Accountability in a time of uncertainty

PwC's Annual Review of Corporate Reporting in the FTSE 350 2019/2020

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Introduction

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The 2019/20 reporting season was always going to be an important one. With the introduction of significant new requirements around how directors carry out their duties under s172 of the Companies Act, our 15th annual review of reporting practices in the FTSE 350 was set to be about the year of the stakeholder. The revised UK Corporate Governance Code 2018 was also set to encourage more clarity on the culture of businesses and their role in society. And major issues such as the environment and climate change were also high on the agenda.

And then we had the emergence of COVID-19. Of course, we asked ourselves whether our review – much of it done before the pandemic really took hold – was still relevant. But, in my view, events have only emphasised how important the stakeholder agenda is. This year's findings show how companies have been responding to these challenges, before and after the impact of COVID-19 began to be felt in earnest.

In the upcoming reporting cycle it will be increasingly important for companies to strike the right balance between looking back at what the impact of the pandemic has been on the business and providing more forward-looking information at the sustainability of the business model and how it, and the strategy, might need to adapt in the medium to long-term. This forward-looking orientation is also clearly important when considering the impact of climate change on business models.

Societies' understanding of climate change and the need to take action has increased over recent years, and has led to an increase in both public discourse and government initiatives. As recent announcements from the UK Government, Financial Conduct Authority, and Financial Reporting Council ('FRC') demonstrate there is growing scrutiny from governments, regulators and investors on the reporting on climate change. The FRC's review of climate related reporting illustrates their belief that climate change reporting needs to improve and there needs to be greater consideration and disclosure of climate change matters in the financial statements. The spotlight will be on climate change reporting in the year ahead and the expectations are that companies will respond.

In my experience, a crisis often drives innovation in reporting and this year is no different. With the challenge of articulating your company's response to COVID-19 and responding to increased pressure on demonstrate the role of your business in society and its impact on the environment, I'm confident that you'll find some interesting and useful insights from our work this year, along with four key themes to focus on as you plan for the reporting season ahead.

FTSE 350 reporting trends

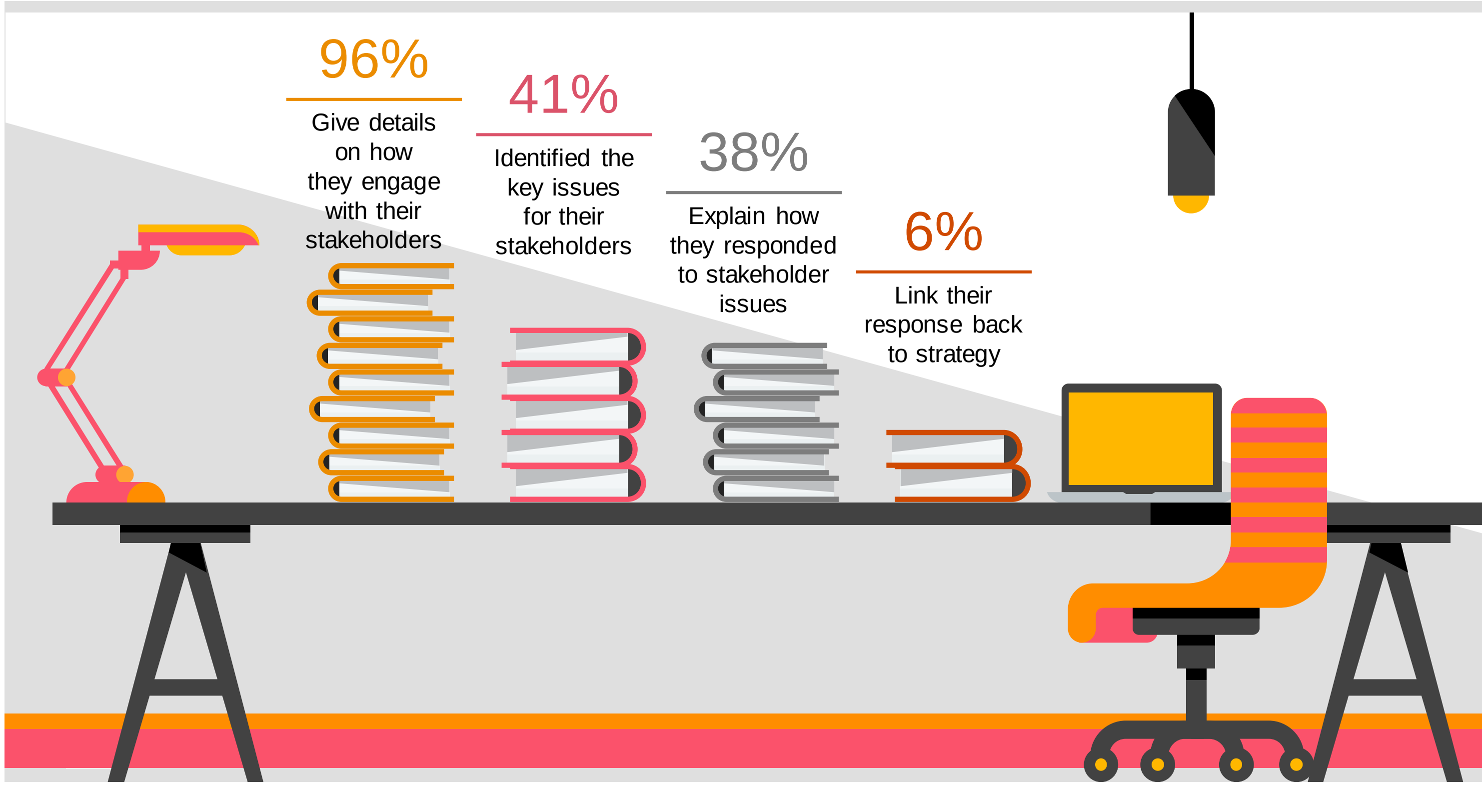
Responding to regulatory changes

Length of reporting

We were not surprised to see that reports continue to grow in length, particularly given new reporting requirements and the need to address COVID-19. The average annual report is now nearly 200 pages long, up 13% from 2018. It is notable that firms with a March year end had annual reports that were on average five pages longer than those reporting earlier – often as companies sought to explain their immediate response to the pandemic.

We understand the competing challenges of meeting new requirements while also being pressured to make reports clearer and more concise. In our experience, successful reports don't take last year's report and add to it; they think again about what's needed overall.

With relatively little in the way of regulatory change for the coming reporting season, we will be looking with interest to see whether companies grasp the opportunity to refine their disclosures – particularly with regard to s172 and stakeholder reporting – to home in on what really matters. We fully expect that the need to report with transparency and accountability on the impact of COVID-19 will inevitably lead to continued growth in the length of reports.



61%

Focused their response on stakeholders

28%

Listed out the s172 factors and responded to each in turn

79%

s172 statements were in the strategic report – 21% were in the governance report

s172 and stakeholder reporting

Information on how companies engage with stakeholders, particularly employees, has been present in reports for several years. But the new reporting requirements on these areas are more formal and extensive, and often result in companies bringing engagement information together in a specific section or table. The new requirements have also turned the focus onto s172 of the Companies Act and how directors are carrying out their duties in that regard.
This includes considering the interests of a range of stakeholders, but it also brings in issues like the longer-term implications of decisions and a company's impact on the environment. So it's wider in scope than just another report on stakeholder engagement.

For most companies, the 'how' – the process – of engagement was the major focus in year one. But it is only one part of ensuring meaningful reporting about stakeholders. The better disclosures focus on the principal decisions that were made in the year and how stakeholders were considered in relation to these.

This next step goes beyond simply describing a process or procedure. It answers the 'so what?' questions: 'So what happened as a result of the engagement?' or 'So what was the result of considering the s172 factors?' This is a recurring theme throughout our findings. And, in relation to stakeholder engagement, this goes beyond good practice. It's also a requirement of the regulations to disclose the impact of the regard for stakeholders on the Board's principal decisions in the year.

Around a quarter of companies responded to the new requirement for not an s172 statement by providing information on each of the factors to be considered in s172 in turn. While it's systematic, this also tends to produce a 'tick-box' approach.

In our view, the better method is to start with the company's strategy and the key decisions and show how the s172 factors (including stakeholders) were considered in relation to these – so start from the business and work back to the requirement, rather than vice versa.

Those that have done this often make use of case studies to illustrate and bring to life the key decisions made. How companies have responded to the pandemic has itself already become a case study for many.

Though the regulations are clear about where the various statements on s172 and stakeholder engagement should be in the annual report, companies often want to talk about related topics once and cross-refer to meet the compliance requirements. We agree with this approach.
As long as all the right statements are in the right reports, and all the right content is present, the structure and placement of the content is flexible.

In particular, the s172 statement is a strategic report requirement, but 21% of companies made the disclosure in the corporate governance report and cross-referred from the strategic report. We understand the thinking behind this. As s172 relates to the duties of directors, it can also help to create a link between the governance report and what has been going on in the business.

As a final note to this, we did see a lot of reports that did not reflect the stakeholder engagement statements properly in the directors' report. That is an issue for a number of companies to address next year. Cross-referring is fine but headings for these statements need to at least be present in the directors' report.

44%

Applied governance

Report on how the board has contributed to the delivery of strategy

51%

The board

Explained the board's process for considering s172 in their decision making

82%

Stakeholder agenda

Referred to the Board's role in stakeholder engagement

2018 Corporate Governance Code

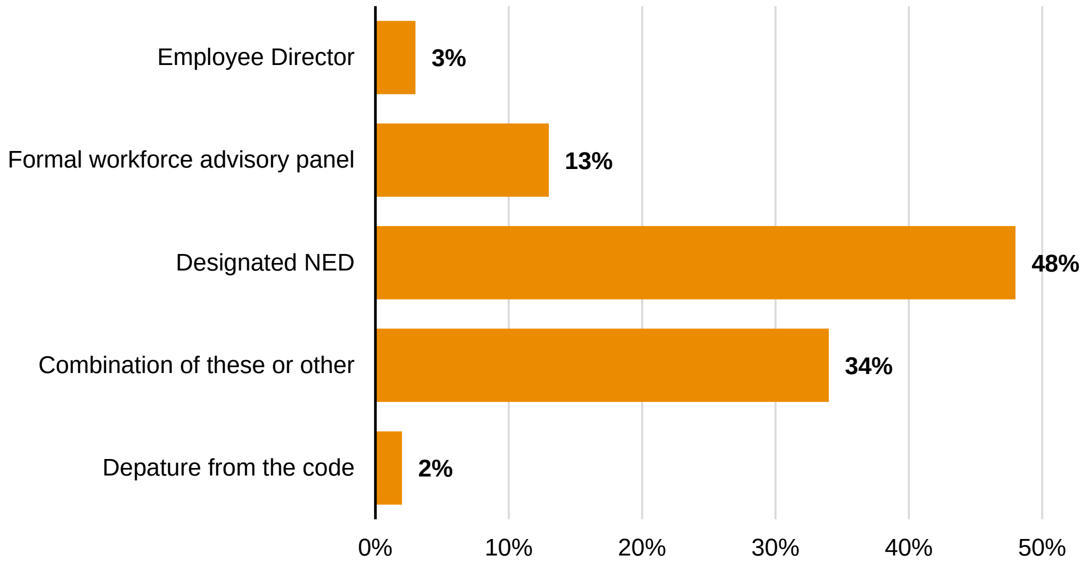
There is a significant cross-over between the stakeholder and s172 reporting we've just discussed and the 2018 Corporate Governance Code. But there is also a lot more to the new Code.

One of its major areas of focus is on how companies should report. There is a new section in the FRC's introduction to the Code advocating what is called 'applied governance reporting' – using governance reports to demonstrate which governance processes and procedures were actually applied, rather than just a listing of the roles and responsibilities.

Although applied governance reporting is explicitly part of the first provision of the new Code, our review showed that only 44% of companies demonstrated how governance had been applied to deliver on strategy. However, more said something about the Board's process for considering s172 and engaging with stakeholders.

Engaging with the workforce was among the highest-profile changes to the Code. A designated non-executive director (NED) is the most popular single option of the three suggested by the FRC. It also forms part of most of the combined approaches (where companies adopt more than one of the mechanisms – typically a designated NED combined with a workforce advisory panel).

Methods of workflow engagement



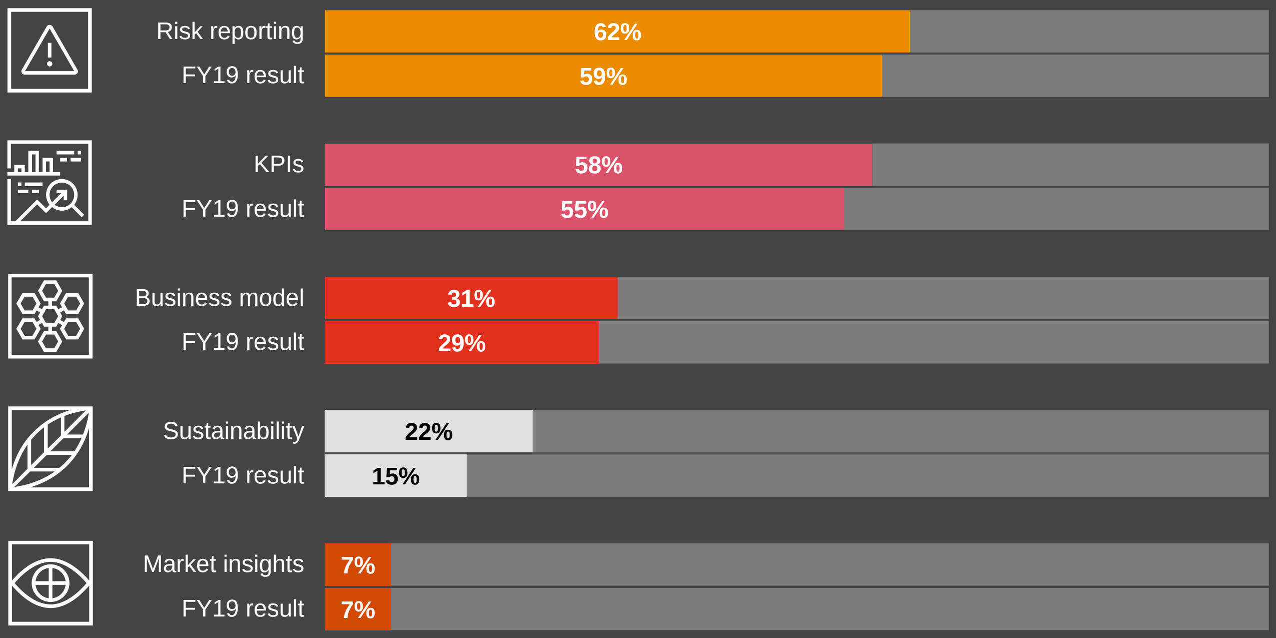
The new Code also includes a provision looking for the Board to assess and monitor the corporate culture, having established the company's purpose. This remains a challenging area to report on well. In our review, we saw a lot of high-level summaries of what the culture is, or acknowledging the Board's need to set and monitor it. The better disclosures – 25% of those we reviewed – show how the Board is satisfied that the culture of the company is as stated, and how it maintains that.

It's important to bear in mind that the new Code was being developed at a time when there was an ongoing stream of corporate failures and scandals, and much of what changed was targeted at issues that were seen as having contributed to these. The emphasis on purpose, culture, s172 and stakeholder engagement are major parts of this. But so are less high-profile changes, such as the shift of responsibility for whistleblowing to the Board as a whole, or the need for all directors to have sufficient time to carry out their role effectively. Many companies will need to consider these other aspects of the 2018 Code further in year two of applying and reporting against it.

Gradual but continued improvements

Strategic backbone

We believe that strategy should be at the heart of the strategic report. This means showing how other parts of the report relate to the overall strategy – and linkage is an important part of this.



The chart shows small year-on-year improvements in linkage between strategy and the various other parts of the report. With climate change increasingly on the mind of investors, regulators and other stakeholders, it was encouraging to see the largest improvement in percentage terms was for companies providing a clearer link between strategy and sustainability. As pressure mounts on companies to better demonstrate how they have considered the risk (and opportunities) of climate change in their decision making, it will be interesting to see whether this improvement continues – there's a danger that disclosures made separately from the main strategy might seem to be aimed mainly at specific stakeholders or pressure groups.

To be clear, when we say 'linkage', this is about more than just using symbols or icons. The better reports explain the connections, too – and this begins with the quality of the strategic disclosures themselves.

To be useful as the backbone of the report, the information given about the strategy itself needs to be sufficiently clear – high-level or generic disclosures make it difficult to build upon meaningfully.

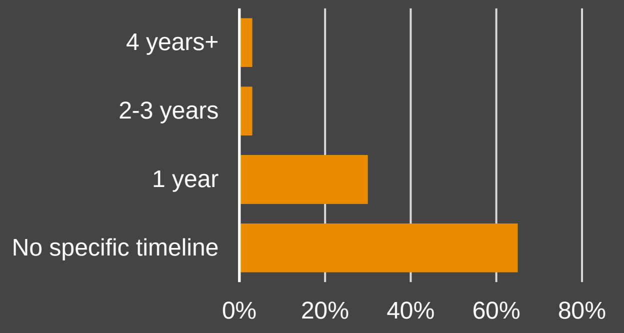
51%

Set out strategic plans at a high level

44%

Set out strategic plans with specific actions

Does strategy look out over a specific period of time?



Another thing that should be clear about the strategy disclosure is the period covered. But this is done only in a minority of strategic reports: this year, 64% of companies gave no specific timeline, compared to 52% last year. In fact, it's often hard to tell whether the disclosures simply cover the period to the next annual report or have a different time horizon in mind.

The discussion of why a period was chosen for the viability statement (usually, because it's the period of the strategic plan) is often the first time any time period is mentioned in the annual report. Yet the period referred to in the viability statement rarely aligns with the one disclosed in the discussion around strategy.

Risk disclosures

Risk reporting remains a major focus for the regulator and for investors. They want evidence that companies are actively managing risks and not just rolling forward disclosures year on year.

74%

Confirm the process for identifying emerging risks

40%

Identify their emerging risks

32%

Of companies that state their emerging risks include COVID-19 as one of these

11%

Average number of principal risks

The requirement to confirm that a robust assessment of the emerging risks (as well as of the principal risks) has been done was introduced as part of the 2018 Code, and 74% of companies have confirmed the process for identifying emerging risks. But only 40% identify what their emerging risks actually are.

COVID-19 was included by 32% of companies that disclosed emerging risks, suggesting that there are different views as to what constitutes an emerging risk. In our view, it is important that the definition of emerging risks used by companies would also cover longer-term risks, such as those that are identified by horizon-scanning techniques.

The key in relation to this is to explain how the company's systems would identify such matters in a timely way and start to manage them appropriately – although they would be unlikely to be subject to the same level of management and mitigation as matters that are already at the level of principal risks.

Where COVID-19 is included in the principal risk disclosures, some companies are classifying it as a risk in itself – a 'pandemic risk', for instance. Others report its impact on existing risks, and some do both. As usual, the clarity of the disclosures is the key consideration.

Still, with principal risks there continues to be a gentle upward trend in the number of companies discussing matters such as risk appetite, key risk indicators and how risks have changed year on year – all disclosures that we would advocate. The average number of risks remains at 11, which is unchanged from 2019. This is arguably surprising, given the COVID-19 situation and the number of companies that now recognise the risk implications of our next topic: climate change. Climate change is also an example of a risk that is sometimes included as a principal risk and sometimes as an emerging risk.

Climate change

Climate change was set to be high among the reporting topics this year before the pandemic emerged. As former governor of the Bank of England Mark Carney recently said, “We can’t self-isolate from climate change, and it’s clear that we are at only the start of its impact on the reporting agenda”.

Carney chaired the Task Force on Climate-related Financial Disclosures (TCFD). This has now emerged as the leading framework for reporting on this issue. The FCA have confirmed that for periods beginning 1st Jan 2021, premium listed issuers in the UK will be required to report on a ‘comply or explain’ basis against the TCFD framework.

26%

Include TCFD reporting

19%

Indicate that TCFD is part of future plans

53%

Of companies that state emerging risks include climate change as one of these

The FRC, in it's climate change thematic supported this call, saying that ‘action is needed now’ and encouraged public interest entities to report against the TCFD’s recommended disclosures and, with reference to their sector, to use the Sustainability Accounting Standards Board metrics.

With this increased focus on climate change, it will also be interesting to see how many companies begin to make reference to, and account for, climate change in their financial statements in line with the growing pressure to do this from investor groups.

The impact of COVID-19 on reporting

Looking briefly at the impact of COVID-19 on reporting, our observations are based partly on our main survey but also on the work we’ve done since then on interim reports and other announcements published after March 2020.

Liquidity and solvency have obviously been key issues for many companies during the crisis and this has driven extensive additional disclosures around going concern.

The FRC has indicated that it expects to see more material uncertainties for going concern being disclosed. Where there is a material uncertainty, there will clearly be extensive disclosure of the company’s position and prospects.

But even when the Board judges the uncertainty to be a lower-level concern, the impact – and potential impact – is important to disclose.

Consequently, we have already seen a significant increase in the length of going concern disclosures compared to the last annual report.

179%

Increase in length of average going concern disclosure compared to 2019 reporting

73%

Included stress or scenario analysis compared to 14% in 2019

The additional length of disclosures often relates to discussion of stress or scenario testing, including reverse stress testing in some cases. Previously, stress testing was mainly seen in the context of the viability statement. But the additional short-term uncertainties have driven it into the going concern disclosures.

Other aspects of the annual report have been affected by the pandemic as well, including how companies are balancing the interests of shareholders and other stakeholders to be consistent with the company’s culture and values. A significant number of companies have taken steps to explain, for instance, why they are continuing to pay dividends.

And finally, there is also a risk management and governance angle. The FRC issued guidance for companies in March and updated it in May. This resulted in some good disclosures on how governance and control arrangements have been adapted, but most have not been extensive.

Overall, then, there seems little doubt that most companies will have significant additional disclosure to make when the next main reporting season comes around.

Where next? Reporting themes for 20/21

Coming out of the work discussed above, we've identified four themes that we will be looking at in more detail over the coming months in the run-up to the next reporting season.
For more insights visit our website: https://www.pwc.co.uk/services/audit/insights/ftse-350-reporting-trends.html

Breaking down the boundaries

Encouraging reporting with a strategic mindset, avoiding repetition and being clear and concise.

Reporting time horizons

Building on the new levels of forward-looking information created as a result of COVID-19, to evidence long-term decision making including the consideration of climate change risks and opportunities.

Striking the right balance

Exploring how companies most effectively report on the balance they strike between the interests of different stakeholder groups, and show how this is consistent with their underlying purpose and values.

Focusing on purpose, culture and values

Reflecting the objectives of the 2018 UK Corporate Governance Code, this encompasses approaches to risk management, the Board's involvement in culture involvement in culture and strategy, and the transparency around viability statements.

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