



AUDIT &
ASSURANCE
FACULTY

Audit insights: corporate reporting

Seven questions and a debate for 2016



Executive summary

Seven questions and a debate for the 2016 company reporting season

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 they play in the corporate reporting framework, it is essential that annual reports are relevant and present a coherent and balanced picture of the business and its prospects.

We welcome recent communications and publications, 'Summary of key developments for 2015 annual reports' and *Clear & Concise: Developments in Narrative Reporting*, issued by the Financial Reporting Council (FRC) to assist companies in this reporting season. This *Audit insights* publication on corporate reporting should be seen as complementary to the FRC's summary. In it we offer seven questions for users, preparers and auditors to ask that will provide better information for this reporting season, enabling companies to be held to account and promoting their sustainable growth.

The seven questions cover seven important aspects of reporting and will form part of a more detailed report into corporate reporting that we will publish in early 2016 that will offer recommendations to improve in the short term the quality of information provided in the 'front half' of annual reports.

What is needed is a longer-term solution to the problems of complexity and information overload that affect reporting. We are using this report to signal our intent to start a debate over the future of corporate reporting as we believe a more radical approach should be considered to address the challenges of complexity, fairness, balance and understandability of corporate reporting in the modern world.

Seven questions

1. Is everything in the report material?

Too many annual reports are too long and too complex, and as a result they are not easily understood. The needs of the user should be at the heart of deciding what to report and how. 'Will the reader understand it?' would be a good benchmark. Information should only be provided that is material so that it produces a coherent business story.

The way annual reports are currently presented is old-fashioned. There is a real opportunity for digital innovation to enable easier access to what is important rather than simply using the annual report as the repository for all company-related matters. Where information is only useful for some, for example detailed corporate social responsibility information, consideration should be given to how it can be presented separately, such as on a company's website.

2. Are performance measures credible?

Companies are keen to use alternative performance measures to provide insight into how they have performed over their reporting period. They are often also used as the basis for executive remuneration. To ensure they are credible and do not distort the underlying results, alternative performance measures should be used honestly (there needs to be a fair balance between good and bad news, and consistency between periods) and clearly (over what they actually measure, how they have been arrived at and how they tie in with the information in the financial statements). They should also not be given so much prominence that they overshadow the financial statements.

3. Is tax reporting understandable?

It is clear from the level of public interest that there is an increased focus on tax transparency. Some companies have responded with increased disclosure of what taxes are being paid and where, while others continue to limit themselves to what is required by law and accounting standards. Where information is disclosed the language used is sometimes shrouded in technical tax and accounting jargon which is not well understood by readers, resulting in unclear explanation of the tax bill. The highest

quality tax statements are those where the board has considered what is important to provide readers with a better understanding of their company's tax approach.

Auditors should read the tax narrative with a user's mindset and consider whether the narrative description is sufficient to explain the tax charge and the company's approach to tax. Where the narrative explanation is unclear or incomplete, preparers should be challenged to make improvements.

4. 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 2012 *UK Corporate Governance 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.

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. The greater transparency offered in audit committee reports should provide opportunities for this dialogue and engagement to occur. However, it is important to remember that not all investors (eg, private investors) can enter into dialogue. An insightful audit committee report should give readers confidence that the audit committee is exercising its oversight role effectively.

The language currently used is often a passive description of process(es) rather than an active description of activity and outcome. Clearer active language should be used that describes what the committee did during the year to address the issues under its remit and the issues it faced, debated and challenged.

Seven questions

Continued

5. Is the audit report providing insights?

The need to disclose information on the scope, materiality and areas of focus in audits has greatly increased the quality of debate that 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. The new enhanced auditor reports are greatly welcomed by many investors.

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

One further way that the audit report can be made more useful would be to think about it in the same way the directors think about the annual report – is it 'fair, balanced and understandable?' Readers should not be left with the hanging question of 'so what?' when reading the auditor's response to the risks they have identified. Auditors should not be afraid of telling the whole story of the audit and should also include the outcome of their work.

6. Does the remuneration report explain high pay?

The remuneration report is 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 why the remuneration committee of the company 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 information. Consequently we have reached saturation point with the volume of remuneration data. Some reports approach up to 30 pages in length in a large company, which has made the information less clear and understandable.

Readers benefit where the chair of the remuneration committee provides meaningful and concise information at the beginning of the report that covers the important issues. It is also important that companies get the wording around their remuneration policy right because this is where the board sets out its ethos around which the detailed numbers are based. Companies should think about the different requirements of readers when disclosing information and explain clearly how, and why, the actual remuneration paid is or is not connected to actual company performance.

7. Is the company putting enough resources into reporting?

Smaller listed companies struggle with the response to the detailed disclosure requirements because of the limited resources available in their finance departments and the failure to fully appreciate the appetite that investors have for their annual reports. The lack of investment in financial resources represents a false economy. It is the one chance in the year these companies have to communicate with the market.

If investors are not seeing the information they want, companies may be at risk of losing the interest of potential investors and of discouraging existing investors. 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.

The debate

Everyone agrees that company reports are too long, but there does not seem to be much 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 looking at corporate reporting it has become clear 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 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 criticism about the tsunami of information raises questions over whether the future direction of annual reports should be debated.

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 provided 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 good or bad. 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 in producing annual reports that only provide meaningful and relevant information that tells a coherent story.

A fundamental change is needed because in today's more complex business environment annual reports are failing to communicate important company information to a wider range of stakeholders. Companies are no longer accountable to only capital providers. The time has come for a radical rethink of annual reporting if it is to genuinely meet the *UK Corporate Governance Code* principles of being fair, balanced and understandable for all stakeholders. The Audit and Assurance Faculty hopes that this guide will help to reignite the debate in 2016 over how corporate reporting needs to change to improve communication and accountability.

Auditors and insight

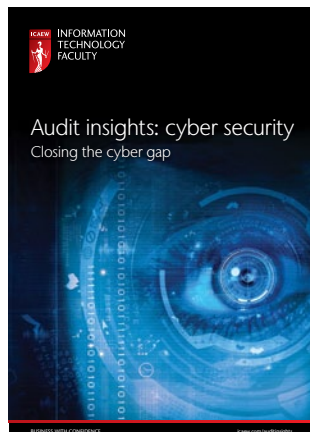
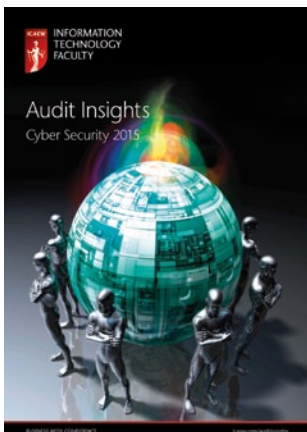
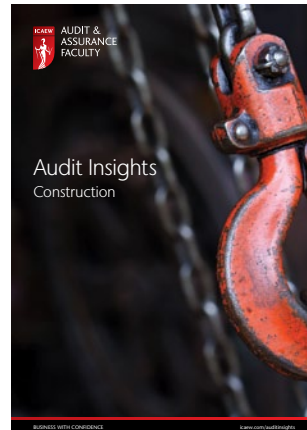
Audit is a public interest activity. Reports from external auditors build confidence in financial statements and give credibility to companies and comfort to their stakeholders. Companies also benefit from the insight that auditors have into business processes and the wider market environment.

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, Seven questions and a debate for 2016 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.

About the *Audit insights* series

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The Audit and Assurance Faculty is a leading authority on external audit and assurance. *Audit Insights* is one of several initiatives launched by the faculty.

Audit Futures, established in partnership with the Finance Innovation Lab, aims to inspire collaborative and creative solutions to the evolving role of audit and the accountancy profession.

The *re:Assurance* initiative explores where assurance services over business information strengthen markets and enhance confidence, and also asks how the International Framework for Assurance Engagements can be applied and developed.

The faculty's Audit Quality Forum (AQF) brings together external auditors, investors, business and regulatory bodies, encouraging stakeholders to work together by promoting open and constructive dialogue about transparency, accountability, reporting and confidence in external audit.

ICAEW is a world leading professional membership organisation that promotes, develops and supports over 146,000 chartered accountants worldwide. We provide qualifications and professional development, share our knowledge, insight and technical expertise, and protect the quality and integrity of the accountancy and finance profession.

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