ICAEW AUDIT & ASSURANCE FACULTY

Audit insights: corporate reporting

Improving annual reports of listed companies

Foreword

Audit is a public interest activity. Reports from external auditors build confidence in financial statements and give credibility to companies and comfort to their stakeholders. Companies also benefit from the insight that auditors have into business processes and the wider market environment.

External auditors see many issues during their work in auditing the financial statements of a company, including issues related to its results, assets and liabilities, people, processes and the market it operates in. These issues have a broader application and are of wider interest than the financial statements alone. *Audit insights* is an opportunity for external auditors to share some of their knowledge of specific sectors or corporate issues with the public, capturing more value for a wider audience. Shared insights and observations have been brought together in an environment which protects client confidentiality to produce this document.

Audit insights: corporate reporting – improving annual reports of listed companies is the work of a group of external auditors from all the leading firms in the UK, with many years' combined experience of auditing and reporting. Representatives of the following firms formed the working group: BDO, Deloitte, EY, Grant Thornton, KPMG, Mazars, and PwC.

Shareholders are entitled to information about the financial performance and state of affairs of the listed company in which they have invested and its strategy for future growth. The company annual report, including the financial statements, is one important source of that information. Analysts' and media commentaries and half-yearly reports are others. But it is the annual report that shareholders and other stakeholders still see as the most important tool to better understand a company because it contains a wealth of valuable financial and non-financial information about its business model, strategy and objectives, risk, performance and rewards.

The adoption of International Financial Reporting Standards (IFRS) in more than 100 countries has resulted in greater comparability of financial statements. But it has also raised concerns about increased complexity and information overload in the current reporting within financial statements. There is an opportunity to reduce some of this complexity by improving the 'front half' of the annual report, which is the focus of the report, although some of the principles outlined could equally be applied to the financial statements.

The Financial Reporting Council's (FRC) Clear & Concise initiative has provided preparers of annual reports with ideas for how disclosures might look, with relevant information and factors to consider when planning the annual report process. We welcome the FRC's year-end advice letter to audit committee chairs and its report *Clear & Concise: Developments in narrative reporting* to assist companies in preparing their annual reports, and the contribution to the debate by the Federation of European Accountants with its paper on the future of corporate reporting. However, many preparers still err on the side of caution and continue to disclose voluminous amounts of information rather than risk facing regulatory criticism.

Company reports are too long but there does not seem to be enough momentum to do anything about it. The auditor's pivotal role in independently auditing the financial statements and reviewing other information in the annual report means that they are in a valuable position to offer insights into annual reporting as a whole. In this *Audit insights* report, which builds on the short guide for corporate reporting that we published in December 2015, we offer recommendations for improvements in seven important aspects of reporting that will provide better information to stakeholders, enabling them to hold companies to account and potentially opening up greater access to capital for some companies.

Executive summary

The annual report matters because it provides key information that enables a range of stakeholders (including shareholders, potential investors, regulators and the public) to understand a company's financial performance, its business model, strategy for future growth and key risks. Given the important role that annual reports play in the corporate reporting framework, it is essential that they are relevant and present a coherent and balanced picture of the business and its prospects.

This publication examines seven important areas of annual reporting and makes recommendations that will improve the quality of corporate information provided. These recommendations offer practical guidance for those involved with annual reports.

We believe that the annual report has become a compendium of different reporting requirements that have been placed on companies. There has been a steady increase in the rules and regulations for disclosure in response to crises and demands for more corporate transparency from government, regulators and investors. Individual initiatives have value but together they have been become increasingly onerous, which can obscure the vital function of holding companies to account. Consequently the size of annual reports has ballooned with companies publishing information that may seem overly complicated and indigestible. The annual reports of high street banks can weigh in at nearly 600 pages[1]. Although these are a minority, it is common to find annual reports running up to 200 pages long. The criticism about the tsunami of information raises questions over whether annual reports are in danger of not being fit for purpose.

We want to encourage improved reporting so that companies give an insightful and understandable picture of their corporate performance to a wider stakeholder audience. The annual report needs to be easy to navigate so that users can drill down from the high-level information to find more detail in the areas that interest them. Boards need to recognise that the public interest requires that they are open and informative about how companies perform, whether well or badly. The annual report should provide an opportunity for companies to communicate information that society requires rather than a compliance-driven, box-ticking exercise. Preparers need to be braver and produce annual reports that only provide meaningful and relevant information which tells a coherent story.

The adoption of IFRS has made European-listed companies' financial statements more transparent and comparable and enabled EU capital markets to operate more efficiently. A clear majority of investors has made it clear that they value IFRS reporting. Consequently the scope of this report does not revisit IFRS. Our focus is on the length and complexity of material in the front half of the annual report to ensure that it remains useful for investors and other stakeholders.

To achieve this regulators and standard-setters need to play an active and liberating role. We endorse the FRC's Clear & Concise initiative and the work of the Financial Reporting Lab in encouraging innovation. But the FRC needs to support initiatives that allow information to be published outside the annual report – for example, on the company's website. This will empower risk-averse preparers to be more challenging and confident in

1 'Bank annual reports too long or complex', FT, 8 June 2014.

only including information that is meaningful to a company's specific circumstances. There is real opportunity for digital innovation in how information is provided and preparers need to be supported to be more creative.

Auditors should read the annual report with a user's mindset to determine whether it is fair, balanced and understandable. Where an explanation is inadequate or misleading, they should challenge preparers to improve the reporting.

If investors are to make well-informed decisions then they need to encourage the provision of clear and relevant information in the annual report. We believe that for the efficient running of capital markets there is a need for investor dialogue with the companies they invest in. Such a two-way stewardship dialogue would put companies in a stronger position to understand what they need to disclose to better inform their investors.

In addition, we think that the time has come for a radical rethink of annual reporting if it is to genuinely meet the *UK Corporate Governance Code* (the Code) expectation of being fair, balanced and understandable. ICAEW's Audit and Assurance Faculty hopes that this report will help to reignite the debate over how corporate reporting needs to change to improve communication and accountability.

To improve the annual report

- Preparers should only provide meaningful and relevant information that will produce a coherent business story.
- We encourage the FRC as regulator to be more radical with its Clear & Concise initiative. It should play a liberating role by providing more examples of good practice and reassessing the implementation of regulations to reduce the volume of disclosures and make them more relevant.
- Auditors should help companies navigate the complexities of current reporting with best-practice advice and by producing an informative audit report.
- Investors need to play a more active role to influence what is disclosed.

Is everything in the report material?

Some annual reports are clear and tell a good story. However, in our view too many annual reports are too long and too complex and as a result they are not easily understood.

CFA UK has conducted a survey on financial reporting and analysis. The resulting themes were clear and best summarised by the response: 'Risks and uncertainties has [sic] become a general legal tick-box exercise to note every risk and worst case rather than [a] more bespoke review of the firm's real current risks and smaller range of impacts'. When asked whether the majority of financial reports contain large amounts of irrelevant information, only 22% disagreed.

But this problem has not developed by accident. We believe there are three reasons why annual reports are often too long and too complex. The first is that regulation continues apace with ever more disclosures required – not just in the back half but also the front half of annual reports. The obvious question is whether all that information is required. Should, for example, a listed investment trust be required to disclose its global greenhouse gas emissions in its annual report or can this be disclosed in a separate sustainability report?

Secondly, while regulators have a very important role to play in terms of quality, more should be done to help preparers. Does the current environment mean that too often information is included simply because it is perceived that a regulator would like it rather than an accounting standard requiring it? With this in mind we welcome the FRC's recent research into the quality of reporting by smaller listed companies where 'the general consensus from all stakeholders we spoke to was that they would welcome reduced disclosure requirements for smaller companies'. This could easily be applied to larger companies.

Auditors also have a role to play in this area. Too often we require information to be included in annual reports based on regulatory perception rather than an actual requirement, or as a result of our direct experience of regulatory reviews (which helps to shape that perception).

Thirdly, the way annual reports are currently presented is old-fashioned. Is paper still needed? We should be thinking about how technology can enable easier access to what is important rather than simply using the annual report as a repository for all company-related matters. For example, is it really necessary to prepare one set of accounts for shareholders (with images) and another for Companies House (with no images)? Doing things differently might be constrained by current law or regulation, which needs to be reviewed – it is unlikely to be restricted by technology.

One of the reasons iPhones became so popular was their ease of use. At one point Google revealed there were 50 times more searches originating from the iPhone than any other mobile handset. If something is easy to use then people use it – and they will enjoy using it.

A further issue for companies is that producing an annual report in 'silos', with limited interaction between those responsible for the front-half narrative and for financial statements, is no longer a practical policy. If an annual report is not produced in a coordinated manner, the finished product stands little chance of addressing the problems we have highlighted and also meeting the Code principle that it should be fair, balanced and understandable. Integrated thinking and action is essential.

Recommendations

Preparers

- Invest time in your annual reports. They should tell a complete story and make sense.
- Fair, balanced and understandable is one thing but 'does the public understand it?' is also a good benchmark. Don't use technical jargon simply because you feel an accounting standard/regulation requires it. It is of little value if nobody understands.
- Engage with your auditors and regulators in constructive debate on what needs to change.
- Where there are exemptions from disclosing information that you think is not meaningful, make full use of them – but do not misuse them (exemptions allowing companies to only disclose material subsidiaries have recently been removed because filing the names of all subsidiaries at Companies House was widely being ignored).
- Where information is only useful for some (or only read by some) can it be communicated outside the annual report? For example, could detailed corporate social responsibility information that is not relevant for an understanding of a company's performance or strategy be presented separately, such as on a company's website?
- Be brave and ask yourself whether anything can be left out. Is it relevant or is information being included because it always has been or because you feel it must?

Auditors

- Rebut the view as quoted in the CFA's report that 'auditors are to blame for not focussing more on quality over quantity' – less is very often more. When advising companies, go further than saying which disclosures are missing. If there is too much information included, highlight what should be excluded.
- Share best practice with companies.
- Work constructively with the regulator to achieve consensus on what information should be in and what should not.

Regulators

- Given that the format is prescribed by various rules, standards and laws, these should be reviewed to make sure they are informative and understandable. For example, directors' reports could be disclosed on a company's website.
- Assess whether everything that is in an annual report actually needs to be there.
- Share best practice and help to break the perception that information must be included even if it is not required.
- Is the concept of an annual report itself too restrictive? Encourage constructive debate on what users want as well as how they want it.

Investors

- Join the debate on what information you really need and how you want to receive it – often the inclusion of additional disclosure is based on the belief that investors want more information, which may not be the case if that information is not meaningful.

Are performance measures credible?

One area of tension in corporate reporting is the prevalent use of non-GAAP (Generally Accepted Accounting Principles) measures in the front half of annual reports.

These include underlying profit, free cash flow, like-for-like sales, and earnings before interest, taxes, depreciation and amortisation (EBITDA). These non-GAAP or alternative performance measures are part of the financial reporting lexicon. Like common law, their status comes from precedent and familiarity. But do they help the user by focusing on core business performance or distort the picture by ignoring real gains and losses?

Some of the problems that have been identified in the use of non-GAAP measures include:

- a lack of comparability between entities;
- the fact that they are often given undue prominence and are sometimes considered to be more important than GAAP measures;
- a lack of understanding over what they actually measure, how they have been arrived at and how they tie in with the information in the financial statements;
- a perception that they have been audited; and
- the apparent exclusion or categorisation as exceptional only of debits and losses.

The lack of transparency and consistency over how they are calculated makes them vulnerable to accusations of bias or misinterpretation. One response to these criticisms would be for industry bodies to develop common templates for widely adopted measures (such as like-for-like sales in the retail industry) so that users can be reasonably assured of consistency between similar businesses. However, this approach would have to be applied with care as even apparently similar businesses in the same industry can have significantly different business models or structures that validly result in the use of different performance measures.

Various standard-setting bodies are now taking action to deliver better practice in the use of non-GAAP measures.

FRC

Drawing on the Code principle that the annual report should be fair, balanced and understandable, the FRC has said that the following key points should be considered in arriving at the non-GAAP measure of 'underlying profit'.

- The approach to identifying 'exceptional' items should be even-handed between gains and losses, clearly disclosed and applied consistently from one year to the next.
- Alternative performance measures intended to be consistent with IFRS principles should be distinguished from those which are not.
- Gains and losses should not be 'netted off'.
- Caution should be applied in concluding that recurring material items are not part of a company's underlying profit.
- Tax and cash flows relating to exceptional items should be presented clearly and explained.
- Clear disclosure of underlying profit measures is important when such figures are used in determining executive remuneration or compliance with loan covenants.

ESMA

The European Securities and Markets Authority (ESMA) has chosen to issue its own guidelines on what it terms alternative performance measures. These guidelines, which will apply to information issued from 3 July 2016, are mostly consistent with existing best practice in stating that alternative performance measures should:

- be given meaningful labels and defined in a clear and readable way;
- be reconciled to the most directly reconcilable line item, subtotal or total from the financial statements, with material reconciling items identified and explained;
- be explained to allow users to understand their relevance and reliability;
- not be displayed with more prominence, emphasis or authority than measures directly stemming from financial statements; and
- be consistent over time and accompanied by comparatives.

Are performance measures credible?

continued

Although ESMA guidelines do not cover financial statements, they will cover all 'regulated information' including the narrative section of the annual report. This includes information disclosed under Article 6 of the Market Abuse Directive and captures, for example, analyst presentations that a company is required to provide to the market. Issuers (eg, listed companies in the UK) and competent authorities (eg, the FRC) will be required to make every effort to comply.

IASB

ESMA excluded financial statements from the scope of its guidelines in response to feedback that the guidelines might otherwise stray into the territory of the standard-setter. The standard-setter in question, the International Accounting Standards Board (IASB), has started to look at the issue of non-GAAP measures as part of its broad-ranging Disclosure Initiative. To date this has resulted in piecemeal amendments to IAS 1 *Presentation of Financial Statements* on the use of subtotals to the balance sheet or income statement.

Looking ahead, the IASB would like to introduce more rigour to non-GAAP measures. IASB Chairman Hans Hoogervost has said that while the IASB has no ambition to stamp out the use of non-GAAP measures, it does think that investors would benefit from 'greater discipline' in their presentation.

While the involvement of multiple bodies may be frustrating, we welcome the level of consistency throughout and the clear direction of travel. Although no one is seeking to ban the use of non-GAAP measures, there is an increasing push to use them honestly (balance between the good news and the bad, apply consistency between periods) and clearly (define the terms, reconcile back to GAAP). This trend is likely to continue and companies that fail to apply good practice are likely to face regulatory scrutiny.

Recommendations

Preparers

- Look to the spirit of the individual guidance as well as the letter. At heart it is only asking companies to be honest, balanced and transparent in how they use non-GAAP measures.
- Bear in mind metrics that are used elsewhere in the business – notably for determining bonus payments. Are these the same as the non-GAAP measures presented to investors? If not, why not?
- Do not overlook the extended scope of the upcoming ESMA guidelines; they are enforceable. Companies may not have previously given much thought to the question of whether the information issued falls within the scope of the Market Abuse Directive, but going forward this will make a difference.

Auditors

- Ensure that the non-GAAP measure is being reported in a way that is honest, balanced and transparent, and does not distort the underlying results of the company.

Regulators

- There needs to be a debate about the merits of developing a common comprehensive framework that will cover non-GAAP measures. In the absence of current global standard-setting, regulators have acted to manage practice in their own jurisdictions. But in a globalised world a level playing field must be preferable to a variety of national requirements.

Investors

- Use the reconciliation that companies provide between GAAP and non-GAAP measures as a source of information, and not just an arithmetic proof. The questions you should be asking yourselves include: 'Would you have excluded that cost from underlying profit?' and 'Do you understand why you're being given one number but the directors are assessed against another?'. If not, maybe there are questions to be asked of the company.

Is tax reporting understandable?

It is clear from the level of public debate that there is an increased focus on tax transparency.

From what we see some boards are taking transparency very seriously, with increased disclosure of what taxes are paid and where, and we support this trend where it plays a meaningful role in explaining a company's approach to taxation. But too many companies either continue to overwhelm users with tax detail that they find difficult to understand or are reluctant to disclose more information than is necessary. Where information is disclosed, the language used is shrouded in technical tax and accounting jargon that is not well understood by the public.

Tax transparency is a difficult challenge for corporate reporting. It is an emotive subject with a high level of public and political interest, fuelled by statements in the media that large corporates have lost their moral compass through aggressive tax planning. Customers have demonstrated they will change their buying choices if they believe a business is not paying its fair tax. Many employees also want to know that they are working for an organisation with a strong ethical stance towards social responsibility, including paying fair amounts of tax, while investors want to understand the reputational and tax risks their investments face. The demand for greater tax transparency and, in particular, for multinational entities such as multinational companies to publicly disclose their country-by-country (CbC) tax data is strong. There is also a perception that it will help prevent aggressive tax avoidance.

In our experience most multinational companies are open to disclose more tax information where it is not competitively damaging. However, the extent of transparency – what should be disclosed and to whom – is difficult to judge. In recent years the international and EU taxation landscape has changed dramatically. There are already requirements for financial institutions and extractive industries to enhance their tax transparency. Two important examples are the:

(a) Capital Requirements Directive IV (CRD IV) which requires that credit institutions and investment firms must disclose specified CbC data (eg, turnover, number of employees, tax paid) in an annex to the annual financial statements that will be included within the scope of the audit; and

(b) Extractive Industries Transparency Initiative (EITI) which the UK Government has signed and which requires full disclosure of taxes and other payments made by oil, gas and mining companies to governments, though this reporting is not within the financial statements.

Both the OECD with its Base Erosion and Profit Shifting (BEPS) Action Plan and the EU through its consultation on corporate tax transparency have demonstrated a commitment to increasing the level of tax transparency through enhanced reporting. The UK Government is one of the strongest voices behind OECD's BEPS project and also an international leader in implementing automatic exchange of information agreements. It is anticipated that the UK will publish legislation to adopt the CbC tax data reporting requirements of the EU Directives for all multinational entities with a turnover above €750m (£580.58m)[2] from 2016.

The challenge for preparers

While enhanced tax transparency reporting within the annual report appears inevitable for large companies, preparers need to consider whether disclosure of CbC information should also be best practice for all multinationals including smaller non-public entities.

2 Exchange rate: 1 EUR = 0.7741 GBP, 15/2/16.

Some companies seek to disclose the minimum level of information, limiting themselves to what is required by law and accounting standards. However, the highest quality tax disclosures are those where the board has also considered what is important to its key stakeholders and made appropriate disclosures to aid their understanding.

Whether disclosing on the company's website or in the annual report as a whole, including the financial statements, we believe that more meaningful tax disclosures are necessary to give investors and other stakeholders a much better understanding of a company's tax approach.

However, it is important that the published information is clear to avoid the risk of misinterpretation, especially if the reader does not have sufficient knowledge of the tax environments for each country in which the multinational operates. For example, many countries provide special incentives where a company undertakes significant capital investment in infrastructure or plant and machinery. The tax paid in a year of significant investment may be reduced as a result of these incentives designed by governments to encourage investment for the mutual benefit of the company and the local economy.

Recommendations

Preparers

- Review the adequacy of your taxation disclosures, particularly within the strategic report. Ensure that stakeholders can fairly assess the taxation risks facing your business, the board's approach to tax planning and its governance approach to tax, together with an overview of how this has translated to tax payments made to the jurisdictions in which your group operates. This narrative explanation will create a platform from which the board can be held accountable.
- Consider the best place to include this information and whether any of it, regulations permitting, could safely be included on the company's website with short summary narratives in the annual report.
- In determining the adequacy of disclosures, consider the following key questions.
  - Have you adequately explained significant variances in the effective tax rate between countries, particularly where the effective tax rate differs notably from the base rate?
  - Are there any apparent contradictions between the CbC data presented in the financial statements and the narrative description of your tax approach? Such contradictions should be resolved through additional narrative disclosure if necessary.
  - Will stakeholders and external commentators fairly understand your approach to tax planning and tax governance?

Auditors

- Read the tax narrative with a stakeholder's mindset and consider whether the narrative description is sufficient to enable you to accurately interpret, for example, the CbC data in line with the multinational's approach to tax planning and governance. Where the narrative explanation is inadequate or misleading, challenge the preparers to make improvements.

Regulators

- Although more tax transparency is welcome, there is a question over how it should best be communicated. Consider whether the annual report is the proper place to provide CbC data and other information on a company's taxation policy. CbC data with narrative explanations of the taxation approach could be published instead on a company's website.

Investors

- Take care to read the narrative disclosures and tax data together to ensure you properly understand the company's approach to taxation. However, where a company is evasive or contradictory in its narrative disclosures then it is of course reasonable to challenge them.

Does the audit committee report on key issues?

Audit committee reports have changed significantly in the last two years as a result of measures introduced in the wake of the financial crisis to enhance corporate governance, stewardship and reporting.

These have included strengthening the Code to encourage more useful disclosures, such as confirmation by the board that the entire annual report and accounts are fair, balanced and understandable and the significant issues that the audit committee has considered in relation to the financial statements.

We have welcomed these enhanced audit committee reports, and the feedback we have received shows that many investors also value them. The reports add significantly to users' understanding of companies by providing greater insight, when well written, into the considerations, debates and conclusions of the audit committee. As a consequence of the enhanced reporting requirements we see audit committees being far more diligent and granular in their considerations. In our view this will only continue; the 2014 changes to the Code that require the board to make specific statements concerning its risk assessment and the viability of the company will no doubt result in a heavier focus by the audit committee in this area. Additionally, with the implementation of the EU audit reform legislation the spotlight on audit committees is only going to get brighter in the coming years.

The role of the audit committee is to support the board in ensuring proper risk management, internal control, and external audit arrangements. Provision C.3.8 of the Code states that 'a separate section of the annual report should describe the work of the committee in discharging its responsibilities'. This deliberately puts the focus on the audit committee and gives it an authority that it might otherwise lack.[3] The audit committee report is one of the company's key communications to shareholders and provides the audit committee with an opportunity to share what it has done in its oversight role to discharge its responsibilities.

But regulations and reporting can only go so far in driving good governance. The essence should be engagement, dialogue and challenge. This applies both within the audit committee and between the audit committee and other stakeholders including executive management, the external auditor and even investors. However, it is important to remember that not all investors (eg, private investors) can enter into dialogue. The greater transparency offered in audit committee reports will provide opportunities for this dialogue and engagement to occur. An insightful audit committee report will also create the basis for a level playing field and should provide comfort to all investors that the audit committee is exercising its oversight role effectively.

Currently the degree of oversight and challenge posed by the audit committee of management and the auditor is not as clearly communicated in the audit committee's report as it could be – this is not to say this debate and challenge does not occur within the committee: it often does. But the user is not given any insight as to whether it occurs or what areas it concerns. More transparent reporting by audit committees will provide investors with greater insight into key areas of focus, and more accountability about how the committee is carrying out its impartial oversight role.

3 *Guidance on Audit Committees,* FRC, para 1.5.

The language used in the audit committee report is often a description of process(es) rather than activity and its outcome. The use of passive language (eg, 'The audit committee approves … or reviews … ') also makes disclosure generic or boilerplate and runs the risk of being repeated year on year. Reports should be insightful and specific to the year under review and provide an engaging account of the audit committee's activities, with emphasis on key issues and how they are dealt with.

Recommendations

Preparers

- Take personal responsibility to write your own report (especially the introductory committee chairman's letter, where one exists). Such reports will show more accountability and will usually be more impactful.
- 'Continue the story' – it is important to report on any actions the audit committee committed to undertake in the previous year (eg, on areas of focus). State how these were progressed during the year and include a forward-looking section to provide insight into emerging issues or areas of focus for the year ahead.
- Use clear language to describe what the committee **did** during the year to address the issues under its remit and the issues it faced, debated and challenged, ('In October, the committee reviewed … As part of this review, it debated … and challenged ... '), as opposed to stating what the committee **does** in general in line with its terms of reference.
- Ensure the disclosure on significant issues tells the user something about the business rather than only the accounting judgement. For example, if the committee considered impairment as an issue, what part of the business was it really concerned about and why?

For best practice for audit committees, refer to the appendix.

Auditors

- Ensure that between the audit committee's report, the auditor's report and the disclosure on significant estimates and judgements it is clear what the key issues are, the judgement applied and conclusions reached. It is not necessary to have perfect symmetry between these three disclosures, but the auditor and the audit committee should be able to explain the reasons for any differences.

Regulators

- Take time to see how companies continually develop their reports in light of feedback they receive.
- In the interest of more relevant and concise reporting, endeavour to provide clarity on which required audit committee disclosures can be published elsewhere eg, on the company's website. This would be especially useful for those disclosures which do not change year on year, like roles and responsibilities.

Investors

- Use the information disclosed to engage with companies and the audit committee to gain further insight both into the committee's workings as well as the issues in hand. This feedback loop should lead to improvements in disclosure over time.

Is the audit report providing insights?

Extended audit reports have provided an opportunity to lift the lid on the black box of audit. The need to disclose information on the scope, materiality and areas of focus in audits has greatly increased the quality of debate auditors have with management, audit committees and boards.

In the best companies this is creating a shared sense of responsibility to accurately reflect the continuum of disclosures between risk reporting, the audit committee's considerations and auditors' areas of focus.

To a large extent the FRC has been world leading in this area, moving ahead of the international standard-setter and other national standard-setters in not only implementing extended audit reports some time ago but also being more extensive about what is required.

The extended audit report not only provides the key audit risks of material misstatement but also insight, in more layman's terms, into complex accounting treatments and transactional issues. In this sense it can be a tool for cutting through much of the complexity and clutter that is often present in today's annual reports, particularly those for large, global companies, as it directs the user to the areas they might want to focus on in the financial statements. This is particularly helpful to non-institutional, private shareholders who, without the benefit of intermediaries to interpret the information for them, rely on the audit report to help break down the vast amount of information provided.

The extended audit report also provides insight into the scoping and materiality decisions made in the audit. An explanation of the materiality applied helps the user to better understand one of the most important inputs into the audit process and the thought process behind its determination. This helps to put context around the audit and should reduce the expectation gap between what an audit does and does not involve.

The information given on the scope of the audit is also useful because it focuses on how the audit evidence was obtained through the work of both group and other auditors and the extent to which audit work has 'covered' the account balances. It also provides insight into where the senior members of audit teams spent their time, thus highlighting what might be considered the more risky and/or complex areas.

While very valuable on a standalone basis, the audit report is now also an integral part of the annual report as a whole, complementing and linking to the directors' and audit committees' articulation of risks and other disclosures. For instance, if non-GAAP information is presented in the annual report, the audit report can increase the user's understanding if the non-GAAP presentation is one of the areas of focus. In this respect, the audit report has become more relevant and has moved with the times by being part of more open and transparent annual reports.

All of this is great news but only if extended audit reports are fully embraced and made as meaningful and useful as they can be. In our experience, although auditors have largely embraced the changes, there are still a number of examples where boilerplate, less specific or meaningful descriptions are used and there is plenty of room for continued improvement.

Recommendations

Auditors

- A good extended audit report should have the following qualities.
  - The structure should be logical, flow well and be easy to follow – tables and graphics can be helpful.
  - It should tell the complete story of the audit: what the auditor did, where they did it, and, critically, **why** they did it.
  - Descriptions of risks and responses should be client specific, detailed and focused on micro and macro events that have impacted the company and, as a result, the audit.
  - Although it is unlikely that the auditor's assessment of risks will be significantly different each year, the report shouldn't be blindly rolled forward. Keep the report 'fresh' wherever possible and consider highlighting and explaining risks or approaches that are new.
  - The scoping section should be specific to the audit and consistent with where the greatest risks of material misstatement were identified. It is helpful to outline the structure of the company eg, geographic locations and whether a shared services centre is used. Focus on where the senior members of the audit team spent their time and what was important to them.
  - The description of materiality should explain the rationale for the benchmark used, any adjustments made and the reasons for those adjustments.
- Think about the audit report in the same way the directors think about the annual report – is it 'fair, balanced and understandable'?
- Avoid leaving the reader with the hanging question of 'so what' when reading the auditor's response to the risks they have identified. Recent EU legislation will help because auditors will also be including the outcome of their audit work.

Preparers

- Challenge the auditor to make the audit reports as useful as they can by following these principles.
  - Don't be afraid of telling a complete story. If the company and the auditors had a differing view but through discussion came to common ground, this is an important story to tell in the audit report and demonstrates the openness of management and the company to other views.
  - Think about consistency with the company's own descriptions of risks and significant issues (including those in the report of the audit committee). Do the disclosures complement or contradict each other?
  - Make the audit report as readable and user friendly as possible, avoiding excessive jargon or overly technical descriptions.
  - Think about whether the audit report accurately reflects the conversations and communications between the auditor, the directors and audit committee.
- Audit committees should apply these same principles when discussing significant issues in audit committee reports.

Regulators

- Audit reports must reflect the individual circumstances of companies. Having issued general principles, see how auditors innovate and determine whether additional guidance or best practice are needed.

Investors

- Read audit reports – they can significantly increase your understanding of the risks that companies face. They can also cut through a lot of the complexity in the annual report by directing you to the key areas to focus on.

Does the remuneration report explain high pay?

If there is one section of the annual report that has grown in length and density over recent years it is the remuneration report. But is all this information helpful?

We have seen companies respond diligently to the level of public interest in this area, which has given rise to ever-growing detailed disclosure requirements. As a consequence we have now reached saturation point on the volume of remuneration data published. We need to consider whether all of this information is needed and, if it is, whether it would be better served by being placed outside the annual report.

Companies need to be clear about the structure of the report and especially concerning what information needs to be communicated at the beginning of the report. Many remuneration reports are developed in a way that ensures compliance with legislation rather than producing an effective and concise story that explains the links between key performance indicators (KPIs) and remuneration policies.

In the current climate of concern around directors' remuneration, it is instructive to know that it is now 21 years since the Greenbury Report of 1995 ushered the remuneration report into the reporting requirements of listed companies following public outrage over salary levels of certain executives, particularly in the privatised utilities. The latest refresh of the remuneration report came in 2013 and was arguably the most wide-ranging rewrite of the requirements since they were originally issued, adding a number of new disclosure requirements. Among the changes is the requirement for a statement of remuneration policy, where the company is required to set out its overall approach, including how it will remunerate directors and the level of flexibility built in to link performance with reward, and for this to be approved by shareholders at least every three years.

The remuneration report is ultimately there to enable a company to disclose the totality of remuneration paid to its directors in whatever form that may be (salary, bonus, options, long-term incentives, etc) and explain why the company's remuneration committee regards those amounts as appropriate (how they were set, what benchmarks were used, how incentive schemes operate, etc). However, these messages are often lost in the plethora of detail and the ever-increasing complexity of many remuneration schemes, all of which can be difficult to put across in plain English. With the addition of sundry disclosures, which have been deposited into the remuneration report by parliament, it has become a dumping ground for a wide variety of matters.

Balancing clarity and complexity

The annual statement at the start of the remuneration report provides a good opportunity for the board to set the tone on what follows and to focus users' attention on what matters. It should set out information about the major decisions on remuneration, substantial changes that have been made in the year, and the context in which those changes took place. The board may also want to highlight the discretion it has applied in the year and any stakeholder engagement it has been involved in.

The bulk of the detail is then built around the 'single total figure table'. This provides the amounts earned by or paid to directors, including salaries, fees, taxable benefits, bonus arrangements, long-term incentive plans and pensions. The table is designed to capture all and any forms of remuneration which all directors, including non-executives and those arriving or departing during the year, have received or could receive in the future for

their performance during that financial year. There is a risk that those looking at the table without considering supporting explanations may not understand the figures, leading to misinformed comment, particularly in the media. Companies can try to avoid this by ensuring that their written explanations are as clear as possible.

To a degree the complexity of the disclosure requirements has had to develop to mirror the increasing complexity of remuneration schemes. However, there are other areas where they have evolved to respond to the political environment, for example a requirement to set out the percentage change in the CEO's salary compared to the percentage change in the average pay of all employees.

Does the report achieve its aims?

These complexities mean that remuneration reports for large companies can now approach up to 30 pages in length. It is important to consider whether that serves shareholders' requirements. It most likely meets the requirements for transparency on what directors have been paid and why, and has to an extent made shareholders better informed so as to challenge remuneration. But how clear and understandable is the information for the public?

We have surely reached a point where a cull of the disclosure requirements would benefit all. Some information could be better placed on a company's website – such as a graphical analysis of changes in operating expenditure, and changes in shareholder distributions compared to changes in directors' remuneration.

Recommendations

Preparers

- Think about the needs of users. The chair of the remuneration committee should provide meaningful and concise information at the beginning of the report that covers the important issues users require.
- You may find it helpful to refer to guidance on directors' remuneration to get the drafting right. For example, guidance from the GC100 and Investor Group covers from a shareholder perspective the level of flexibility, discretion and judgement they would expect to see in the disclosures.
- Consider what measures of performance are used. Where reward is based on an alternative performance measure or a KPI, think about how to explain this, particularly if the performance measure or KPI is out of line with the bottom-line performance shown in the financial statements.
- It is important to get the wording around the remuneration policy right because this is where the board sets out its ethos around which the detailed numbers are based. Think through the various performance scenarios before setting the policy itself, and ensure that shareholders understand it so they are prepared for the eventuality of high reward and weaker performance.

Auditors

- Read the whole report and make sure it is internally coherent and the messages are clear and consistent with the rest of the annual report.

Regulators

- Reconsider what needs to be published in the directors' remuneration section of the annual report and whether some of this information could be published on company websites.
- Take the opportunity to review whether all the information is needed, what information is useful for investors and whether the current volume of information published is having the intended effect of linking directors' pay and performance.

Investors

- Challenge whether the actual amounts paid to directors are commensurate with what has been delivered in terms of company performance rather than only considering whether they were in line with the remuneration policy.

Is the company putting enough resources into reporting?

We see smaller listed companies struggling to respond to the detailed disclosure requirements that are applicable to both large and small listed companies.

This reflects the limited resources available in their finance departments and perhaps the failure to fully appreciate the appetite that investors have for their annual reports.

This needs to be addressed as the annual report continues to be the main source of financial information for more investors than any other medium, according to the UK investment community. For example, Jessica Ground, Global Head of Stewardship, Schroders, has said, 'We look to the report to provide us with the building blocks on which we make our investment decisions. The quality of these reports really matters.'

The CEO of the FRC has written that there is a 'gap between what investors want to see reported and what smaller quoted companies are able to tell them'. To tackle this gap the FRC has issued a discussion paper on improving the quality of reporting by these companies and identified a number of areas where it believes there are shortcomings in the standard of reporting. It has also detected a higher instance of poorer quality reporting by smaller quoted companies than by larger ones.

The lack of investment in financial resources represents a false economy. If investors are not seeing information they want, and company behaviour is not adjusting to provide this, it raises a deeper question than technical compliance with reporting rules. Smaller quoted companies may be at risk of losing the interest of potential investors, and of discouraging existing investors, by failing to engage in an open and transparent manner to enhance their annual reports. Those making or influencing lending decisions also pay attention to the detail in annual reports, and the quality can affect their rating and lending decisions. High quality annual reports improve a company's access to capital and can also reduce the cost of capital.

Shortcomings in reporting

The FRC has identified that the areas where it believes smaller company reporting should be improved are synonymous with those which investors focus upon most. These include cash-flow statements, disclosure of principle risks and uncertainties and certain accounting policies. The FRC has also recognised areas which are not always dealt with to a level of granularity or with sufficient clarity to inform users, including an explanation of the business model, discussion of financial performance and the nature of provision movements.

Companies need to improve their engagement with investors by being more open and discursive. Investors are looking to better understand companies' business, risk environments and cultures. More transparency would reassure investors that stewardship obligations are being properly observed and that their businesses are being managed well.

The resource issue

Compliance deficiencies in smaller company reporting are often cited as a consequence of relative weakness in the quantum, breadth and quality of their financial reporting resources. It is inevitable that smaller companies will have these deficiencies compared with larger, more sophisticated businesses and historically, many smaller companies have relied on their auditors to supplement gaps in knowledge during the process of preparing the annual report. In recent years such assistance has become proscribed but companies have been very reluctant, as a rule, to employ additional resources (either in-house or from an external source) to fill gaps that have appeared. We recognise that companies will be reluctant to make, what for many of them would be, significant additional investment in reporting resource without investor relations benefits.

This reflects a perceived shortfall in the cost/value equation that companies see in the annual report. There seems to be a general belief among the boards of smaller companies that their annual reports are not read and are rarely, if ever, used as a basis for making investment decisions by shareholders or potential investors. This is at odds with the research that the FRC has carried out which indicates that investors take smaller company reports seriously (and even more so than they do for those of larger companies) because of the lack of availability of other analysis for such companies in the market place. It would be informative to have a more granular understanding of the form and nature of this investor feedback so that reporting can more closely mirror investor needs.

Minimum compliance

The tendency is for smaller company executives to see annual report production as a compliance exercise alone rather than adding any real value to the company, and to seek to minimise its cost and impact on resources. There are a number of outcomes that this attitude produces.

- By default, the production of the annual report becomes the sole responsibility of the finance function.
- The line of least resistance is one of rolling forward the prior year rather than considering the content afresh.
- As it is not a highly valued activity it tends to be left late, giving little opportunity for auditors, advisers or other board members, including audit committees, to meaningfully contribute or comment.

The consequences are that it is difficult to achieve better than a minimum level of compliance and it can be very difficult for other stakeholders in the annual report production process to influence the shape and content of the overall report. This behaviour is also not consistent with the obligations that come with external equity investment.

Telling the story

There has been a raft of new regulation and guidance on the narrative elements of annual reports issued over the last three years. Some is relevant only to companies applying the Code, while some has more general application. Irrespective of where a smaller listed or AIM company sits in this, we would urge preparers to take the opportunity to tell investors about their business – how the business works and makes money for those investors, how it has performed over the year and how it is performing now, what the opportunities and risks are. Do this in the most straightforward way possible.

Is the company putting enough resources into reporting?

continued

It is also important to give investors a flavour of how things are done in the business, thus offering some insight into its culture. For example, audit committee material (whether in a separate report for a company where the Code applies, or as part of a more general governance report for an AIM business) will commonly report that 'the committee met three times during the year and discussed xyz'. How much more informative it would be to know what they had done outside formal meetings, who they had met with, the breadth of locations they had visited, and the issues discussed and actions taken. Similarly, by discussing financial reporting risks (which smaller companies are not required to do) investors can be reassured that there is appropriate oversight and control.

Regulation's impact

Auditors are very aware of regulators' interest in corporate reporting, whereas in our experience smaller companies appear to be much less aware, to the extent that the FRC is rarely recognised as a regulator by many smaller companies. At best, they see the FRC as being fairly peripheral to their corporate life. We believe that this is an unfortunate state of affairs and that greater regulator visibility among smaller corporates would help to improve the quality of reporting. Corporate reporting is one area where the onus of regulation is upon the regulated rather than the regulator. When this approach is accompanied by a rather hit-and-miss enforcement regime it ceases to be as effective as it could be. We do appreciate the FRC's resource constraints, but a higher profile among smaller companies might improve the standard of reporting.

Recommendations

Preparers

- Engage with willing investors about what they want from your annual report and consider it more holistically, rather than seeing it as simply a report the finance department produces once a year. Make it part of a senior employee's full-time role to prepare the annual report in line with stakeholder requirements.
- Use your annual report to give a sensible account of the company's performance, current position and future prospects to reflect its real worth and to give investors and other stakeholders confidence.

Auditors

- Resist the temptation to rely on your disclosure checklist unless the exceptions are genuinely material, qualitatively or quantitatively.
- Make sure that when you have real concerns about the quality of reporting you leave the board in no doubt about those concerns and don't be swayed into issuing its report before you are absolutely in a position to do so.

Regulators

- Consider whether the public could be better served by some minor relaxations in the independence standards for auditors. The result could be better corporate reporting, enabling auditors to help draft disclosures and accounting policies. Talk more to smaller companies and make sure they know they are subject to regulation.
- Think small: when setting standards consider the impact on the vast majority of reporters, that is the smaller ones, and frame standards to reflect their reasonable capabilities and circumstances.

Investors

- Engage with companies and reinforce the message that good quality reporting in the annual report matters.

Appendix: best-practice tips for audit committee reports

Complying with disclosure requirements in letter and spirit

Disclosure requirements are primarily derived from the Code and the Disclosure and Transparency Rules (DTR)[4] of the FCA. The table below sets out each reporting requirement alongside best-practice tips. Please note that this appendix focuses on certain key disclosure requirements only and should not be used as a checklist.

Code provision	Best-practice tips
C.3.8. Describing the work of the committee in a separate section of the annual report DTR also require disclosures which overlap. DTR 7.1.5 requires a statement disclosing which body carries out the functions required by DTR 7.1.3[5] and how the body is composed. DTR 7.2.7R also requires a description of the composition and operation of the administrative, management and supervisory bodies and their committees.	• Leading practice is for the report to be a separate report within the overall governance section of the annual report. • A personal introduction to the report from the audit committee (AC) chairman shows accountability. • Use active language throughout the report to show what the AC actually did rather than a description of policy/process eg, 'the AC reviewed' rather than 'the AC reviews'. **Roles, remit and membership of the committee** • Consider placing this information, if unchanged from the previous year, in an appendix within the annual report or on the website. This keeps the emphasis on the AC's activities during the year. If this is done, include a cross reference in the AC report to where the relevant information can be found. • Clearly signpost to who has been on the AC during the year and whether changes to AC composition were made during the year.
C.3.8. Significant issues considered by the committee in relation to the financial statements, and how they were addressed.	• Be as clear and specific as possible in explaining what the issue is and how it is relevant to the company and its circumstances (including an amount if relevant or a cross reference to the relevant note). • Provide business context in relation to each significant issue, such as which geography, division etc, is most affected. For example, rather than simply describing 'impairment', elaborate that the AC specifically focused on impairment in South America. • Provide insight into the AC's specific role in how the issues were addressed, including what it challenged and debated. Using active language demonstrates to shareholders how the AC exercised its oversight role. • In certain industries/sectors there are common accounting issues that one would expect committees to consider. These issues are likely to be consistent from year to year, and committees should consider separating out recurring issues from one-off issues that are specific to the year under review – eg, acquisition accounting. • Committees should be prepared to explain any difference between the issues they detail and the risk areas considered by the auditor. We do not expect perfect symmetry between the two, but differences should be explainable.
C.3.8. Explanation of how the committee assessed the effectiveness of the external audit process.	• Include information on the methodology used in assessing the external audit process. • Include details of the factors or criteria considered in the assessment. Remember that this is wider than an assessment of independence and objectivity. • Explain the evidence that was considered in reaching a conclusion. • As well as including information on the assessment of the external audit firm, describe how the role of management and the AC were assessed as part of the overall assessment of the external audit process as these parties also have an important influence on the effectiveness of the external audit process.

4 Unlike the Code which only applies to premium listed companies, the DTR represent EU minimum requirements and apply to standard listed companies too.

5 The functions required by DTR 7.1.3 are to: monitor the financial reporting process; monitor the effectiveness of the issuer's internal control, internal audit where applicable, and risk management systems; monitor the statutory audit of the annual and consolidated accounts; and review and monitor the independence of the statutory auditor and, in particular, the provision of additional services to the issuer.

Appendix: best-practice tips for audit committee reports

continued

Additional guidance

The FRC's *Guidance on Audit Committees* also includes further guidance on AC reporting. The table below sets out points of guidance and common practice alongside tips for making each of these disclosures effective.

FRC *Guidance on Audit Committees*	Best-practice tips
Paragraph 5.2. The audit committee section should include, inter alia: • a summary of the role of the audit committee • the names and qualifications of all members of the audit committee during the period • the number of audit committee meetings	Note – this overlaps with DTR 7.1.5R above. • Highlight key changes to this information in the body of the report or state that there have been no key changes. • Consider placing information which remains unchanged year on year in an appendix or on the company website with specific cross referencing in the AC report to the relevant information.
Paragraph 5.4. When reporting on the significant issues, the audit committee would not be expected to disclose information which, in its opinion, would be prejudicial to the interests of the company (for example, because it related to impending developments or matters in the course of negotiation).	• In the spirit of fair, balanced, and understandable (FBU) reporting, ensure that AC's report provides shareholders with an overall understanding of the true position of the company even if it is not possible to disclose certain specific details which would be prejudicial to the interests of the company.

Other items that may typically be included in the AC's report	Best-practice tips
The AC may be requested by the board to carry out specific activities. Two specific examples include: • supporting the board in producing the viability statement as required by C2.2 of the Code as well the related risk management aspects under C2. 1 and C2.3[6]; and • advising the board on whether the entire annual report is FBU (C3.4 of the Code)	• Within the risk management and viability statement: – as these are board responsibilities, the AC report must clearly describe the role it played in supporting the board; and – in particular, the challenge and debate by the AC (eg, of management's analysis) must come across clearly. • Disclose any changes/enhancements to the AC's activities/processes undertaken as compared to the prior year. • Explain the interaction and communication between the AC and the board throughout the process of producing the statement(s).

6 Disclosures related to the risk management and viability statement:
• Under C2.1 the board is required to confirm that it has carried out a robust assessment of principal risks.
• Under C2.2 the board, taking account of the company's current position and principal risks, must explain how it has assessed the prospects of the company, over what period it has done so and why it considers that period to be appropriate. The board must also state whether it has a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over that period of its assessment, drawing attention to any qualifications or assumptions as necessary.
• Under C2.3 the board is required to report on its review of the effectiveness of internal control and risk management systems.

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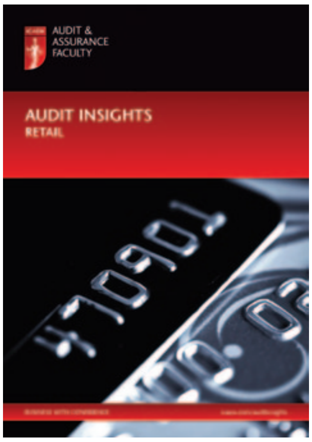

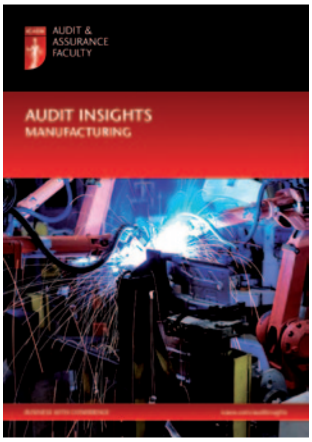

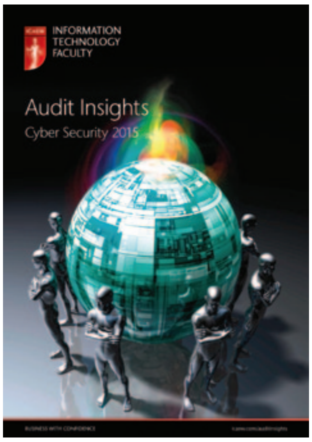

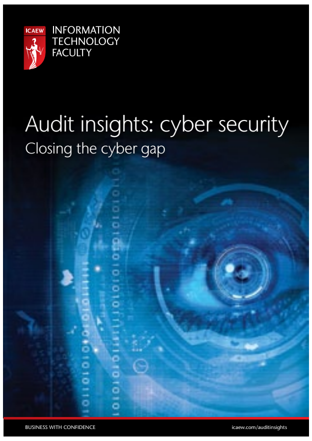

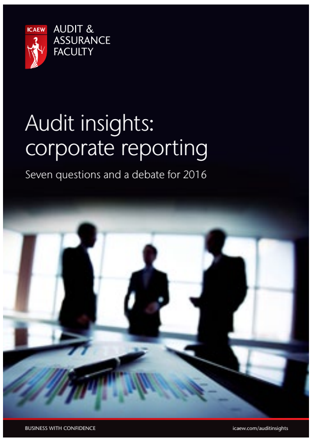

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