Summary of the Financial Reporting Lab Conference – 21 June 2018

Introduction

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. Since its inception it has completed 18 project reports and has worked with 76 different companies, 85 investment organisations and over 300 retail investors to bring insight and understanding to a number of key areas of disclosure.

> **"Good corporate reporting should act as a window, and not as a billboard"**
>
> – Sir Win Bischoff, Chairman of the Financial Reporting Council

Opening Remarks

The conference was opened by Sir Win Bischoff, Chairman of the Financial Reporting Council. Sir Win highlighted the unique nature of Lab in encouraging good reporting by companies by finding practical, market-led solutions.

Sir Win encouraged all of those present to become involved with Lab projects and use the opportunity to influence corporate reporting to face the challenges that lie ahead. He said, "If anything, the pressure of corporate reporting has increased.... The combination of new regulations, new technology and increased stakeholder interest means that transparent, credible and well-articulated corporate communication are both more in demand and increasingly challenging to deliver."

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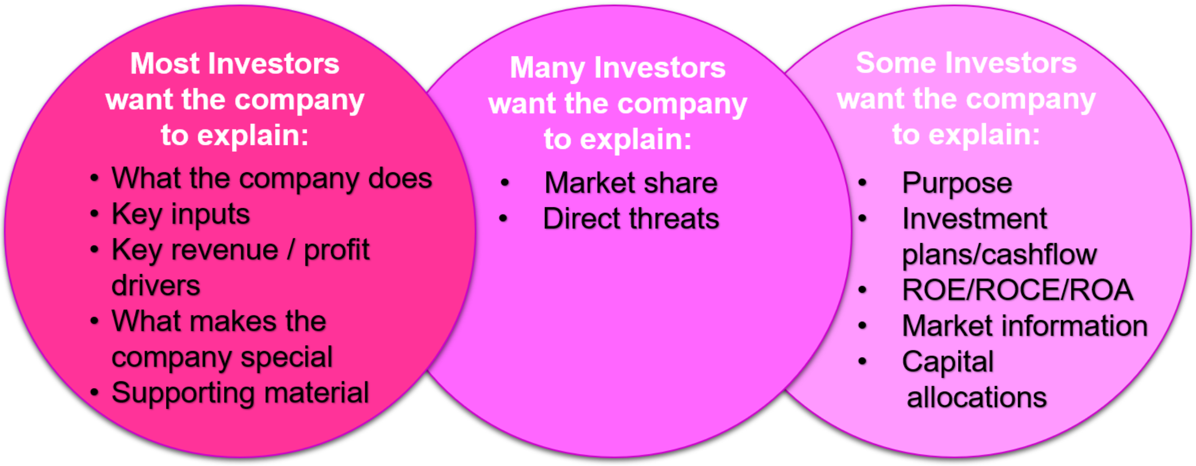
In the first session, Phil Fitz-Gerald, Director of the Financial Reporting Lab, introduced the Lab and its past reports and launched the first report from its project on performance metrics. He also set out some of the early findings from the Lab's implementation study into how the reports on business model reporting, and risk and viability reporting have influenced corporate reporting practice. A full implementation study report is due to be published later on this year.

Business Model Reporting

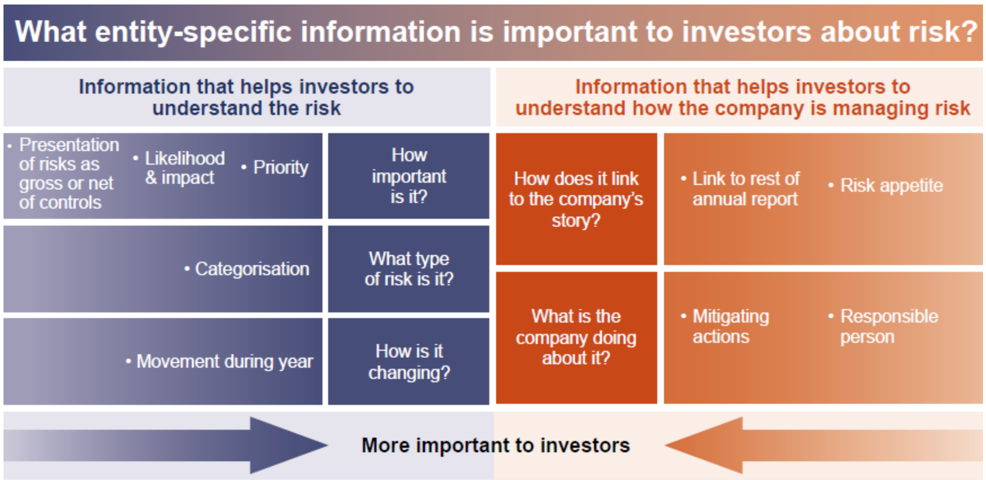
Phil recapped the business model report, drawing attention to how the Lab's reports aim to reflect the full breadth of views obtained during meetings with investors and companies in a practical and simple way. For this report, the attributes of good business model disclosure are presented as what 'most' investors what, what 'many' investors want, and what 'some' investors are looking for, in order to give companies an idea of where they should prioritise their efforts:



Phil explained that so far "we are finding that companies *are* putting in more disclosure around their purpose, what makes the company special, and information about the market in which it operates." However, Phil noted that there has been less attention paid to disclosure around key revenue, profit drivers, investment plans and cash flow, and most significantly, a simple explanation of what the company does. In addition, Phil also described how there has been a trend towards moving disclosure out of the business model section, and into an 'at a glance' or overview section in the annual report. This is a good development as it can show in a succinct manner how a company is run. However, it can result in some of the detail behind what the company does and how it is generates value being missed.

Risk and Viability Reporting

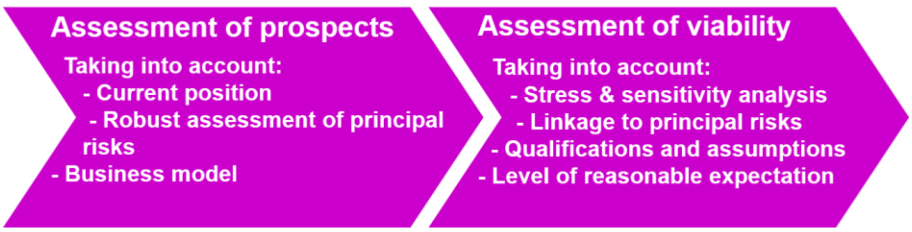
Phil gave a brief overview of the Lab's report on risk and viability that was published in November 2017. The report included a graphic that set out what investors reported was most important to them:



During the risk and viability reporting project investors were particularly keen to understand how risks change over time, and where risks move in and out of a company's principal risks, and the reasons behind this. It was therefore pleasing to see that more companies were disclosing changes in their risks year-to-year. Other areas of change also identified by the implementation study so far include more disclosure of linkage between risk and the rest of the annual report, such as strategy and KPIs, and clear prioritisation of principal risks.

Areas where there has been less development in risk disclosure, were on the detailed disclosure of the likelihood and impact of principal risks, and the disclosure or risk appetite for different risks and risk categories. He acknowledged that these areas can be more difficult for companies to disclose. Phil also noted that the implementation study so far has found a trend towards greater consideration of Brexit and cybersecurity in companies' risk disclosure.

The Lab's report "emphasised the two-stage approach to the viability statement, which was envisaged in the Corporate Governance Code," Phil said. He noted that "the two-stage process is a developing practice," and "many [companies] are starting to disclose longer-term time horizons when assessing prospects and then having a limited time horizon for the viability statement." During the project, investors also emphasised that the stress and sensitivity analyses performed are important to their decision making, and "we are starting to see companies describe the scenarios they are modelling," Phil said.



Overall, Phil summarised that with regards to the business model and risk and viability reports released by the Lab, we are "starting to see practice developing in those two areas, and some of the recommendations of the lab reports being put into place."

Reporting of Performance Metrics

Following on from the Lab's reports on business models and risks and viability, the Lab has carried out a project on the use of performance metrics in reporting to look at how companies measure the success of their business model. This project covers a wide range of metrics, including the increasing use of wider metrics.

"Given that there has been a lot of regulatory focus on non-GAAP measures, with ESMA's guidance and the FRC's focus on it, over the last couple of years we felt that it was time the Lab looked at an investor perspective." While, as Phil noted, "collating investors views is always a challenge, particularly in this area," the Lab report has developed a set of five investor principles for performance metric reporting.

Performance metrics should be…

Aligned to strategy

"performance metrics should be aligned to the company's strategy and clearly link between the measurement of it, and what the company is trying to achieve in its strategy. This can be applied to any metric, whether it is financial, non-GAAP, or whether it is a wider metric"

Transparent

"if a measure is being calculated which is not an IFRS measure, there should be clear explanations as to why that is a better measure to use, and how that is being calculated"

In context

"if a metric is reported, it should explain how good or bad that metric is – is it improving from prior years, is it decreasing, is it in line with the targets that the company is setting"

Reliable

"particularly where they are unaudited…some sort of sign around the level of assurance that those metrics have been subject to is important to investors as well, the extent to which the board and the audit committee has had oversight of those metrics…"

Consistent

"if companies are continually changing their metrics from one year to the next, it is difficult for investors to assess how that business is going and how those metrics are measuring performance over time"

– Phil Fitz-Gerald, Director of the Financial Reporting Lab

The second stage of the project, released later on in the year, will include practical examples to demonstrate how the principles have been put in place.

Panel One

Thomas Toomse-Smith, a Project Director in the Financial Reporting Lab, asked the panelists for their views on the development of business model reporting. Freddie Woolfe gave an investor perspective and explained that there is a diversity of approaches taken towards the business

Panel Session <Reporting PAST>

Panellists

- Susan Swabey, Company Secretary, Smith and Nephew
- Andrew Tusa, Managing Director Corporate Broking, Barclays
- Freddie Woolfe, Head of Responsible Investment, Old Mutual Global Investors

Panel Moderator

- Thomas Toomse-Smith, Project Director, FRC Lab model. However, for him, a business model is "all about how a company adds value for its customers, and in doing so creates money for its investors." That is the most important question an investor needs to answer, he continued, when trying to understand what a company's strategy is, how likely that strategy is to be sustainable, and how the company is going to deliver on that strategy. That will then flow through to the company's financial statements. Freddie commented that the business model does not need to be complicated, and should be focused on answering some basic questions. Where the business model is excessively complicated, he said it can raise questions about the quality of management and the board, and whether they are focusing on the right things. What investors want to see is clarity and simplicity.

Susan Swabey noted that, from the corporate side, the business model can be more difficult to disclose because everyone wants to get involved. Many people have an input and opinion on it which makes it more difficult to produce a simple, clear and coherent disclosure than other sections of the annual report. She said that to make the most of participating in a Lab project, it is best for the person who is responsible for that particular section to attend, to make sure that all of the value and feedback from the Lab project process are made use of.

Andrew Tusa added that it is very important for Lab projects to be iterative, and that change takes time, and it is part of the process for ideas, views and suggestions to be tested. Andrew observed that as far as best practice is concerned, there is room for business model disclosure to evolve. He said that a fundamental aspect of what a business model needs to disclose is the allocation of capital for a company to create value for their shareholders, and it is this allocation of capital which is then compared across companies. Andrew raised the question of the business model being 'inside out' or 'outside in' and noted that sometimes it can be easier for investors to describe what a company's business model is than for the companies themselves, because they can more easily make comparisons across many companies, leading to greater clarity.

Thomas then turned the panel discussion to risk and viability reporting, asking from a company perspective how participating in the Lab project influenced reporting. Susan replied that taking part in the project was useful for what they decided to include in the disclosure, and what they decided to leave out. In particular, she noted that participating in the Lab project was useful to their communication. From their view, she said, the internal process for producing those disclosures was largely similar to what it had been in previous years. However, taking part in the Lab project then changed how they communicated and disclosed that information.

> **"[Participating in Lab projects] is a very useful use of your time. It does help, and I think four or five hours contributing to a project saves you tens of hours later on when you're actually writing the sections of your annual reports"**
> – Susan Swabey, Company Secretary, Smith and Nephew

She also added that taking part in Lab project helps to focus on a single topic of reporting which a company wouldn't ordinarily get from its investor meetings. Andrew noted that dialogues between investors and companies about disclosure are becoming increasingly common.

> **"There needs to be a forum for investors to have those discussions [about disclosure] more broadly, and I think that is where the Lab can play a very valuable role"**
> – Andrew Tusa, Managing Director Corporate Broking, Barclays

Thomas then asked the panel how they see the viability statement evolving over the next few years, to which Freddie replied that, currently, one of the areas where there is much room for improvement is the viability statement. Whilst the risk and scenario disclosures are improving, there is also an opportunity to consider wider issues and also to demonstrate board engagement. He stressed that companies should be frank about the limitations of their modelling and disclosing changes throughout the year, and to view the viability statement as an opportunity to demonstrate how the internal control system is working. In addition, he added, the homogeneity of timeframes for the viability statement implies that there is a benchmark, and this should evolve so that timeframes are reflective of business cycles, strategy, investment and value creation, rather than a 'standard'.

Thomas then invited any audience questions, the first of which suggested that investor challenge and dialogue could be an important way to meaningfully improve the viability statement. Susan responded that she was already finding increased interest from investors who are asking them about their viability statement, and the main risks to the company. She added that from a company perspective, one of the main challenges with the viability statement is that risks often build up over time, rather than being a one-off event (and controls and mitigating actions evolve to respond to these), so the worst-case scenario would most likely never come to fruition.

Responding to an audience question as to how the annual report and the disclosures within fit in among the suite of information available to investors, Susan said that feedback they get from investors is that they are generally more interested in the preliminary statement than the annual report. The annual report is still a "key communication document," Freddie added. The preliminary statement is more about reporting the numbers, he continued, whereas the annual report is about stewardship, in a broader sense, and can give key insights into companies.

> **“It’s about inputs, not outputs. It’s about the process that forms these statements, rather than the statements themselves.”**
> – Andrew Tusa, Managing Director Corporate Broking, Barclays

Thomas ended the panel with a final question to the panelists to lead into the second session of the conference, asking what they consider to be the challenges for reporting in the future. Susan replied that addressing the requirements of Section 172 is one of the upcoming challenges. Andrew added that credibility is one of the major challenges for reporting, which is influenced by the culture of communication. Freddie agreed that both trust and credibility in business is very important, and Section 172 disclosures present an opportunity for companies to demonstrate to their investors, and other stakeholders, that the directors of a company are engaged and have fulfilled their duties to investors and other stakeholders as well. Section 172 ties together how important it is to work with broader stakeholders to add value for investors and, he continued, this is an opportunity to demonstrate the thoughtfulness of the board in some large topics that are fundamental to the sustainability of the company. Susan added that for Section 172 disclosures to be the most useful, they should allow companies the flexibility to focus on stakeholders and issues that are important for them, rather than having boilerplate statements on matters that might not be material for that company.

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Panel Two

> **Panel Session <Reporting FUTURE>**
>
> **Panellists**
> - Stephanie Maier, Director, Responsible Investment, HSBC Global Asset Management
> - Douglas Radcliffe, Group Investor Relations Director, Lloyds Banking Group
> - Ben Yeoh, Senior Portfolio Manager, RBC Global Asset Management
>
> **Panel Moderator**
> - Sallie Pilot, Director, Black Sun

“This is all about thinking about the future”, said Sallie Pilot, panel moderator and Director of Black Sun Plc, as she introduced the second session. Sallie started the conversation following on from Phil Fitz-Gerald’s information on the Lab’s Performance Metrics report, asking, from a corporate viewpoint, “How do you balance the financial and non-financial, and defining the right [broader performance] measures?”

“Really understanding what investors want is actually quite difficult,” said Douglas Radcliffe, and “investors are also only one of the stakeholder groups that we are looking to satisfy with the report and accounts”. On top of this, while there are many different stakeholders, there is also no single investor view. He advocated for an approach whereby the most important thing is for the performance metrics to be driven by the company, and its strategy and purpose, rather than seeking to satisfy all stakeholders through boilerplate statements.

> **"Whatever you do actually disclose, both financial and non-financial, has to be related to the strategy of the organisation that you work for"**
> – Douglas Radcliffe, Group Investor Relations Director at Lloyds Banking Group plc

Sallie briefly discussed the results from the preconference survey, highlighting that most respondents note Section 172 as one of the biggest challenges facing corporate reporting, as well as the new Corporate Governance Code and the Guidance on the Strategic Report.

Sallie then turned to the investor view, asking investors what they expect from corporates with regard to wider performance measures. Stephanie Maier commented that it is a somewhat artificial divide between financial and non-financial performance metrics, and there is often a large overlap between them with regards to what is financially relevant to a company. And even then, the issues that a company responds to and decisions about what is material are rapidly evolving. Stephanie also acknowledged the tension between having comparable disclosure that allows for comparison between companies, and the fact that every company *is* different and the ultimate aim is to understand the story of each company.

> **"A company can no longer just respond [to all reporting frameworks] – it needs to choose. It needs to choose the frameworks, it needs to choose the indicators, it needs to choose its audience that it prioritises to be able to best articulate the company, the strategy, the things that it thinks are most important for its investors and its stakeholders to understand about its business"**
> – Stephanie Maier, Director, Responsible Investment, HSBC Global Asset Management

Ben Yeoh echoed the sentiment of Stephanie and Douglas that corporates need to make the decision of what is important and material for their company, with the added comment that what investors view as material may be different to what other stakeholders may view as material. Additionally, Ben said that there is evidence now that the majority of a company's valuation is in its intangible asset base, that is, research and development, brand, people and corporate culture, all of which are relatively poorly reported on from an investor point of view. He said that investors are looking for things that are going to make a real difference to businesses and how they compete. He suggested that, in this area, regulators may have a role in defining the minimum standards of wider metrics, and investors will have saying a role in what is useful.

Regarding the landscape of many regulators, frameworks and standard setters, Sallie asked for a corporate viewpoint on how these are navigated by corporates. Douglas replied that due to the hugely complex landscape, corporates need to rely on advisors as to what to focus on, and commented that trying to include everything could lead to ‘tick box’ governance, as companies do not have the capacity or resources to engage with all frameworks on a deeper level. He added that “identifying where you can really add value becomes increasingly difficult – but that is where I hope the likes of the Lab and the FRC should be able to add value.”

Stephanie commented that is it important to keep in mind what the information disclosed will be used for, and for investors that is “using this information to make investment decisions, and ideally better investment decisions than others.” She added that companies should understand the use of data by different stakeholders to help them decide and prioritise what is really important, and to ensure that they are articulating how they are driving value. In particular, if companies believe they are doing well in an area that has value attached, for example employee engagement, then they should make sure they are communicating this to stakeholders.

Sallie then asked how important the annual report is for telling the story of a company and creating a narrative, with regard to the idea of broader performance measures being used for bringing confidence to a company narrative. Ben replied that the business model is the key, and if companies focus on their business model and strategy, then the other aspects should flow. From this, he continued, issues should be material to the company and the industry, and companies should start from what *they* think is important.

Ben commented that while the annual report and accounts are still important, they are no longer the first port of call for investors, with investor slide decks and CEO presentations generally taking precedence. In fact, he said, some investors, particularly passive investors, may never directly access the annual report and account, and would rather gather their information through third parties, or from the annual report after it has been analysed by artificial intelligence software, using natural language processing to search for key words or indicators. In addition, he added that where a company has not provided any information, investors will seek out that information from third party sources, for example, GlassDoor for employee information. He stressed that material information will be available from other parties, and if a company is not providing data points, then somebody else will derive them. Companies are no longer solely in control of the data that people are consuming about their company, he said, so companies need to think ‘what are the are the material issues that we would rather people hear about from us, rather than derived from someone else?’, while also saying that “as investors, we’re dealing with imperfect information.”

“My advice to corporates on this is to always start with your business model and strategy”
– Ben Yeoh, Senior Portfolio Manager, RBC Global Asset Management

Stephanie agreed that narrative is important, because numbers do not tell the whole story about a company. The fact that the annual report and accounts come from the board, she explained, and what is presented in the document is what they believe to be true adds to its accountability.

Sallie opened the panel to audience questions, the first question asked about intangibles and reputational risk, and how it might be possible for investors to gain a greater understanding of the drivers that lead to crystallisation of reputational risks. Ben replied that investors are getting more sophisticated about these

scenarios, such as looking for early flags for these kinds of risks that may not be reported by the company, and also increased scrutiny of corporates and their reporting, for example, focusing on adjusted numbers, particularly where adjusted numbers are presented year after year. Stephanie and Ben both commented that transparency is always liked by investors, and is useful in both ‘good’ and ‘bad’ situations. Stephanie noted that the degree to which a company and also investors are surprised by risks crystallising is a function of how narrow or broad the outlook of that company is, and highlights the importance of how companies report on, measure and manage wider metrics. Companies that are looking beyond their own boundaries, she continued, are more likely to see things coming down the line, to see trends and regulations coming, perhaps from looking at another sector where something similar has happened. On this point, she added that in addition to overall quality and independence, this is why diversity in boards is important, as diversity can help to provide different perspectives which in term can allow for some degree of ‘future-proofing’ with wider awareness and horizon scanning.

To finish the panel, Sallie asked for final remarks on a message for corporates, and what they should be thinking about to deliver greater value for the information they provide investors. Stephanie responded that her message for companies is that while reporting is, by definition, backwards-looking, the desire for information on how the company is preparing to go forward and preparing for risks in the future will become more and more important. Currently, she continued, this is achieved by looking at metrics that are important historically but can also potentially be used to predict future performance, but boards should start thinking about the future of their company and what they want to communicate.

Digital Future

Thomas Toomse-Smith provided an update on the Lab’s Digital Future project, which aims to investigate how technology might affect corporate reporting. The project began with the publication of a framework of 12 characteristics that represent desired qualities for any digital reporting. It was created to provide a structure through which to explore whether existing and future technologies might be useful in the production, distribution and consumption of corporate reporting.

He highlighted the recently released report, ‘Blockchain and the future of corporate reporting’, which found that blockchain may be useful for some aspects of the corporate reporting process, particularly where there is a desire for trust and resilience of data. However, he noted that blockchain is unlikely to disrupt the entire process of corporate reporting, particularly in areas where there is a focus on narratives, judgements and communication.

Thomas called for participants to become involved in the next Digital Future report on artificial intelligence.

Regarding the use of technology in corporate reporting, Sallie asked Ben how he sees this developing. Ben said that it is difficult to predict exactly what impact technology will have on corporate reporting over and above the wider effect it has on society. However, even before looking at developing technologies, there is still an opportunity for companies to use what technology is available today to better communicate, such as data visualisation and even short videos to explain message to key stakeholders. Douglas agreed that technology can be of massive benefit to organisations and investors, but stressed that it is important to carefully consider who will be engaging with the technology, and design the solutions accordingly.

Douglas gave a final message for investors and regulatory bodies, for there to be greater coordination in order for companies to know what to focus on and what is the most important amongst the wealth and volume of data and frameworks, which Ben also reiterated, calling for perhaps greater communication of the commonalities of what investors are seeking from companies.

Closing Remarks

Phil closed the conference with a few final remarks, thanking the panelists and panel moderators for the helpful and insightful discussions. He also called for companies and investors to become involved in Lab projects wherever possible.

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