Deloitte.

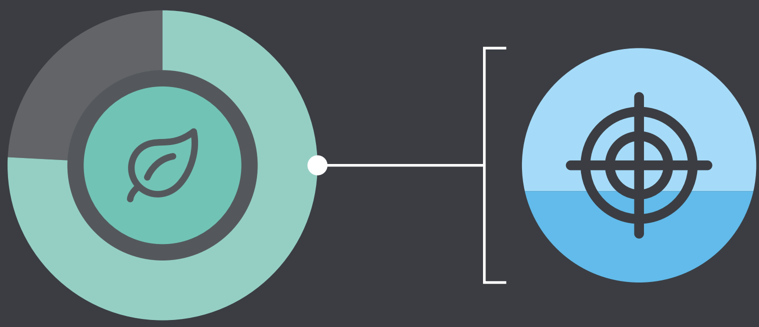
Annual report insights 2020 – Profit

Surveying FTSE reporting

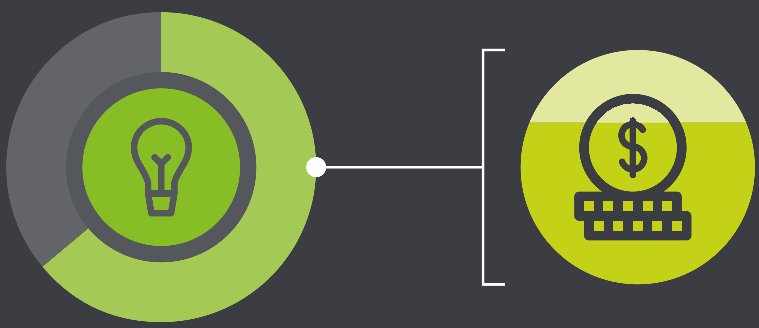
Contents

Profit

72% disclosed or described a dividend policy

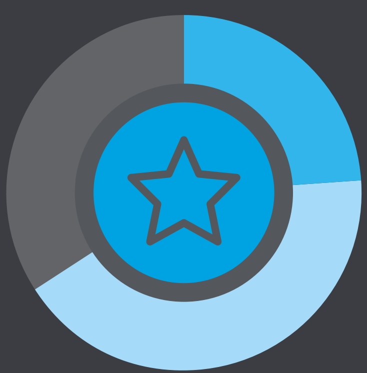


76% indicated that elements of directors' remuneration related to broader ESG factors, with 39% of those quantifying some or all targets



Of the 64% of companies that disclosed the assumptions underlying their viability statement, 69% made assumptions about the availability of funding or refinancing

Only 26% of companies clearly described the procedures in place to identify emerging risks



24% considered Brexit to be a principal risk, while a further 42% included Brexit within a broader risk

Under the triple bottom line concept of "people, planet, profit", 'profits' go beyond the financial value created by a company, and encapsulate the broader economic value generated, such as through taxes, job creation, and contribution to wider economic health. Companies operate within a wider economic ecosystem, impacting on and benefiting from economic and social prosperity in myriad ways. But society is also the source of capital for all organisations and therefore business can only thrive by ensuring the social contract is maintained, without which the sources of value that it depends on may not be sustained.

Companies operate within a wider economic ecosystem, impacting on and benefiting from economic and social prosperity in myriad ways.

In this way company purpose and company profit become inextricably linked. Profits are crucial for a company to serve all of its stakeholders over time. The company purpose guides the culture and provides a framework for decision-making, helping to sustain long-term financial returns.

In this section we consider this perspective by looking at value creation, capital allocation, remuneration in relation to ESG factors, and a company's resilience and long-term viability.

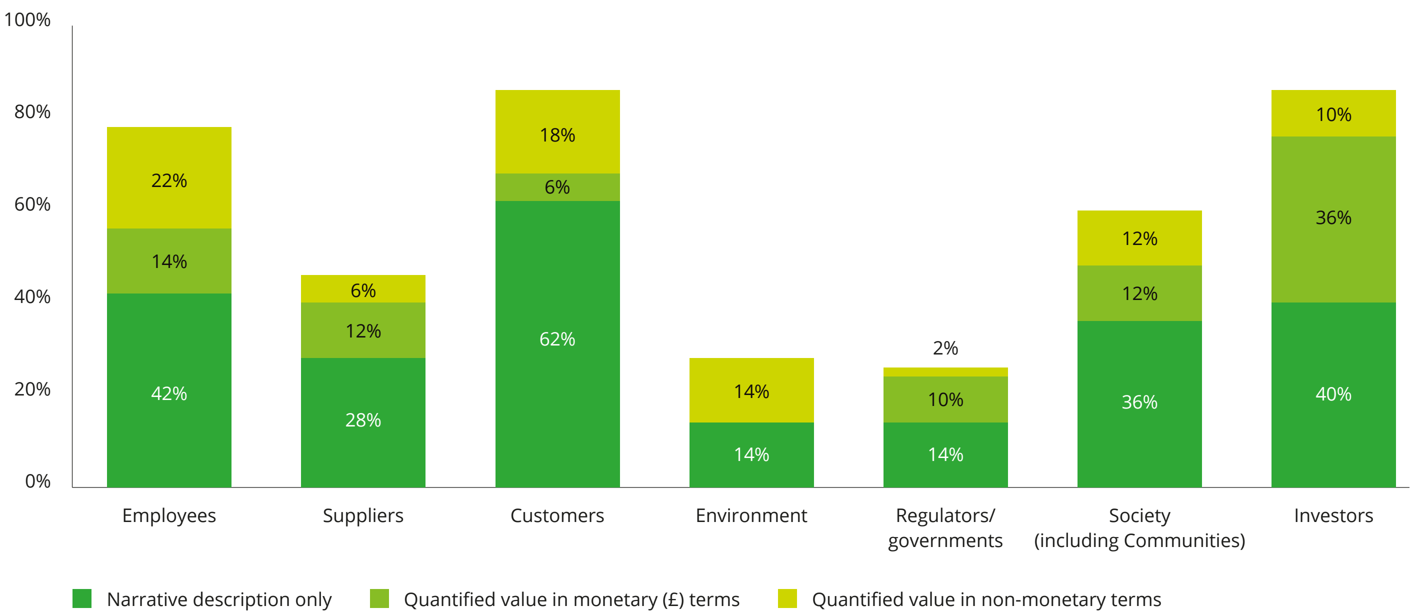
Value creation

Value is created by a business for its shareholders (for example, through dividends) and for a range of other stakeholders. This is essential in order to ensure long-term success and resilience, as these stakeholder relationships themselves can in turn affect the company's ability to create value for itself.

The FRC Guidance expects that the description of a business model should explain how the company generates and preserves value over the longer term and to be consistent with the company's purpose, although there is no requirement to quantify the value created. It is useful to do so, however, as a description of value created demonstrates what the outcomes or impacts of the business were in the year and whether this is in line with their objectives and targets. Companies can indicate how these then feed back into the business model as 'inputs' or otherwise key sources of value upon which the business depends. This dynamic between impacts the company has and its dependencies provides further insight into the resilience of the business model. Figure 11 summarises the extent to which reporters quantify value creation for stakeholders in their business model. Three companies did not clearly address value creation in their business model.

Perhaps unsurprisingly, value creation for investors, customers and employees were the most referred to. Value for investors tended to be defined in terms of strong financial returns in dividends or through a broader reference to earnings (such as earnings per share). Customer value tended to refer to strong customer service or experience. Net promoter scores (demonstrating customer satisfaction) were also common. Those companies which monetised value for customers (expressed as the value of R&D spent on developing products for customers, or the value of orders for the year) also provided a description of how their products benefited customers.

Figure 11. Is value creation discussed in the business model for the following stakeholders?



Value created for employees ranged from simply providing a job (quantifying the number of jobs in the period), to the value of wages and salaries paid, to more company-specific value creation in terms of career progression and training received.

Value created for suppliers varied from the strength of relationship to the value of orders placed with suppliers, with one retailer citing a supplier satisfaction score. Those companies that cited value created for the environment ranged from those describing their sustainable products and practices which enhance the environment to those companies describing 'value created' as a reduction in a negative impact by referring to improved environmental metrics, such as reducing GHG emissions, energy consumption or waste-to-landfill. Value created for governments or regulators tended to be described as either taxes paid (for those quantifying the value) or else a description of conducting business in line with relevant laws and regulations.

Most descriptions of value created for society or local communities (regardless of whether they were quantified) were in relation to provision of local jobs and charitable fundraising. The more informative reports in this area looked beyond merely how profits are donated to charitable causes, articulating how their operations in themselves create social value. Whitbread plc highlights in its business model the importance of choosing the right location for its hotels (considering both recruitment and broader impacts on the community) and as an outcome describes its operations as playing a key part in local communities. Elsewhere in the strategic report it describes how engagement with local communities forms a vital part of this decision-making. G4S plc linked their description of social and economic benefits they bring to the communities in which they operate to the realisation of some of the UN's Sustainable Development Goals (SDG). For example, their ordnance clearance and mine risk education contracts facilitate the safety of local communities and the opportunity for communities to rebuild their lives by returning land to productive use, achieving various SDGs, including "Peace, justice and strong institutions".

Recognition of the company's impact on and value created for broader stakeholders than shareholders is now commonplace in business model disclosures. Preparers should be careful to ensure they consider the connectivity between the business model – arguably the heart of the strategic report – and other key disclosures such as the new s172(1) statement (which also calls for discussion of the board's consideration of impact upon broader stakeholders), principal risks and KPIs measuring the impact.

Capital allocation

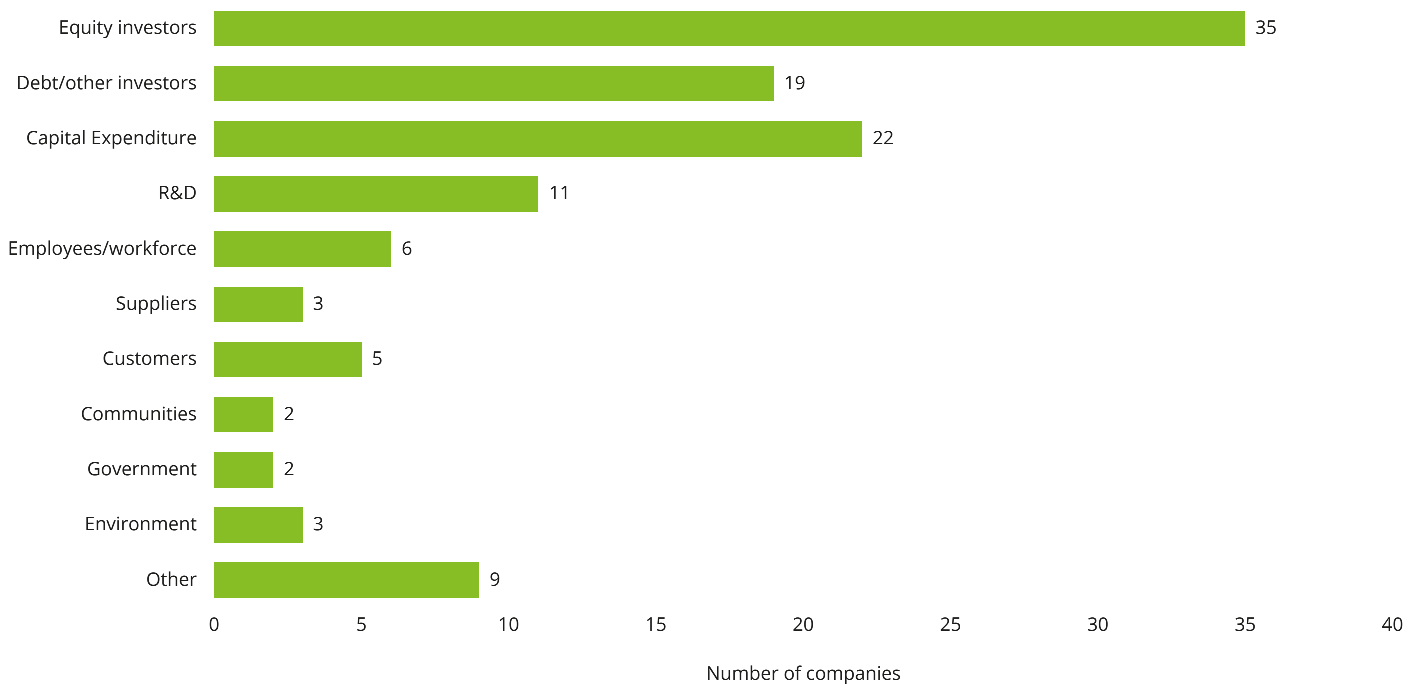
The way companies allocate financial capital and determine and communicate their dividend policy and practice are a specific area of focus for investors[1] and are high on the political agenda, particularly against the backdrop of COVID-19. Investors are challenging companies on the issue as they perceive a lack of transparency about how companies allocate surplus capital between dividends, investment (such as R&D), capital expenditure, investment in skills and training and other significant areas such as pension contributions or deficit reductions. Many institutional investors regard capital allocation decisions as being among the most important responsibilities of directors and a key area for shareholder engagement with boards because they are seen as playing a vital role in determining a company's ability to be successful in the long-term.

The FRC Guidance specifically calls out decisions around capital allocation and dividends to be a key example for boards to refer to in their s172(1) statement, as these typically impact the long-term prospects of the business. Linking these disclosures to the s172(1) statement demonstrates how the board is considering the likely long-term consequences of their decisions.

74% of companies provided an insight into capital allocation. We were looking here for specific discussion (even brief) of how capital is allocated more broadly rather than passing references to "investing in our people" or "investing in IT" without either quantifying this or providing a more in-depth description. This captured information both about how capital had been allocated in the past and how it might be allocated in the future. A number of companies referred to having a "disciplined approach to capital" or reference to a capital allocation policy which was then not clearly articulated or explored further.

Description of an overall policy and approach to allocation of capital across all strategic priorities is useful as a starting point. Further insight can be gained through discussion of capital allocation in the context of delivering on purpose and value creation for those stakeholders or matters included in the purpose. Indeed, this can provide evidence of purpose in action and stop it looking like a mere soundbite on the opening pages of the annual report. Ideally disclosures should address matters such as how decisions on capital are consistent with purpose and the narrative on broader value creation, how directors consider the balance of long-term versus short-term when allocating capital, what the trade-offs are against the various value drivers, and how investment is made in sources of competitive advantage. Such detail would also provide insight into how resilient the business model is (see below).Bringing these disclosures together in one place in the annual report can help present a fuller and more connected picture.

Figure 12. Within the capital allocation discussion, which stakeholders or matters were referred to?



Almost all disclosures about capital allocation referred to shareholders, usually with regards to dividends or share buy-back schemes. References to capital expenditure and debt were also commonplace. Many "other" matters were acquisitions or disposals. References to broader stakeholders were less common, and certainly the detail was much more limited, without much quantification of capital. Half of the disclosures about capital allocated to employees were in relation to pension contributions and management of deficits.

Based upon our understanding of the company, taking into consideration its purpose, business model, and strategy, we considered 32% of companies providing an insight into capital allocation had covered all material or the most significant stakeholders. For the remaining 68% we observed omissions of broader stakeholders which implied a narrower focus that was not consistent with the company's stated purpose, strategy or description of value creation.

Consistent with findings on the general discussion of capital allocation, whilst 54% quantified their allocation of capital, this tended to be in relation to dividends, debt repayment or capital expenditure. Some companies, where relevant, quantified their pension contributions, but otherwise there was little detail on the quantification of capital allocation in respect of other stakeholders.

The FRC Guidance suggests including a quantified analysis of allocations of free cash flow to enable users of the accounts to understand how discretionary resources have been allocated between shareholders, other stakeholders and retained in the company. This was provided by KAZ Minerals PLC in the context of their approach to sustainability.

Economic value generated and distributed

$ million	2019	2018
Direct economic value generated		
Revenues	2,266	2,162
Economic value distributed		
Operating cash costs[1]	670	659
Employee wages and benefits[2]	219	184
Payments to providers of capital[3]	277	256
Taxes paid[4]		
Kazakhstan	324	321
Kyrgyzstan	11	9
Russia	–	–
United Kingdom	–	3
Community investments[5]	22	9
Economic value retained	743	721

1 Operating cash costs as disclosed in the Financial review (page 41), being the difference between revenues and EBITDA adjusted to exclude total employee costs (see note 9 to the financial statements) and social spend, which are shown separately in the table above.
2 Employee wages and benefits are the Group's total labour costs and associated social taxes (see note 9 to the financial statements).
3 Payments to providers of capital represents interest paid on borrowing facilities and dividends to shareholders during the period (see consolidated statement of cash flows on page 130).
4 Taxes paid for each region is reflected in the payments to governments table on page 49 (see Financial review) and is the total taxes paid adjusted to remove employee and employers' payroll taxes, which are reflected within employee wages and benefits for each region and excludes social spend, reflected as community investments.
5 Community investments represents the social payments as reflected in the payments to government table on page 49.

Other reporters, such as Rotork plc, included similar quantified information in their business model where they identified value created.

Creating value in 2019

Customers
We develop solutions that improve our customers' productivity.

£692m
Order intake

17
New product launches

Employees
We create an environment where each and every employee is able to be their best.

£188m
Amount paid in wages, salaries, social security etc.

275
Sales people trained in value selling

Suppliers
We have a reputation for integrity, fair dealing and ethical behaviour.

£240m
Spend with external materials suppliers

300+
Supplier audits completed

Governments & communities
We engage positively with the community and offer support through donations and volunteering.

£33m
Corporation tax (cash paid)

3
Global charity partners

Shareholders
We have a strong track record of creating shareholder value and have increased our dividend each year for nearly 20 years.

£52m
Dividends paid to shareholders

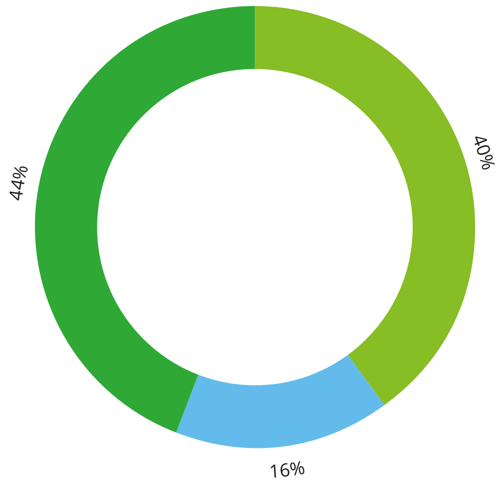
38%
Total shareholder return

More on page 52

Distributions

Investors have been calling for more insight and transparency around dividend policy, with some wanting to see an audited figure for distributable reserves within the annual report. In particular, the Investment Association has called on all listed companies to improve the transparency of their approach to paying dividends, recommending that they include their distribution policy with their annual report. The UK Government is yet to mandate any specific capital allocation or dividend disclosures, but it has stated that if sufficient progress is not made it will consider whether to mandate the disclosure of an audited distributable reserves figure.

Figure 13. Is the level of distributable profits disclosed?



Yes, as a single figure
No
No, but indicate which reserves are (un)distributable

With 44% of companies not clearly indicating the level of distributable reserves available, there is still work to be done by some companies to meet investors' expectations in this area.

72% disclosed or described a dividend policy. These ranged from detailed explanations, to concise although relatively unclear descriptions of a "progressive dividend policy". The FRC Lab's report on disclosure of dividend policy and its subsequent implementation study identify the key aspects that investors want to see in this area and provide a number of good examples.

G4S plc clearly identify the key considerations by the board before proposing a dividend and also state the impact of COVID-19 upon their most recent decision (see the Pandemic section, below).

Dividend

In assessing the dividend, the board considers:

- future investment requirements;
- the Group's pension obligations;
- net debt to Adjusted EBITDA;
- the availability of distributable reserves in the parent company; and
- reward to shareholders.

As announced on 23 March 2020, notwithstanding the Group's strong liquidity and robust business continuity plans, the board considers that the uncertainty relating to Covid-19 and its impact on economic activity in our key markets has increased substantially since the date of the Group's preliminary full year results announcement. In these circumstances, the board will not be proposing the payment of a final dividend in respect of the full year 2019 at the forthcoming Annual General Meeting. Once the adverse impact of Covid-19 has abated, it is the board's intention to restore the dividend, taking into account the board's objective of attaining dividend cover of 2.0x and thereafter pursuing a progressive dividend policy. For the year ended 31 December 2019, the interim dividend was 3.59p (DKK 0.2905) per share (for the year ended 31 December 2018, the interim dividend was 3.59p; DKK 0.2969 and the total dividend was 9.70p; DKK 0.8290).

OneSavings Bank plc defined its dividend policy in the directors' report and also provided a table within an "appendix" in the annual report which showed the basis of the calculation of the proposed final dividend.

Results and dividends

The results for the year are set out in the Statement of Comprehensive Income on page 162. Our dividend policy for 2020 remains a payout ratio of at least 25% of underlying profit after taxation to ordinary shareholders. The Directors recommend the payment of a final dividend of 11.2 pence per share on 13 May 2020, subject to approval at the AGM on 7 May 2020, with an ex-dividend date of 26 March 2020 and a record date of 27 March 2020. This is in addition to the 2019 interim dividend of 4.9 pence per share paid during the year (2018: 14.6 pence total dividend).

2. Calculation of 2019 final dividend

The table below shows the basis of calculation of the Bank's proposed final dividend for 2019:

	2019 £m	2018 £m
Statutory profit after tax	**158.8**	139.6[1]
Less: Coupons on AT1 Securities classified as equity	**(5.5)**	(5.5)
Tax on coupons	**–**	1.5
Statutory profit attributable to ordinary shareholders	**153.3**	135.6
Add: CCFS pre-acquisition profits	**92.5**	–
Add back: CCFS pre-acquisition exceptional items	**15.7**	–
Add back: CCFS pre-acquisition integration costs	**5.2**	–
Tax on CCFS pre-acquisition integration costs	**(1.6)**	–
Add back: Group's exceptional items	**15.6**	9.8
Add back: Tax on Heritable option	**2.6**	(2.6)
Add back: Amortisation of fair value adjustment	**21.6**	–
Add back: Inception adjustment	**(3.3)**	–
Add back: Amortisation of intangible assets acquired	**1.3**	–
Release of deferred taxation on the above amortisation adjustments	**(7.0)**	–
Less: gain on Combination	**(10.8)**	–
Add back: ECL on Combination	**3.6**	–
Pro forma underlying profit attributable to ordinary shareholders	**288.7**	142.8
Total dividend: 25% of pro forma underlying profit attributable to ordinary shareholders	**72.2**	35.7
Less interim dividends paid:		
CCFS (pre-acquisition)	**(10.3)**	
OSB	**(12.0)**	(10.5)
Proposed final dividend	**49.9**	25.2

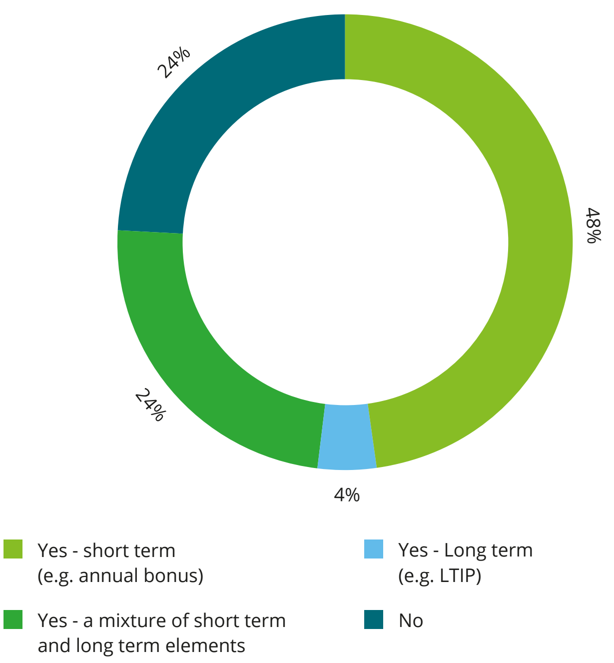
1. In 2019, the Group restated the prior year comparatives to recognise interest expense and taxation on the £22m Perpetual Subordinated Bonds previously classified as equity.

Directors' remuneration

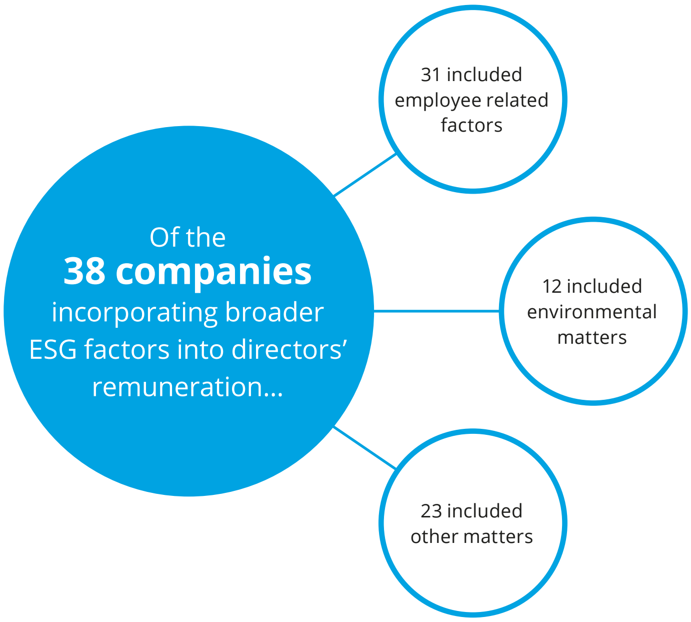
The broader value created by a company in achieving its purpose often drives the variable elements of directors' remuneration as a means of incentivising directors to succeed in their role. The extent to which directors are taking capital out of a company is also an important part of broader capital allocation. Shareholders of quoted UK companies must approve the directors' remuneration policy and directors' remuneration is addressed in a separate part of the annual report.

We sought to understand the extent to which ESG factors that are material to value creation over time and which are explicitly referenced as part of a director's duty in s172 are embedded in performance management and incentives. The connection between remuneration and broader company strategy, particularly the consideration of broader ESG matters, was not always clear.

Figure 14. Are there any elements of directors' remuneration relating to performance of broader ESG factors?



We looked at the most recent remuneration policies disclosed in the annual report. It was encouraging to see that 38 companies (76%) had incorporated broader ESG factors into the remuneration policy to some degree. However, not all companies were forthcoming with the types of measures that will be used in the coming year to assess performance of broader ESG factors. Where they are included, over half provided broad themes without specific measures cited (on occasion noting this was due to commercial sensitivity and would be published after the event next year; in general there was more detail in the policies for the year gone by), while 39% provided quantified targets for some or all of the measures.



The "other" matters covered in remuneration policies were often linked to customer metrics and outcomes, with some companies citing culture, regulatory compliance or other strategy-specific metrics. It was also interesting to note that those companies linking elements of remuneration to environmental matters were from a wide variety of industries, including telecommunications and food and drink, not just those that might traditionally be thought of as 'polluting'.

The proportion of directors' remuneration depending on these broader ESG performance metrics varied considerably from company to company, as may be expected, with some having as little an impact as 5% of bonus and some as much as 50% of directors' bonus; the range for longer term incentive schemes was broadly 10% to 33%.

OneSavings Bank plc set out their Business Balanced Scorecard which clearly indicated which metrics (not all of them KPIs for the group) were driving directors' remuneration, and the outcome in the year. They outlined the KPIs per category and weighting of each category for the following year, although acknowledged the targets would not be published in advance as they are commercially sensitive.

2019 performance against the Business Balanced Scorecard

		Targets[1]					
Category	**Key performance indicator**	**Threshold (25%)**	**Budget (50%)**	**Max (100%)**	**Actual result**	**Outcome CEO**	**Outcome CFO**
Financial (50%)	Underlying PBT	£192.9m	£196.9m	£204.9m	£199.1m	33.44%	33.44%
	All-in ROE	21.4%	22.4%	24.4%	23.2%		
	Cost to income ratio	31.0%	30.0%	28.0%	30.4%		
	Net loan book growth	16.2%	17.2%	19.2%	20.1%		
Customer (15%)	Customer satisfaction	45	50	60	67	11%	11%
	Broker satisfaction	27.5	30	35	26.6		
	Complaints	0.8%	0.5%	0.1%	0.1%		
Quality (15%)	Overdue actions	3	2	0	1	11.45%	11.45%
	Arrears	1.25%	1.0%	0.5%	0.96%		
	High-severity incidents	4	3	1	0		
Staff (10%)	Diversity[2]	27.0%	28.0%	30.0%	30.9%	10%	10%
	Employee engagement[3]	3	4	6	7		
Personal (10%)	Vary by executive – see section below					10%	10%
Total						75.89%	75.89%

1. Targets – based on a sliding scale between threshold, target and maximum.
2. Diversity – based on the gender diversity of the senior leadership team.
3. Employee engagement – the employee engagement score represents the number of categories which showed improvement versus the prior year.

Resilience of the business model

Capital allocation decisions, distributions made and the remuneration of executive directors provide insight into the board's perspective on the success of the business. Investors and other stakeholders increasingly expect to understand the connection between capital allocation and forward looking statements that reflect the board's views of the sustainability of the business model over the longer term. This is especially relevant in relation to investment required to enable a company to transition to a low-carbon business model.

The proposed Resilience Statement

The Brydon Report echoes the above view and considers that information about the resilience of the business is information that is critical to stakeholders. Reporting on resilience is expected to provide "more information about the likely survival of the company into an indeterminate future." The report proposes that the board makes a Resilience Statement covering three future time periods:

- A short-term statement over a period of about a year with a high degree of certainty, subject to audit (the equivalent of the current going concern period).
- A medium-term statement over a longer period detailing stress-testing or scenario-testing and explaining the directors' conclusions on that, not subject to audit but with the possibility of the directors obtaining other assurance (some of the most informative current viability statements include similar disclosure around stress-testing or scenario-testing).
- A long-term statement about business resilience describing long-term risks and the directors' analysis of the resilience of the business to those risks, not subject to audit or assurance.

As we conducted this year's survey, we focused on disclosures in the front half around sustainability of the business model and adequate disclosure of the directors' stress or scenario testing of the company's business model as part of the viability statement.

Last year, 13% of companies included disclosure around the resilience of the business model in the viability statement. This year seven companies did so – a similar number. However, the picture was quite different when we considered whether there was discussion of the resilience or sustainability of the business model elsewhere in the annual report, pushing the total number of those providing disclosures to 70%. The sharp increase is perhaps driven by Provision 1 of the 2018 Code, which includes a disclosure requirement for the board to describe the sustainability of the company's business model.

Persimmon Plc incorporates a discussion of the sustainability of the business model in the future prospects section of its viability statement, covering market positioning, strategy and fundamentals:

Key Factors in assessing the long term prospects of the Group:

1. The Group's current market positioning

- Strong sales network from active developments across the UK providing geographic diversification of revenue generation
- Three distinct brands providing diversified products and pricing deliver further diversification of sales
- Imaginative and comprehensive master planning of development schemes with high amenity value to support sustainable, inclusive neighbourhoods which generate long term value to the community
- Disciplined land replacement reflecting the extent and location of housing needs across the UK provides a high quality land bank in the most sustainable locations supporting future operations
- Long term supplier and subcontractor relationships providing healthy and sustainable supply chains
- Flexible cost structure to allow the effective response to changes in market conditions
- Increased investment to support higher levels of construction quality and customer service through implementation of the Group's customer care improvement plan
- Strong financial position with considerable cash reserves and with additional substantial working capital credit facilities maturing March 2024

2. Strategy and business model

- Clear strategy to support continued investment in sustainable, inclusive residential development opportunities for the long term benefit of local communities and other stakeholders throughout the UK
- Focusing on constructing new homes for our customers to the high quality standards that they expect and helping to create attractive neighbourhoods
- Strategy recognises the Group's ability to generate surplus capital beyond the reinvestment needs of the business
- Positioning the business to retain appropriate flexibility to mitigate the impacts of the cyclicality of the UK housing market is a key element of the Group's strategy
- Substantial investment in staff engagement, training and support to sustain operations over the long term
- Approach to land investment and development activity provides the opportunity to successfully deliver much needed new housing supply and create value over the long term
- Differentiation through vertical integration achieving security of supply of key materials and complementary modern methods of construction to support sustainable growth in output
- Simple capital structure maintained with no structural gearing

3. Principal risks associated with the Group's strategy and business model include:

- Risk of the impact of disruption to the UK economy resulting from the departure of the UK from the EU
- Market risk related to reduced consumer confidence due to regional economic uncertainties
- The risk of a reduction in mortgage funding availability and/or affordability due to reduced lender risk appetite and/or regulatory change
- Team, skills and talent related risks regarding retention and change management

See pages 58 to 63 for the full list of principal risks together with detailed descriptions.

The longer term viability statement

Much of the information called for as part of the suggested medium-term resilience statement should already be captured in a high quality longer term viability statement. Provision 31 of the 2018 Code explains the requirements:

> "Taking account of the company's current position and principal risks, the board should explain in the annual report how it has assessed the prospects of the company, over what period it has done so and why it considers that period to be appropriate. The board should state whether it has a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary."

In other words, in addition to the board's statement that it has a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due, the viability statement should include:

- An explanation of how the board has assessed the longer term prospects of the company
- The lookout period for the viability statement and why the board considers that period to be appropriate
- How the analysis of viability has been performed
- Any qualifications or assumptions as necessary

All companies we surveyed prepared the viability statement over a 3 – 5 year period, with 84% looking out for three years (2019: 82%).

All companies we surveyed referred to the nature of the analysis they undertook to support the statement and all described performing one or more of modelling, stress testing, sensitivity analysis or scenario planning; some described a quite detailed modelling approach. 20% of companies had also performed reverse stress testing as part of their analysis.

Smith & Nephew provided high-level detail on the scenarios they modelled, including some numerical detail of how this was reflected in the stress testing of the business plan. They also explained the link to strategy and to principal risks (where they covered elements of their mitigation strategies).

2019 Scenarios modelled

Scenario 1 – Pricing and reimbursement pressures	
Pricing and reimbursement pressures (Principal Risk) – leading to a major loss of revenues and profits.	**Action taken:** We have modelled additional annual price erosion of 1% from 2020.
Link to strategy – Achieve the full potential of our portfolio	**Link to principal risks** – Pricing and Reimbursement
Scenario 2 – Operational risk	
Execution risk – our inability to launch new products losing significant market share to the competition.	**Action taken:** We have modelled revenue growth for China at 50% of the plan over the three-year period.
Key supplier disruption – resulting in our inability to manufacture or supply a few key products for a full year.	**Action taken:** We have modelled an interruption to receiving goods from a key supplier for a period of one year.
Temporary loss of key production capability – resulting in our inability to manufacture several key products for two years.	**Action taken:** We have modelled the loss of strategic production machinery, resulting in the loss of production and sales of several key products for two years from 2021.
Product liability claim – giving rise to significant claim or loss.	**Action taken:** One-off significant loss occurring due to a new product defect.
Link to strategy – Become the best owner. – Transform the business through enabling technologies. – Achieve the full potential of our portfolio.	**Link to principal risks** – Supply – New Product Innovation, Design & Development Including Intellectual Property. – Commercial Execution. – Business Continuity and Business Change.
Scenario 3 – Finance, legal regulatory and compliance risks	
Regulatory measures – impacting our ability to continue to sell key products.	**Action taken:** We have modelled the complete loss of revenue from a key product effective beginning of 2020 for two years and returning back in lower volumes in 2022.
Tax or treasury failure – giving rise to a significant fine or loss.	**Action taken:** We have assumed a one-off significant fine or loss resulting from a tax compliance or treasury operations issue in 2021.
Link to strategy – Become the best owner.	**Link to principal risks** – Legal and Compliance. – Quality and Regulatory. – Finance.
Scenario 4 – Cybersecurity	
Inability to issue invoices or collect money for a period of time.	**Action taken:** We have modelled one of our key regions being unable to invoice for a month in 2021 due to an IT disruption.
Link to strategy – Transform the business through enabling technologies.	**Link to principal risks** – Cybersecurity.
Scenario 5 – Mergers and acquisitions	
Failure to integrate newly acquired business effectively to achieve expected growth.	**Action taken:** We have modelled a scenario of zero growth in a recently acquired business.
Link to strategy – Achieve the full potential of our portfolio.	**Link to principal risks** – Mergers and Acquisitions.
Scenario 6 – Political and economic	
Political and economic risk – for example, political upheaval, which could cause us to withdraw from a major market for a period of time.	**Action taken:** We have modelled a loss of revenue in our Middle East markets due to global conflict for twelve months.
Link to strategy – Become the best owner.	**Link to principal risks** – Political and Economic.

> Much of the information called for as part of the suggested medium-term resilience statement should already be captured in a high quality longer term viability statement.

We considered that almost half of companies disclosed their analysis in sufficient detail to provide investors with an understanding of the nature of the scenarios they had explored and 58% of those included clear conclusions on each scenario. 36% of companies included at least some detail on possible mitigating activities. The most detailed disclosure in our sample for any individual scenario was from Next plc on the COVID-19 pandemic.

Sales Scenarios

We have modelled three scenarios for full price sales as set out below. The first scenario assumes a shorter pandemic duration. The second and third are spread out over 24 weeks. It is important to stress that no one knows, and the phasing shown below is pure guesswork. Our gut feeling is that the -10% scenario is too optimistic, and we believe the -25% scenario is overly pessimistic. The week by week progression does not make much difference to our cash resources and the number to focus on is the total quantum of lost sales rather than the timing.

Full price sales versus last year	**Scenario -10%**	**Scenario -20%**	**Scenario -25%**
Weeks 1 & 2	- 45%	- 45%	- 45%
Weeks 3 & 4	- 90%	- 90%	- 100%
Weeks 5 & 6	- 45%	- 90%	- 100%
Weeks 7 & 8	- 25%	- 65%	- 75%
Weeks 9 & 10	- 25%	- 65%	- 75%
Weeks 11 & 12	- 25%	- 45%	- 60%
Weeks 13 & 14	-	- 45%	- 60%
Weeks 15 & 16	-	- 25%	- 40%
Weeks 17 & 18	-	- 25%	- 40%
Weeks 19 & 20	-	- 10%	- 25%
Weeks 21 & 22	-	- 10%	- 25%
Weeks 23 & 24	-	- 10%	- 10%
Decline for affected period	**- 42%**	**- 45%**	**- 53%**
Rest of year	0%	0%	0%
Full year	**- 10%**	**- 20%**	**- 25%**

Cost Assumptions

The paragraphs below set out the way in which we have modelled the major heads of cost.

Stock	We have assumed that we can cancel out of somewhere between 10% and 20% of the lost sales, saving the cost value of the stock. The later in the year the sales are lost, the greater our opportunity to cancel orders.
Clearance rates	We have assumed that we will not achieve any additional markdown sales by clearing additional surplus stock. This is potentially overly conservative.
Variable costs	As sales reduce, the demand for labour in our warehouses, stores and call centres would reduce. We have assumed that for warehouses and call centres, costs are 20% variable. So if Online sales drop by -10%, costs would only fall by -2%. Retail store wages are assumed to be 30% variable to Retail sales. We believe this can be achieved mainly through not requiring staff to work more than their contracted hours and, in the short term, we would not replace leavers. In the event of a prolonged closure period, and in the absence of any Government assistance, we may have to take more radical action on wages, but we have not factored this into the model. Online distribution costs, many of which are contracted out to a third-party on a per parcel basis, are assumed to be 65% variable.
Head office	Most Head Office functions are vital to the long term future of the business and we have assumed that wages remain broadly fixed.
Bad debt	We have not assumed any change in bad debt rates or payment profile though in reality payments may be a little slower than expected and bad debt may increase.
Rents	We have assumed that rents and all other fixed costs are not variable.

64% of companies, an increase from 51% last year, chose to disclose qualifications or assumptions underlying their assessment. Predictably given the course of 2020, 69% of these companies made assumptions about the availability of funding or refinancing. A further 16% included assumptions either explicitly or implicitly about the future impact of COVID-19, including the length of lockdown. Although most of the companies in our survey did not have a full picture of the outcomes of the pandemic at the time they reported, it is clear that risk was risk recognised in the business environment. This compares to assumptions about availability of funding or refinancing being disclosed by only 23% of companies in 2019.

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Risk management – emerging risks

Provision 28 of the 2018 Code introduces the requirement to perform a robust analysis of emerging risks in addition to principal risks for the first time. This is the first year in which companies have been required to provide disclosure in this area, which should include a description of the procedures that are in place to identify emerging risks. This is intended to help understand the approach the board takes to risks that are on the horizon and may be critical to business resilience in years to come.

Describing the procedures in place to identify emerging risks has not been done effectively by the majority of companies. We considered that only 26% of companies included a disclosure in the annual report that clearly covered this point. Disclosures that met the requirement referred to procedures such as horizon scanning, bottom-up strategic planning processes, executive board workshops, review of the macroeconomic or industry-specific landscape, in each case focused on the identification of emerging risks.

ITV plc described a recent review of its risk management framework, including emerging risks, together with ongoing horizon scanning, dialogue with the business and wider market and economic movements:

> **Principal risks**
> The recent review of our risk management framework included refreshing our principal risks and updating the way they are presented and defined. We took a blank sheet, top down approach with stakeholders across the business to better define existing risks and also identify potential emerging risks. The Divisional Boards and Management Board then took part in a series of externally facilitated workshops to assess and prioritise these risks. The outcome of this exercise is our refreshed principal risks, which have been reviewed and approved by the Board.

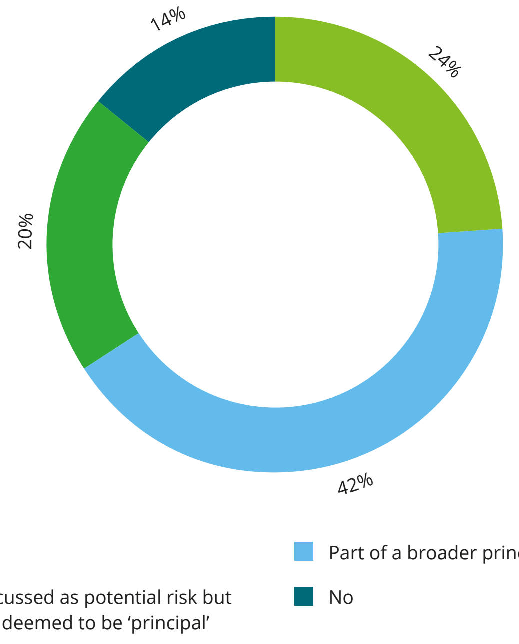
> **Emerging risks**
> We define emerging risks as uncertainties which originate from known or previously unconsidered sources, but which are not clearly understood, visible or possible to fully assess. These risks could impact over a longer period and have the potential to significantly impact our business model and/or operations.
>
> Emerging risks are identified by the business on an ongoing basis and are escalated through risk management processes and reporting. ITV's Group Risk team supports the business in identifying and highlighting emerging risks to the Board. They do this through undertaking horizon scanning, maintaining ongoing dialogue with the business and keeping up to date with wider market and environment movements.
>
> As part of our efforts to redefine our principal risks this year, we also considered emerging risk areas. We have undertaken exercises to analyse emerging risk areas in order to determine whether they should be promoted to principal risks and monitored as part of our existing risk management processes. Where the risks have not been assessed as principal risks they have been categorised as emerging risks, have been reviewed by the Board, and will continue to be periodically reported and reviewed internally.

Some companies did discuss emerging risks but with a lens of management or mitigation, which is also useful and informative but does not respond to the Code requirement to describe the procedures in place to identify emerging risks.

Risk management – Brexit

Brexit was described by many companies last year as an "emerging risk". Many companies continue to include Brexit within a broader principal risk (42%) or else call out Brexit as a principal risk in its own right (24%).

Figure 15. Is Brexit included as a principal risk?



More generally, Brexit remains a hot topic and a driver of uncertainty for many companies. 40% referred to Brexit within their longer term viability statement, while 74% mention Brexit elsewhere in their strategic report outside of the risk section. Boards are talking about it too, with 62% mentioning Brexit in their corporate governance statements, often as part of a list of key matters discussed by the board or else in the audit committee reports in relation to risk. One retailer has set up a dedicated governance steering group to discuss the group's plans and approach to manage the impact of Brexit.

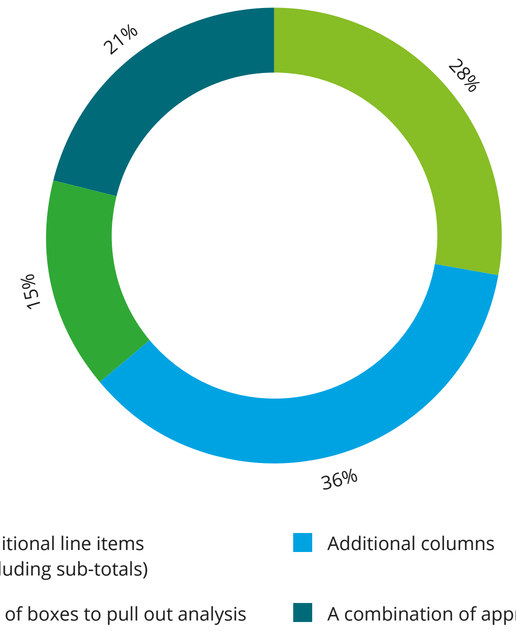
28% referred to Brexit within the financial statements, although in a small number of cases this was negative confirmation of the lack of anticipated impact.

Alternative Performance Measures (APMs)

The use of APMs continues to be commonplace by UK reporters, with many preparers believing that they serve a useful purpose in telling a company's story. APMs have been an area of focus by the FRC over recent years, being the third most commonly raised substantive issue in their 2018/2019 monitoring activity. The FRC recommend adherence to the ESMA guidelines and expect compliance.

78% of companies presented adjusted measures of profitability on the face of their income statement.

Figure 16. How are non-GAAP measures presented on the face of the income statement?



The use of additional columns (whereby typically a 'before exceptionals' column of results is presented, followed by a column of 'exceptional' figures with a third column showing the statutory total results) remains the most common way to present non-GAAP measures. The IASB's recent exposure draft on general presentation and disclosure introduces the term "management performance measures" (MPMs), broadly being subtotals of income and expenses used in financial statements that complement totals or subtotals in the IFRS Standards, and communicate to users management's view of an aspect of an entity's financial performance. The exposure draft proposes that presentation of MPMs on the face of the income statement would be restricted, with the use of columns to present MPMs prohibited entirely. Further data on the use of APMs can be found in Appendix 1 of our consolidated survey publication.

What to watch out for

- [ ] When describing capital allocation policies or processes, consider how to stretch beyond providers of financial capital and capital investment to include discussion of other key stakeholders, how capital is allocated to address their needs, and how this fulfils the company purpose.
- [ ] Consider the consistency of and connection between those stakeholders identified in the business model as key relationships or resources, those described as for whom value is being created and those discussed by the board in explaining how they have discharged their duty under s172.
- [ ] Investors are calling for detail around dividend policies and the level of reserves available for distribution. Be sure to include this in a clear and meaningful way.
- [ ] Ensure there is clear linkage in the strategic report between the company's performance and directors' remuneration; investors are looking beyond financial measures alone to drive remuneration and seeking to understand how broader ESG factors are taken into account.
- [ ] When describing the work the board has performed on the viability statement, include enough granular information on the nature of testing and the scenarios assessed for investors to determine whether they consider the work sufficiently robust.
- [ ] Remember to include a good analysis to explain the directors' view of the sustainability of the business model, in line with Code requirements and regulator requests – the viability statement or business model disclosures may be a natural place for this.

Appendix – Survey methodology

For many years the Annual report insights series has presented the findings of a survey of 100 annual reports of UK companies with a premium listing of their equity on the London Stock Exchange, both within and outside of the FTSE 350. This year we have adopted a different approach to facilitate a deeper look into key areas where regulators and investors are increasing their focus.

Purpose, people, planet and profit chapters

In four key areas – purpose, people, planet and profit – the publication presents the findings of a survey of 50 UK companies with a premium listing of their equity on the London Stock Exchange. The population comprises 21 FTSE 100 companies and 29 FTSE 250 companies across a range of industries. All companies had financial years ending between 31 December 2019 and 31 March 2020 and had more than 500 employees, and were therefore required to disclose both an NFI statement and s172(1) statement and were in scope of the 2018 Code. As many of these companies as possible were included within the sample used in the previous survey.

Pandemic chapter

A large number of the annual reports surveyed for the four previous chapters that were approved in February or early March 2020 made little or no reference to COVID-19. As such, in this section we look at some of the emerging trends in annual reporting regarding COVID-19 for a sample of 20 FTSE 350 March year-ends.

Appendix 1 of consolidated publication – additional findings

This appendix presents various statistics from surveying the larger sample of annual reports that includes 100 UK companies spread across the whole of the FTSE. 91 of the 100 companies are the same as those used in the previous year's survey. The population comprises 20 FTSE 100 companies (2019: 19), 39 FTSE 250 companies (2019: 37) and 41 companies outside the FTSE 350 (2019: 44). Investment trusts, other than real estate investment trusts, are excluded from the sample due to their specialised nature. The reports analysed are for financial years ended between 28 September 2019 and 31 March 2020.

Although our survey data uses only companies from our samples, when selecting examples of good practice we have used material from companies that, in our view, best illustrate a particular requirement or innovation, regardless of whether they are in our sample.

Each chapter also includes a short list of items to watch out for in the reporting season ahead, reflecting areas of changing requirements or practice and areas of regulatory focus.

Glossary of terms and abbreviations

Term	Definition
2018 Code, or the new Code	The 2018 UK Corporate Governance Code
Acc Regs Sch. 7	Schedule 7 of *The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410)*, as amended
the Act	UK Companies Act 2006, as amended
BEIS	The Department for Business, Energy and Industrial Strategy
BEIS Q&As	A set of frequently asked questions published by BEIS regarding *The Companies (Miscellaneous Reporting) Regulations 2018 (SI 2008/860)*
Brydon review	An independent review by Sir Donald Brydon into the quality and effectiveness of audit
Climate Action 100 +	An investor initiative encouraging large corporate greenhouse gas emitters to take necessary action on climate change
ESG	Environment, social and governance matters
ESMA Guidelines	Guidelines on Alternative Performance Measures (APMs) for listed issuers published by the European Securities and Markets Authority (ESMA). Since original publication, ESMA has published several questions and answers on the guidelines to promote common supervisory approaches and practices in the implementation of them
FCA	Financial Conduct Authority
FRC	Financial Reporting Council
FRC Guidance	The FRC's Guidance on the Strategic Report published in July 2018
FRC Lab	The Financial Reporting Lab was launched in 2011 to provide an environment where investors and companies can come together to develop pragmatic solutions to today's reporting needs. Latest reports can be found here.
FRC's Annual Review of the UK Corporate Governance Code	See this link
FRC's Annual Review of Corporate Reporting 2018/2019	See this link
GHG	Greenhouse Gases
IASB	International Accounting Standards Board
IBC	The World Economic Forum's International Business Council
Investment Association	A trade body and industry voice for UK investment managers
IPCC	Intergovernmental Panel on Climate Change, the United Nations body for assessing the science related to climate change
KPI	Key performance indicator
NFI Statement	the Non Financial Information Statement as required by s414CB of the Act
NFR Regulations	*The Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016 (SI 2016/1245)* which implement the EU Non Financial Reporting Directive into sections 414CA and 414CB of the Act
Parker Review	An independent review by Sir John Parker into the ethnic diversity of UK boards
R&D	Research and development
s172	Section 172 of the Act which sets out certain directors' duties
s172(1) statement	The statement required by s414CZ of the Act, under which the directors must explain how they have fulfilled their duty under s172(1) of the Act
SASB	Sustainability Accounting Standards Board
SDGs	Sustainable Development Goals, a set of targets set out by the United Nations
SECR	Streamlined Energy and Carbon Reporting, as set out in *The Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018 (SI 2018/1155)*
TCFD	Task Force on Climate-related Financial Disclosures
TCFD recommendations	Recommendations as set out by the TCFD which promote voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders
TCFD 2019 Status Report	An overview of current disclosure practices as they relate to the TCFD recommendations
WEF	The World Economic Forum

Endnotes

1. For further information see the FRC's Financial Reporting Lab's report on Disclosure of dividends – policy and practice (Nov 2015) and the two implementation studies, all available at https://www.frc.org.uk/investors/financial-reporting-lab/publications

To find out more annual report insights visit:

www.deloitte.co.uk/annualreportinsights

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