Joining the dots*
A summary of the narrative reporting practices of the FTSE 350
Reporting and communications are activities that, if done well, can deliver competitive advantage in a variety of ways from securing capital and credit, to winning in the war for talent and building strong business relationships. At times such as these, where markets are in a state of flux and where trust and confidence are in short supply, effective corporate transparency is even more critical for rebuilding trust and protecting the share price.

The experience of past market downturns when confidence was fragile, is that any bad news provides the signal for the market to mark down the whole sector, only then followed by the illuminating questions. The challenge and opportunity facing individual companies, in this environment, is to ensure they stand out from the pack. By explaining clearly the dynamics of their business model and, where appropriate, highlighting the critical differences between themselves and their competitors, some of the market risk can be mitigated. Reporting is a competitive tool, so it would not be surprising to see the year-on-year quality of reporting moving on a gentle upward trend. This is precisely the picture painted by our latest annual review of the quality of reporting among the entire FTSE 350. As in the past, the pace of improvement is largely determined by a number of management teams that take the reporting agenda seriously and see it as a useful discipline that delivers benefits in a variety of ways. Many companies, and their investors, have correctly identified that the quality of external reporting is a reflection of how the company is managed internally. If you understand your strategy and you understand what needs to be measured and managed internally, external reporting is less of a chore and less of a surprise for all those involved. Furthermore, when management teams set out a clear picture of their ambitions, with objectives, goals and targets, the mere fact creates a focus and discipline that is considered healthy.

Clearly the quality of reporting, the level of effort and investment made, is a decision for each company’s management team and its board of directors. It is worth noting, however, that the best company reporting goes well beyond what is required by regulation. It’s not difficult for readers to discern which management teams have approached their reporting with clear communication to their stakeholders in mind and those that have come at it from the compliance end of the spectrum. Each presents a rather different view of management.

Through the work we do, we have seen how important it is for management and the board to challenge the quality of their companies’ reporting. In particular, we believe all executive teams should have an objective view of how their company’s reporting measures up against their peers and good practice – forewarned is forearmed. In today’s market environment this is critical. If you are ‘off the pace’ on reporting, it could precipitate one of those share price downgrades that is based on ignorance rather than fact.

David Phillips
Senior Corporate Reporting Partner, PricewaterhouseCoopers
Companies face the significant challenge of responding to growing pressure for them to communicate a broader picture of their corporate performance. Investors are demanding greater transparency to compensate for an increasingly complex financial reporting model, consumers are demanding ethical sourcing and production and communities are scrutinising environmental performance. At the same time, the government is demanding a ‘fair’ contribution to society from business, particularly in relation to employment and taxation.

Companies that can communicate their performance across a broad range of business drivers to this increasingly well-informed set of stakeholders have the potential to gain competitive advantage.

Against this backdrop, the current economic climate has placed a more immediate demand on management to provide sufficient information to allow the market to form a view of the underlying quality and sustainability of corporate performance.

Business Review encourages broader reporting

The Business Review legislation (including the Enhanced Business Review) asks for a broad picture of company performance to be presented and therefore provides regulatory encouragement for an open dialogue between company management and their stakeholders. While its sole focus is on the content of the annual report, just one strand of companies’ overall communication suite, an understanding of how they are responding to the legislation can act as a useful barometer for their overall reporting strategy and appetite for transparency.

The Business Review provides companies with a framework for explaining the strategic context in which business operates, together with an explanation of the financial numbers. Furthermore, it enables other critical information to be presented in a logical and integrated way that is essential for an understanding of companies’ long-term direction and short-term performance. Put simply, it can help management teams to report in a more strategic and balanced way on the issues that impact performance, rather than allowing pure financial reporting to dominate their communications to the market.

Narrative reporting improved

In this publication we present the findings of our second review of the FTSE 350’s response to the Business Review and identify evolving trends in narrative reporting over the last 12 months.

The findings from our review illustrate the continued improvement in narrative reporting during the year. Nowhere is this more evident than in the communication of macro-economic trends, key performance indicators (KPIs) and principal risks:

- 75% (52%) of companies provide some discussion of the macro-economic environment in which they operate
- 84% (75%) explicitly identify their KPIs
- 92% (75%) clearly set out what they consider to be their principal risks and uncertainties

1 Numbers in brackets refer to the results from the 2007 review of narrative reporting. A summary of last year’s findings – Business Review: has it made a difference? may be found on www.corporatereporting.com
Executive Summary

Strategic alignment still a challenge

Despite the improvements in the scope of information reported, our review of the annual reports of the FTSE 350 highlights some ongoing challenges companies face when trying to present a credible and coherent picture of performance. In particular, many still struggle to present a picture of performance that joins the dots between strategic priorities, management actions, remuneration and performance.

- Only 18% (34%) use strategy to help the reader navigate through the other information presented
- Only 19% support strategic statements with an explanation of the actions necessary for their delivery
- Only 31% (42%) clearly align KPIs with strategic priorities
- KPIs remain largely financial in nature – customers and people were identified as important resources in over 80% of company reports, yet only about 35% reported associated KPIs
- 75% (83%) include an explicit sustainability (or equivalent term) section in their annual report, however, only 23% (17%) identify sustainability as a strategic priority

Increased focus from regulators

The Business Review now falls within the Financial Reporting Review Panel’s (FRRPs) remit and in October 2008, the panel published its annual review which noted that comments on the Business Reviews now feature regularly in the panel’s correspondence with companies. The issues raised most frequently by the FRRP to date relate to the disclosure of principal risks and uncertainties and identification of KPIs.

While our survey indicates some improvement in both these areas, there is clearly more that can be done. In particular, the panel highlighted that principal risks and uncertainties are likely to warrant greater attention during the forthcoming reporting season given current market conditions.

Effectiveness rests equally on management information

Companies have responded well to the Business Review and stakeholder demands for a broader information set. Yet for many companies, the main challenge is as much about improving internal management information as it is about the quality of external reporting. In our work with companies, it is noticeable that the process of articulating corporate strategy for external stakeholders is leading boards to challenge the breadth, depth and quality of the internal information that is routinely collated to measure strategic progress. Management teams that focus on the quality and scope of internal information can gain a significant competitive edge.

Mark O’Sullivan
Director of Corporate Reporting, PricewaterhouseCoopers
Our challenge to management is to look at their company’s reporting and see where they might be missing a vital element in the story.

Many companies have embraced the challenge of narrative reporting over the last few years, driven in part by the introduction of the Business Review and increased focus from the regulators. This has led, in many cases, to an improvement in the quality of annual reports, but challenges remain. Most notable is the need for reporting to ‘join the dots’ – to link strategy to KPIs, remuneration and performance. It is the coherent explanation of the direction of travel and of performance throughout the annual report and other communication channels that PwC believes is the key to providing investors with the information that they need to forecast with confidence.

The data within this survey was based on the results of a desk-top research project undertaken in the first half of 2008 to study the narrative reporting sections of the FTSE 350 annual reports for companies with years ending between 1 April 2007 and 31 March 2008. Nine companies were not reviewed because they did not report in this period (either because they were newly listed or taken over). A further nine companies were not assessed because they did not publish their annual report during the period of the survey. The final sample size was therefore 332 companies.

This year’s survey findings show how companies have performed against the key building blocks required to see the full picture. Our challenge to management is to look at their company’s reporting and see where it might be missing a vital element in the story.

The foundation of companies’ reporting, as well as this survey, is strategy. The opening section of the survey findings therefore looks at how effectively company reports communicate this critical information. The following sections then explore how well they communicate the basis for that strategy, how it will be executed and how performance will be assessed.
Strategy is the backbone
Strategy should underpin companies’ reporting and provide the context for understanding their activities and performance.

Management teams continue to show a willingness to share strategic information with investors – 89% presented their strategic objectives, 91% their strategic priorities and 49% strategic targets.

However, only 19% of company reports outlined specific strategic actions and 18% used strategy to underpin their discussion of performance, so a question mark remains over the relevance of a large number of strategies and how they are embedded into companies. This is a cause for concern since effective reporting relies on presenting a joined-up analysis of performance.

What we looked for
- Clear articulation of overall company ambition and short to medium-term strategic priorities
- Use of strategy to underpin other disclosures made
- Explanation of specific strategic actions management is taking
- Identification of strategic targets, along with discussion of performance against previously set targets

What we found
- Company reports clearly outline overall strategic objectives (89%) and specific strategic priorities (91%)
- Only 18% (34%) use their strategy to underpin their discussion of performance
- Only 19% outline specific actions being taken to deliver on their strategy
- 49% (35%) provide strategic targets, yet only 22% (11%) remind the reader of previously set targets and report performance against them
Embedding agility and sustainability

It is important that companies' strategies should not remain static but flex to take account of changing circumstances and priorities. Sustainability is a clear example of a high profile area that is rising up management’s agenda and is challenging strategic priorities.

In today’s interconnected world, long-term success is dependent on access to scarce resources that goes beyond financial capital to skilled labour and natural resources, such as energy. Management’s response to sustainability is therefore critical not just in managing reputational risk but in identifying business opportunities. By embedding sustainability into day to day operations, rather than simply providing a ‘green wash’, companies can gain competitive advantage whether in controlling costs through energy saving ideas, winning in the war for talent, or in identifying and developing new products or markets.

But how are companies’ strategies and reporting responding to such a dynamic environment? How are management explaining the strategic relevance of sustainability initiatives and the ultimate economic consequences arising from them? A fall in the number of company reports providing an explicit sustainability section suggests that companies are trying to integrate sustainability into their discussion on performance. However, it is clear that companies are still slow to adapt their strategy to reflect this shift, with only 23% (17%) incorporating sustainability in their priorities/objectives.

Increasingly volatile capital markets make it even more important that management explain the sustainability of corporate performance to enable investors to look ‘across the valley’ to the longer-term, objective of the business.

What we looked for
- A corporate responsibility section in the annual report
- Use of quantifiable data to support management discussion
- Clear reference to corporate responsibility in strategy statement
- Identification of corporate responsibility as a business risk or opportunity

What we found
- 87% include some information on sustainability
- 75% (83%) of reports include a section on sustainability
- 60% provide quantifiable data
- Only 23% (17%) clearly align aspects of sustainability to strategy. Of these reports:
  - 51% clearly identify the key sustainability risks to the business
  - 33% clearly identify the sustainability opportunities to the business
Setting the market context

Management can provide the context for readers to understand and challenge strategy and performance by describing their market place and the trends and factors that shape it.

The number of companies reporting on competitive and regulatory market factors has remained broadly consistent year on year. However, there has been a significant increase in company reports describing the macro economic environment – 75% doing so this year, compared to 52% in 2007. This underlines the growing media attention given to this subject in the past year and points to management wanting to reassure investors that they have the structure in place to cope with any volatility in market conditions. Unfortunately, many management teams (over 40%) are still reluctant to set out their views on future market conditions, perhaps reflecting their uncertainty when faced with such turmoil.

We expect to see this area of reporting, in particular, improve during the forthcoming reporting season. This will be driven, in part, by the Enhanced Business Review, effective from 1 October 2007, which requires discussion of the main ‘trends and factors’ likely to affect the future development, performance and position of the company.

What we looked for

- Explanation of what the company does and its key markets
- Impact of competitive, regulatory and macro economic trends and factors
- Expected future trends
- Quantifiable evidence to support the discussion

What we found

- 98% (93%) provide a description of the markets in which they operate
- 75% (52%) describe the macro trends and factors affecting their business, yet only 41% support this discussion with quantifiable evidence
- 35% (37%) provide some discussion, qualitative or quantitative, around competitive and regulatory trends and factors
- 57% (41%) discuss future market trends, yet only 30% (25%) support this with quantifiable evidence
Key resources – delivering on strategic priorities

It is critical to provide investors with an understanding of companies’ key resources, how they are managed and developed and how their performance is assessed. This gives investors insight into management’s ability to execute strategic priorities and therefore confidence in their analysis of the long-term quality and sustainability of corporate performance.

Nearly all companies have identified the resources and relationships that they manage to enable strategic success. However, the quality of the disclosure varies significantly. Too often statements of the importance of resources were supported by high-level examples rather than a discussion of overall priorities and actions taken, supported by quantifiable data. For example 86% of company reports state that people are key, yet only 46% accompany this statement with quantifiable data and 32% of companies with KPIs provide a corresponding people KPI.

What do these findings suggest to the external reader about the apparent importance of these resources or how far the management, development or performance assessment of them is embedded into companies?

### Survey findings

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<tr>
<th>What we looked for</th>
<th>What we found</th>
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<tr>
<td>Explicit identification of key company resources</td>
<td>98% provide information on their financial assets – 74% provide both qualitative and quantitative insights</td>
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<tr>
<td>Explanation of how resources are managed</td>
<td>86% identify employees as important, yet only 44% support this discussion with quantitative data</td>
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<tr>
<td>Performance data to demonstrate the effectiveness of management actions</td>
<td>64% identify customers as important, yet only 33% of these support this discussion with quantifiable data</td>
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<td>Few identify innovation or their brands as key resources</td>
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#### Resources highlighted as key by companies

- Supply chain: 100%
- Brand: 50%
- Innovation: 0%
- People: 100%
- Customers: 50%
- Physical assets: 50%
- Financial assets: 100%
Risk reporting remains a priority

There are two components of performance that investors are particularly interested in understanding – the returns achieved and the risks assumed in achieving them. Unfortunately today, while they receive a lot of information on financial performance, and are typically faced with a laundry list of potential risks, little is done to link the two in a meaningful and insightful way.

This year’s review did, however, show continued improvement in the communication of risks with 92% (75%) of companies explicitly identifying their principal risks.

87% (57%) then provided some background as to how these risks were managed. Although the quality of disclosure varied greatly between high-level commentary on overall risk management procedures and detailed disclosure on how each individual risk is managed.

The focus of reporting traditionally has been financial, whether in setting strategic priorities, identifying KPIs or discussing performance. However, the trends set out in our review illustrate a move towards a broader corporate reporting model. The categorisation of risks between strategic, operational, hazard and financial provide further evidence, if any is needed, of why this shift is important.

Less than a quarter of companies’ risks are financial, which highlights the need for a broader reporting model

What we looked for
- Explicit identification of principal risks
- Link to strategic priorities and key resources
- Explanation of how risks are managed
- Support disclosures with quantifiable evidence

What we found
- 92% (75%) outline their principal risks
- The average number of principal risks is 10 (8)
- 37% provide some link between their principal risks and stated strategy
- 87% (57%) provide some risk management information, but only 10% (9%) provide any quantification of risks
- Even split between the broad categories of risk

Survey findings

What category of risks are reported?

- Financial: 21%
- Hazard: 23%
- Strategic: 28%
- Operational: 28%
Measuring strategic success

A clear strategy is not very helpful without explanation of how success will be monitored and assessed. Companies’ KPIs should therefore be the same as those management use internally to assess strategic progress and ultimately success. It is therefore important to look at how well KPIs align with strategic priorities and the underlying resources that have been identified as critical to the delivery of those priorities.

This year’s review showed a continued improvement in the communication of KPIs with 84% (75%) explicitly identifying their key performance indicators. However, there was a fall in the number of companies identifying non-financial KPIs (63% 2008, 68% 2007) and an even bigger fall in the number aligning KPIs with their strategy (31% 2008, 42% 2007). This suggests that management teams may be reporting the information they have at their fingertips, rather than information that is of strategic and operational importance.

The ongoing challenge for companies remains to determine what their strategy really is, what information is required to measure strategic success and whether it is appropriate for it to be communicated externally.

What we looked for

- Explicit identification of KPIs
- Balance of financial and non-financial KPIs
- Clear link to stated strategy
- Information to support measures – definition, trend data, benchmark data
- Quantified future targets

What we found

- 84% (75%) explicitly identify their KPIs
- 31% (42%) clearly align KPIs to strategy while 33% (22%) provide some link between the two
- The average number of KPIs is eight, with five financial and three non-financial measures, which is consistent with 2007 results
- 50% (55%) provide definitions of their KPIs
- 33% (38%) describe why KPIs have been selected
- Only 24% (21%) set quantitative future targets
Navigation and messaging

Annual reports are often considered as the annual reference document for companies – the means by which an external observer might become familiar with strategy and performance before delving into other sources of information, such as websites and analyst presentations. Good communicators therefore use effective design techniques to ensure that reports are easy to navigate, key messages can be easily obtained without reading every word and that sources of more detailed information are clearly identified.

34% (24%) of companies used tabs to signpost different sections of the annual report and thereby aid navigation. However, most other indicators of effective communication showed little change from 2007.

This suggests that companies can do more to enhance the effectiveness of messaging and communications in the annual report. It may also suggest that, in some eyes, the annual report remains a pure regulatory filing document. Either way, a real opportunity exists to improve the effectiveness and accessibility of reporting.

Survey findings

There's an opportunity to improve how information is being communicated

What we looked for

- Use of clear signposting to indicate key information (eg, strategy, KPIs)
- Graphical representation of strategy
- Ease of navigation through the report (eg, with the use of tabs)
- Cross referencing and use of external sources
- Pictorial support to content (eg, with bridge charts)

What we found

- 85% of companies signpost strategy information and 86% signpost KPIs
- 14% (11%) use graphics to illustrate strategy
- 34% (24%) use tabs to aid navigation of their report
- 41% (43%) make use of externally sourced data
- Only 6% (7%) use bridge charts to explain underlying drivers of financial performance
Practical tips for improving narrative reporting

Set out below are a series of practical tips for making your reporting more effective and accessible.

Have a backbone

- Outline the strategy early on in the annual report
- Make statements of overall objectives and strategy highly visible
- Ensure that the actions and resources identified as important to business success are adequately reflected in the strategy
- Explain how strategic success will be measured
- Where possible provide a timeframe over which strategic success will be measured
- Clearly align KPIs with strategic priorities and the key resources necessary to deliver on the strategy
- Remember that performance against strategy happens over time – there is value in reiterating plans and actions in progress from previous years

The big picture

- Ensure that your reporting covers the most relevant aspects of your market place – competitive, regulatory and macro-economic
- Make appropriate use of available information on your market, both from within your own company and from external sources
- Wherever possible, adopt a forward-looking orientation by explaining the future trends and factors likely to impact your market environment
- Support qualitative statements clearly with quantifiable evidence
- Reference external sources

Not the kitchen sink

- Be realistic about how many risks are ‘key’
- Differentiate between company, industry-specific and general risks
- Ensure that key risks clearly align to statements made elsewhere in the report
- Explain how each principal risk is identified, monitored and managed
- Where possible, provide quantitative analysis to support any statements on risk management
- Provide an assessment of the company’s overall risk profile, analysed between likelihood of the risk and its expected impact

Wood for the trees

- Organise information into a logical sequence
- Clearly signpost information – don’t hide key messages
- Use clear and consistent headings to carry key strategic themes throughout the report
- Cross-reference other sources to support statements made and to provide further details
- Use graphics, as well as text, to express the strategy simply, consistently and memorably
- Present information visually by using charts, tables or diagrams
- Use bridges to demonstrate the key drivers of financial performance
- Make use of a glossary or an index to allow information to be found easily and industry- or company-specific terminology to be understood

For more tips and good practice examples to help you communicate more effectively with the capital markets, see www.corporatereporting.com or email info@corporatereporting.com
Insights into reporting

Reporting practices

11 Reporting Tips
Eleven simple actions that management can take to make their company reporting more accessible and effective. Tips also available for sustainability reporting.

Report Leadership
Far-reaching, yet practical, ideas for improving the content of annual reports, remuneration reports and online reporting. The contributors are the Chartered Institute of Management Accountants, PricewaterhouseCoopers and Radley Yeldar together with investors and corporates.

Business review: has it made a difference?
The 2007 survey of the narrative reporting practices of the FTSE 350, which assessed trends following the Business Review legislation.

Sustainability reporting

Carbon Disclosure Project
The Carbon Disclosure Project (CDP) has published 2008 carbon disclosure and climate change reporting results. This information is increasingly critical for companies and their investors to fully assess the risks, liabilities and opportunities.

Investor reporting needs

Corporate reporting: is it what investment professionals expect?
Insights into the strengths and weaknesses of companies’ external reporting based on interviews with over 250 analysts and investors around the world.

Performance statement: coming together to shape the future
Survey of investors’ and management views to compare their perceptions and identify gaps in companies’ current reporting practices.

Measuring assets and liabilities: Investment professionals’ views
How do investment professionals use the balance sheet? How do they want assets and liabilities to be measured? Thoughts from participants in the major global capital markets.

Management reporting

Management information and performance
A survey to establish how finance executives view the quality of the management information they produce and how well their organisations use management information to aid decision-making.

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