

A hand, painted with vibrant colors like blue, green, and yellow, is shown holding a large, billowing cloud of fine, multi-colored powder. The powder is a mix of bright colors including pink, red, orange, yellow, and green, creating a dynamic and energetic visual effect. The background is dark, making the bright colors of the powder and the hand stand out.

Annual reporting in 2017/18: demonstrating purpose, creating value

September 2018 | Fifth edition



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Introduction



Welcome to the fifth edition of our FTSE 350 annual reporting review.

Last year, we touched on the looming changes to reporting resulting from initiatives by the Government and the Financial Reporting Council (FRC). We were already seeing some impact in anticipation of these, reflecting a general desire to encourage trust in business. The companies in this year's sample – at the time of preparing their annual reports and accounts (ARAs) – had still not seen the final text of the 2018 UK Corporate Governance Code, nor the secondary legislation in detail. However, they have anticipated some of the changes mooted in the draft Code and made adjustments.

Last year, we also discussed the increased level of reporting relating to wider stakeholder concerns and impacts. We observed that many reporters were adding disclosures with stakeholders in mind, but we called for more specificity and a clear focus on materiality. The new non-financial information statement disclosures have added to this materiality challenge.

The stakeholder theme again features strongly in our report this year. Our key findings, following a review of 100 ARAs across the FTSE 350, indicate that many reporters have improved their disclosures on stakeholder engagement and impacts, with some added specificity. However, most are still only at the beginning of a journey towards reporting that articulates these engagements and impacts in line with a clear long-term value creation narrative. It's a journey we see many reporters ambitious to undertake.

There are many challenges along the way – there are no clear cut answers and no one right approach – but also opportunities for increased investor and stakeholder engagement.

For those exploring how they can best report on areas such as company purpose, long-term value and impacts on stakeholders, we hope you will find this report to be a valuable resource. We also cover other important areas of reporting on which investors and regulators have recently focused, including reporting on people, culture and diversity, and audit committee activities. Finally, we look ahead at some of the developments shaping annual reports. We hope you will read our report in full, but you can also dive straight into the section that's most relevant for you.

As part of our research we interviewed a number of investors to gather their views on what they look for in ARAs. We also spoke to

Aviva, which has made significant changes to its reporting this year, and to the Financial Reporting Lab, which has undertaken some insightful projects. You will find comments from these participants throughout our report. I thank them for their input and time. As in previous editions, we have also included case studies of leading practice examples and our updated 'acid test'. These resources provide a practical toolkit for you to use when looking at your next annual report.

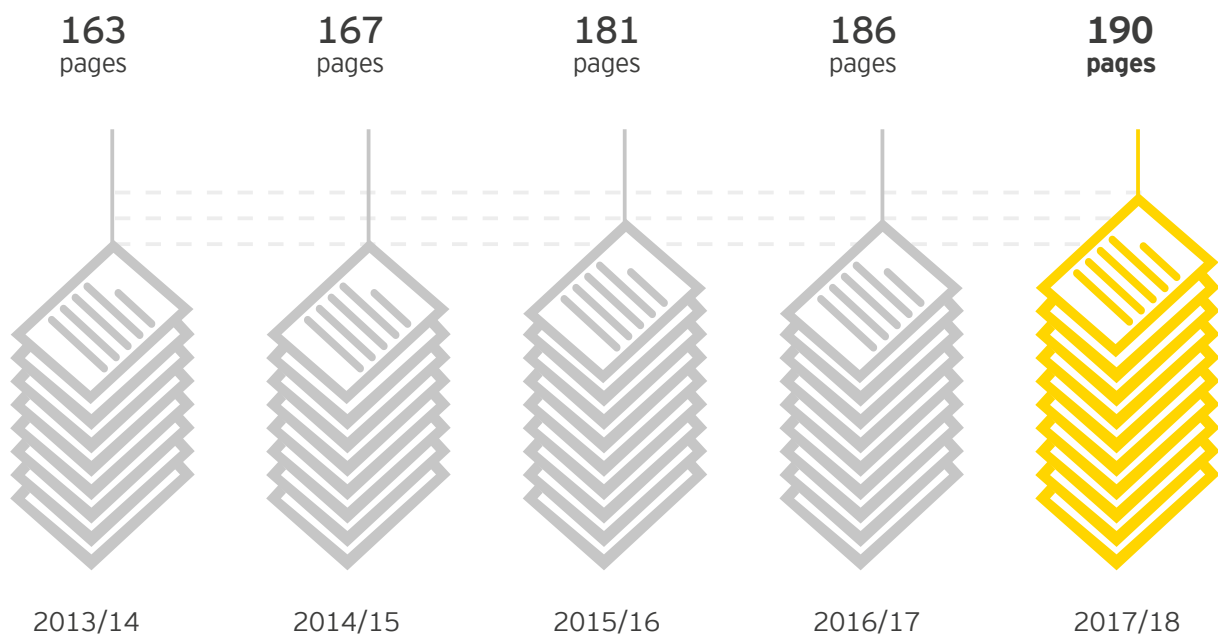
We look forward to hearing your feedback and views.

Ken Williamson

Head of Corporate Governance
EY UK & Ireland

Highlights from our analysis

Average length of ARAs



Purpose and long-term value (see page 10 for more)

There has been a slight increase in the number of reports articulating the company's purpose, in particular a broad societal purpose that goes beyond shareholder value, **up to 47% this year**. The proportion of these that also link their purpose to strategy has also improved.



41%
of companies
clearly link their
'purpose' to
their strategy.

This year we also saw a significant increase in the number of companies demonstrating the outputs, outcomes or value created for a range of stakeholders, with some including quantification.

Stakeholder engagement (see page 14 for more)

There has been an increase in reports mentioning directors' s172 duty, rising to **11% from just 1% last year**.

Most companies identify some stakeholder groups beyond their shareholders (**86%, up from 81% last year**).



83%

of companies disclose some form of employee engagement mechanism.



69%

of companies specifically identify their stakeholders in one single disclosure within the annual report.



65%

of companies describe methods used to engage with other stakeholders such as customers, suppliers, communities and governments.

Social impact reporting (see page 14 for more)



74%

of companies have a standalone section on Corporate Responsibility / Sustainability rather than using a more integrated approach.



20%

of companies state that they have responded to the Task Force on Climate-related Financial Disclosures (TCFD), or have stated the intention to do so in the future.



8%

of companies include a statement referencing the non-financial reporting regulations, and disclosing at a high level where the disclosures have been incorporated.

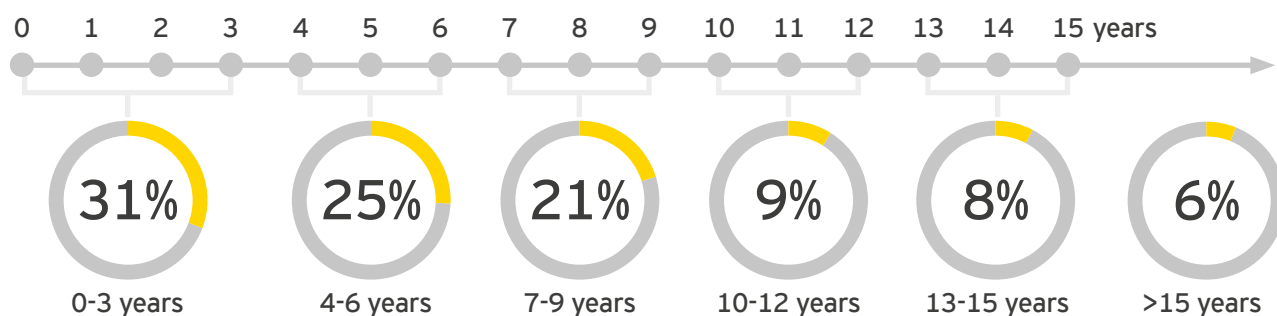


18%

explain how they have determined materiality in relation to non-financial reporting disclosures.

Chair tenure, diversity, culture and remuneration (see page 28 for more)

Total board tenure of chairs since first appointed to board:



23% of companies in our sample have chairs who have served on the board for more than 9 years.

47%

of reports articulate the culture the company has or the culture it seeks to create.

37%

of reports articulate how culture is embedded.

15%

of reports provide detail on the impact of the initiatives taken to improve diversity.

25%

of companies disclose their gender pay gap figures in their ARAs, up from 4% last year.

39%

explain how culture supports the business model or strategy (up from 10% in 2015/16).

30%

explain how culture is measured (up from 9% in 2015/16).

23%

of companies discuss diversity beyond gender in a meaningful way.

7%

of companies voluntarily report the CEO pay ratio figures.

Audit committee (AC) reporting (see page 34 for more)



26%
disclose plans to
tender their audit.



12%
disclose that the FRC's
Corporate Reporting
Review Team (CRRT)
reviewed their ARA.



14%
report on an
audit tender
during the year.



23%
disclose that a review of
the company's external
auditor was carried out by
the FRC's Audit Quality
Review Team (AQRT),
with 15% including
detail around the AC's
involvement in the
AQRT review process.



8%
provide an
explanation of the
tender process and
selection criteria set.

Viability statement (see page 38 for more)

The time period chosen for assessing viability has remained in line with last year, with **76% opting for 3 years, 5% for 4 years and 19% for 5 years.**

Last year, 76% simply stated that the time period was in line with strategic planning, rather than including any more company specific rationale. However, this has improved, **falling to 35% this year.**

There has also been continued gradual improvement on disclosure of scenarios, up from 49% last year:



69%
disclose some detail
on scenarios tested,
but far fewer quantify
those scenarios.

Disclosure and quantification of assumptions has remained the same as last year, included in 38% and 6% of reports respectively.

Our 'acid test': a practical aid

As a practical tool for preparers and boards looking to ensure their annual report covers key qualitative aspects of leading practice, we include our 'acid test'. These are the key questions we believe a reader should be able to answer after having read the narrative report. We update these each year in line with changing expectations (the yellow underline indicates the updates we made in light of this year's review and 2018 Code):

Purpose and strategy:

- ▶ What is the company's purpose? Does it explain 'why' the company exists?
- ▶ Does the company's purpose clearly inform its strategy?
- ▶ What are the company's strategic objectives? Are they clear and measurable?

Business model:

- ▶ How does the company make money?
- ▶ What are the company's key inputs, processes and outputs (for shareholders and stakeholders)?
- ▶ How are the company's key tangible and intangible assets (including its physical assets, IP, people, culture, technology, etc.) engaged in the process of value creation?
- ▶ How does the board make decisions regarding how capital is allocated across short and long-term priorities?
For example, R&D activities, shareholder payments, tax, pensions, employee salaries and bonuses.
- ▶ What is the company's competitive advantage and how is it sustained over time?
- ▶ How does the business model help deliver the strategy?
- ▶ Which aspects of the company's culture are critical to the business model and/or strategy and how does the board measure and monitor the extent to which the culture is embedded?

Key performance indicators (KPIs):

- ▶ What are the key metrics the board uses to measure progress against its strategic objectives? Are these focused on outcomes in order to truly measure performance against strategy over the long term?
- ▶ How has the company performed against these metrics over time and how has this influenced the remuneration of key executives?
- ▶ Are alternative performance measures (APMs) clearly signposted and reconciled to statutory measures? Is their use balanced with statutory measures?

Risk appetite and principal risks:

- ▶ What levels of risk is the board willing to take in pursuit of its strategy and how is this monitored by the board?
- ▶ What are the key risks to the successful delivery of the strategy and operation of the business model?
- ▶ What are the risks that pose the greatest threat to the viability of the company i.e., solvency and liquidity risks?
- ▶ How, specifically, might these risks manifest themselves in the company?

Risk management and internal control disclosures:

- ▶ How are the principal and emerging risks mitigated and controlled by the company's systems of internal controls and risk management and how does the board monitor these controls?
- ▶ What did the board's review of the effectiveness of these systems and controls encompass and what were the findings?
- ▶ Has the board identified significant failings or weaknesses and is it clear what actions have been or will be taken to address these failings or weaknesses?

Viability statement:

- ▶ Over what timeframe has the board considered the viability of the company and why? How has the period been rationalised in sectors where the company is making investment decisions over longer periods?
- ▶ What process did the board use to assess viability?
- ▶ Does the board understand which, if any, severe but plausible risks (or combination of risks) would threaten the viability of the company and has appropriate disclosure been provided?
- ▶ What assurance did the board obtain over relevant elements (e.g., stress testing)?
- ▶ What assumptions did the board use in reaching its conclusion?
- ▶ Did the board give a point of view on the wider prospects of the company beyond the period of the viability statement?

Governance:

- ▶ What did the board and its committees actually do in the year to govern the company – what specific governance issues arose and how were they addressed?
- ▶ What, if any, changes were made to governance arrangements during the year and why?
- ▶ What areas for improvement were identified from the board and committee evaluations and what progress was made against actions from the previous evaluations?
- ▶ How is board and committee composition and succession planning being managed, giving due regard to the evolving strategy of the group, skills, experience, diversity and tenure?
- ▶ Are the key stakeholders of the company clearly identified?
- ▶ How did the board seek to understand the views of both shareholders and stakeholders during the year? Does this include reference to the feedback received and actions taken? How has the board had regard to these groups in their principal decision making?

1

Purpose and long-term value

Articulating purpose

This year we found an increase in the percentage of reports articulating the company's purpose, in particular a broad societal purpose that goes beyond shareholder value – up to 47% from 41% last year. This aligns with encouragement from the FRC and investors for boards to agree on and articulate their purpose.

This year's letter to company CEOs from Larry Fink, Chairman and CEO of BlackRock, focused on fostering a sense of purpose. In his call to action to his investee companies, he said: "Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate. Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders."

♦ – Denotes a reference to changes arising from the 2018 UK Corporate Governance Code or the Companies (Miscellaneous Reporting) Regulations 2018. These are explained in more detail in Appendix A 'The 2018 Code, new regulations and guidance' on page 45.

Purpose

Why? *Why does the company exist and for whom?*

Vision/mission

Where? *Where is the company heading?*

Strategy

How? *How will the company achieve this?*

Although we observed more disclosures outlining purpose overall, companies use different terminology and what it means is often unclear. The terms 'purpose', 'vision', 'mission', 'aims' and 'objectives' are used interchangeably by some.

We interpret purpose as the 'why?' Why does your company exist? What value is created and for whom?

Vision can mean either what the company will look like if it is fulfilling that purpose, or where the company is going. Sometimes a company's 'purpose' in annual reports actually reads more like a vision e.g., to be the leader in a given sector.

The company strategy should outline the plan for achieving the vision in line with the company's purpose, with associated measures to demonstrate progress. We saw improvements this year in the connection between purpose and strategy: 41% of companies now make a link. In these ARAs it is clear how the strategic objectives align with the company's purpose. This indicates that the purpose is embedded and 'lived' in practice by the business. It is important that the company's purpose doesn't become a buzzword that companies disclose but employees would not recognise; it can be a valuable tool for embedding and explaining culture and ensuring everyone is pulling in the same direction.

The key to articulating purpose is to focus on the value being created and for whom. We anticipate that many more companies will disclose a purpose next year. The 2018 UK Corporate Governance Code (the 2018 Code) includes a new Principle (Principle B) which specifies that 'the board

should establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned.' It also states that reporting on application of the Principles should be done 'in the context of the particular circumstances of the company and how the board has set the company's purpose and strategy, met objectives and achieved outcomes through the decisions it has taken'.

Therefore, although the 2018 Code does not explicitly require companies to disclose the purpose of the business, we expect many more will choose to do so. We also anticipate that company reporting will evolve even before the 2018 Code comes into effect (accounting periods beginning on or after 1 January 2019).

Long-term value narratives

Many investors have a long-term horizon for their investments and are keen to know how value is being created and preserved over the long term. Reporters are therefore increasingly looking for ways to demonstrate both their tangible and intangible assets and value creation story.

We found that most companies are reasonably successful at articulating the critical attributes and activities that underpin the creation of value for their shareholders and other stakeholders. More companies now take this approach than when we began our analysis five years ago. In most instances the sources of value are disclosed as part of the business model – as part of the resources / inputs or competitive advantages / 'how we create value' elements. The case studies we have selected (overleaf) provide some good examples.

Case studies

GlaxoSmithKline plc 2017 ARA

(pages 2 and 5)

Clear description of broad purpose, goal, strategy and values

The Unite Group plc 2017 ARA

(inside cover)

Clear description of purpose and what it means for the company in practice

Greggs plc 2017 ARA

(pages 4 and 10)

Clearly articulated broad purpose with links to vision and strategy

Kingfisher plc 2018 ARA

(page 1)

Detailed disclosure on the company's re-assessment of its purpose, including a process of engagement with stakeholders

"Investors want to understand companies' long term strategy. They are interested in companies that are looking to do the right thing by their stakeholders as well as making a return."

While traditional financial metrics remain important, investors are increasingly interested in a wider set of metrics which articulate sources of value more broadly."



Phil Fitz-Gerald
Director,
Financial Reporting Lab

This year **we saw a significant increase in the number of companies demonstrating the outputs, outcomes or value created for a range of stakeholders, with some including quantification.**

We also noted that some companies identify particular metrics (e.g., Net Promoter Score) as inputs which others identify as outputs. We are at the beginning of a journey in this aspect of reporting, with companies looking for new ways to articulate their own unique value story.

We continue to observe the influence on business model

disclosures of the Integrated Reporting Framework – but rather than using the six capitals set out in the framework, most companies tailor these to articulate their own sources of value. Many also explain how their competitive advantages supplement their (internal and external) sources of value when describing their business model. Non-financial measures such as people and brand feature heavily, which is a positive shift and reflects companies' intangible assets that contribute to business value. The most common sources of value were:

- ▶ Financial resources and capital discipline
- ▶ Skilled employees and management
- ▶ Supplier and customer relationships
- ▶ Brand strength and quality
- ▶ Innovation

Last year, we referenced 'The Embankment Project for Inclusive Capitalism'. This is a project supporting the development, testing and validation of EY's long-term value framework. See page 43 in the 'Looking ahead' section for more detail.

Capital allocation frameworks

This year we looked again at how companies articulate their overall capital allocation across different priorities.

The majority of companies do not articulate a capital allocation

Case studies

Unilever plc 2017 ARA (page 9)

- ▶ Resources underpinning the business model clearly explained, including the explicit identification of tangible and intangible assets

Intu Properties plc 2017 ARA (page 30)

- ▶ Identification of the company's value sources and quantified outputs for a variety of stakeholders

Royal Bank of Scotland Group plc 2017 ARA (page 24-25)

- ▶ Identification of inputs and processes as well as a qualitative description of the outputs

Aggreko plc 2017 ARA (page 12)

- ▶ Inputs and outputs quantified, including relevant details, e.g., on wages expended rather than just number of employees

framework in their ARA, although, a few companies do provide a good overview of their approach. We understand that some companies currently disclose this information in analyst presentations; however, we believe capital allocation

frameworks should be disclosed in the ARA because of their importance to shareholders. Leading practice capital allocation disclosures include:

- ▶ An explanation of the options available to the board (which will vary according to sector and business model)
- ▶ An indication of the relative priorities, e.g., would the board focus on debt reduction or returning money to shareholders?
- ▶ Information about the parameters set, e.g., what gearing level does the board consider to be appropriate and what impact will this have on returns to shareholders?

Some reports also include information about the way in which the company's capital allocation framework helps the company to shape and achieve its strategic priorities over a measurable period of time.

Case studies

Meggitt plc 2017 ARA (pages 6 and 13)

- ▶ Priorities for capital allocation are articulated
- ▶ Areas of investment and clear description of the cash flow model included

GlaxoSmithKline plc 2017 ARA (pages 54-55)

- ▶ Key priorities for capital and alignment with strategy articulated

Dividend policy disclosures

Many companies still describe their dividend policy as 'progressive', without explaining what this means in practice. Surprisingly, some companies that did not pay a dividend or reduced their dividend payment give no explanation of their reasons, although we would recommend doing so. Some do list the factors considered within the dividend policy, but then do not explain how they arrived at the final dividend payment decision. Very few link their dividend policies to the risks facing the company.

However, several companies do quantify their distributable reserves under the dividend policy disclosure. Some explain the linkages between capital structure and dividend policy or even reference the link between dividend policy and long-term value explicitly under the business model.

Examples of good practice include Taylor Wimpey plc's 2017 ARA (page 8), which explains that the company's 'dividend policy was subject to prudent and comprehensive stress testing against various downside scenarios, which also included a reduction of 20% in average selling prices and a 30% reduction in volumes'. Another useful example of a leading practice dividend policy disclosure is found in the 2017 annual report of Hunting plc (page 16).

Overall, dividend policy disclosures would benefit from further consideration of the recommendations from the Financial Reporting Lab¹ for disclosures to:

- ▶ Identify the explicit links between dividend, principal risks and viability
- ▶ Enhance understanding on constraints
- ▶ Explain more fully what the dividend policy means in practice
- ▶ Enhance understanding of structure and process, e.g., where profit is generated and how profits might flow.

"Value creation should flow throughout the ARA and not just be discussed in a separate section i.e., Corporate Social Responsibility."



Freddie Woolfe
Head of Responsible Investment
and Stewardship, Old Mutual
Global Investors

¹ Financial Reporting Lab, *Lab implementation study: Disclosure of dividends – policy and practice*, October 2017, pg10.

2

Stakeholder engagement and social impact reporting

Stakeholder engagement

There has been a tangible shift in sentiment over the last few years away from a purely shareholder-centric approach, towards a view that relationships with stakeholders are key to a company's success. This principle of enlightened shareholder value is enshrined in the Companies Act 2006 (see Figure 1).

The strategic report is intended to help shareholders assess how the directors have performed their duty to promote the success of the company under s172 of the Companies Act 2006, this is not new. However, engagement with stakeholders (particularly the workforce) and consideration of their concerns has been felt – by some – to be insufficient. In the wake of corporate failures, the UK Government pledged corporate governance reforms to help build a society that works for everyone. This focus culminated in the FRC publishing the 2018 Code and Parliament approving secondary legislation, The Companies (Miscellaneous Reporting) Regulations 2018[♦], which added further obligations such as a requirement to report on how directors have had regard to (a)-(f) of s172.

♦ – Denotes a reference to changes arising from the 2018 UK Corporate Governance Code or the Companies (Miscellaneous Reporting) Regulations 2018. These are explained in more detail in Appendix A 'The 2018 Code, new regulations and guidance' on page 45.

- (1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—
- (a) the likely consequences of any decision in the long term,
 - (b) the interests of the company's employees,
 - (c) the need to foster the company's business relationships with suppliers, customers and others,
 - (d) the impact of the company's operations on the community and the environment,
 - (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
 - (f) the need to act fairly as between members of the company.

Figure 1. Companies Act 2006 s172(1) 'Duty to promote the success of the company'

This year we found a marked increase in reports mentioning the s172 duty, rising to 11% from just 1% last year, with more companies directly or indirectly acknowledging directors' responsibilities.

More broadly, although the 2018 Code and the secondary legislation were finalised after the reports we analysed were published, consideration of the issues raised had already begun to impact reporting.

Identification of stakeholders

In order to operate effectively, companies must understand those resources and relationships that matter most to their success. These will vary from company to company and, as the FRC underlines in its Guidance on the Strategic Report, 'it is important that boards identify its [the company's] key stakeholders and the importance of those stakeholders to the long-term success of the company.'²

In line with last year, **most companies identify some stakeholder groups beyond their shareholders (86% this year, up from 81%)**. The most common stakeholders identified are shown in Figure 2. Almost all stakeholder groups or considerations are mentioned more widely compared to last year.

"We focus on responsible investment not just because it is the 'right thing to do' but because we see a direct link to long-term value creation. Companies focused on stakeholders over the long term will drive more value for shareholders."



Freddie Woolfe
Head of Responsible Investment
and Stewardship, Old Mutual
Global Investors

Common stakeholders identified

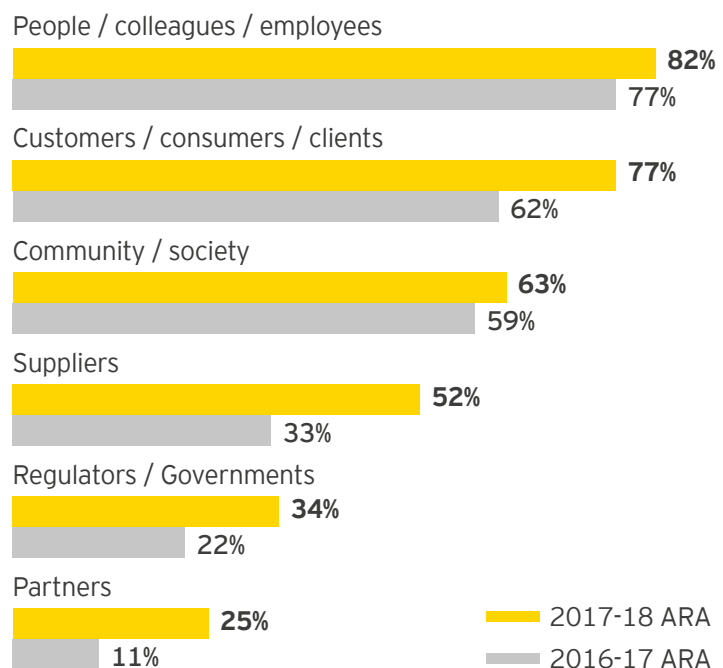


Figure 2. Breakdown of most common stakeholders mentioned

² Financial Reporting Council, *Guidance on the Strategic Report*, July 2018, pg59.



Why it's important to engage	Investors	Universities	Students	Employees	Communities	Suppliers
	We seek to provide balanced, clear and transparent communications that allow investors to better understand our business and our strategy, and how we deliver long-term shareholder value through earnings and capital growth.	We aim to be the partner of choice to mid and high-ranking Universities. It is important Universities understand how our Home for Success purpose aligns with their own ambitions for their students. Quality properties, in great locations with great service are an asset to Universities and can make their offer more attractive.	Creating a Home for Success for our students is our purpose. We engage with the students who live with us every day. Students need to know we understand their needs, and that our unique insight is being leveraged to provide them with a living environment that helps them get the best out of their time at University.	Our people are the heart of our student proposition and engagement with all our stakeholders. From our emergency contact centre on hand 24/7 in times of crisis and for lockouts, to our student ambassadors there to help students settle in to their new home, together we deliver a Home for Success.	We operate in 24 cities across the UK, providing a home for around 50,000 students. Providing a home for our students means playing a part in the local community, whether that's through being responsible neighbours or giving something back through volunteering and charity work. We also engage with local communities around the planning and building of new properties.	Unite Students utilises technology and supplier relationships to be at the forefront of our sector. With the right third parties in place, we can deliver quality properties and service, while driving efficiency.
Stakeholder interests	We hold regular meetings, Capital Markets Days, results briefings and trading updates with institutional shareholders, equity analysts and investors. All reports and presentations are available on our website.	Universities trust us to provide a safe and secure home for students – a key element of students' experience at University, supporting personal and academic achievement. Through the Unite Foundation we work with 28 Universities to provide scholarships for a safe and secure home for 170 students. Working together, we can create better futures for our students.	Our unique insight allows us to deliver products and services our students need. Our My Unite app helps students connect to flatmates and services such as laundry. With all-inclusive bills and 24/7 maintenance and support services, we help our students focus on their studies. We want them to feel at home with us. We also strive to do what is right by supporting the Unite Foundation, which provides accommodation scholarships to young people who have been in care or are estranged from their families.	Our values guide us to deliver a strong internal culture focused on high performance, operational efficiency and engagement. We strive to be a responsible and attractive employer, proud of our high retention rates and career development. We are committed to fostering a diverse and inclusive workforce. We are a Living Wage employer and hold Investors in People Gold status.	We support those who need it, whether that be raising £272,000 for the British Heart Foundation, or through employee volunteering on away days. We pioneer new ways to work with non-profit and charity partners to build stronger local relationships. We consider community needs in the development of new buildings, for example by prohibiting cars on site or adding retail facilities to a planning proposal.	A rigorous tender process ensures our partners share our corporate commitment to excellence, innovation and responsible business practices. We take a leading role in industry developments.
Relevance to the business model and strategy	Investors are a key source of efficient capital, enabling the business to invest and grow.	We continue to grow the proportion of beds let through long-term nominations agreements with Universities, underpinning security of earnings.	We strive for the best customer experience for our students, delivered by having the best people, the best service and the best properties.	Our people are the key to our service-focused business, delivering for both our customers and our University partners. Employing and training the best people enables us to provide great customer service and operational efficiency.	We work hard to grow and develop local relationships, ensuring our students and employees have a positive impact on communities in which we operate.	Working with the right partners ensures we are able to drive efficiencies and improve margins, from both an operational and development perspective while delivering consistently high quality and innovation.

Figure 3. Unite Group plc 2017 ARA (pages 6 and 7)

“Long-term investors are more likely to invest in companies which seek to engage in a meaningful way with customers, employees, environment, the community and other stakeholders.”



Phil Fitz-Gerald
Director,
Financial Reporting Lab

69% of companies specifically identify their stakeholders in one single disclosure within the annual report. These disclosures typically occur in the chair's statement

or the business model. This year we have also seen them more frequently included in distinct stakeholder engagement sections.

Good practice isn't just about identifying stakeholders, however. In our view, companies should explain why it is that groups are considered to be the key stakeholders. Unite Group plc (Figure 3) do this by setting out why it is important that it engage with each stakeholder group, and how each is relevant to its business model and strategy, as well as how each set of interests has been considered.

Engagement with the workforce

Some of the recent governance reforms focus specifically on engagement with the workforce. The new secondary legislation[♦] will require in the strategic report the inclusion of a s172 (1) statement on how directors have had regard for a number of stakeholders,

including employees (as set out in Figure 1). However, it also requires disclosures in the directors' report of how the directors have engaged with employees.

Similarly, Provision 5 of the 2018 Code[♦] recommends the use of one or more of three methods to engage with the workforce: a director appointed from the workforce; a formal advisory panel; or a designated non-executive director. Note that although the secondary legislation refers to *employees*, the 2018 Code uses the term *workforce* to encourage companies to think more broadly and beyond those with formal employment contracts.

This year, 8% of the reports we analysed already indicate that the company intends to adopt, or has already adopted, at least one of the three mechanisms set out in the 2018 Code. This percentage will rise significantly over the coming years.

Encouragingly, we saw a significant development in the reporting on employee engagement in this year's review: 83% of companies in our sample disclose some form of employee engagement mechanism. Engagement surveys are most popular, followed by representative councils or consultative committees.

"If you don't look after your customers, you have no business. If you don't have staff, there is no one to look after your customers. To make the most of the opportunity boards should not explain how they have had regard for matters set out in s172 in a siloed statement, but it should cross-refer to other disclosures in the annual report to join all the dots."



Freddie Woolfe
Head of Responsible Investment
and Stewardship, Old Mutual
Global Investors

However, not all disclosures clearly explain how the mechanisms work in practice, and whether the board engages with employees or if it is management only who conducts this engagement. This lack of clarity about the board's role also applies to the reporting on engagement with other

stakeholder groups. Both the 2018 Code and the new secondary legislation³ require the board's involvement in engagement with employees and other stakeholders, so this is an area of practice and reporting that we expect to develop in coming years.

Many disclosures make boilerplate references to the process or mechanism in place, rather than focusing on the outcomes. Some do go further, such as by disclosing metrics relating to employee engagement. As an example, Inmarsat plc's 2017 ARA (page 17) includes employee engagement as a KPI, linking it to the company's strategy, risks and remuneration outcomes for executive directors. Fewer companies disclose details such as issues raised (see more below).

Engagement with other stakeholders

In terms of engagement, employees and shareholders are the most common stakeholder groups referred to in disclosures. However, 65% of companies describe methods used to engage with other stakeholders such as customers, suppliers, communities and governments.

For these other stakeholder groups, customer engagement mechanisms are most often described, with 17% of companies explaining their use of customer satisfaction surveys or the Net Promoter Score. For example, St. James's Place plc discloses in its 2017 ARA (page 20) three related KPIs: client numbers, client retention and client advocacy (the number who would recommend the service to someone else). It will be interesting to see the development of trends with

Case studies

Drax Group plc 2017 ARA (pages 44 and 45)

- ▶ Detail of key engagement activities and topics raised segmented by stakeholder group
- ▶ Stakeholder and shareholder engagement disclosed alongside each other

Taylor Wimpey plc 2017 ARA (page 51)

- ▶ Overview of both shareholder and stakeholder engagement activities
- ▶ Cross-references to sections of the report where greater detail can be found

these KPIs over time, especially as investors (and other groups) increasingly focus on wider performance metrics.³

One current trend is for companies to report on their engagement activities with shareholders alongside their engagement activities with other stakeholders: 32% of companies in our sample have done so this year. We expect this percentage to increase in future. Many governance reports still follow the structure set out in the 2016 Corporate Governance Code, but Section E 'Relations with shareholders' has now been integrated throughout the 2018 Code³. Therefore, companies will have the opportunity to innovate and change the way they present this information.

³ Financial Reporting Lab, *Reporting of performance metrics*, June 2018.

Shareholder engagement

Last year we found that only a minority of ARAs disclosed the specific feedback or topics discussed with shareholders during the year. Encouragingly, the majority now do this. Figure 4 shows the most commonly discussed issues.

We also compared the disclosures made by companies in our sample with those in two investor stewardship reports (Standard Life Investments⁴ and Legal & General Investment Management⁵) that reference specific engagements undertaken. These reports highlight board composition and succession planning, executive pay, climate change, and transparency as the top five themes discussed in meetings in 2017. Consistent with our findings last year, just over half of the companies referenced in the stewardship reports reflect in their own annual reports the topics that investors raised with them. However, these companies do not fully cross-refer to all the topics outlined in the stewardship reports.

Effect of stakeholder engagement on board decision-making

Disclosures of stakeholder engagement are more useful if they explain what matters were discussed, the feedback received, and detail the actions, if any, taken as a result. However, the majority of ARAs we reviewed simply describe the company's engagement mechanisms. This may be partly because the engagement methods are new to many companies, so reporting in this area will take time to develop.

Companies will have to evolve their disclosures, as the new secondary legislation⁶ requires reporting on how they have had regard for their employees, suppliers, customers and others, including *the effect of that regard on principal decisions taken by the company*.

We found that some companies are already moving in this direction. A significant minority of the reports we analysed disclose the feedback or topics discussed with stakeholders (including shareholders), and some already go the step further to explain how that feedback has impacted the company's decision-making (see Figure 5).

From our direct discussions with companies, we believe that, in practice, more companies do take this engagement into account in their decision-making. We expect disclosures to become clearer on these effects in future.

As indicated earlier (when considering engagement with the

workforce), ARAs also fail to make clear whether the directors are involved in engagement processes or whether reports on the results of engagement are fed up to the board. In the light of both the secondary legislation and the 2018 Code⁷, we look forward to seeing more information about how directors gain the necessary exposure to stakeholder interests, and the outcomes of these interactions.

Social impact reporting

In addition to greater focus on engaging with stakeholders, there have been a few developments requiring companies to disclose more on their social impacts. In this year's report we look at two areas:

- ▶ The 'non-financial information statement'
- ▶ The Task Force on Climate-related Financial Disclosures (TCFD)

Topics discussed with shareholders

% of those who report topics

Remuneration	82%
Strategy	32%
Financial performance	25%
Capital allocation/investments/disposals	15%
Shareholder returns (dividends and buybacks)	6%
Board effectiveness, composition and succession	14%
Other governance	22%
Sustainability	9%
Other	18%

Figure 4. Most commonly discussed topics with shareholders

⁴ Standard Life Investments, *ESG Annual Review 2017*, May 2018. Following the merger with Aberdeen Asset Management Plc to create Standard Life Aberdeen plc, this is the last ESG Annual Review from Standard Life Investments.

⁵ Legal & General Investment Management, *2017 Corporate Governance Report*, May 2018.

Employee engagement survey

Employee engagement remains a consistent priority as we navigate changes to our business. Last year, each member of the Pearson Executive Management team committed to respond to the key themes highlighted in our 2016 Employee Engagement Survey. Each Executive developed a plan with progress monitored quarterly. Highlights from those plans:

Aspect	Issue	Response
Career Development and Mentoring	More information for employees on how to progress their careers at Pearson	Over 1,500 employees participated in Career Development Workshops across 111 sessions in 27 locations in 23 countries. Over 100 mentoring relationships have been established.
Company Strategy	To do more to communicate on our products and reporting on progress	We introduced Discovery Days – forums to engage employees on our strategy, products and brand and provide workshops to gain new skills. 24 Discovery Days were held in 2017 in 14 countries. Since 2016, 24% of Pearson employees have attended a Discovery Day.
Learning and Development	More opportunity to develop functional and management skills	Academies were launched on Technology, Product, Sales and Finance to strengthen expertise and career development. We introduced Workforce 2020 capabilities defining who we are, how we act and what we do. These provide guidance on the capabilities Pearson expects. We launched our Leadership Academy, delivering what leadership looks like at all levels in the organisation. The Academy offers a range of programmes, resources and support. It includes a pilot of a new Manager Fundamentals training programme to help prepare new managers for success. All of the above are available through Pearson U and open to all employees. In 2017, 25,725 employees took at least one course in Pearson U.

During 2017, we followed up by asking 1,700 Pearson leaders to take an organisational health survey to help us understand areas where we could further boost performance. Key findings include the following:

Aspect:	Action taken:
Being clear on our strategy	Set our three strategic priorities, published a company-wide performance dashboard, appointed a new Chief Strategy Officer and been clear on our priorities as part of our brand focus
Accountability and ownership	Have been more explicit on expectations of individuals to collaborate and deliver against the strategy
Innovation and partnership	Invested in new platforms and partnerships
Insight	Created a global research and insight function
Operational excellence	Accelerated the investment in centres of excellence, driving efficiency through investment in technology
Diversity and inclusion	Established a new committee and global team to help us better reflect the communities we serve

Figure 5. Pearson plc 2017 ARA (page 27)

Non-financial information statement

Last year, we highlighted that the EU Non-Financial Reporting Directive (NFRD) would be implemented through The Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016. These amended strategic reporting requirements in the Companies Act 2006 through the insertion of sections 414CA and 414CB, as well as diversity policy disclosures through amendments to the Disclosure and Transparency Rules.

The requirements apply to financial years beginning on or after 1 January 2017, and the ARAs we analysed were the first needing to comply. These disclosures were made in advance

of the FRC's July 2018 *Guidance on the Strategic Report*, which is a useful tool for interpreting the regulations, and so we expect reporting to mature in future years.

It is worth noting that some FTSE 350 companies are not caught by these rules, either because they are incorporated in another EU member state that has implemented the directive differently, or because they are incorporated outside the EU, such as in Jersey. An example of an EU member state that implemented the NFRD differently to the UK is Ireland, which allows the non-financial information statement to be included in a separate report (such as a sustainability report); the UK does not.

"There's a link between value creation and stakeholder engagement. Investors are interested in information about employees and customers as they affect a company's value."



Hannah Armitage
Project Manager,
Financial Reporting Lab

Separately, there are clear materiality tests (discussed on page 23) and the level of disclosure by companies in each area of non-financial reporting may vary, subject to what companies deem to be material.

Presentation

The regulations require the inclusion of a 'non-financial information statement' in the strategic report of qualifying companies, although this can be incorporated across the strategic report. We found that only a handful of companies make their disclosures in a single statement or section, such as International Consolidated Airlines Group SA (2017 ARA pages 47 to 56).⁶

8% of our sample include a statement referencing the regulations and disclosing at a high level where the disclosures have been incorporated, as shown in Figure 6. This approach is the one that the FRC recommended in its guidance issued in July 2018.⁷ One company, Lloyds Banking Group plc (Figure 7), provides a destination table cross-referencing how all the requirements of the regulations are met. This is the only such example we have seen and we consider it an effective approach.

The vast majority of companies incorporate the disclosures throughout their ARAs without making an explicit reference to the non-financial reporting

NOTE:

The information required to be contained in the non-financial reporting statement under section 414CA Companies Act 2006 is set out on pages 23 to 24 and 45 to 48 of this strategic report. Other relevant information is detailed in the sections on Capita's business model, key performance indicators and approach to risk management.

Figure 6. Capita plc 2017 ARA (page 48)

regulations. Companies tend to concentrate the majority of their disclosures in one place, such as a corporate social responsibility section, but with non-financial KPIs and relevant principal risks disclosed within the sections relating to their other KPIs and risks.

Non-financial information statement			
We aim to comply with the new Non-Financial Reporting requirements contained in sections 414CA and 414CB of the Companies Act 2006. The below table, and information it refers to, is intended to help stakeholders understand our position on key non-financial matters. This builds on existing reporting that we already do under the following frameworks: CDP, Global Reporting Initiative, Guidance on the Strategic Report (UK Financial Reporting Council), UN Global Compact, UN Sustainable Development Goals and UN Guiding Principles.			
Reporting requirement	Policies and standards which govern our approach	Risk management and additional information	
Environmental matters	<ul style="list-style-type: none"> Environmental statement 	Environment, pages 26–27	Environmental risk management, page 133
Employees	<ul style="list-style-type: none"> Ethics and Responsible Business Policy¹ Ethical Policy Statement Colleague Policy¹ Code of Responsibility Health and Safety Policy¹ 	<ul style="list-style-type: none"> Equality, inclusion and diversity, page 21 Health, safety and wellbeing, page 22 Learning and development, page 22 Responsible conduct and culture, page 24 Diversity, skills and composition, page 58 	<ul style="list-style-type: none"> Board Diversity Policy, page 72 People risk, page 136 Governance risk, page 150
Human rights	<ul style="list-style-type: none"> Human Rights Policy statement Colleague Policy¹ Pre-Employment vetting standards¹ Data Privacy Policy¹ Anti-Slavery and Trafficking Statement Information and Cyber Security Policy 	<ul style="list-style-type: none"> Human rights, page 22 Responsible and ethical lending, page 24 Working with suppliers, page 25 	
Social matters	<ul style="list-style-type: none"> Volunteering standards¹ Matched giving guidelines¹ 	Helping communities, page 19	Communities, page 25
Anti-corruption and anti-bribery	<ul style="list-style-type: none"> Anti-bribery Policy¹ Anti-bribery policy statement Anti-money laundering and counter terrorist financing Policy¹ Fraud Risk Management Policy¹ 	<ul style="list-style-type: none"> Customer privacy and data security, page 23 Responsible conduct and culture, page 24 Operational risk, pages 135–136 	
Policy embedding², due diligence and outcomes		Risk overview, pages 32–33	Risk management, pages 107–156
Description of principal risks and impact of business activity		<ul style="list-style-type: none"> External environment, pages 8–9 Creating value for our stakeholders, page 11 Addressing the issues that matter most, page 21 	<ul style="list-style-type: none"> Direct and indirect economic contribution, page 24 Risk overview, pages 32–33 Principal risks, pages 34–37
Description of the business model		Our business model, pages 10–11	Our next chapter, page 14
Non-financial key performance indicators		<ul style="list-style-type: none"> Key performance indicators, page 7 What we have achieved over the past three years, page 12 Doing business responsibly, page 18 Helping Britain Prosper, pages 19–20 	<ul style="list-style-type: none"> Running a responsible business, pages 21–25 Environment, pages 26–27

¹ Certain Group Policies and internal standards and guidelines are not published externally.

² The policies mentioned above form part of the Group's Policy Framework which is founded on key risk management principles. The policies which underpin the principles define mandatory requirements for risk management. Robust processes and controls to identify and report policy outcomes are in place and were followed in 2017.

Figure 7. Lloyds Banking Group plc 2017 ARA (page 27)

⁶ Note: this example is incorporated in Spain.

⁷ Financial Reporting Council, *Guidance on the Strategic Report*, July 2018, pg47.

- (1) The non-financial information statement must contain information, to the extent necessary for an understanding of the company's development, performance and position and the impact of its activity, relating to, as a minimum—
- (a) environmental matters (including the impact of the company's business on the environment),
 - (b) the company's employees,
 - (c) social matters,
 - (d) respect for human rights, and
 - (e) anti-corruption and anti-bribery matters.

Figure 8. Companies Act 2006 s414CB 'Contents of non-financial information statement'

74% of the companies we looked at have a single standalone section on corporate responsibility or sustainability within their strategic report.

KPIs and principal risks

The non-financial reporting regulations overlap significantly with pre-existing requirements under s414C to report on environmental matters, employees, social, community and human rights issues to the extent necessary for an understanding of the development, performance and position of the company. The non-financial information statement extends this list of matters to include anti-corruption and anti-bribery.

Figure 9.

Most common new principal risk categories

Principal risk	Number of companies
Cyber security / Data protection	15
Environment / HSE	8
People / Employee	7
Competitor as a new risk	6
Bribery / Corruption	4

Even though a description of non-financial KPIs relevant to the non-financial reporting matters (NFR matters) (see Figure 8) was required in this year's ARAs, we saw no significant increase in the number of KPIs disclosed from last year (finding an average of six non-financial KPIs).

The number of principal risks also remains unchanged (at 12), however, there was some change to the categories used by companies. It is interesting to note that where companies added new principal risks, three of the top five most common additions relate to NFR matters (they relate to the environment, employees and anti-corruption and anti-bribery matters). Please see Figure 9. Broadly speaking, the same applies to non-financial KPIs, with the exception being that the most common additional KPI relate to employee engagement, followed by a customer-related metric, in line with the broader stakeholder engagement agenda.

A key change introduced by the regulations is that companies are

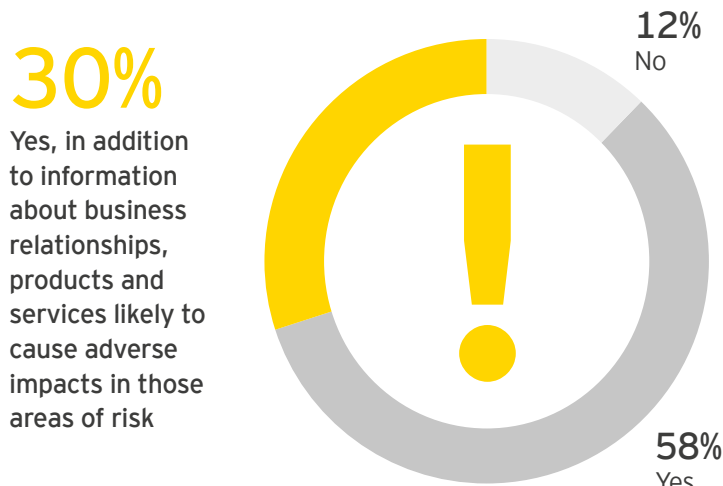
required to describe not only the principal risks relating to the NFR matters, but also the business relationships, products and services likely to cause adverse impacts in those areas of risk. As seen in Figure 10, we found that although 88% of companies disclose at least one principal risk relating to the NFR matters, only 30% outline in the risk description those relationships, products or services. Most commonly this relates to the risk posed by suppliers and other third parties, but not exclusively. ITV plc (Figure 11), for example, provides a description of the potential impact of the expansion of ITV Studios on the risk of a health and safety incident that could result in the loss of human life. We also saw some examples of companies highlighting business relationships, products and services as separate principal risks, although this is not required by the regulations.

Policies, due diligence and outcomes

Pre-existing law required companies to disclose policies –

Figure 10.

Do companies disclose principal risks relating to NFR matters?



Case studies

G4S plc 2017 ARA

(page 13)

- Full list of relevant policies provided
- Links to different pages of website where policies and case studies can be viewed

Aggreko plc 2017 ARA

(page 73)

- Overview of compliance programme with some information of due diligence processes implemented in pursuance of policies

and their *effectiveness* – in relation to environmental matters, employees, and social, community and human rights issues. The non-financial information statement goes further, with an additional area (anti-bribery and corruption), and requiring an explanation of the due diligence processes implemented

in pursuance of the policies disclosed. In addition, rather than reporting on effectiveness, companies must report the outcome of the policies.

The vast majority of reports we analysed state that they had policies in place relating to the NFR matters, but this consists mostly

of a high-level confirmation (e.g., 'we have an anti-bribery and anti-corruption policy'). Few describe those policies. Moreover, it is questionable whether the policies disclosed cover all the issues raised by the NFR matters; for example, whether charitable donations policies truly cover social matters, or if health and safety policies fully cover employee matters.

There is a major health and safety incident that results in a significant loss of human life on a production.

- As ITV Studios expands, there is a continued increase in the number of production hours, and an increased potential to produce certain types of programming that have higher inherent risks
- ITV has a central health and safety team and health and safety policies and procedures in place, with appropriate training for employees where required
- We have developed our safety management approach to align with our studios label model to ensure ownership of risk in the appropriate business areas. To reflect this, we are developing our training programme initially through Leading Risk (see case study on page 79)
- We are continually reviewing our processes and overall approach to production safety (see case study on page 78) and have built a comprehensive online resource to provide easily accessible production focused health and safety advice and support
- We are developing our reporting tools to provide increased oversight of risks across the Studios division

This risk has increased since last year as ITV undertakes more complex productions.

Figure 11. ITV plc 2017 ARA (page 55)

Fewer companies disclose the due diligence processes implemented in pursuance of their policies. However, many companies may have more due diligence processes in place than they report. Where ARAs do include disclosures on due diligence processes, these are generally boilerplate. This is despite FRC guidance, which states: 'Any disclosures relating to due diligence processes should be entity-specific



Figure 12. WPP plc 2017 ARA (page 40)

and informative. Boilerplate disclosures are of limited use.¹⁸ The disclosures we saw typically include mentions of mandatory training, whistleblowing, supplier screening or audits, or monitoring of health and safety metrics. It is not necessarily obvious to which policies the due diligence processes relate (e.g., when discussing whistleblowing metrics, it was not clear if these relate to corruption, theft, misconduct, etc.).

Reporting in this area could well evolve, particularly given the increased scrutiny of employee and stakeholder engagement, and the board's increasing role in assessing and monitoring culture. For example, we see scope for cross-referencing between sections, which would help to reduce the boilerplate nature of current disclosures.

Even fewer companies disclose the outcomes of their policies. Some report outcomes included

putting due diligence processes in place, although it is not clear that this is truly what the EU or UK Government intended.

We found some positive examples, which include the disclosure of quantitative metrics demonstrating reductions in environmental degradation, emissions and waste, and fewer reportable health and safety incidents. However, we noted that companies tend to articulate *improvements* in outcomes; few openly discuss worsening outcomes and any need for corrective action in future periods. This brings into question how these disclosures meet the fair, balanced and understandable test, since it appears they may not be balanced in nature.

Impact of activity

NFRD introduced into UK law an additional filter for determining what to disclose in relation to non-financial matters. Companies

already had to report on the matters to the *extent necessary* for an understanding of the *company's development, performance and position*, but now they must additionally do so to the extent necessary for an understanding of the *impact of the company's activity*.

Many companies explain the positive impacts of their business, such as contributions to charity, volunteer days and employee opportunities. In Figure 12, WPP plc's disclosure is an example of a company that illustrates these positive impacts, as well as some indirect and negative impacts.

As with the outcome of policies, fewer companies disclose the negative impacts of their activities. To gain a balanced understanding of the impact of a company's activity from an external perspective, it is critical that negative as well as positive impacts are considered and disclosed.

Some companies do address this aspect of the regulations well, and some of the relevant disclosures are highlighted as case studies, overleaf.

Materiality

Given that the 'impact of activities' should be viewed as a 'materiality' filter, itemised disclosures of impact for all the NFR matters are not, strictly speaking, required. Rather, if the company's activity has a material impact on, for example, a local community (judged externally, and not in terms of materiality to the company's revenue), then that information needs to be disclosed.

¹⁸ Financial Reporting Council, *Guidance on the Strategic Report*, July 2018, pg49.

“It is important to ensure that non-financial reporting does not revert to boilerplate or marketing hype. I am concerned that narrative sections often contain information which is scattered, repeated and sometimes exaggerated for marketing purposes – making the front half of ARAs very long and difficult to pick through to get at key information.”



Peter Parry
Policy Director,
UK Shareholders' Association

Moreover, in its guidance, the FRC states that the descriptions of policies, due diligence and outcomes are only to be disclosed when necessary for an understanding of the company's development, performance and position, and the impact of its activity.⁹ If the company decides to report additional information, this should be located outside the strategic report, e.g., in a sustainability report located online.

We found that the majority of companies make their non-financial disclosures without reference to how they have determined that the information is deemed to be material. Only 18% mention materiality in relation

to these matters. This ranges from high-level disclosures on the process undertaken to assess materiality to ones which give more detail, including some which publish materiality matrices (see Figure 13).

The Global Reporting Initiative has published guidance on defining materiality in relation to stakeholder issues. This includes industry-specific guidance, such as for the mining, metals and electric utilities sectors (see Appendix A for more details). Although the guidance does not exactly align with the regulations, it does overlap, and a few companies in our sample have been using it to help with their materiality assessment.

It will be interesting to see whether companies, alongside adopting the *Guidance on the Strategic Report*, leverage increased stakeholder engagement and wider changes to corporate governance to improve reporting in relation to the non-financial information statement. However, overlaps between the non-financial reporting regulations and wider UK corporate governance reforms could impede progress – companies may focus on the newest changes, influenced by the increased Government and press interest in the governance reform agenda.

Task Force on Climate-related Financial Disclosures

Awareness of the potential impacts of climate change has been increasing for some time. Some

Case studies

Evrac plc 2017 ARA

(pages 104 and 105)

- Narrative analysis of the company's compliance regarding anti-bribery and corruption

Polymetal International plc 2017 ARA

(pages 52, 53 and 56)

- Disclosure of the impact of the company's activity in relation to its employees

Glencore plc 2017 ARA

(pages 34 and 35)

- Disclosure of the impact of the company's activity in relation to social matters

Unilever plc 2017 ARA

(pages 7 and 14)

- Disclosure of the impact of the company's activity in relation to human rights

companies, however, may still view climate change as a distant issue, even though its implications form a risk to the long-term viability of businesses across many sectors and geographies. For example, the rise in extreme weather events, carbon policy mechanisms (e.g., carbon cap-and-trade mechanisms and low-carbon levies) and disruptive shifts to green technologies.

⁹ Financial Reporting Council, *Guidance on the Strategic Report*, July 2018, pgs49-50.

Until recently, the degree to which companies report on how they manage these risks has varied considerably and, in many cases, disclosures are limited. However, the recent wave in shareholder resolutions on this topic demonstrates that investors are increasingly dissatisfied with the lack of quality disclosure on climate-related risk. In response, the Financial Stability Board (FSB) created the Task Force on Climate-related Financial Disclosures (TCFD) to establish a set of recommendations for consistent 'disclosures that will help financial market participants understand their climate risks'. The recommendations, issued in June 2017, suggest that companies start to disclose the following:

1. The risks and opportunities born out of climate change
2. The strategy and governance structure they intend to establish to address them

3. Metrics and targets they have set themselves to monitor their performance

The climate change debate is heating up

A year after the release of the TCFD recommendations, 20% of the companies we reviewed already claim to have responded, or state their intention to do so. But even more companies discuss the implications of climate change on their business without specifically referencing TCFD: 37% describe the long-term risks and/or opportunities of climate change on their business. 23% include information on the board's oversight and management's role in assessing risks and/or opportunities arising from climate change, and 17% of companies include information on how climate risks and opportunities could impact strategic and financial planning.

"On value creation, investors are most interested in the answer to the question 'If scenario X happens, what does it do to your business model?' That's why TCFD has gained a lot of momentum. TCFD is not asking for impact on the environment for the sake of it, but asking for impact on the business model."



Hannah Armitage
Project Manager,
Financial Reporting Lab



Figure 13. Pearson plc 2017 ARA (page 26)

Climate change affects all sectors – but some more than others

The TCFD recommendations apply to all sectors, but there is also specific guidance for a number of high impact sectors. Over half of insurance companies described their response to climate change in detail, indicating relatively high awareness of the long-term implications climate change may have for their services, investments and ultimately their beneficiaries (e.g., policy-holders, future pensioners, etc.). Conversely, industries that typically operate under shorter time horizons appear less prepared for climate change. For example, a very small proportion of companies in the industrial goods and services sector discussed the topic.

Shareholder pressure to move beyond disclosure

Although climate change receives much attention, only 10% of companies reference climate change in their principal risks and only four consider climate change as a separate principal risk. This leads readers to question how seriously companies consider the severity of climate change compared to other factors. But as shareholder awareness of climate risk is increasing, companies are facing pressure to go beyond disclosure alone and embed climate change in core risk processes.

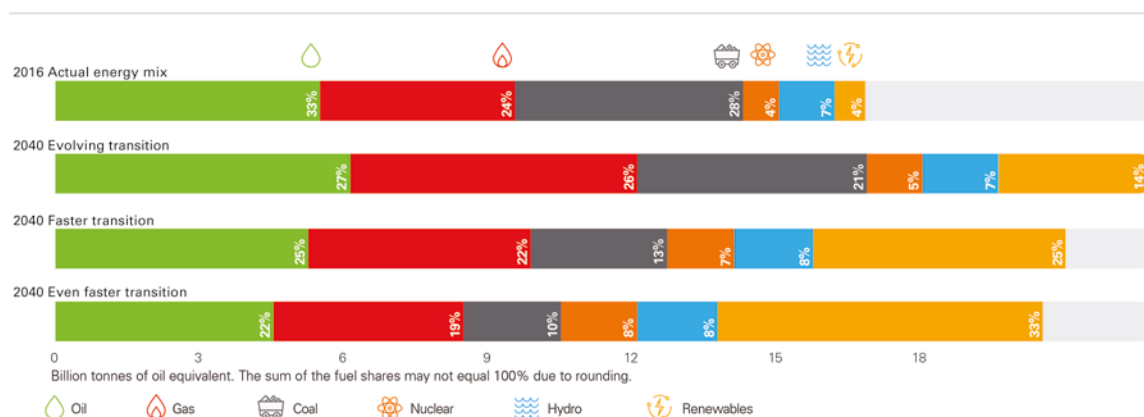
During some annual general meetings (AGMs) this year, a growing number of shareholders have shown their unease about the limited level of disclosure regarding the quantifiable financial implications of climate change on

future planning. One of the most comprehensive recommendations of the TCFD addresses this, by suggesting companies undertake analysis of company resilience under different climate scenarios. In our sample, only BP plc (see Figure 14) and Unilever plc (2017 ARA page 32) discuss the outcomes of their climate scenario analysis in their annual report, which may indicate the complexity of this exercise. But as the practice of climate scenario analysis matures and tools become more widespread, more companies should find it feasible to conduct scenario analyses that will help them respond to shareholder concerns.

Turning a risk into an opportunity

TCFD primarily puts forward recommendations in the context of risk, but climate change

Energy consumption – 2040 projections



Evolving transition

In this scenario, government policies, technology and social preferences evolve in a manner and speed seen in the recent past. The growing world economy requires more energy but consumption increases less quickly than in the past.

Faster transition

This scenario sees carbon prices rising faster than in the evolving transition scenario with other policy interventions encouraging more rapid energy efficiency gains and fuel switching.

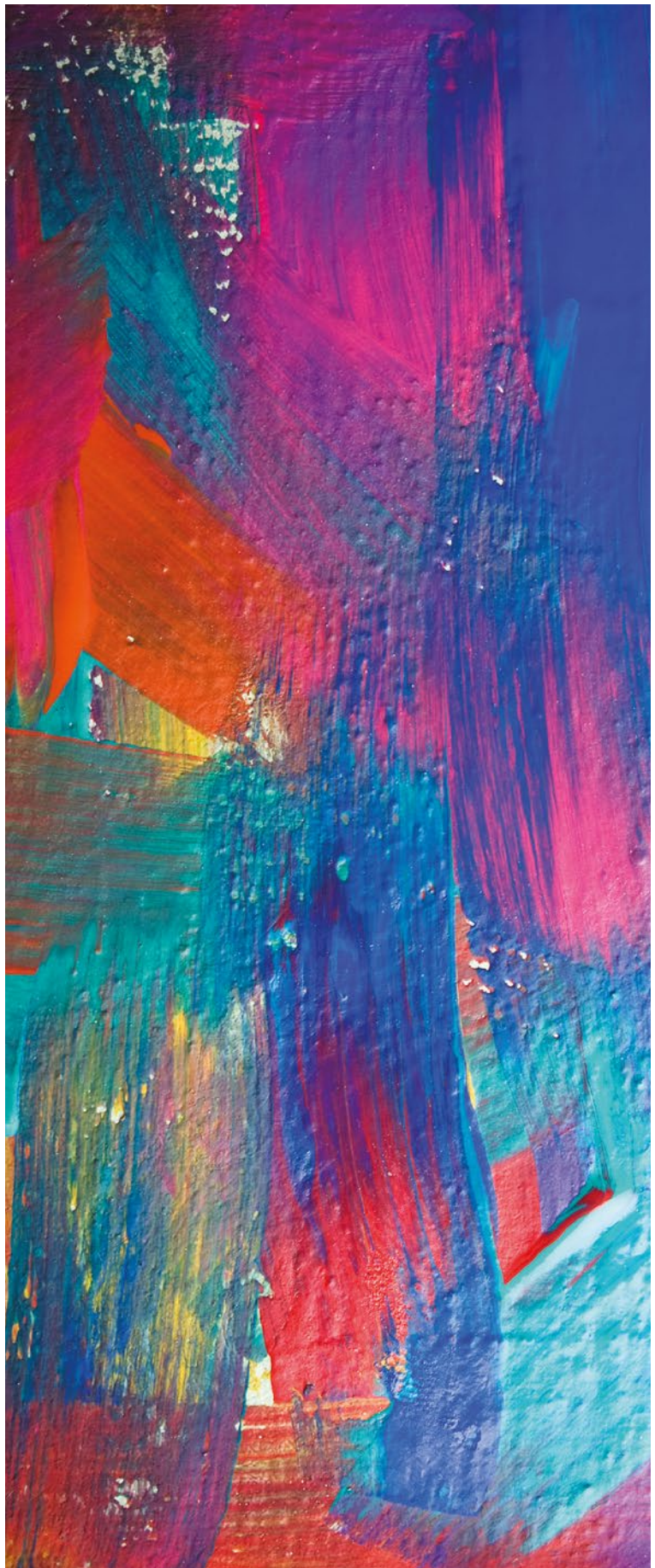
Even faster transition

This scenario matches carbon emissions similar to the International Energy Agency's sustainable development scenario which aims to limit the global temperature rise to well below 2°C.

Figure 14. BP plc 2017 ARA (page 11)

also provides opportunities to companies that respond to it successfully. 22% of companies in our review deem that climate change will result in both risks and opportunities for their business, with 9% seeing climate change solely as an opportunity. Companies acknowledge that climate change cannot be solved by one entity in isolation and that collaboration is required between different stakeholders, including businesses, their supply chains, regulators and governments.

Implementing the TCFD recommendations requires changes to typical governance and risk assessment processes. It will likely take several years for an organisation to be in a position to generate valuable information for investors to help them make informed decisions. The earlier organisations embark on this journey, the better – the TCFD initiative provides a platform to help educate directors and management about climate risks, and enables them to engage with investors on the impacts and opportunities for their company.



3

Chair tenure, diversity, culture and remuneration

Chair tenure

The 2018 Code[♦] (Provision 19) now states that the chair should not remain in post beyond nine years from the date of their first appointment to the board. This nine year period can be extended for a limited time, particularly in cases where the chair was a board member previously. However, in these cases, a clear explanation should be provided. This change is designed to encourage board refreshment and diversity.

The flexibility of extending the appointment was added to address concerns that introducing a time limit would discourage internal appointments (for e.g., from senior independent director to chair), with the result that companies would lose talent.

Our review found that 23% of companies in our sample have chairs who have served on the board more than nine years (see Figure 15). Going forward, these companies will be scrutinised more heavily as a result of the change in the 2018 Code.

Once the 2018 Code[♦] comes into effect, we recommend that companies whose chair is approaching the nine year limit consider disclosing: how much longer the chair is expected to remain in post; how wider succession planning, diversity and company objectives have been considered; and details of engagement with major shareholders on the topic.

0 - 3 years	31%
4 - 6 years	25%
7 - 9 years	21%
10 - 12 years	9%
13 - 15 years	8%
>15 years	6%

Figure 15. Total board tenure of chairs since first appointed to board

Diversity

Companies often disclose information on their diversity initiatives, but fewer disclose their effectiveness and impact. This remains an area for improvement. Examples of reported initiatives include the creation of transgender policies, programmes for women, diversity and inclusion awards, and flexible working arrangements for staff. Leading practice disclosures include the quantification of trends or historic data to demonstrate impact. Paddy Power Betfair plc's 2017 ARA (page 31) is an encouraging example: 'Since updating our job specs to be more inclusive, rolling out training to

"As diversity ought to result in a company having access to the best talent, it just makes common sense, and unsurprisingly studies have shown that board diversity can boost a company's performance. Investors are also interested in seeing how boards are building diversity below board level for the same reason."



Freddie Woolfe
Head of Responsible Investment
and Stewardship, Old Mutual
Global Investors

hiring managers, and requesting more diversity from our search partners and ourselves, we have increased the number of female hires from 20% (in May 2017) to 33% (in September 2017).[♦] Barclays plc also provides specific data to demonstrate the impact of its diversity initiatives (see Figure 16).

The 2018 Code[♦] (Principle J) expands companies' consideration of diversity to include social and ethnic backgrounds, and cognitive and personal strengths. We are seeing an increase in disclosures on diversity beyond gender, although other factors are not often discussed in a meaningful way. When they are, the most discussed aspects beyond gender include ethnicity, age, nationality, culture, disability, sexual orientation, type of contracts and experience of working in specific regions. Some companies, such as John Wood Group plc in its 2017 ARA (page 30), also discuss diversity of thought and cognitive strength. One of the key drivers of the diversity debate in corporate governance remains the need to avoid 'group-think' and increase board effectiveness.

15%

of reports provide detail on the impact of the initiatives taken to improve diversity.

23%

of companies discuss diversity beyond gender in a meaningful way.

[♦] – Denotes a reference to changes arising from the 2018 UK Corporate Governance Code or the Companies (Miscellaneous Reporting) Regulations 2018. These are explained in more detail in Appendix A 'The 2018 Code, new regulations and guidance' on page 45.

Case studies

Reckitt Benckiser Group plc 2017 ARA

(pages 2, 10 and 14)

- ▶ 'Our people and culture' identified as a strategic input under business model (page 2)
- ▶ 'Organisation and culture' identified as a strategic objective with targets, KPIs set out, progress and future actions set out

Metro Bank plc 2017 ARA

(pages 6 and 8)

- ▶ 'Unique culture' is identified as key to business model and is a strategic objective, with detail on progress and outlook, linkages with KPIs and risks

Aggreko plc 2017 ARA

(pages 14, 42 and 64)

- ▶ Culture is referenced under strategy and as a competitive advantage
- ▶ Culture is listed as an area of focus for board meetings, with detail on discussion and actions

Rentokil Initial plc 2017 ARA

(pages 6, 19, 35 and 49)

- ▶ Disclosed external metrics (Glassdoor and Trustpilot) to explain how culture is monitored in relation to workforce and customers
- ▶ Clear articulation of the culture and measurements used

"Investors today have access to a wide range of information. A company should consider whether the story in the ARA is comparable to third party information. If they don't, investors will, and it is likely to affect their views on the credibility of the information. Companies should seek to take control of their narrative."

Some metrics presented by companies may not be sufficiently reliable for an investor and as such they may be more likely to use third party information."



Phil Fitz-Gerald
Director,
Financial Reporting Lab

The majority of reports disclose information on board-level diversity only, with just a few companies meaningfully disclosing details about diversity below board level. Lloyds Banking Group plc's 2017 ARA (page 21) provides a good overview of various diversity aspects beyond gender across the workforce (including below board level). Disclosures could be even further improved by including a description of management's analysis of the current diversity levels and any targets to improve.

Culture

Culture has been a hot topic for a number of years and is of great interest to the FRC, investors and other stakeholders. The 2018 Code[♦] (Principle B) encourages the alignment of culture with the company's purpose, values and strategy. It also emphasises (Provision 2) the importance of board oversight of the assessment and monitoring of culture. This is a significant update and raises the importance of this area further.

47%

of reports articulate the culture the company has or the culture it seeks to create.

39%

explain how culture supports the business model or strategy (up from 10% in 2015/16).

Some companies have started to include more detailed descriptions of the culture they seek to create and the values they aim to embed. In certain sectors, specific values are given prominence, for example, health and safety in energy and mining companies, and innovation in healthcare companies. Culture is often mentioned in more than one place within reports, but is more frequently discussed in the chair's statement, the CEO's review, sections on corporate social responsibility, people and diversity, risk disclosures, and the corporate governance report.

More companies are explaining how instilling the right culture is important for their business model or strategy. Leading practice reporting in this area includes

"Culture disclosures often read like marketing, generic statements – it is hard to get a sense of the true culture through reading ARAs. Companies should articulate: What culture they need to build the business model and strategy and what measures (financial and non-accounting) are used. A company should disclose its success in relation to culture but also be transparent about the areas for improvement. In the long-term, culture will impact a company's ability to create value profitability. Investors do not only judge a company by their numbers but also look at their narrative for credibility."

Value creation and human capital reporting are not well reported. Metrics (e.g., employee satisfaction surveys) can be used to hide a lot of things. Companies should disclose external evidence corroborating their disclosures in their ARAs, where possible."



Freddie Woolfe
Head of Responsible Investment
and Stewardship, Old Mutual
Global Investors

explaining how having the right culture delivers positive outcomes and contributes to competitive advantage.

37%

of reports articulate how culture is embedded.

30%

explain how culture is measured (up from 9% in 2015/16).

Many discuss the importance of culture or identify culture as a board priority. However, only a minority (37%) explain clearly how culture is embedded (beyond 'setting the tone from the top'). The examples we found include the use of culture champions, new codes of ethics and the introduction of teams set up to address cultural change. We recommend that companies provide more context as to the purpose of their culture initiatives, and their reach where possible. For example, Meggitt plc's 2017 ARA (page 9) explains how it launched a culture development programme, how it has been deployed, that its aims are to foster more effective collaboration and increase employee engagement, and its link to financial targets.

We observed improvements in the explanations of how culture is measured beyond the use of employee surveys. Other methods include recording regional site visits, increases in training available, workforce turnover, informal engagement across the business, and the number of senior appointments made from within the business. However, the majority of companies do not explain clearly how culture is monitored. For example, a few referenced the use of a 'culture

dashboard' and 'culture audit' without providing details on the methodology or outcomes. The best examples disclose third party metrics in their culture reporting (see the Rentokil case study on page 29 of this report).

Overall, however, reporting on culture is often generic and limited. We have seen very few disclosures that identify any challenges faced in relation to culture or embedding it. One exception is Man Group plc's 2017 ARA (page 44), which discloses the board's challenge to management over the extent to which its business principles are embedded in employees' day-to-day behaviours (including any variation of penetration across different teams), despite the difficulties reporting and monitoring such qualitative issues.

In addition, we found that while a few companies disclose employee turnover, the workers' reasons for leaving (an area of interest to investors) is not discussed.

Multigenerational

Our Dynamic Working campaign is relevant to colleagues at every life stage. It addresses the diverse needs of a workforce comprised of five generations, by encouraging the integration of personal and professional responsibilities through smarter work patterns. The campaign is having a positive impact on colleague engagement with the 59% of colleagues actively working dynamically in 2017 reporting 5% points higher than the Group sustainable engagement result. Dynamic Working is also enabling Barclays to have a positive impact on the retention of diverse talent, examples include a 13% improvement in maternity returners retained after 12 months, and 95% of those taking Shared Parental Leave are fathers.

Addressing the changing needs of a multigenerational workforce will be an ongoing focus in 2018 but we are pleased that Working Families UK has recognised Barclays as one of the top 10 Employers for Working Families in 2017.

Figure 16. Barclays plc ARA (page 46)

"Companies often say 'our people are our biggest asset' without setting out what particular aspects of the workforce are considered to be important – high skills and productivity? Low staff turnover? Companies should articulate how the culture drives value, performance and strategy.

Investors are particularly interested in employees because they are the ones that are driving the success of the company."



Phil Fitz-Gerald
Director,
Financial Reporting Lab

Remuneration

More companies have disclosed their gender pay gap figures in their ARAs this year (25%, up from 4%), despite it only being a mandatory website disclosure. Many more companies referred readers to their websites for this information. Among the companies choosing to disclose gender pay gap details in their annual report, the better examples provide some benchmarking (e.g., to Office for National Statistics national averages), explanations, assumptions and limitations of the findings, and future actions. Examples of this can be found in Barclays plc's 2017 ARA (pages 90 and 91) and Spire Healthcare Group plc's 2017 ARA (pages 46 and 47).

The Companies (Miscellaneous Reporting) Regulations 2018 (see Appendix A) ♦ include a requirement for companies to report CEO to employee pay ratios. Although the regulations are not yet effective and the detail was unknown when our sample of companies published their ARAs, 7% voluntarily reported pay ratios.

When companies published their ARAs the secondary legislation ♦ had not yet been made public, therefore some companies devised their own methodology for calculating the ratios. For example, John Wood Group plc's 2017 ARA (page 64) uses two different methodologies to calculate the ratio, and Metro Bank plc's 2017 ARA (page 75) states that its current year methodology changed from last year.

The secondary legislation will require companies to disclose a 'pay ratios table' of CEO pay to the first quartile, median and third quartile of employee pay. It gives companies three options for how to calculate these figures. Going forward, historical data will have to be disclosed for each preceding year in which the requirement applied, up to a maximum of nine years. In the next couple of years, however, and especially where companies have reported pay ratios ahead of the regulations, data will not be comparable until more than one year's worth of calculations have been performed using the same methodology.

The 2018 Code ♦ explicitly links culture, practices and behaviour to incentives and rewards throughout the whole company (Principle Q, and Provision 2 and 33). The remuneration committee should also review workforce and related policies, and the alignment of incentives and rewards. The committee's role now also includes setting senior management (i.e., first layer below board level) pay.

With a view to this, we found that 40% of companies discussed senior management remuneration. Their discussions focused on topics such as the broad senior management remuneration policy or structure, the general incentives or reward strategy (e.g., shares and bonuses), how senior management reward schemes are aligned to those of executive directors, the gender pay gap, and high earners. We also identified two companies that explicitly referenced culture – which forms

"Gender pay gap disclosures can be instructive. They can indicate if something is wrong or out of kilter. For example, if women are not properly represented at higher levels of management and are not amongst the highest earners, it calls into question the company's commitment to promoting a meritocracy in the workplace."



Peter Parry
Policy Director,
UK Shareholders' Association

part of their strategy – as a consideration in the remuneration section: ITV plc (2017 ARA page 89) and Elementis plc (2017 ARA page 71).

In the next reporting cycle we expect to see remuneration committee reporting to discuss these issues much more widely, in advance of adopting the wider responsibilities set out in the 2018 Code ♦.



4

Audit committee reporting

Current trends in audit committee (AC) reporting

This year's review included the first December and January year-end companies required to apply the 2016 UK Corporate Governance Code. This added the requirement for the audit committee as a whole to have competence relevant to the sector in which the company operates, and for advance notice of any audit retendering plans to be given in the annual report. Additional disclosure recommendations were also added to the 2016 Guidance on Audit Committees. These were as follows:

- ▶ How the AC composition requirements have been addressed, and the names and qualifications of all members of the AC during the period, if not provided elsewhere
- ▶ How the AC's performance evaluation has been conducted
- ▶ The name of the current external audit partner, and how long they have held the role
- ▶ If the external auditor provides non-audit services, the AC's policy for approval of non-audit services
- ▶ Audit fees for the statutory audit of the financial statements
- ▶ Fees paid to the auditor and its network firms for audit-related services and other non-audit services, including the ratio of audit to non-audit work
- ▶ For each significant engagement, or category of engagements, an explanation of what the services are and why the AC concluded that it was in the interests of the company to purchase them from the external auditor

- ▶ An explanation of how the committee has assessed the effectiveness of internal audit and satisfied itself that the quality, experience and expertise of the function is appropriate for the business
- ▶ The nature and extent of interaction (if any) with the FRC's Corporate Reporting Review Team (CRRT)
- ▶ Where a company's audit has been reviewed by the FRC's Audit Quality Review Team (AQRT), disclosures about any significant findings and the actions the AC and the auditors plan to take (but should not include disclosure of the audit quality category)

Last year we found that some companies were already starting to make some of these disclosures early. It has been interesting to observe how reporting has progressed this year.

Disclosure on meeting composition requirements

The percentage of companies providing an explanation of how the composition requirements of the AC have been addressed (a recommendation in the Guidance on Audit Committees), particularly in relation to the sector competence, has remained static at 61%. However, the quality of the information given has broadly improved. Although the board director biographies would usually provide sufficient information to be able to determine who has financial and sector-relevant experience, readers can benefit from the AC report bringing this information together to explain exactly what type of experiences qualify the AC members and meet the composition requirements. There

are some good examples to be found in the 2017 annual reports of Fidessa Group plc (page 45) and Astrazeneca plc (page 102).

Reporting on external audit and tendering

It has long been established that the AC should recommend the appointment and removal of the auditors to the board. Updates to regulations following the EU audit reforms also made the AC responsible for the process of selection and required it to provide a minimum of two recommendations of prospective audit firms to the board.

"An important feature of disclosure on tendering is an explanation of how the AC is or was involved in the tender process and in recommending the auditor. Companies should explain how the AC satisfied itself that the auditor appointed has the right skills and resources for the audit. This would increase the reader's confidence in the integrity of the financial statements, which is an integral component of the ARA."



Charles Henderson
Business Manager,
Invesco Perpetual, and member
of FRC AQR Committee

In line with this, the 2016 Code added a Provision for disclosing advance notice of any retendering plans. We found that 26% of companies disclose such plans. Another 26% either had an audit tender in the year or were retendering when they reported. A significant proportion of the others may not have been planning for their next tender, in which case this disclosure requirement would not be relevant. Overall, however, more companies made disclosures about their retendering plans this year.

The 2016 Guidance for Audit Committees also suggests that ACs give an explanation of how they have assessed the effectiveness of the external audit process and of the approach taken to the appointment or reappointment of the external auditor. Of the 14 companies that reported on an audit tender during the year, eight provided an explanation of the tender process and selection criteria. Common criteria included audit quality findings, independence, understanding of the business, geographic coverage, resources, use of data analytics and technology, ability to offer robust challenge, cultural fit and value for money. We found that leading practice disclosures on process included some or all of the following:

- ▶ Clarity on AC leadership in conducting the tender
- ▶ Evaluation criteria in the request for proposal
- ▶ Considerations in determining a shortlist and number of participating firms
- ▶ Who from the company was involved in the process and who was involved in meetings
- ▶ Information on any site visits

- Topics discussed in meetings and presentations
- Reasons why the auditor was appointed

Reckitt Benckiser plc's 2017 ARA (page 74) provides a leading practice disclosure on the AC role in running the tender and what the process entailed, including the number of participating firms and criteria for selection. Some reports also discuss the plan for audit transition, such as BAE Systems plc's 2017 ARA (page 83).

We saw less disclosure from companies that are not currently tendering their audit on the length of tenure of the current audit firm, when a tender was last conducted, who the current audit partner is and how long they have held the role – all suggested disclosures in the 2016 Guidance for Audit

Committees. This is an area for potential improvement.

Going forward, the scrutiny on the AC's role in tender process is set to increase even further. Where language previously centred on responsibility for the process and making recommendations, the 2018 Code[♦] (Provision 25) is now much more specific on the committee's role being to *conduct* the tender.

Interactions with the CRRT and AQRT

We looked to see how many reports followed the 2016 Guidance on Audit Committees recommendations for disclosure on:

- The nature and extent of interaction (if any) with the FRC's CRRT
- Where a company's audit has been reviewed by the FRC's AQRT, disclosures of any significant findings and the actions the AC and the auditors plan to take

12% of companies disclosed that the CRRT had reviewed their ARA. Leading practice disclosures provide details on:

- The objective of the review
- Dates when the review occurred
- What was reviewed by the CRRT
- Conclusions and recommendations reached by the CRRT
- Any subsequent responses or changes made by the company

Similar to last year, 23% of reports in our sample disclose that a

review of the company's external audit was carried out by the FRC's AQRT, with 15% including detail around the AC's involvement in the review process, an improvement from last year. Value-adding insights include:

- The focus of the review
- How the AC was informed of AQRT findings
- The interaction between the AQRT, the AC and the audit firm
- Any impact on the quality of the audit for the company
- Agreed actions taken by the audit firm for the company's audit and for the audit firm more broadly

It should be noted that many companies will not have been subject to a CRRT or AQRT review in the year. Others that were subject to one may not have disclosed this.

Assessment of the AC's own performance and effectiveness

According to the 2016 Code, board evaluations (both internal and external) should include reviews of each of the committees. The FRC Guidance recommends that ACs provide an explanation specifically on how their performance evaluation was conducted. This year, 71% of AC reports mention how the AC's own effectiveness was evaluated during the year. However, the explanations vary considerably in terms of depth, with many reports making only a brief mention that the AC was assessed as part of the overall board evaluation. Leading practice disclosures feature

"AQRT disclosures should form part of the explanation of how the AC gained assurance over the financial reporting. Context should be provided, which shouldn't be difficult to do."



Charles Henderson
Business Manager,
Invesco Perpetual, and member
of FRC AQR Committee

[♦] – Denotes a reference to changes arising from the 2018 UK Corporate Governance Code or the Companies (Miscellaneous Reporting) Regulations 2018. These are explained in more detail in Appendix A 'The 2018 Code, new regulations and guidance' on page 45.

additional details on findings and actions specific to the AC. Man Group plc's 2017 ARA (page 61) offers an example of in-depth AC reporting on how the committee assessed its own performance, including information on actions and progress from the previous year.

The 2018 Code[♦] further emphasises the importance of board evaluations (Principle L, and Provisions 21, 22 and 23). In particular, the 2018 Code emphasises the importance of the evaluator having direct contact with the board and individual directors. We believe this may result in more quality engagement between evaluators, the board and its committees.

Internal audit performance and effectiveness

The FRC's updated 2016 Guidance on Audit Committee recommends that AC reports include an explanation of how the committee has assessed the effectiveness of internal audit and satisfied itself that the quality, experience and expertise of the function is appropriate for the business. Our review found that 78% of ACs at least confirm that they have assessed the effectiveness of the internal audit function, an increase from 53% last year – perhaps due in part to the additional time the recommendations have had to bed in. Of those, 27 companies provide detail on how the AC's assessment of the internal audit function's effectiveness was undertaken – up from 14 last year. This is likely to be an area of increasing levels of insight: the 2018 Code[♦] now

"The main criticism of annual reporting in general is that often the ARA looks like a compliance document instead of a communication document. AC reports often do not sound like they are written by the chair as it is usually written by someone else.

The disclosures which investors pay the most attention to in the AC report are the:

- ▶ *Reliability of the financial statement (e.g., external audit process)*
- ▶ *Reliability of controls (internal audit, general controls etc.)*
- ▶ *Judgment and estimates*
- ▶ *Reliability of the information relied on by shareholders which are usually price sensitive (e.g., How did the company become comfortable with non-GAAP measures? How can investors become comfortable with TCFD disclosures? What are the relevant AC measures/due diligence?)*

I would like AC reports to become more succinct and relevant to institutional investors."



Charles Henderson

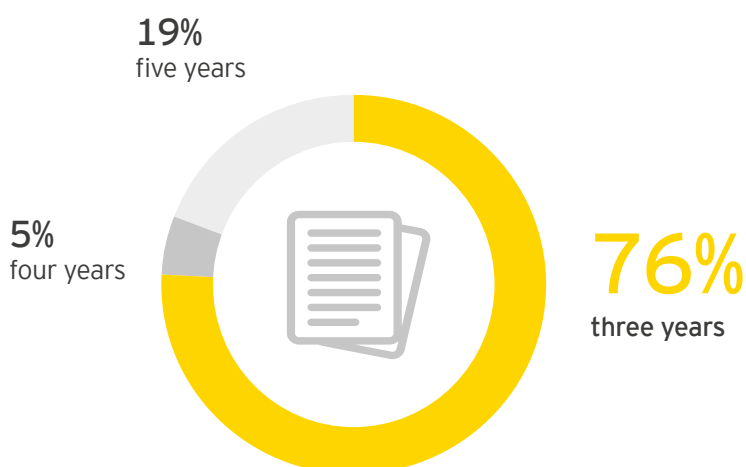
Business Manager, Invesco Perpetual,
and member of FRC AQR Committee

asks companies to explain not only why they don't have an internal audit function (if they don't), but

also how internal assurance is achieved in these cases and how this affects the work of external audit (Provision 26).

Figure 17.

Time period chosen for viability statements



Viability statement reporting

Our findings in relation to the time period chosen for assessing viability are similar to last year's results, with 76% of companies opting for three years, 5% for four years and 19% for five years (see Figure 17). Although investors often question why certain companies are not prepared to make the statement over a longer period, explanations for why particular time periods were chosen have significantly improved. Last year, 76% of companies simply stated that the period was in line with strategic planning, compared to only 35% this year. We noticed a lot of added specificity relating to factors such as contract lengths, customer and supplier contracts, lease terms, product development cycles, incoming regulatory change, financing and credit facilities, order books, R&D pipelines and Brexit.

We also found better disclosure of scenarios tested, with 69% now providing some detail. However, as we also found last year, far

fewer companies quantified these scenarios. In addition, 38% of companies disclose their assumptions and 6% quantify them (the same result as last year). However, more could be done in AC reports to highlight the challenges made by the AC in making the statement.

Some best practice examples refer to the company's longer-term prospects, drawing on other timescales used by the business to indicate the planning and investment cycles used. Such timescales relate to credit periods, bank loans, conversion projects, new land investments, other forecasts, pensions deficit repayment plans, the remaining operational life of projects, foreign currency hedging, development cycles, the cash impact of tax charges, funding plans to clear a pension deficit, the average length of business relationship with clients, and shareholding requirements for executive remuneration.

In its report on risk and viability reporting, the Financial Reporting Lab says that the intention of the

"Companies need to move away from boilerplate viability statements. They should aim to present what the board believes to be the long-term viability period of the business. This involves doing more to reflect the wide range of timeframes they work across. E.g., climate change disclosures can go out to 2030/2050 for a company with a three year viability period."



Charles Henderson

Business Manager,
Invesco Perpetual, and member
of FRC AQR Committee

Code's Provision on viability is for it to be applied 'in two stages, firstly for directors to assess the prospects of the company and secondly to make a statement of its viability.'¹⁰ We believe this two-fold approach would improve viability disclosures and make them of greater interest to investors.

¹⁰ Financial Reporting Lab, *Risk and viability reporting*, November 2017, pg7.





5

Looking ahead

We have already highlighted how the 2018 Code[♦] and the secondary legislation will affect company reporting in a few years' time. We provide further details of these developments in Appendix A. However, a number of other developments will also impact reporting in the future.

We have seen significant progress in the quality of reporting since we began our reviews five years ago. It is important for regulators, companies and investors to keep innovating – using new ways of working and technological advances to ensure the relevance of company reporting. Some companies report that website traffic to ARAs is relatively low, causing them to question the relevance of annual reporting. This is why this year (as in some previous years) we talked to investors about what they find useful and included their views throughout our report. We are also playing a part in exploring the future of corporate reporting through EY's involvement in the Embankment Project for Inclusive Capitalism (see more on page 43).

Digital reporting

The use of technology in corporate reporting is an area of focus for both the FRC and the EU.

[♦] – Denotes a reference to changes arising from the 2018 UK Corporate Governance Code or the Companies (Miscellaneous Reporting) Regulations 2018. These are explained in more detail in Appendix A 'The 2018 Code, new regulations and guidance' on page 45.

"I prefer to look at information in one place – within the ARA – rather than across several webpages as I know I have read the totality of what a company wants to communicate on certain topics."



Freddie Woolfe

Head of Responsible Investment and Stewardship, Old Mutual Global Investors

The European Securities and Market Authority (ESMA) is awaiting European Commission endorsement for new legislation, the European Single Electronic Format (ESEF), which will apply to all annual financial reports of issuers with securities listed on regulated markets in the EU from 1 January 2020. Under ESEF, all annual financial reports will need to be prepared in XHTML (a hybrid of XML and HTML, which allows the creation and structure of design elements, and encodes rules for making documents human and machine-readable). Where the annual financial report contains consolidated financial statements that apply International Financial Reporting Standards (IFRS), these XHTML documents should be tagged with the eXtensible Business Reporting Language (XBRL). The resulting report is an 'In Line XBRL format' (i.e., iXBRL, combining XBRL and XHTML). XBRL tagging is only

Case study

We found that Aviva plc had made significant changes in its reporting this year. The Aviva plc 2017 ARA is 110 pages shorter than last year's report, with fewer graphs and less use of imagery.

"The change was driven partly by wanting simplicity due to our values 'kill complexity' and 'digital first'. In removing the imagery in our report we focussed on saying it better with words, conscious that prose had to flow better, and words needed to have greater clarity. It is a journey and this is our first effort, but we really felt the benefit of focusing on content and not on design. We also felt that this simplified reporting would position us well with the direction of travel towards tagging of reports."

The annual report is still a valuable tool, a good record of events, and will cover disclosure that won't appear elsewhere e.g., significant

issues that the audit committee looked at during the year. The litmus test will be that investors will be able to find the information they want.

Outside of the Annual Report we have sought to focus on other forms of engagement with investors such as the use of video presentations and material on our website. We are always conscious of the volume of disclosures required, some that sit within the ARA and some outside e.g., gender pay gap, tax policy and Solvency II. These wider disclosures will also begin to change the shape of Annual Reporting itself."



Roy Tooley

Head of Secretariat – Corporate & Board Governance, Aviva plc

required for the primary financial statements for the first two years (after this, the notes will need to be tagged as a block), but the whole annual financial report will required to be in XHTML from the start in order to do this. XBRL enables information to be machine-readable so that users, such as analysts, are better able to extract and compare data across companies more efficiently. It remains unclear how Brexit will impact ESEF, or how ESEF will impact auditors.

We recommend that companies develop their understanding of ESEF ahead of its implementation. The Financial Reporting Lab has issued a helpful report explaining how XBRL could be used in the production, distribution and consumption of annual reports.¹¹ ESMA has also published guidance on the preparation of Inline XBRL instance annual reports.¹² Although there is still much to learn on this topic, some companies are preparing for the new regulatory requirements

¹¹ Financial Reporting Lab, *XBRL: Deep-dive – Digital future of corporate reporting*, December 2017.

¹² ESMA, *ESEF reporting manual*, December 2017.

"In the future, the Lab will develop more examples of how companies can apply ESEF while maintaining ARAs that are engaging.

We will also investigate the use of other technologies, such as artificial intelligence, augmented and virtual reality, in the corporate reporting process."



Phil Fitz-Gerald
Director,
Financial Reporting Lab

and have already made changes to their reporting. Based on our discussions with such companies, we believe that changes to reporting in terms of tagging could undermine the UK's narrative reporting framework and result in more US-style reporting. We believe this would be a retrograde step.

As pointed out by the Lab, the two types of iXBRL output are plain iXBRL files (akin to plain Word documents) and designed iXBRL files (akin to glossy annual reports with graphic elements). Between the two types, the latter is currently the less common output.¹³ Although both the UK and ESMA mandates are silent on the required level of design

for the iXBRL files, we encourage companies to adopt designed iXBRL files: well-designed ARAs can help convey information in a clear and concise manner to aid understanding. For example, data visualisation using infographics can be help to highlight information, trends, anomalies and movements in some sections of the ARA, e.g., those covering KPIs and principal risks.

50%

of companies in our sample still produce their ARAs in simple PDF format only (down from 69% last year).

This year we saw an increase in the number of companies providing interactive reports in the format of a flipbook or interactive PDF. The interactive functions include the option to view the ARA on a mobile phone using a downloaded app (e.g., Equiniti Group plc's 2017 ARA, page 3). A few companies have also uploaded short videos alongside their ARAs, such as CLS Holdings plc. In a three-minute video, its CEO communicated key details of its business model, strategy and dividend policy.

The Lab has also been looking at another element of digital reporting – blockchain. It found that blockchain has the potential to lead to greater trust and resilience in the corporate reporting process.¹⁴ However, its influence is likely to be gradual and restricted to certain cases (e.g., to improve accounting records) and the need for clear communication and human judgment will remain

"The current system of nominee accounts means that many private investors do not receive paper copies; they have to download and read ARAs online. It is important, therefore, that they are designed to be read on-screen. They should be interactive and should be easy to navigate and use on-screen. The approach of simply providing an electronic copy of a paper document is inadequate and unhelpful. It is also a missed opportunity."



Peter Parry
Policy Director,
UK Shareholders' Association

important. In the future, the Lab will be looking into the use of artificial intelligence in corporate reporting.

Reporting of performance metrics

The Lab has also been exploring the use of performance metrics in response to the increasing focus by ESMA and the FRC on this area. Its report on the first stage of the project sets out the five key qualities looked for by investors in performance metrics disclosures i.e., that they should be aligned to

¹³ Financial Reporting Lab, *XBRL: Deep-dive – Digital future of corporate reporting*, December 2017, pg11.

¹⁴ Financial Reporting Lab, *Blockchain and the future of corporate reporting: How does it measure up?*, June 2018.

“One of the disclosures investors are most interested in relates to customer engagement in helping a company to develop a sustainable brand and competitive advantage. One company published its Net Promoter Score (NPS). However the reality was that it struggled to obtain answers from customers; it only surveys 10% of its customers for feedback, out of which only 6% or so reply, so in total they knew the views of less than 1% of their customer base. But this limitation was not disclosed in the report, so it is unsurprising that investors may be sceptical about the reliability of some metrics disclosed. Companies should explain how the board satisfies itself of the integrity of strategically important non-accounting data.”



Freddie Woolfe

Head of Responsible Investment
and Stewardship, Old Mutual
Global Investors

strategy, transparent, in context, reliable and consistent.¹⁵ The report also includes questions for companies to consider when deciding how to report their performance. As part of the next phase of this project, the Lab will explore examples to demonstrate how the principles have been applied (with a report expected later in 2018). In the meantime, we encourage companies to consider how their performance metrics reporting could be improved to meet investors' needs more effectively.

The Embankment Project for Inclusive Capitalism and long-term value reporting

The ongoing Embankment Project for Inclusive Capitalism represents an important opportunity to transform the way businesses measure and report on the value they create for stakeholders. Bringing together over 30 major global organisations across the entire investment value chain, representing almost US\$30 trillion in assets, the participants first identified the areas they considered to be the most important relating to long-term value creation: trust, culture and purpose, innovation, Sustainable Development Goals, human capital, health outcomes and corporate governance. The aim is to develop a measurable, comparable and meaningful way to report on these topics.

Over the course of the project, participants are testing and further developing a proof-of-concept framework created by EY. The framework builds upon the context to which the organisation is

responding, as well as its purpose, strategy and the governance that underpins it. These factors help determine which stakeholders are core to the organisation's value creation model and the outcomes it is aiming to deliver for them. This in turn defines the metrics for each significant value area, which can complement or even replace existing short-term performance indicators.

With input from an advisory council comprised of leading business influencers and academics, participant-led groups are identifying metrics that already exist but could be applied more broadly, or where those do not exist, developing and piloting new metrics and methodologies.

For the information to be trusted, companies need to be transparent, balanced and consistent. These metrics will allow asset managers to measure how well a company is executing on its strategy and identify those assets that are better positioned to grow and protect future cash flows. Asset managers will have better information to make investment decisions and a greater ability to engage with asset owners.

When it comes to its conclusion, the Embankment Project for Inclusive Capitalism will deliver a tested long-term value methodology, and a number of metrics, categorised by value area, available for anyone to use. Find out more and keep up to date here: <https://www.inc-cap.com>

¹⁵ Financial Reporting Lab, *Performance metrics – an investor perspective*, June 2018.



Appendices

Appendix A:

The 2018 Code, new regulations and guidance



The 2018 UK Corporate Governance Code

Source: Financial Reporting Council

Timing: Financial years beginning on or after 1 January 2019

Detail: For an analysis of the Code, highlights of key issues and resulting considerations, read our paper *2018 UK Corporate Governance Code and new legislation: latest governance developments impacting UK premium listed companies*. A full detailed analysis of the key changes between the 2016 and 2018 Codes can be found in the Appendix.

The Companies (Miscellaneous Reporting) Regulations 2018

Source: UK Government

Timing: Financial years beginning on or after 1 January 2019

Requirement

1. Section 172(1) statement

A statement in the strategic report to set out how directors have had regard to the matters set out in Section 172 (1) (a)-(f) when performing their duty under section 172. This is now called a 'section 172(1) statement'.

For companies that are unquoted, the section 172(1) statement must also be made available on the website and updated each year.

Scope

All companies that prepare a strategic report unless they qualify as medium-sized.

At a high level, this means **all public companies** and any company which meet any two of the below fall in scope:

- ▶ Turnover £36m or more
- ▶ Balance sheet £18m or more
- ▶ 250 employees or more

Requirement	Scope
2. Employee engagement and stakeholder interests	
The directors' report must detail how directors have engaged with employees, and the effect of their regard for employee interests, including on the principal decisions taken by the company.	All companies with 250 UK employees or more. If the company is a parent, this refers to the number of UK employees within the group.
The directors' report must summarise how directors have had regard to the need to foster business relationships with suppliers, customers and others, and the effect of that regard, including on the principal decisions taken by the company.	Any two of the below: <ul style="list-style-type: none"> ▶ Turnover £36m or more ▶ Balance sheet £18m or more ▶ 250 employees or more
3. Statement of corporate governance arrangements	
A statement of corporate governance arrangements must be made in the directors' report detailing which corporate governance code the company applies (and how the code is applied, including explanations for any departure from application), and if no code is applied, why and what governance arrangements are in place.	All UK companies with either: <ul style="list-style-type: none"> ▶ More than 2,000 employees globally; or ▶ Turnover above £200m AND a balance sheet of over £2bn. Subsidiaries will be in scope.
For companies that are unquoted, this statement must be made available on the website and updated each year.	Exemptions apply for those who already provide a 'corporate governance statement' (DTR 7.2) and CICs and charitable companies.
<p>In relation to the above, the regulations set two definitions:</p> <p><i>Corporate governance</i>, in relation to a company, means:</p> <ul style="list-style-type: none"> (a) the nature, constitution or functions of the organs of the company, (b) the manner in which organs of the company conduct themselves, (c) the requirements imposed on organs of the company, (d) the relationship between different organs of the company, and (e) the relationship between the organs of the company and the members of the company <p><i>Corporate governance code</i> means a code of practice on corporate governance.</p>	
4. CEO pay ratio	
A 'pay ratios table' of CEO pay to the first quartile, median and third quartile of employee pay. Where a company is a parent, the ratio information must relate to the group. There are three options for how to calculate the pay and benefits.	Quoted companies with more than 250 UK employees.
Going forward, historical data will have to be disclosed for each preceding year in which the requirement applied, up to a maximum of nine years.	
Narrative on changes to ratio and context, including changes of employment model.	
There are a number of other amendments to Directors' Remuneration Report requirements, including enhanced reporting on the impact of a share price change on executive pay awards.	Quoted companies.

European Single Electronic Format (ESEF)

Source: EU Commission, European Securities and Markets Authority (ESMA)

Timing: Financial years beginning on or after 1 January 2020

Detail: In December 2017, ESMA published the final draft Regulatory Technical Standards (RTS) setting

out ESEF. All annual reports shall be prepared in XHTML. IFRS consolidated financial statements shall be labelled with XBRL tags, making the labelled disclosures structured and machine-readable. ESMA has also prepared an ESEF reporting manual to provide guidance on common issues encountered when generating Inline XBRL instance documents.

Guidance

Several diverse sources of guidance are useful to preparers of the annual report. Below is a non-exhaustive list of guidance you may wish to consult.

Source	Title	Published	Summary
ESMA	ESEF reporting manual	December 2017	Provides guidance on common issues encountered when generating Inline XBRL instance documents.
ICSA: The Governance Institute, and The Investment Association	The Stakeholder Voice in Board Decision Making	September 2017	Guidance to assist boards in thinking about how to ensure they understand and weigh up the interests of their key stakeholders when taking strategic decisions. It identifies ten principles to guide the way boards approach these issues.
Financial Reporting Council	Guidance on the Strategic Report	July 2018	The guidance has been updated to reflect the 2018 Code, and regulatory updates resulting from The Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016 and The Companies (Miscellaneous Reporting) Regulations 2018.
Financial Reporting Council	Guidance on Board Effectiveness	July 2018	This guidance was published (and consulted on) at the same time as the 2018 Code. It contains suggestions of good practice to support directors in applying the Code, and should be viewed alongside it.
FRC Financial Reporting Lab	Performance metrics – an investor perspective	June 2018	This report forms the first phase of the Lab's project on the reporting of performance metrics, which involved discussions with investors. The next phase of the project will include examples of how companies have put these principles into practice.

Source	Title	Published	Summary
FRC Financial Reporting Lab	Blockchain and the future of corporate reporting: how does it measure up?	June 2018	This report forms part of the Digital Future project and explores the possibilities of blockchain in the corporate reporting process.
FRC Financial Reporting Lab	XBRL: Deep-dive – Digital future of corporate reporting	December 2017	Also part of the Digital Future project, this report provides a summary of the potential impacts and issues of the use of XBRL in the context of ESEF.
FRC Financial Reporting Lab	Risk and viability reporting	November 2017	This report seeks to understand how companies can better inform investors on the risks they face and their viability.
FRC Audit & Assurance Lab	Audit Committee Reporting	December 2017	This report looks at the external reporting by audit committees in the annual report. It is the first phase of a project to explore how investors' confidence in audit is enhanced.
Global Reporting Initiative	G4 Sustainability Reporting Guidelines – Implementation Manual	August 2015	Guidance on Materiality can be found on pp.11-12, including tests and a visual representation of prioritisation of aspects.
Global Reporting Initiative and RobecoSam	Defining Materiality (Technology Hardware & Equipment and Banks & Diverse Financials)	March 2015	The aim of these publications is to understand how companies in the selected sectors are defining the (sustainability) issues that are material, and whether this aligns with the needs of investors.
	Defining What Matters (Mining, Metals and Electric Utilities)	May 2016	

Appendix B: Methodology

Except where otherwise indicated, the sample consisted of 100 ARAs of FTSE 350 companies with 31 December 2017 to 31 January 2018 year-ends. The sample was weighted 45% FTSE 100 and 55% FTSE 250 companies. Our sample covered a range of industries that broadly reflects the composition of the FTSE 350, other than excluding investment trusts and mutual funds.

Our research compiled qualitative and quantitative findings on a broad range of measures and key themes, which we present throughout this report alongside recommendations for leading practice. The case studies highlight examples of leading practice from our sample or that we have become aware of from our wider work.



Appendix C:

Interviewee biographies

In order of first appearance



Phil Fitz-Gerald

Director,
Financial Reporting Lab

Phil became Director of the Financial Reporting Lab in 2017. He is a Chartered Accountant in the UK with over 20 years of experience in accounting and audit, focusing on improving the quality of company reporting. He has worked for the Financial Reporting Council since 2009 and was previously the Head of Case Examination and Enquiries.

Phil started his career in the audit practice of a major firm where he spent ten years, the latter half of which he worked as a senior manager in the firm's professional practice department. After leaving practice, he spent five years as a training consultant helping companies with their corporate reporting requirements before joining the FRC.



Freddie Woolfe

Head of Responsible
Investment and Stewardship,
Old Mutual Global Investors

Freddie joined Old Mutual Global Investors in 2017 from Newton Investment Management where he was a responsible investment analyst primarily covering the healthcare, technology, media and telecommunications sectors, a role he held for nearly three years. Prior to this position, he worked at Hermes Equity Ownership Services as associate director, head of UK engagement from 2008. He started his career in 2006 in HSBC's fraud, risk and security office and studied French and Italian at University College, London.



Peter Parry

Policy Director, UK
Shareholders' Association

Peter started his career in the manufacturing industry working in South America and Europe. On returning to the UK he spent a number of years working in logistics with the National Freight Consortium (NFC) shortly after the business was bought by the employees from the government. Peter notes that experiencing change at first hand – over a very short time – from a bureaucratic culture to one that was entrepreneurial and motivating was fascinating and informs his belief in the importance of active and committed ownership.

Over the last twenty years he has worked in management consultancy, specialising in purchasing and supply chain management. He spent five years with a large international consultancy and for the last twelve years has run his own business.

Peter has been investing for over forty-five years and now has a portfolio of about 100 different holdings. He makes use of advisory services, which he finds expensive, but believes the information and advice fed to him as an experienced investor pays for itself over time.



Hannah Armitage

Project Manager,
Financial Reporting Lab

Hannah joined the lab in 2017. She moved from the FRC's Corporate Governance Team, where she worked on reviews of the Stewardship Code and UK Corporate Governance Code.

Hannah is a qualified lawyer and prior to joining the FRC, worked in the Australian Department of the Treasury on corporations and corporate law policy.



Charles Henderson

Business Manager, Invesco
Perpetual, and member of
FRC AQR Committee

Charles joined Invesco Perpetual in May 1994 and has worked in a number of senior roles, including Head of Fund Administration and Accounting, Head of Global Investment Operations and Head of Invesco Perpetual's Investment Management Operations. Based in Henley-on-Thames, he joined the UK Equities team in April 2012 as their Business Manager to support its fund managers with their funds' corporate finance activities on primary transactions, compliance requirements and shareholder engagement. He is also a non-executive member of the FRC's Audit Quality Review Committee.

Charles' career began in 1979 at Blease Lloyd & Co where he trained as a Chartered Accountant. In 1985, he moved to Touche Ross & Co (now Deloitte), where he became a senior audit manager responsible for a number of financial institutions' clients including Perpetual plc and Nationwide Anglia Building Society.



Roy Tooley

Head of Secretariat –
Corporate & Board
Governance, Aviva plc

Roy joined Aviva in February 2016 and leads a team of five that provide governance and company secretarial support to Aviva plc. This includes responsibility for the corporate governance elements of the Annual Report and Accounts, annual Solvency II reports, compliance with the Corporate Governance Code, the relationship with the Registrar and Depositary, compliance with MAR and with the listing rules. He has recently been engaged with the implementation of Mandatory Direct Credit for the payment of cash dividends and a share forfeiture programme that will raise funds for an Aviva charitable foundation.

Prior to Aviva, Roy spent almost five years with BT Group as Head of Corporate Governance, and before that nine years with BP as an assistant secretary.

Appendix D:

Recent publications and relevant materials

Contact us at corporategovernance@uk.ey.com for hard copies of our reports or visit our website www.ey.com/corporategovernance to download them:



July 2018 2018 UK Corporate Governance Code and new legislation

Analyses how the new 2018 Code and secondary legislation will impact premium listed companies.



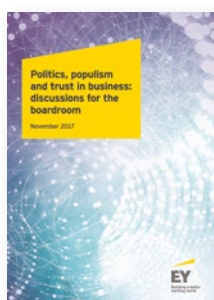
July 2018 Governance in large privately-held businesses and the Wates Principles

Overviews the scope, timing, and implications of the 'statement of corporate governance arrangements' requirement and the Wates Principles.



June 2018 Update on the new QCA Corporate Governance Code

Provides an overview of the new QCA Code and in light of changes to AIM Rule 26 what it may mean for AIM companies.



November 2017 Politics, populism and trust in business: discussions for the boardroom

Reflects on interviews with senior business leaders and provides key considerations for boards navigating political uncertainty.



September 2017 AGM Trends 2017

Produced in partnership with Equiniti and Prism Cossec, this report looks at trends and developments during the 2017 AGM season. It also highlights some considerations to bear in mind when planning 2018 AGMs.



June 2017 Future proofing corporate governance – reflections and practical questions for board consideration

Based on a series of roundtables where we explored how boards are responding to the accelerated pace of change in the world and business environment.

Appendix E:

EY contacts

If you want to know more about...		EY contacts		
Corporate governance and narrative reporting	▸ Perspectives and trends in governance	Ken Williamson	kwilliamson@uk.ey.com	+44 20 7951 4641
	▸ Board composition and effectiveness	Mala Shah-Coulon	mshahcoulon@uk.ey.com	+44 20 7951 0355
	▸ Leading practices in corporate reporting	Natalie Bell	nbell1@uk.ey.com	+44 20 7951 1316
	▸ Future developments in governance and reporting			
Performance and reward	▸ Executive remuneration including policy design, governance and reporting	Rupal Patel	rpatel15@uk.ey.com	+44 20 7951 0658
		Isobel Evans	ievans@uk.ey.com	+44 20 7951 3113
	▸ Incentive design for executive, management and all employee populations including equity incentives	David Ellis	dellis@uk.ey.com	+44 20 7980 0163
	▸ Share plan implementation in the UK and internationally, including addressing regulatory and tax matters			
Climate change and sustainability	▸ Remuneration benchmarking and market surveys			
	▸ Sustainability strategy assessment and implementation	Doug Johnston	djohnston2@uk.ey.com	+44 20 7951 4630
	▸ Environment, health and safety risk			
	▸ Sustainable supply chains			
Long-term value	▸ Sustainable finance solutions			
	▸ Integrated reporting and sustainability report assurance			
	▸ Investor trend reviews	Hywel Ball	hball@uk.ey.com	+44 20 7951 2474
	▸ Purpose-driven organisation reviews	Barend van Bergen	bvanbergen@uk.ey.com	+44 20 7951 1009
	▸ Alignment of metrics to the range of capitals that investors are analysing	Karl Havers	khavers@uk.ey.com	+44 11 8928 1502

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