in several cases non-GAAP measures were given more prominence than GAAP measures. The financial review must be comprehensive and the annual report as a whole should tell a cohesive story so it is important for companies to ensure that the financial review gives appropriate emphasis to GAAP measures and provides a balanced analysis of the development, performance, position and future prospects of the company.

Some financial reviews focused on an analysis of financial performance and little explanation of the financial position at year-end. It is important for companies to provide a balanced review that reflects critical aspects of the business. The FRC's *Corporate Reporting Review: Annual Report 2015* highlighted that disclosures in the strategic report should be consistent with a company's business model. For example, if a company is reliant on long-term contracts then we would expect the financial review to provide information on the company's ability to turn profits into cash over the period of the contracts.

Many companies included a sub-section in the annual report discussing trends in the markets in which the company operates, which provided context for the review of financial performance and the strategy. Some companies linked these disclosures together to highlight the interdependencies between them.

33 The FRC's Corporate Reporting Review: Annual Report 2015 is available at https://www.frc.org.uk/Our-Work/Publications/Corporate-Reporting-Review/Corporate-Reporting-Review-Annual-Report-2015.pdf.

Environmental, employee, social, community and human rights matters

> To the extent necessary for an understanding of the development, performance or position of a company, the strategic report should include information about environmental, employee, social, community or human rights matters (EESCH matters) and the interdependencies between them.

We have heard from investors that they have an interest in EESCH matters to the extent that these are likely to impact the company's future performance. Some investors also tell us that quality reporting on sustainability matters provides a strong indication that a company is well managed, and is therefore an important factor in their investment decisions.[34] Our study found that the quality of reporting in this area has generally improved in recent years.

We found that several companies have improved the entity-specific focus of their EESCH reporting, ensuring that it is relevant to their business, but some still present boilerplate disclosures in this area.

> Some companies in our detailed review sample provided a good summary in the strategic report of how they manage the impact of their supply chain and risks to their employees, mitigate their environmental impact and information on their activities within the wider community. We found that the relevance of the EESCH matters disclosed was clearer when the EESCH reporting was linked to the business model, principal risks or KPIs, highlighting the impact of EESCH matters on the business and how the company operates.

EESCH matters disclosed in the strategic report should be limited to those that are material in the context of the strategic report. Based on our detailed review, it is encouraging that companies are not adopting a 'checklist' type approach to EESCH matters and generally are disclosing only those that are material to an understanding of the business. Some companies provide a separate sustainability report outside the annual report containing more detailed information on EESCH matters and signpost this from the strategic report.

In some cases, we noted that less favourable EESCH matters were highlighted in other components of the annual report but were not referred to in the EESCH section of the strategic report. We consider that it is important that companies balance positive EESCH messages with sufficient discussion of the negative impacts of the business on EESCH matters. Investors tell us that they welcome transparency.

Some companies did not include disclosures on one or more of the EESCH matters and in doing so some overlooked the requirement in section 414C(7) of the Companies Act 2006 (the Act) to disclose why they had not included information on that particular EESCH matter in the strategic report.

34 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 investor research *Tomorrow's Investment Rules: global survey of institutional investors on non-financial performance.*

Gender diversity

Section 414C(8–9) of the Act requires companies to provide a gender diversity disclosure. The disclosure of the number of 'senior managers' of each gender requires inclusion of all directors of the companies included in the consolidation which may not necessarily be representative of the talent pipeline. Some companies built on the statutory disclosure requirements to present additional information that they felt was more relevant to how they manage their talent pipeline and succession planning.

To comply with the Act, companies must disclose the number of directors, senior managers and other employees of each gender, rather than just percentages of each. We noted that some companies only disclosed percentages.

Our study found that most companies present their gender diversity disclosure as a table, enabling easy comparison. Many companies presented the gender diversity disclosure in their strategic report while others included the disclosure in the corporate governance statement, directors' report or nominations committee report to group it with other similar information and then incorporated it into the strategic report by cross-reference.

Materiality

Information is material if its omission or misrepresentation could influence the economic decisions shareholders take on the basis of the annual report as a whole. Only information that is material in the context of the strategic report should be included within it.

While the application of materiality requires considerable judgement, it is essential when producing a strategic report that is concise and provides relevant information for investors.[35]

Our study found that some companies have made significant progress with making their 2014/15 strategic report and annual report more concise.[36] However, in most cases we found that reports were a similar length over the two reporting cycles since the strategic report was introduced.[37]

We believe that there is scope for companies to go further in the application of materiality to certain areas of their strategic report, particularly in relation to disclosures of principal risks and KPIs.

The use of signposting to direct readers to additional information that may be of interest but was not material within the context of the strategic report helped to reduce clutter. More companies may wish to use this technique in the future as they continue to develop their annual reports.

Appropriate application of materiality is crucial to clear communication in the strategic report, both in terms of omitting information that is not of strategic relevance, and including sufficient information on material issues.[38]

In a recent interview with EY, an investor said that annual reports 'include more and more irrelevant information, while often omitting more pertinent detail.[39]

Materiality judgements in the strategic report are largely qualitative and disclosures can be made clearer and volume reduced by focusing on the purpose of the disclosure. For example, the clearest business model disclosures focus on how the company generates and captures value, whereas clear strategy disclosures enable an investor to understand the Board's plans for developing the business over the coming years and capitalising on opportunities.

35 60% of investors responding to the 2015 *CFA UK annual survey on Financial Reporting and Analysis* felt that the majority of annual reports contained large amounts of irrelevant information.
36 The Deloitte report noted that 16% of companies explicitly stated that they had omitted certain disclosures on the grounds of immateriality.
37 The Deloitte report noted that the average 2014/15 annual report in their sample was 135 pages long, an increase of 3 pages from 2013/14. The EY report found an average length of 167 pages, and an increase of 3 pages.
38 55% of investors responding to the 2015 *CFA UK annual survey on Financial Reporting and Analysis* believed that the majority of annual reports omit important information about the company's financial performance and position.
39 Quote from the EY report.

3 Emerging developments

Over the last few years we have seen an increased emphasis on narrative reporting and this has been accompanied by changes to the regulatory framework. In addition to the introduction of the strategic report, 2013 also saw the introduction of new remuneration reporting regulations.

The FRC's *Guidance on the Strategic Report* sets out a high level principles based framework for narrative reporting. The principles in that guidance are consistent with the International Integrated Reporting Council's *International Integrated Reporting Framework*.[40] UK companies are required by law to prepare a strategic report. A high quality strategic report prepared using the principles in the FRC's guidance will achieve the objectives of integrated reporting.

We have also made complementary improvements in corporate governance reporting. Updates in 2012 and 2014 to the FRC's *UK Corporate Governance Code*—which applies on a 'comply or explain' basis—require annual reports to be fair, balanced and understandable and require companies to include a viability statement, encouraging companies to take a broader longer-term view of solvency and liquidity risks.

In 2014 the FRC also issued *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting,*[41] bringing together elements of best practice for risk management, prompting Boards to consider how to discharge their responsibilities in relation to the existing and emerging principal risks faced by the company and embed risk management and internal control in the business process.

40 The IIRC's framework is available at http://integratedreporting.org/wp-content/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf.

41 The FRC's *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* is available at https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Risk-Management,-Internal-Control-and.pdf.

Looking ahead, there are a number of emerging trends that are likely to have an impact on corporate reporting in the future. We discuss some of the developments that are in the pipeline below.

Non-financial reporting

Non-financial reporting is gaining greater prominence as an integral part of corporate reporting. In the UK there are already reporting requirements in this area; companies must report on EESCH matters in the strategic report to the extent necessary for an understanding of the development, performance or position of the business.

The UK will soon be implementing the requirements of the EU Directive on disclosure of non-financial and diversity information – 2014/95/EU ('non-financial reporting Directive'). The Directive contains disclosure requirements that are similar to those in the strategic report.

The Department for Business, Innovation and Skills (BIS) will consult shortly on changes to the Companies Act 2006 to transpose the non-financial reporting Directive into UK law. The FRC intends to update the *Guidance on the Strategic Report* once the regulations are in place.

A number of organisations, including the FRC, UK government and the European Commission are turning their attention to making regulation more effective and reducing costs for business. The UK government has a de-regulatory agenda and we welcome that as part of the consultation on the UK implementation of the non-financial reporting Directive, BIS will be inviting comments on whether there are existing narrative reporting requirements that can be repealed.

Upcoming in 2016

Increasingly, we are seeing a trend in the UK and the rest of Europe towards the introduction of new disclosure requirements, to tackle the broader societal impacts of business. There are some developments on the horizon that could result in new reporting requirements in 2016.

These aim to address:

- prompt payment of suppliers
- closing the gender pay gap
- tax transparency, including country-by-country reporting; and
- transparency in supply chains - annual slavery and human trafficking statement in the Modern Slavery Act.

We welcome proposals for much of this statutory information to be reported outside the annual report.

Risks and going concern

Many companies that apply the Corporate Governance Code will be preparing a viability statement for the first time in their 2015 annual reports (effective for accounting periods beginning on or after 1 October 2014). The FRC's *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* supplements the Code requirements.

In 2016, the FRC intends to publish non-mandatory simplified Guidance on the going concern basis of accounting and reporting on solvency risk and liquidity risk for non-Code companies.[42]

Alternative performance measures (APMs)

Investors use a range of measures when assessing a company's performance. These include 'Alternative Performance' or 'non-GAAP' measures. Recently, there has been an increasing focus on the use of these measures by regulators. In 2015, ESMA published *Guidelines on Alternative Performance Measures.*[43] The Guidelines apply to issuers whose securities are admitted to trading on a regulated market and will be effective for all documents within scope issued on or after 3 July 2016.

In 2016, we are expecting guidance from the International Organisation of Securities Commissions (IOSCO) on non-GAAP measures and the International Accounting Standards Board (IASB) will also be considering non-GAAP measures as part of its Disclosure Initiative.

These different sets of guidance have common aims of ensuring that APMs are:

- defined;
- reconciled to GAAP numbers, where appropriate;
- are consistently calculated and presented; and
- are not given undue prominence.

42 Further details are available at https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2015/October/FRC-proposes-new-guidance-to-enhance-reporting-on.aspx.

43 A copy of the Guidelines is included as Annex IV in ESMA's *Final Report* available at http://www.esma.europa.eu/system/files/2015-esma-1057_final_report_on_guidelines_on_alternative_performance_measures.pdf.

IASB Disclosure Initiative

The IASB is progressing with its initiative aimed at improving the quality of disclosures in the financial statements. The FRC welcomes this important project and we expect to see developments in two key strands of the IASB's work during 2016: a Discussion Paper on Principles of Disclosure and a Practice Statement on Materiality. We believe that both of these projects could contribute towards Clear & Concise disclosures in the financial statements.

Digital reporting

Technology is changing the way we use information. The digital environment presents new opportunities for reporting, including considering the different channels available to communicate information and encouraging a move away from thinking about the annual report as a printed document.

In 2015, the FRC's Financial Reporting Lab published a report *Digital present.*[44] In 2016, the Lab intends to work on the next phase of this project *Digital future*.[45]

44 The Financial Reporting Lab's reports are available on the FRC's website at https://www.frc.org.uk/Lab/Reports.
45 Information on the Financial Reporting Lab's current projects is available at https://www.frc.org.uk/Lab/Current-projects.

Appendix A – Questions to consider

From our study, we have identified the following questions for companies to consider in further improving their annual reports.

Materiality

Is there immaterial information that can be removed?
Are all performance indicators 'key'?
Are all risks 'principal'?

Placement

Is the information in the strategic report of strategic importance?
Is there information that can be moved online?

Boilerplate

Is the information in the annual report sufficiently tailored to the specific circumstances of the company?

Single story

Do the separate elements of the annual report combine to tell a single coherent story?

Business model

Does the disclosure go beyond what the company does and explain how it makes its money, and what differentiates it from its competitors?

Alternative performance measures

Are alternative performance measures:

- defined;
- reconciled to GAAP measures where appropriate;
- consistently calculated and presented; and
- not given more prominence than GAAP measures?

Forward-looking information

Is forward-looking information included in the strategic report?

Environmental, employee, social, community and human rights (EESCH) matters

Has the company considered EESCH risks as part of its assessment of principal risks?
Is all information on EESCH material and entity-specific?

Appendix B – Study design

Our study on the impact of the strategic report aimed to identify broad trends in relation to the four key themes which underpin the *Guidance on the Strategic Report:* communication, placement of information, content elements and materiality. The study was based on a number of reports on the quality of UK corporate reporting. We considered the findings of research performed by a number of organisations as well as reports published by the FRC:

- Searching for buried treasure: A review of 2015 strategic reporting practices in the FTSE 350, PwC, 2015.
- Annual report insights 2015: building a better report, Deloitte, 2015.
- Annual reporting in 2014: reflections on the past, direction for the future, EY, 2015.
- The Complete 100: Living the story, 2014 analysis of FTSE 100 corporate reporting trends, Black Sun, 2015.
- How does it stack up?, Radley Yeldar, 2015.
- CFA UK annual survey on Financial Reporting and Analysis, CFA UK, 2015.
- Tomorrow's Investment Rules: global survey of institutional investors on non-financial performance, EY, 2014.
- The Handbook: Corporate Reporting Trends for Decision Makers, PortAlchemy, 2015.
- Capital Market Report 2015, Comprend UK, 2015.
- Digital present: Current use of digital media in corporate reporting, Financial Reporting Lab, 2015.
- Towards Clear & Concise Reporting, Financial Reporting Lab, 2014.
- Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies: Discussion paper on the FRC's findings and proposals, FRC, 2015.
- Corporate Reporting Review: Annual Report 2015, FRC, 2015.

We supplemented this research with a detailed review of the strategic reports of 15 FTSE 350 companies across a range of industries. We reviewed the strategic reports for 2013/14 and 2014/15 for each company in our detailed review sample, to provide insight into how reporting has developed over the first two reporting cycles since the strategic report was introduced. The findings of this detailed review were consistent with those of the reports included in the study.

We also sought views from investors and companies on the impact and quality of strategic reports and how they would like to see reporting develop in the future.

We would like to thank the organisations whose research contributed to this study for the use of, and references made to, their reports.

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