Accountability in changing times

Analysis of FTSE 350 corporate reporting trends in 2017

pwc

www.pwc.co.uk/corporatereporting

Contents

Our review of reporting in 2017

Mark O'Sullivan
Head of Corporate Reporting, PwC UK

Welcome to our review of narrative reporting practices in the FTSE 350 for year ends from 1 April 2016 to 31 March 2017.

It's been a year of relatively little regulatory change and our review suggests most companies have used this as an opportunity to consolidate. We've seen continued improvements in the quality of risk and business model reporting but in most areas that we focus on there's been roughly the same slow but steady progress this year that we've seen for some time: it's very much a case of evolution not revolution.

However it's clear that this quiet period is fast coming to an end. With the new non-financial regulations[1] and the recent consultation from the Financial Reporting Council (FRC) on proposed amendments to their *Guidance on the Strategic Report,* as well as the UK Government's response to last year's Green Paper on corporate governance reform, change is in the air.

The ongoing debate on governance reform has been focused on whether boards have been properly accountable to the whole range of a company's stakeholders, and whether they've considered the long-term consequences of their decisions. Leading reporters have been responding to related questions about their purpose and impact on society for some time and we're already seeing signs of the 'stakeholder agenda' being more widely taken up in the reporting of the early 2017 year ends. But it would be fair to say that many find it difficult to know how to do justice to this dynamic in their reporting.

Although we're seeing more forward-looking information in reports, giving the long-term view that many are looking for still seems to be a particular challenge.

Stepping back from the specifics, when I look at the major findings of this year's review, I am left with a dilemma. The dilemma is that I recognise the hard work that many companies continue to put into their reporting and if I was to compare most reports with their equivalent from 10 years back they would be chalk and cheese, particularly in the areas that we look at on pages 6 to 13. But, after so many years of this slow but steady progress, I have to ask myself whether the net effect is enough. Of course the annual report is primarily a technical document for a specific audience. But surely it also has to reflect the impact on businesses of a society with a new attitude towards accountability and the communication tools to back it up? We look in more detail at these issues from page 16 onwards and I'd be really interested to hear your views on our analysis – I think we've got some challenging thoughts!

Where you see this symbol in our report we've set out the findings of a survey that we carried out in August 2017 among over 100 corporates and investors. These provide some interesting insights into what the market thinks of annual reports today and how they should change in the future, and we'd like to thank everyone who took the trouble to participate. What's clear is that in a number of areas there is a divergence of views between corporates (including directors) and investors, with the latter generally less comfortable with today's reporting and more convinced about the need for change.

1 The non financial reporting regulations – what do they mean in practice? http://www.pwc.co.uk/services/audit-assurance/insights/non-financial-reporting-regulations.html

Why are we focusing on the annual report?

The message we hear all too often from companies is that they don't see the value in the annual report:

- *Why invest in the annual report?* Companies say they don't get any reaction to their reporting so they don't make the effort, whilst investors say reports are boilerplate and lacking in information value. It is this lack of insight in reporting that creates a vicious and downward spiral.
- *Why risk moving first?* There can be pressures from boards to stay within the pack and not differentiate the company's reporting, or to keep reporting minimalist as part of the corporate image/culture.

Our answer is that:

- The annual report remains an important source of information for investors. In their May 2017 *Long Term Reporting Guidance* the Investment Association stated that "A company's annual report is an important source of information for investors, and the primary means of communication to the market"[2]. See page 23 for more on the Investment Association Guidance.
- Evidence from our research confirms that the quality of a company's annual report is indicative of the quality of reporting across other channels[3]. We have always seen the ability to produce a good annual report as a sign of good reporting discipline within a company generally, and our research bears that out.

Is it about resources?

We are often told that bigger companies have more resource to use when producing an annual report and therefore their disclosures will be better, but our experience suggests that this isn't necessarily the case. Our leading reporters in the FTSE 350 come from both the 100 and 250, from big teams working on the report to just one or two people writing the whole thing. What really seems to matter is that those involved have the support of the board in putting transparency first, that they look beyond the numbers, and that they take the opportunity to communicate their story with both the highs and the lows, making it both engaging and useful to all their stakeholders.

2 https://www.ivis.co.uk/media/12519/Long-Term-Reporting-Guidance.pdf

3 http://pwc.blogs.com/corporatereporting/2017/05/cant-live-with-it-cant-live-without-it-the-continuing-role-of-the-annual-report.html

Forward-looking perspective

- ***More forward-looking language but use of specific timeframes is still limited***
- ***Quantified information is generally focused on market trends as opposed to the company***

By definition, strategic reports should include forward-looking information and the FRC is clear about this in its Guidance on the Strategic Report.

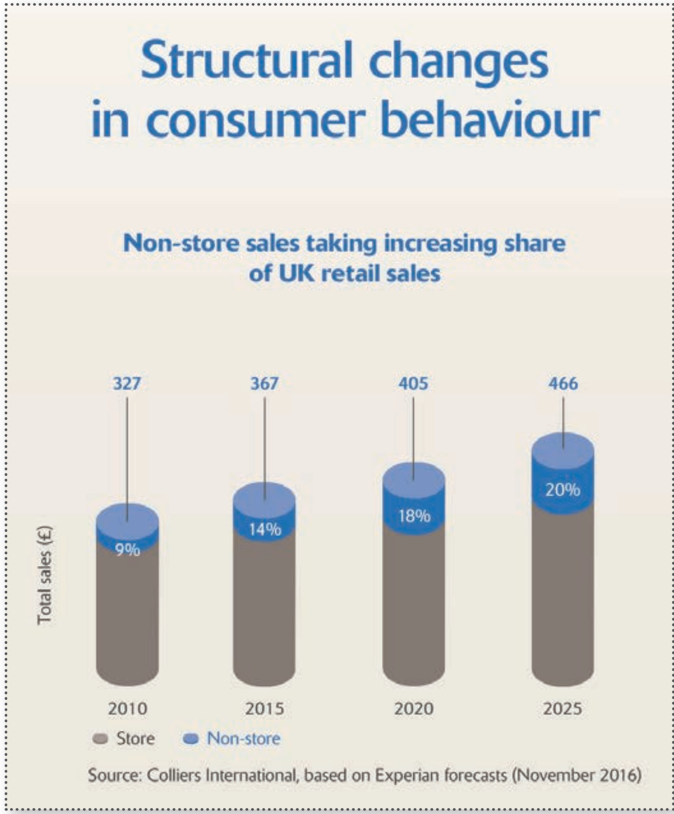
This is always a source of tension, however. Comments left by those responding to our survey indicated that companies and directors worry about the uncertainties attached to long-term information and also about the risk that they will be held to account if events turn out differently – understandable, perhaps, in the current economic and political circumstances.

We found that reports often use more forward-looking language when talking about strategic goals than they did in the past.

In our survey, investors seemed to recognise the efforts companies have been making, with 50% agreeing or strongly agreeing that reports generally include appropriate forward-looking information. Corporates and directors rated themselves slightly more conservatively, with only 45% agreeing or strongly agreeing.

However, the evidence shows that companies feel more comfortable giving quantified forward-looking information when it's about the market as a whole. Our review showed that 34% provide quantitative data in their market disclosures beyond the next year, like Segro [Example 1], but only 9% provide quantitative KPI targets for the company itself.

Example 1: Segro AR 2016



28%
of companies make reference to strategic timelines

34%
of companies provide quantitative market data beyond the next year

9%
of companies provide quantitative KPI targets

Forward-looking perspective continued

The advent of the viability statement has focused attention on the period over which companies plan, and highlighted the fact that many disclosures around strategy are either unclear about the timeline they address, or address only the next year.

Our findings showed that whilst 28% of companies make reference to strategic timelines only 10% are specific about a strategic time period beyond the next year. SSE [Example 2] attached a specific time period to their strategic goals, allowing focus on the medium to long-term as well as the immediate future.

Risk reporting shows a similar picture. Only 25% of companies discussed emerging risks [Example 3, from Great Portland Estates] or future plans for mitigating activities, and these tend to be focused on the upcoming period.

In our survey there was a major difference between companies and investors on whether annual reports should look out further in time than they generally do today. 70% of investors agreed or strongly agreed that they should, compared to only 26% of companies and directors. 45% of companies and directors disagreed or strongly disagreed with providing longer time horizons.

Example 2: SSE AR 2016

Outlook to 2020

- Efficiently execute our £6bn investment programme 2016 – 2020, including our two largest projects: the Caithness-Moray transmission link and the Beatrice offshore wind farm, due for completion in 2018 and 2019 respectively
- Take the RAV of the networks business to almost £9bn through investment in new assets and timely connections to our networks
- Continue progress with onshore wind projects in construction which are on track to take our total renewable electricity capacity to 4.3GW
- Explore strategic generation development options in new gas, offshore wind and multi-fuel to diversify and bring flexibility to our portfolio
- Further investment in digital customer service platforms to improve our customer service

Example 3: Great Portland Estates AR 2017

Emerging risks

The risks identified on pages 68 to 75 are risks that impact us as of today. However, we are also mindful that we need to consider other potential emerging principal risks in advance of them affecting us, including:

- in designing our buildings, taking into account that how people use offices may change over time together with the impact of climate change. We are considering both of these through our Disruption Project outlined more on page 38; and
- tenants becoming more 'fleet of foot' and willing to move to new areas within central London where they perceive they will obtain greater value or where the buildings and/or the area appeal more to their employees. With good transport being a big deciding factor in occupiers' decisions, in addition to the work we are doing looking at building design within the Disruption Project, we are well positioned with 85% of our buildings within walking distance of a Crossrail station.

Risk disclosures

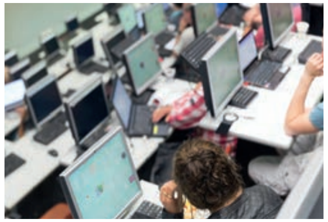
- ***Increased discussion of risks and risk management processes and how they change***
- ***But the descriptions of the risks themselves and mitigating activities lack specificity***

The combination of the strategic report requirements, the 2014 UK Corporate Governance Code and Guidance on risk management has led more companies to explain their risk management processes, including risk appetite, and to explore ways to present a more dynamic picture of their risk profile.

19% of companies provided a risk heat map, compared to 13% last year and 61% indicated risk movement, up from 55% in 2016.

However whilst these elements improve the overall risk disclosure, their value is limited by the quality of the description of the risks themselves – and too many of these remain boilerplate. Our review showed that around 70% of companies use generic language when describing mitigating activities in particular.

Risk disclosures *continued*



Risk dynamics also need to be put in context. Some companies, such as Pearson [Example 4], have introduced risk case studies to bring more depth to certain key risks.

Whilst 61% of companies indicated risk movement, only 30% of the FTSE 350 gave any commentary as to why the movement had occurred. Fresnillo [Example 5] provided a clear explanation of the reasoning for changes in their heatmap.

Our survey showed that companies and directors have a sense of improvement in risk reporting: 72% of them agreed or strongly agreed that annual reports provide useful insights into companies' principal risks and how they are managed. Investors were far less convinced – only 36% agreed or strongly agreed.

Example 4: Pearson AR 2016

Risk in action case study – Pearson Test of English (PTE)

How risk management adds value to strategic and day-to-day business decision making

Following recent rapid growth of PTE, one of our successful global products, further work was needed to prevent any risks associated with future delivery, in order to ensure that quality was maintained and to avoid reputational risk.

Risk governance

A cross-company programme was set up in 2016, with workstreams based around identified risks and recommending actions in time for strategy decision-making in September. Each workstream owner was tasked with setting up their own working group to identify risks relating to their area, presenting these back for debate by the wider group, along with proposed recommendations for resolving them.

Risk treatment

Identified risks were rated in terms of their impact on the business in order to support their prioritisation and recommended courses of action were divided into two categories:

'Compliance' risks – potential areas that needed to be tackled in order to ensure ongoing secure delivery. These are risks for which we typically have a low risk appetite and were the highest priority to resolve.

'Opportunity' risks – these recommendations (sometimes requiring further investment) were identified as areas we needed to tackle to accelerate future growth of the product. We typically have a higher risk appetite for 'opportunity' risks.

A high-level summary of the risks and mitigation plans formed part of a strategic paper for the Pearson executive to make better informed decisions on the future strategic direction of (and related investment in) PTE.

Risk monitoring

Tracking the full set of recommendations will be part of business-as-usual in 2017, monitored by a cross-functional governance board who will also continue to identify opportunities for continuous improvement.

Example 5: Fresnillo AR 2016

Change in heat map:

=

Description of risk change

During 2016 all macroeconomic variables favoured our financial results, however volatility and uncertainty were constants in the same period (and are expected to remain as such in 2017); therefore we still consider the impact of global macroeconomic developments our principal risk driver; in addition, most industry and financial analysts who follow metal prices continue to foresee volatility in silver and gold prices for 2017, with a notable spread among forecasts, meaning continued volatility.

Key risk indicators

- Gross profit sensitivity to % change in metals price and to MXP/US$ exchange rate.
- EBITDA sensitivity to % change in metals price and to MXP/US$ exchange rate.

"Risks tend to be boilerplate and not really those that keep company executives awake at night and/or relevant to key stakeholders."

Investor comment in our survey

61%
of companies indicate risk movement

30%
of companies explain the reason for risk movement

19%
of companies provide a risk heat map

Integration

- ***Improvement in quality of individual disclosures in report***
- ***More work to do to link them together to tell a coherent story***

Those responding to our survey often commented on the difficulty of addressing the many regulatory requirements in a joined-up way – a situation which they saw worsening as the requirements expand. Our review backed this up. And even where the quality of individual disclosures has improved, their relevance can be lost where they are not part of a cohesive overall narrative.

Strategy should sit at the heart of reporting and be the core that underpins and demonstrates the relevance of other disclosures. But our review shows that only around 40% of companies link, for instance, strategy to KPIs or risks, as in the case of Aggreko [Example 6].

Example 6: Aggreko AR 2016

	Risk	Primary strategic area affected	Primary KPIs impacted	Change in 2016
STRATEGIC RISK RISKS RELATED TO THE COMPANY'S ABILITY TO DELIVER ON OUR STRATEGIC PRIORITIES				
Market conditions – Rental Solutions	Challenging market conditions reduce volume and profitability in our Rental Solutions business.		• Revenue growth • Margins • Returns • Capital efficiency	
Market dynamics – Power Solutions	Changes in market dynamics result in major contracts maturing without equivalent replacement.		• Fleet size and composition • Capital efficiency	
Change management relating to our strategic priorities	Failure to deliver the expected benefits from our strategic priorities.		• Revenue growth • Margins • Returns	
Talent management	Failure to attract, retain and develop key employees.		• Employee satisfaction	
Technology – market introduction	Ineffective new product market introduction hinders growth.		• Fleet size and composition • Capital efficiency • Revenue growth	

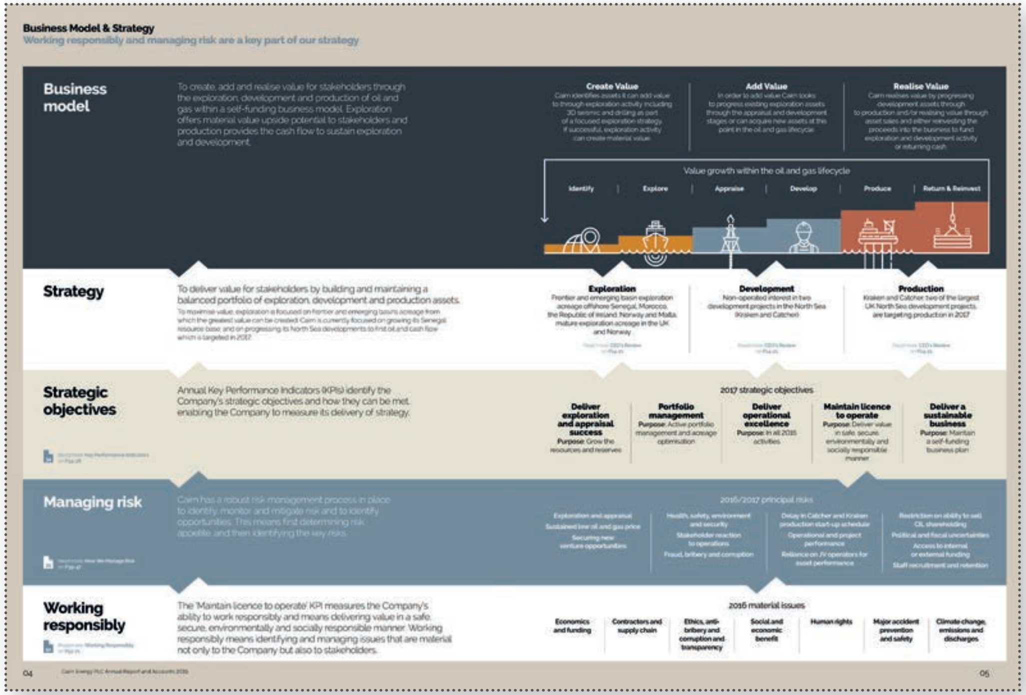
Integration *continued*

But how integrated is the information in reality? Often it is integrated in a report through the use of simple design or cross-referencing techniques. However, look more closely, and it often remains unclear how various content elements relate to each other – for instance how a KPI could measure the strategic objective it is aligned to, or the impact a risk might have on its related strategic priority. Our recent report *"KPIs and the link to strategic objectives"* looks at this in more detail.[4]

The element of reporting that most commonly sits in isolation continues to be the business model disclosure, with only 25% of FTSE 100 companies linking it clearly to the rest of the strategic report. Cairn Energy [Example 7] provides a good overview of the connection between their core reporting elements, including the business model.

The introduction of the viability statement has created a new challenge for integration. 97% of companies state that the period they choose is based on their strategic plan. But in most cases, it is not clear how the discussion of strategy (or risk) reflects the same timeframe.

Example 7: Cairn Energy AR 2016



Business Model & Strategy
Working responsibly and managing risk are a key part of our strategy

Business model
To create, add and realise value for stakeholders through the exploration, development and production of oil and gas within a self-funding business model. Exploration offers material value upside potential to stakeholders and production provides the cash flow to sustain exploration and development.

Create Value | **Add Value** | **Realise Value**

Value growth within the oil and gas lifecycle
Identify | Explore | Appraise | Develop | Produce | Return & Reinvest

Strategy
To deliver value for stakeholders by building and maintaining a balanced portfolio of exploration, development and production assets.

Exploration – Frontier and emerging basin exploration acreage offshore Senegal, Morocco, the Republic of Ireland, Norway and Malta, mature exploration acreage in the UK and Norway
Development – Non-operated interest in two development projects in the North Sea (Kraken and Catcher)
Production – Kraken and Catcher: two of the largest UK North Sea development projects, are targeting production in 2017

Strategic objectives
Annual Key Performance Indicators (KPIs) identify the Company's strategic objectives and how they can be met, enabling the Company to measure its delivery of strategy.

2017 strategic objectives
Deliver exploration and appraisal success – Purpose: Grow the resources and reserves
Portfolio management – Purpose: Active portfolio management and acreage optimisation
Deliver operational excellence – Purpose: In all 2016 activities
Maintain licence to operate – Purpose: Deliver value in safe, secure, environmentally and socially responsible manner
Deliver a sustainable business – Purpose: Maintain a self-funding business plan

Managing risk
Cairn has a robust risk management process in place to identify, monitor and mitigate risk and to identify opportunities. This means first determining risk appetite, and then identifying the key risks.

2016/2017 principal risks

Working responsibly
The 'Maintain licence to operate' KPI measures the Company's ability to work responsibly and means delivering value in a safe, secure, environmentally and socially responsible manner. Working responsibly means identifying and managing issues that are material not only to the Company but also to stakeholders.

2016 material issues
Economics and funding | Contractors and supply chain | Ethics, anti-bribery and corruption and transparency | Social and economic benefit | Human rights | Major accident prevention and safety | Climate change, emissions and discharges

42%
of companies link KPIs to strategy

25%
of FTSE 100 companies show the relationship between business model and strategy

41%
of companies link risks to strategic objectives

4 http://www.pwc.co.uk/audit-assurance/assets/pdf/kpis-and-the-link-to-strategic-objectives.pdf

The business model

- ***Business model disclosures continue to develop and now often recognise the importance of resources & relationships***
- ***They could still explain better what makes the business unique***

Business model disclosures are responding to the focus on business's impact on society. More now identify the relationships, resources and other dependencies that are necessary for business success, and show how they create value for more than just shareholders.

We particularly focused our review on FTSE 100 business models and found that almost 60% explained the company's key inputs and outputs. Whilst many of the outputs remain financial some, like Berendsen [Example 8], also highlight the wider benefits of the business.

59%

of FTSE 100 companies outline the inputs into their business model

40%

of FTSE 100 companies provide some insight into their differentiating factors

Example 8: Berendsen AR 2016

The benefits our customers get...

Efficiency and cost-saving
Our differentiated production sites allow us to be very competitive without compromising on quality.

Environmental credentials
Lower washing temperature, introduction of telematics in our vehicles, lower use of chemicals and many more initiatives are being progressed to reduce our carbon footprint; this allows our customers to improve their environmental credentials, as we work together for a sustainable business.

New ideas and solutions
We are always working to improve our customers' experience, introducing new products or services to alleviate our customers' effort in the management of the textiles they need for their business.

Low capital expenditure
Our customers can rely on us to rent the best products and service to fit their needs, greatly reducing the capital expenditure needed.

Service level
We work with our customers to determine what service levels they need to support their operations and we put in place operations to meet or exceed that service level.

The results of what we do

Our business model not only provides our customers with a differentiated service to suit their needs, but creates value which can take many different forms.

Revenue
£1,110.0m

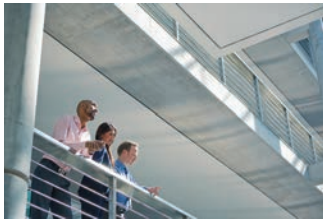
Operating profit
£140.7m

Career prospects
15,700
We employ 15,700 employees in over 140+ sites across Europe.

Cleaner environment
3% reduction
We demonstrate our environmental efficiency through the reduction of our CO_2 emissions in kg of CO_2 per tonne of laundry shipped.

Shareholder return
33.0p
33.0p dividend per share (+5% from 31.5p in 2015) demonstrates the value we create for shareholders as a result of the improvements we make to the business.

The business model continued



Business models could still be more distinctive, however. Our review showed that only 40% focused on the factors that differentiated their business model, as Anglo American did [Example 9]. The result is that business model disclosures end up blurring into one homogeneous picture characterised by generic descriptions of inputs/outputs and shapes/arrows. Without more specificity, it can be difficult to understand what makes companies in the same industry distinctive from each other.

In our survey 48% of companies and directors agreed or strongly agreed that business model disclosures generally capture what is distinctive about a company. However only 20% of investors agreed or strongly agreed, making this one of the major areas of difference in the survey – it's clear that investors feel there is more to do.

"The coherence of annual reporting has improved but most are still internally inconsistent at worst, disconnected at best. Making discussions of business models truly distinctive would help."

Investor comment in our survey

Example 9: Anglo American AR 2016

WHAT MAKES US DIFFERENT: BUILDING STRATEGIC ADVANTAGE

Across De Beers, PGMs and Copper, our assets are characterised by having world class orebodies, competitive industry cost positions, long reserve lives and significant resource potential, offering considerable organic growth opportunities, thereby representing three businesses in which we have leading competitive positions. These are complemented by a number of other high quality, individual assets across iron ore, coal and nickel. Underpinning our uniquely diversified portfolio of differentiated assets is Anglo American's expertise across a number of core processes – exploration, innovation, project development and sustainability – while our Marketing business optimises value from our resources and market positions. The benefits of a systematically embedded Operating Model and the functional governance structure of the Organisation Model combine to create optimal and sustainable value.

For more information on our core processes
See page 10

DIFFERENTIATED ASSETS IN A UNIQUELY DIVERSIFIED PORTFOLIO:

De Beers
De Beers has a global leadership position in diamonds, producing and selling around one-third of the world's rough diamonds by value. Our major diamond mining assets have large, long life and scalable resource bases and we have well-established partnerships in South Africa and with the governments of Botswana and Namibia.

PGMs
We are the world's leading PGMs producer, with positions in the world's two largest PGM deposits – the Bushveld Complex in South Africa and the Great Dyke in Zimbabwe. We operate the world's highest margin platinum mine at Mogalakwena – a long life, scalable open pit operation that has the potential to lift production significantly as market demand requires.

Copper
Anglo American has a world class position in copper, with the potential to establish a global leadership position built around its interests in two of the world's largest copper mines – Los Bronces and Collahuasi – and its feasibility phase Quellaveco project in southern Peru. The mineral endowments of these assets underpin our organic copper growth opportunities, in addition to a number of future potential projects.

Bulk commodities and other minerals
Anglo American also benefits from a number of other high quality assets across the bulk commodities of iron ore and coal, as well as nickel.

These assets are optimised operationally to continue to contribute cash and returns, while being allocated capital to preserve and enhance value, as appropriate.

DISTRIBUTION AND RETAIL

De Beers' leading position is further enhanced by its rough diamond sales operation selling to term customers, accredited buyers and auction sales customers. It also has a presence in the downstream through Forevermark™ and De Beers Diamond Jewellers.

MARKETING

The value from our mineral resources and market positions is optimised by our dedicated Marketing business. Built on direct customer relationships, Marketing creates value across the entire value chain from mine to market through appropriate commercial decisions aligned to our customers' specific requirements – including product specification, volume and timing. In addition, Marketing proactively develops new markets for our products through, for example, investing in new technologies that are expected to drive new sources of demand for PGMs – such as fuel cell electric vehicles – and building consumer awareness in emerging platinum jewellery markets, such as India.

64%

of FTSE 100 companies explain to some extent how value is created in their business model

57%

of FTSE 100 companies outline the outputs of their business model

Summing up – it's time for a change

We applaud those companies taking risks and innovating in their annual reports but our findings show that even in the areas that have improved there is still a lot of work to do. After 15 years of our Building Public Trust Awards[5] we really do have to ask whether the progress we see across the FTSE 350 is enough.

Notwithstanding some of the more positive responses that we had to our survey, it was interesting to see that only 33% of companies and directors agreed or strongly agreed that annual reports today generally build trust in the relevant business. It would be convenient to argue that this is because building trust is not their purpose. To us, that's disingenuous: we see it as a sign of opportunities that are being missed.

So what will encourage companies away from their reporting comfort zone, push them beyond boilerplate reporting, and help them to tell their unique story? Is now the time to really shake things up? We believe so.

5 https://www.pwc.co.uk/build-public-trust/the-building-public-trust-in-corporate-reporting-awards.html

A more accountable annual report

Business in the UK has been in the spotlight since the financial crisis and the level of attention has been ratcheted up further by the events at a small number of companies that have led to the current governance debate.

Alongside this, there can be little doubt that society is in a new age of accountability. Regulation has played a major role in this, as too have changes in the way we communicate with each other, most notably through social media. We routinely expect the organisations we deal with to have, for example, customer charters or service level agreements, and we expect them to be held to account against them. And we certainly expect to be able to make our views known when they do not meet our expectations.

But there is little sign of this revolution in most annual reports. In fact, far from being committed to accountability, annual reports can often feel as though their main aim is to avoid it.

Risk reporting illustrates the point well. The lists of 'risk factors' that we see in US market filings are examined line-by-line by lawyers to make sure that potential investors are made aware of every possible downside, and we have much the same approach in the UK when it comes to the risk disclosures in prospectuses. The problem with these lists is that they pass across the responsibility for identifying the really important information to the potential investor, allowing directors to minimise their accountability by avoiding having to make judgements.

This is built into the regulatory framework for US filings and prospectuses, and there is perhaps not much that directors can do differently in those cases. But many of the principal risk (and risk management) disclosures in UK annual reports take a similar approach, giving a long list of boilerplate 'risks' that could apply to almost any company. As we noted in the findings of our review, even with heat-maps and indicators of whether they have increased or decreased in the year, if the risks themselves don't give sufficient insight into the real issue they are of limited value. Users of the annual report simply cannot get to what it is that 'keeps the directors awake at night'.

The stock argument is always commercial sensitivity, but this does not alter the feeling that these disclosures are for the benefit of the company alone, rather than shareholders and other stakeholders.

There are, however, some areas where reporting has moved on. Regulatory intervention has resulted in many bank annual reports including considerable detail about the 'treating customers fairly' agenda, complete with targets and performance indicators. Similarly, the response of many food companies to food safety scandals has resulted in some of the best reporting on the quality of their products and the positive impact this has on society.

A more accountable annual report continued

Example 10: Lloyds Banking Group AR 2016

The Lloyds 2016 Annual Report is notable for its greater focus on the role of the bank in society and its clear emphasis of what it means by doing business responsibly. It is interesting to see that it has acknowledged the role of its stakeholders in its approach, demonstrating that its actions come as a response to listening to those that it considers important in ensuring the bank's long-term sustainability.

Catalyst for change

So change is possible, but it seems that companies still need a trigger such as a major issue to make it happen. We would argue that this is an increasingly dangerous line to take: companies that wait until change is forced upon them by an impatient society are likely to find it a much more painful process.

What is clear from most of the conversations we have with companies and boards is that they without question recognise the need to be accountable. No organisation can afford to ignore the interests of, for example, its customers, suppliers or employees without risking losing its 'licence to trade'.

Equally, we do not believe that many companies are now driven only by the goal of maximising short-term profits, despite a few high-profile exceptions. 'Enlightened shareholder value' is very much the culture in most of the boardrooms, with a good measure of 'purposeful company' underpinning it[6].

The problem remains that too many annual reports do not reflect this. The approach that many companies still take comes from a time when, as long as profits were being delivered, very few questions were asked, so very little real information was required or given. Non-executive directors were the agents of shareholders in the boardroom and they were largely trusted to carry out their role. But times have and continue to change. Deference and trust for a traditional class of ex-CEO and ex-CFO non-executives is coming to an end and shareholders and other stakeholders want proper information on the key issues and judgements that are made on their behalf. The call for much greater diversity in the boardroom is a very clear signal of this shift.

6 'Enlightened shareholder value' is the model primarily reflected by section 172 of the Companies Act (2006) – see page 19 for more discussion of this. For a discussion of the concept of a 'purposeful company' see for example, the Policy Report of the Purposeful Company taskforce here: http://biginnovationcentre.com/media/uploads/pdf/TPC_Policy%20Report.pdf

A more accountable annual report continued

To keep up with and respond to changing demands, the evidence we see is that many companies and boards will need to make a step-change in how they approach their reporting. Some have already started down this path, but much of the rest of the market still lags behind and will need more motivation to follow.

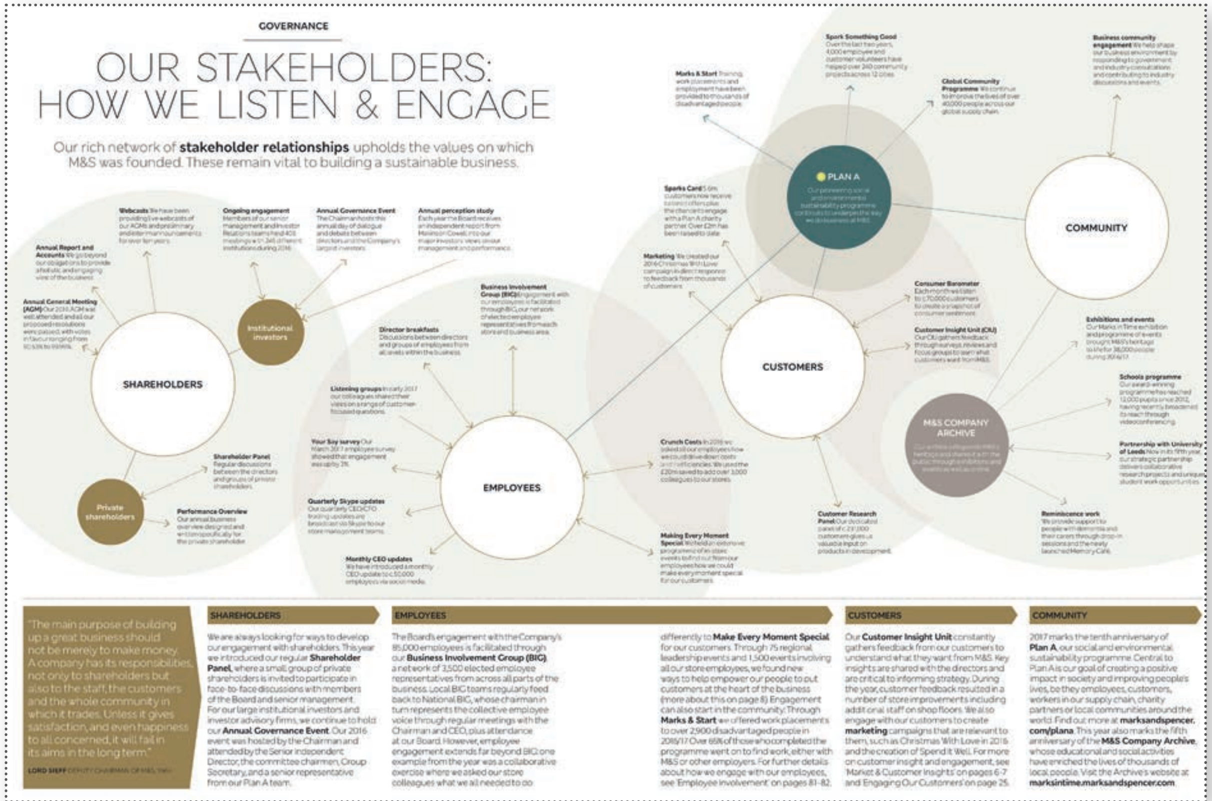
As we've already noted, a regulatory push often helps. And that's exactly what we're now seeing.

More accountability, less management of the reporting risk

To test our proposition that annual reports need to shift from being led by risk management to focus more on accountability we asked whether reports today generally strike the right balance between being accountable to their shareholders and managing reporting risks such as commercial sensitivity. A relatively high 53% of companies and directors agreed or strongly agreed that they do, as against only 29% of investors. 36% of investors also disagreed or strongly disagreed that this was the case. There is clearly a lack of consensus on this question – and evidence that the change of mindset we've called for in companies and boards is needed.

Example 11: Marks and Spencer Group AR 2017

As part of its 2017 Corporate Governance report, Marks and Spencer provide a comprehensive overview of its different stakeholder relationships focusing on the different ways it has of engaging with them on the various different activities of the Group. Its disclosure is particularly notable because it emphasises the two-way relationship that exists with these key groups.



The regulatory push

It's no coincidence that the regulatory agenda should be taking this direction. The governance reform debate has been focused on whether boards have been properly accountable under section 172 of the Companies Act to the whole range of a company's stakeholders, and whether they have considered the long-term consequences of their decisions.

Proposed Guidance on the Strategic Report

We're now seeing this focus coming through very clearly in the FRC's recent consultation on updating its *Guidance on the Strategic Report*. Although the regulations have always been clear that the purpose of the strategic report is "…to inform members of the company and help them assess how the directors have performed their duty under section 172", this has rarely been addressed directly – users of reports are expected to form their own view on this from the overall content of the report.

The FRC's proposals would change this by encouraging a number of specific new content elements for strategic reports. In particular they propose:

"An entity could set out who it considers its major stakeholders to be, how an entity engages with those stakeholders and how the interests of major stakeholder groups and the matters set out in section 172 were taken into account when making significant strategic decisions in the period." [Draft Guidance on the Strategic Report, paragraph 7.10]

"An entity could describe how it develops and maintains its relationships with its key stakeholders. This could include the regular interactions it has with them, how it communicates with them and how regard is had to their interests in key decisions." [Draft Guidance on the Strategic Report, paragraph 7.18]

These are only proposals for now and may change before the revised Guidance is finalised, but the direction from the regulators is clear and has been strongly reinforced in the Government's recent response to last year's Green Paper on governance reform.

Duty to promote the success of the company

(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to –

(a) the likely consequences of any decision in the long term;

(b) the interests of the company's employees;

(c) the need to foster the company's business relationships with suppliers, customers and others;

(d) the impact of the company's operations on the community and the environment;

(e) the desirability of the company maintaining a reputation for high standards of business conduct; and

(f) the need to act fairly as between members of the company.

[Companies Act 2006 section 172 (1)]

The regulatory push *continued*

Stakeholder reporting

Our survey showed that, as we expected, both companies and directors and investors were happy that annual reports show boards to be fully aware of their business's key stakeholders (70% of both groups agreeing or strongly agreeing with this).

There was less confidence in whether reports show that stakeholders are taken into account in decision-making or that they are appropriately engaged with – only between 40% and 50% across all respondents agreed or strongly agreed.

We also asked whether reports should focus more in future on the impact of businesses on stakeholders, and vice versa. Responses were very split on both of these questions among both companies and directors and investors, although 30% of investors strongly agreed.

A focus on all "stakeholders" generally makes a report less useful to the shareholder unless it tells us something about the value driving metrics – customer / supplier engagement, regulation, staff retention / motivation etc. Getting the balance right when communicating with shareholders is key."

Investor comment in our survey

Non-financial reporting regulations

The *Guidance on the Strategic Report* is also being updated to reflect the introduction of the new non-financial reporting regulations, and we also see these as an important driver of a new level of accountability.

The new regulations have a lot in common with the strategic report requirements, but they also contain a notable shift of emphasis. The strategic report is, first and foremost, about a company's commercial strategy and how it plans to deliver on it, but the non-financial reporting regulations are primarily about how the business affects its most relevant stakeholders . While they both require information on environmental matters, employees, social matters and respect for human rights, only the non-financial reporting regulations specifically focus on the impact of a company's activities, including a description of its business relationships, products and services which are likely to cause adverse impacts for its principal risks – something not present in the strategic report requirements for risk reporting.

We believe this will drive reporting change because of the choices that boards will need to make if they are to implement the new regulations in a way that's consistent with their duties to stakeholders under section 172.

As companies have begun to consider the new regulations, there has been considerable discussion about whether a company should report on its activities in relation to all its stakeholders, or whether the requirements should be seen through an 'enlightened shareholder value' lens. This would mean that only information on stakeholder issues of material relevance to the delivery of the company's strategy needs to be included in the annual report.

The new regulations state that information need only be included in the non-financial reporting statement "to the extent necessary for an understanding of the company's development, performance and position and the impact of its activity". It is our view that there is clearly a judgement to be made – this is not a case of a blanket requirement.

However, even accepting this in principle, boards could still take two different approaches to the new reporting:

- Boards could take a 'risk factor' style approach and give high-level information about every area that could conceivably be of relevance to stakeholders – it is always possible to argue that these will be necessary for someone.
- Or boards could choose to exercise judgement as to which stakeholder groups and issues really are material to the delivery of the company's strategy, using an enlightened shareholder value approach.

In the past, we would have expected many boards to take the first option, playing it safe, and treating the new regulations as a 'checklist' of areas to cover. But this is not real accountability. In the context of society's shifting expectations, the governance debate and the direction that the regulators are setting, we believe that more boards will want to look seriously at how best to address these issues in practice, rather than instinctively take the easy option.

Judgement at the heart of accountability

The first step, if the new regulations are to drive meaningful reporting with real information value, is for boards to identify the stakeholders whose interests need to be addressed, including how they could affect the company's risks and delivery of its strategy.

To put this in accountability terms, a company's non-financial reporting should reflect how its strategy and/or activities create accountability to stakeholders in a way that also affects the interest of the shareholders (to whom the directors are primarily accountable). Of course, companies can decide to disclose more about their activities but, if they do, that reporting would properly be a matter for a separate corporate social responsibility or sustainability report rather than the non-financial information in the annual report.

The desired outcome, far from being a list of policies relating to every possible stakeholder, is considered and responsible reporting that gives real insight into the opportunities and risks associated with the most important strategic decisions that boards make.

Boards should already be asking of themselves some potentially difficult questions about the impact on stakeholders and on the long-term success of the company. Of course, they will sometimes make decisions that have negative consequences for some stakeholders because there are often many different sets of interests to balance. That does not change. But what does change is the need to address these decisions in the annual report in a way that reflects the new expectations of accountability. This will involve for many boards a shift of mindset, but it needs to be done and now is the time.

Board decisions that could be relevant to reporting under the new regulations include:

- Mergers & acquisitions
- Outsourcing arrangements
- Doing business (e.g. entering into contracts) in countries with lower standards of governance
- Restructuring
- Rationalisation of product ranges
- IT and personal data handling arrangements

Disclosures boards will need to consider in relation to their decisions:

- Impacts on relevant stakeholders
- Policies in the relevant areas, their impacts and any due diligence carried out
- The business relationships, products and services which are likely to cause adverse impacts in relation to the relevant principal risks

Risk management and the stakeholder agenda

A new context

The governance reform debate and particularly the renewed focus on directors' responsibilities under section 172 of the Companies Act to take into account a whole range of stakeholders could have a significant effect on many boards' analysis of risk.

Add to this the new non-financial reporting regulations, with their requirement to disclose more about the risks across a range of areas relevant to stakeholders, from the environment to human rights, and it's clear that boards would do well to look again at how they are handling these issues.

Impact on risk

Depending on the circumstances, this new focus could change a board's perspective on existing risks or generate new risks.

Risks connected with the most obvious stakeholder groups, such as loss of customers, suppliers, or employees are likely to have been identified and managed already. But there are likely to be new angles on some existing risks too. For instance many boards identify the risk of M&A activity not being as successful as planned but how many consider the risk around the impact on a community that previously relied on the acquired business?

It's precisely these risks to a company's reputation that could change most as a result of the focus on stakeholders. In the past the community affected by M&A activity might have hit the local headlines but often not much more. As several organisations have found recently, the reach and speed of today's communications – particularly on social media – mean that what would in the past have been a relatively manageable issue can quickly lead to significant financial implications as well as sustained reputational damage.

Addressing the challenge

So what can boards do to address these issues?

First, re-assess risks in the new context – as we've seen, it's important to think both about what changes in relation to existing risks and about what new ones might be created. This could mean gathering views from a wider group than is currently involved, and potentially getting perspectives from outside the business. It could also mean revisiting the board's view on risk appetite.

Second, and equally important, recognise where new mitigating actions and plans are needed to reflect the changed circumstances. Emerging issues that drive reputational risks certainly need solid contingency planning, but when the risk has already crystallised much of the damage has already been done. Demonstrating a business's positive culture and values day in day out through its actions and its communications *before* a crisis happens can be the best protection when trouble strikes.

Reporting on the longer-term

Why it matters

The need to consider the likely consequences of board decisions in the long-term is an intrinsic part of the ‘enlightened shareholder value’ model set out in section 172 of the Companies Act. This reflects the fact that many stakeholders have a long-term interest in the success of companies, and contrasts with the focus on short-term profitability which has traditionally been seen as the priority for many investors.

Employees, for example, are looking for long-term job satisfaction and security, pensioners need to be confident that employers will be able to meet their obligations when they retire, and many civil society groups want to know that companies are taking issues like climate change and the depletion of fossil fuels into account appropriately.

These aren’t simply issues for special-interest groups. Many investors also want to know whether companies are sustainable businesses and good long-term investment propositions, and they are increasingly taking steps to encourage companies to go beyond the relatively short-term time horizons that are addressed in most annual reports.

The ‘viability statement’ has helped to pull this into focus. If a company explains in its viability disclosures that it has a strategic plan looking three or five years ahead, how does this compare with the time horizons discussed elsewhere in the annual report? In reality, as we discussed on pages 6 and 7 our review found that disclosures around strategy and risk rarely go beyond two years and many don’t even extend that far.

Investment Association Guidance

Against this background, the Investment Association (‘IA’) recently issued its *Long Term Reporting Guidance*, developing one of the principles outlined in its *Productivity Action Plan* back in 2016. The IA’s overall purpose is to consider how the investment industry can support companies and boards better in making decisions for the longer-term (including for instance investing in plant and equipment, training and research and development activities) and it undertakes in the Action Plan to look at how aspects of the investment chain can change to help with this.

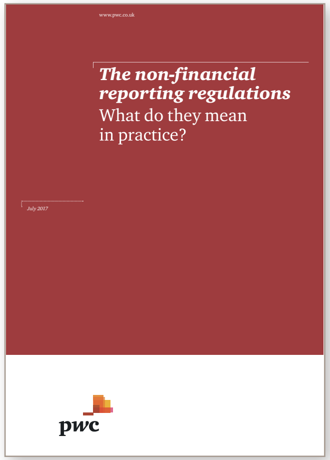
The *Long Term Reporting Guidance* focuses on how companies can help themselves get support for their decisions by giving better information on their long-term prospects. It specifically calls for companies to “strive to provide insight into the significant strategic issues, as well as the principal risks … over the next three to five years – although [the IA’s] members would prefer longer time horizons where possible”[7]. It also sets out specific disclosures in a number of the areas that are important to a company’s longer-term prospects, including the drivers of its productivity, capital management, and ESG and human capital matters, and suggests a number of metrics that companies should consider providing.

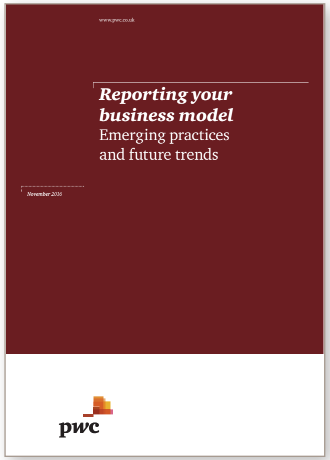
We think that the IA’s Guidance has the potential to help companies make the shift in their reporting mindset that we called for earlier if they focus on showing how the areas that the IA suggests are relevant to the (long-term) delivery of their strategy. As always, a tick-box approach is likely to be much less useful.

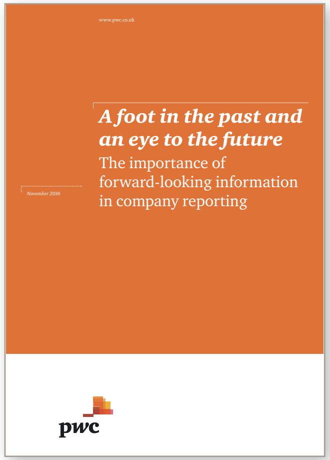
The IA will begin to monitor and report on how companies are responding to the new Guidance through its proxy adviser service IVIS from September 2017 year-ends onwards.

7 Investment Association Long Term Reporting Guidance paragraph 9.

Further information & contacts







Contacts

For further information on any of the themes discussed within this report, please contact us using the details below.

Mark O'Sullivan

T: +44 (0) 20 7804 3459
E: mark.j.osullivan@pwc.com
@MsullsMark

John Patterson

T: +44 (0) 1223 552 413
E: john.t.patterson@pwc.com