# Appendix 3.05.1 What the Big Four say

## Deloitte's annual insights report

Deloitte's publishes an excellent and famous 'insights' report on financial reporting every year[1] examining 100 listed companies of various sizes[2]. The major conclusions are discussed below together with some of our not-so-scientific but larger sample of opinions collected by us. The Deloitte sample of 100 companies adopted the following financial standard: 42 adopted the Full IFRS; 6 adopted the simplified UK GAAP = IFRS 102; and 52 adopted the reduced disclosure framework IFRS 101.

**Motive, purpose, and culture:** Stronger. Our verdict misplaced (avoiding hostile takeovers is their major focus).
Deloitte: Maximising profits for shareholders is not the only interest of companies: 58% of companies explained the values, behaviours and culture that they seem to uphold. And 32% gave a clear prominent description of their purpose beyond making profits for shareholders. Also 92% of the companies referred to off-balance sheet resources such as employees to customers. However, in our research of the same we found the overwhelming preponderance of underlying objectives were financial and based on a) satisfying shareholders (that is not making then likely to sell shares or be subject of a takeover bid) and b) adequate profitability.

**Report structure:** Variable.
Deloitte: The average length of the report had increased again – now heading well over 200 pages (triple column often and small font) for many of the FTSE 100; and up from 155 to 164 pages for the 2018 sample. Deloitte's found that 61% of the report was taken by the front narrative sections and 39% for financial statements and their notes. The narrative section is growing. The narrative section is growing *except for the occasional) private company and is increasingly using visual effects and simulacra to message to the reader. By and large we found that the main users of the narrative section are analysts and journalists. Though analysts say they rely on personal contact and briefing by company management[3]. The glossy visually attractive simulacra used within the narrative reports are increasing in length and sometimes can contain important information and messaging. But often we have found that they contain misleading information and such inconsistencies are ignored by the auditors.

**Strategy and business model:** Visually often good, but hides the underlying truth and lacks any interest in a broader set of stakeholders.

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[1] Deloittes, 2018, Annual reports insights 2018, Surveying FTSE reporting,
Available at:
https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/audit/deloitte-uk-audit-annual-report-insights-2018.pdf
Accessed November 2018.
[2] 19 FTSE 100 companies, 38 FTSE 250, and 43 outside the FTSE 350.
[3] That seems to run counter to insider trading but is common place and not usually classified by the watchdogs as insider trading.

Deloitte: 64% of companies used a combination of narrative and visual (simulacra). 5 used predominantly visual. There was an increase in items such as employees and costumers, though only 2% of the companies indicated change due to Brexit.

**Stakeholders and Section 172** (consider broader non-financial matters such as employee interest and environment): Our verdict strengthening.
Deloitte: More companies are paying attention with 29 companies (up from 17) referring to Section 172. The two areas that were commented on to a greater extent were supplier relationship and actin fairly between all members of the company (including employees). Most companies paid lip-service or more to the environment.

**Other performance metrics**: Our verdict improving but still hopelessly inadequate.
Deloitte: APMs (financial) and KPIs (Non-financial) have expanded in use. This is a growth that we expect to see increasing. Deloitte found one third of the companies included profit APMs with no IFRS equivalent. And 46% included a section dedicated to APMs. The biggest growth area over 2017 related to employee APMs. Disappointing were the number of companies dwelling on greenhouse gasses reporting or carbon footprints. The FTSE 100 had on average 6 KPIs whilst the FTSE 250 had only 3 on average. The two example provided in their report were a) the impact of foreign exchange movements leading to a constant currency revenue at, say, 2016 exchange rates: b) usual IFRS terms such a revenue, operating profit, profit before tax etc. on a like-for-like basis and underlying.

**Long term value creation:** Our verdict still poor.
Deloitte: 76 companies discussed the value created for at least one other type of stakeholder, other than shareholders. And one quarter referred to some sort of assurance for non financial or corporate social responsibility information.

**Employee metrics:** Just developing but we believe still inadequate
Deloitte: Employee metrics headcount: 6 companies distinguished between full-time and part-time employees, whilst 6 gave diversity metrics other than gender, and only 3 provided both. This may change in the future through legislation.
Deloitte: Other employee metrics: 19 companies gave employee 38 companies discussed investment in training, 38 also provided employment satisfaction or engagement scores. Value distribution can be defined as operating profit plus deprecation/amortisation, and impairments. This cane be allocated to employees, providers of capital, taxes and that which is reinvested in the company.

**Risks and opportunities:** Our verdict still quite poor
Deloitte: Risks and opportunities: the average number of principal risks was 10 but this ranged from 4 to 24. By and large Deloitte found there was little appetite to provide meaningful data on such risks. The major risks seemed to be Cyber or IT related such as crime, attacks or threats; failure of IT systems and 44 companies entailed the email issues concerned with the EU General Data Protection Regulation. Brexit, climate change, defined benefit pensions etc seemed the be way down on the principle risks disclosed.

**Viability:** Our verdict hopelessly inadequate.
Deloitte: Our view is that this was also performed badly with less rather than more information being disclosed. Surprising post-Carillion. Most companies produced a 3 year lookout period and the number using 4 or 5 years was down. The principal risks disclosed was availability of funding or refinancing, sales volumes or pricing, cost management, and availability or success of migrating actions.

> Having considered a company's principal risks the directors are required to provide a statement regarding the company's longer term viability. 50% (2017: 34%) indicated which specific risks were considered in making their statement, with 54% disclosing qualifications or assumptions underlying their assessment - 29 companies mentioned the availability of financing or refinancing.
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> The FRC and investors have indicated that they expect to see directors undertaking an assessment of a company's prospects, including the resilience of the business model, over a longer time period than that over which they assess the company's viability. However, only 13% provided a clearly distinct discussion of the company 's prospects in the viability statement. (Page 3)

**Broad stewardship:**
Our verdict is mixed legally but on any non-legal basis not good enough.

Deloitte: Only 74% of companies indicated how they applied the main principles of the Governance Code, down from 80% in 2017. In the FTSE 100 companies surveyed, only 68% included this statement down from 94% in 2017. But there has been a deterioration.
99% of companies (2017: 100%) reported on compliance with the provision of the UK Code. 62% (2017: 52%) reported that they had complied fully (but the Code changes from 2019). Of the 37% that reported they had partially complied with the Code, 86% (2017: 90%) provided an adequate explanation of the reasons for any non-compliance. Only 27% (2017: 44%) of companies refer to the board’s consideration of Brexit in the corporate governance statement. The major disclosure for non-compliance was the composition of the remuneration committee – quite.

**Succession and diversity:** The largest companies seem to be less transparent.
Deloitte: the majority of the companies involved the nomination committee, and described the process used for specific appointments (but to us it was a closed club), and also used an executive search firm to help identify candidates.

> After a significant improvement in our 2017 survey, standards had been maintained in this year's succession planning disclosures. 93% of boards disclosed activity around succession planning (2017: 89%, 2016: 69%). However, in our judgement only 33% (2017: 41o/o) of companies this year included disclosures that explained clearly the systems the board has in place to maintain good succession planning, for example use of a regularly updated skills matrix. (Page 3)

**Board evaluation:** Our verdict is poor.
Deloitte: 35% of companies explained the findings and related action points from board evaluation processes (2017: 41%). A further 17% of companies just described the findings of their evaluation (2017: 9%).

> The performance of directors is often subject to considerable scrutiny nowadays, making board evaluation disclosures of particular interest. 35% of companies explained the findings and related action points from board evaluation processes (2017: 41%). A further 17% of companies just described the findings of their evaluation (2017: 9%). Discussing areas for improvement helps demonstrate transparency, openness to change and commitment to the running of an effective board. (Page 3)

**Diversity:** As yet poor for this new rule
Deloitte: Boards can also benefit from having a suitably diverse make-up. New rules, stemming from the NFR Directive and implemented into the Disclosure Guidelines and Transparency Rules (DTR), became effective for periods commencing on or after 1 January 2017, requiring disclosure of boardroom diversity policies in the corporate governance statement, including aspects such as age, gender, geographical diversity and educational and professional background. Although 80% (2017: 86%) of reports referred to aspects of diversity other than gender, only 29% were regarded as meeting the new DTR requirements. In order to meet the new requirements, boards should aim to describe the policy itself rather than the processes in place or actions taken during the year. Any cross-references to entity-wide diversity policies should also include information on how they specifically apply to the board.

**Accountability and internal control:** Our verdict is variable
Deloitte: 89% of audit committee chairman took ownership of the audit committee report in some way; on average the audit committee identified 4 significant financial reporting issues (5 for the FTSE 100 firms). 15 up from 3 in 2017 referred to engagement with the FRC (who are now much more active), 88% audit committees disclosed how they had assessed the effectiveness of the external audit process, and 60% of the companies explained how they had assessed the effectiveness of the internal audit function. The ratio of non-audit fees was significantly lower in 2018 at 25% down from 62% since the introduction of the FRC's cap on non-audit fees. Only 8% (but still surprising) disclosed a ratio exceed 70%. Whilst only 16% (24%: 2017) gave a comprehensive explanation of the effectiveness of the audit process (a difficult task).

**Judgements and estimates**: Our verdict is poor.

99 companies disclosed key sources of estimation uncertainty with an average number of 2 critical judgements and 3 key sources of estimation uncertainty – making 5 in total. Of which 16 were purely company specific, 29 were purely generic, and 55 were a mixture of both. Deloitte analysed the estimation uncertainties under 5 key areas:

1) Nature and amount of asset/liability - all items 58% (some items 40%)
2) Quantified explanations of assumptions – all items 14% (some items 80%)
3) Sensitivities - all items 17% (some items 78%)
4) Range of reasonably possible outcomes - all items 10% (some items 83%)
5) Changes to past assumptions - all items 0% (some items 1%)

Deloitte: In November 2017, the FRC published findings from its thematic review of financial statement disclosures on critical accounting judgements and key sources of estimation uncertainty under lAS 1. Consistent with the findings therein, it seemed to us that some progress had been made but that there is still room for improvement. For example, 66% (2017: 52%, 2016: 27%) distinguished between judgements and estimates, bearing in mind that different information is required for each, although 18 companies seemed to have misclassified items between these categories. Boilerplate also remains a concern - just under a third of companies we looked at only provided disclosures that were so generic they could have been applied equally to any other company.

## Defined benefit pensions

Another area where the FRC completed a thematic review in 2017, and one that attracts significant attention, is in respect of defined benefit schemes run by companies. Albeit many are now closed to new entrants or future accrual, 67% of companies still had some form of defined benefit ob ligation . Encouragingly, on an accounting basis at least, 40 were in a surplus (where plan assets exceeded the liabilities) and 37 of those surpluses were recognized as assets by companies, although only 21 provided justifications for asset recognition.

**Other financial statement disclosures:**

It was the final year for 81 companies surveyed before the mandatory implementation of significant new accounting standards on financial instruments and revenue, IFRS 9 and IFRS 15. Given this proximity, and perhaps t hanks to regulatory pressure, it was pleasing that companies provided more information on these forth coming standard s than previously.

Six companies indicated that IFRS 15 might have a material impact and a further 20 stated that it would have an impact, which implied that it would be material. Of those 26 companies, 23 quantified the impact. Similarly, 19 companies indicated they expected IFRS 9 to have an impact, which again implied it would be material, with 14 quantifying it.

No companies had early adopted the new leasing standard, IFRS 16, which becomes effective for periods commencing on or after 1 January 2019 and brings most leases on balance sheet for lessees. Some companies appeared well advanced in their preparations, with eight companies quantifying the impact. A further 36 companies gave some idea of the impact through a cross-reference to their operating lease commitments. However, care should be taken in adopting such an approach, due to potential differences between lAS 17's disclosure and the amount to be recognized under I FRS 16. In the forthcoming reporting season expectations will only increase in terms of the information to be provided on the impact this significant new standard will have.

The 2017 report has a survey of FTSE reporting encompassing 92 companies from the top 100 listed UK companies. In the early 1990s the front narrative section was approximately 40% or less of the report and the remainder was occupied by the financial statements. In 2017, Deloitte's found that 61% of the report was taken by the front narrative sections and 39%

Deloitte's found that the income statement and balance sheet does not tell the whole story. They found that 77% up from 70% in 2016 companies identified key inputs in their business models in the forms of off-balance-sheet resources and relationship such as customers, employees and intellectual property. Other features were:

- 6 companies produced an integrated report
- 32 companies notion of the six capitals discussed in chapter 11 but the integrated reporting framework categorises them as financial, manufactured, intellectual, human, social and relationship, and natural.

Other conclusions are shown in the box below.

Links for Deloittes Insights reports
Surveying FTSE reporting 2017 report:
https://www2.deloitte.com/uk/en/pages/audit/articles/annual-report-insights.html

A Clear Vision 2016 report:
https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/audit/deloitte-uk-ari-16-full-details.pdf

The reporting landscape 2015 report:
https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/audit/deloitte-uk-annual-report-insights-2015-full-survey.pdf

One comment on the Deloitte's paper was:

> One of the things Deloitte touch upon in a number of places are metrics for particular businesses, like for like store sales in retail, aircraft load factors in aviation and so on. An area the Americans lead on compared to IFRS is the development of industry specific guidance and rules. If this were done a number of alleged financial reporting failures might have been avoided.

We agree with Deloitte that the vision of relevant data needs to be wider than traditional metrics based on an actual cash transactions.

**Box Deloitte's 2017 Annual report insights 2017**[4]

- Corporate Governance: 18.5% of the companies avoided boilerplate language
- 69% described to varying extent how they engaged with at least one stakeholder group other than shareholders
- 63% discussed value creation for stakeholder group other shareholders
- 13% of the companies referred to the UN's sustainable development goals.
- BEIS SC's April 2017 report on corporate governance also looked at how companies incorporate employee input into board discussions – at present we saw only one company reporting about this.
- 45% description of their purpose beyond just making profits for shareholders
- 74% up from 70% in 2016 used non-financial KPIs with on average four such measures often relating to customer satisfaction, employee engagement, health or safety.

- Increasing use and market reliance on non-financial data and APMs outside scope of external audit. The quality of such data and the effectiveness of internal controls moves into sharper focus. But 33% of the companies with an internal control function failed to explain how they had assessed the effectiveness.
- Longer term viability statements, only 22% up from 14% reported on the lookout period spanning more than three years though the FRC and the Investment Association encourage a longer lookout period appropriate to the business cycle. .
- Only 58% has a satisfactory explanation of their lookout period which went beyond simply referring to the medium term planning cycle.

- 100% had KPIs and APMs
- 96% presented high level highlights in their report before getting into any detail
- Of which 80% were financial metrics and roughly half of those were APMs
- 96% provided comparative KPIs

- 16% up from 7% noted changes in their APMs rather than just changing them without drawing this to the reader's attention. Criticism of APMs = some companies were open to challenge on the degree of prominence counter to the ESMA's guidelines.

- Brexit risk: 60% Brexit principal risk
- Brexit risk: 9% business model may changes as a result of Brexit
- Brexit risk: 23% said there business model would not be changing
- Brexit risk: 2 companies said that their business model had already changed
- Brexit risk: 42% said the board discussions on Brexit had occurred.
- Climate risk: only 2 companies said it was a principal risk in its own right

Other comments on the Deloitte's reports from senior personnel and partners include the following:

[4] Annual report insights 2017, Deloitte. https://www2.deloitte.com/uk/en/pages/audit/articles/annual-report-insights.html

> Deloitte are correct "Just as developments in technology have changed the way we access, read and are fed news, we expect technology to change how investors, and others, access and consume corporate information." I think they could go further. There becomes a business issue - who is going to be the disruptor who brings the data gathering and modelling together and add credibility to that process?
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> I'm not sure that I am as certain as Deloitte in believing "But we also see the annual report retaining its unique position as an audited summary of the business, shaped by globally accepted financial reporting standards, and remaining a cornerstone of corporate reporting" unless the view is restricted to reporting of fiduciary duties. They are right in noting the report gives the company a good platform to put forward the things it wants to say.
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> The extent to which there can be reporting on non-financial or non GAAP metrics is dependent on the ability and/or willingness of the company to invest in systems capable of producing data of an acceptable quality. That said a well run business cannot remain well run if it does not have adequate underlying (in this case engineering or similar) data to manage the business.
>
> Deloitte are part of the way there "We also expect to see a growth in the use of structured data filing requirements, which provide “deconstructed” and tagged data that some investors and analysts can use in their models and analytical tools." This sounds a bit like the application of XBRL - a version of which is already mandated for some SEC filings. I understand it is presently applied only on aggregated data.
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> I agree that there are presently no barriers to companies providing more voluntary information on their website. Cost and lack of imagination are two possible factors why this would not happen. If there is a real benefit in reduced cost of capital through more information then there should be real incentive to it. After all there must be a risk component affecting cost of capital that is driven by the amount and quality of available information. Improving the quality and quantity of information should lower that risk component.

If the recent failures you talk about are the fault of management and auditors then in the famous words of that film: Something's Gotta Give[5]. And that is a very apt expression for the current situation.

[5] Something's Gotta Give is a 2003 American romantic comedy film written, produced and directed by Nancy Meyers. It stars Jack Nicholson, Diane Keaton, Keanu Reeves and Amanda Peet. Columbia Pictures (North America). Warner Bros. Pictures (International).

## EY Annual Reporting in 2016/2017 (September 2017)

The interesting, and to some extent parallel to Deloittes report consisted of 100 annual reports 45 from the FTSE 100 and 55 from the FTSE 250, so their sample is weighted more towards the slightly smaller companies than Deloittes which only had the FTSE 100.
Link:http://www.ey.com/Publication/vwLUAssets/EY_-_Annual_Reporting_in_2016-17/$FILE/ey-annual-reporting-in-2016-17.pdf

**Box Some metrics from the EY Annual Reporting Report**

Linkages between the reports are improving especially to KPIs and risks, but EY is a little critical.

Purpose, business models and risks

- 31% of reports disclose information around potential disruption risks to the business
- 43% of reports include cyber-security as a principal risk (up from 31% last year)
- 41% of reports communicate a broad purpose, but only about half of these companies clearly linked this to their strategic objectives
- 93% of reports disclose some form of information around Brexit and the impact on their business (up from 25% last year)

Time period chosen for the viability statement

EY said that viability statements risk becoming increasingly bland and boilerplate. More companies chose a three-year period and the majority still lack useful disclosure of scenarios tested, including quantification and assumptions.

- 81% use a 3-year period
- 3% use a 4-year period
- 16% use a 5-year period

Wider stakeholder engagement, sustainability and culture

EY said that corporate culture has been a key area of focus for regulators and other stakeholders, and while discussion of culture features in more reports, the information could better include insight into how the board monitors and gets assurance on culture.

- 81% of companies explain who their wider stakeholders are
- 14% of companies do not have any non-financial KPIs (unchanged since prior year)

Governance reporting

EY said that Governance reporting should be focused on decisions, actions and outcomes, rather than roles and processes alone.

- 62% Compliance with all provisions
- 25% Compliance with all but one provision
- 9% Compliance with all but two provisions
- 4% Non-compliance with more than two provisions

Link: http://www.ey.com/Publication/vwLUAssets/EY_-_Annual_Reporting_in_2016-17/$FILE/ey-annual-reporting-in-2016-17.pdf

EY found that the length was 148 pages in 2013 increases to 186 pages in 2016/2017 a 25% increase. They point to the introduction of the strategic report in 2013/2014 and the requirement to disclose a full list of subsidiaries in the notes to the financial statements were factors. We would add the expanded remunerations report. And as time has passed we found hat the strategic and risk sections increased. .

On the governance code the FRC in their new governance guide used a paper showing that the smaller FTSE 250 companies had more non-compliance issues then the FTSE 100. The FTSE 250 had the biggest problem in their independent non-executive directors, and independence of the board and committees.

On future trends in reporting, EY made the interesting point that investors and others obtain information about companies from a variety of sources. However, annual reports remain the primary source of holistic information about a company, particularly for investors making an initial investment decision. There is scope for improvement in the consistency and balance of messaging across preliminary results announcements, analyst presentations and the annual report.

This is the first recognition of the importance of analysts' presentation – a topic we return to in the next chapter. What we disagree with is that the current annual report, with increasing information asked for in the new Governance Code (see Chapter 4) due in 20118/2019. Adding more and more to an already large report is not the way to go in our opinion.