MANAGING INTEREST RATE RISK AND FOREIGN EXCHANGE RISK: DISCLOSURE OF OBJECTIVES, POLICIES AND PROCESSES

Andrew Marshall
University of Strathclyde

Pauline Weetman
University of Glasgow

March 2008
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Fax: +44 (0)20 7638 6009
Tel: +44 (0)20 7920 8634
Website: icaew.com/centre
Email: centre@icaew.com
Briefing

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Summary

This project investigates the ways in which companies report their objectives, policies and processes for managing interest rate risk and foreign exchange risk. Our interest in the subject arises from the increasing complexity of regulation surrounding disclosure of information on risk management and from our previous research where we found that companies disclose approximately half of the information available to management. This Briefing finds a similar proportion of disclosure in the period 2004 to 2006. We conclude that this proportionate response probably reflects the impracticality of reporting all the detail that might fall within the scope of legislation or recommendations.

Our sample of companies is relatively small and accordingly this Briefing is indicative rather than conclusive on disclosure practices. We provide illustrations of the variety of ways in which companies have responded to disclosure regulation and recommended practice. We show that companies tend to repeat the information content from one reporting period to the next, but change the headings and location of information in responding to regulatory change.

We conclude with four policy-related issues:

• Have standard setters fully considered the rationale of using a framework of mandatory disclosure to encourage what is effectively voluntary compliance? Do regulators expect companies have to use individual discretion and experience to identify what is likely to be of interest to users?

• What are the implications of providing relatively little guidance on the preferred location of disclosures? The benefits of allowing companies to present information in a way that suits their organisation have to be weighed against the costs of locating information in a multiplicity of destinations and descriptions. Flexibility competes against comparability.

• Will the multiplicity of sources of regulation of narrative disclosures continue to proliferate? UK companies face requirements or recommendations from the International Accounting Standards Board (IASB), the European Union (EU) Commission (via company law directives) and the UK Accounting Standards Board (ASB). A ‘one-stop shop’ for narrative reporting would rationalise duplication and overlap.

• What is the direction for narrative reporting in the ‘principles not rules’ debate in accounting? The guidance and regulation of disclosure of objectives, policies and processes has been principles-based and remains so in IFRS 7. However IFRS 7 also provides ‘guidance’. If this guidance is interpreted as a rule it may lead to a greater uniformity of disclosure. However such uniformity will not necessarily increase the proportion of available information disclosed.
1. Introduction

In this Briefing we analyse disclosures by UK companies relating to the objectives, policies and processes of managing interest rate risk and foreign exchange risk in the years 2004 to 2006. During that period, such disclosures were the focus of a constantly shifting legal and regulatory background, due to the transition to International Financial Reporting Standards (IFRS) and to changes in company law. In particular we consider the quality and quantity of disclosures. The quality is assessed by comparing the extent of information available internally to management with what was actually revealed in the annual reports. While regulatory attention focuses on the importance of such disclosures to users of financial statements, it may be self-defeating if the complexity results in an obscured message.

We undertook the research to contribute to an understanding of how regulation affects business reporting, with a specific focus on disclosures that contribute to understanding how a business is managed. We expect the Briefing to be of interest to corporate treasurers, finance directors and those preparing annual reports at a time when the idea of improvement in narrative reporting remains at the forefront of legislative attention and is part of the international agenda as the International Accounting Standards Board (IASB) develops a management commentary. This report also provides a benchmark of 2004 to 2006 against which to consider the enhanced disclosure requirements expected under IFRS 7 which will appear when companies publish their 2007 annual reports during 2008.

In previous research covering annual reports of the late 1990s, we found that companies disclosed rather less than half of the information available to them in respect of objectives, policies and processes of risk management for interest rate and foreign exchange risk. In this Briefing we show that the proportion of available information disclosed in the years 2004 to 2006 remained similar to our previous findings and that the nature of disclosures changed very little when the regulations changed during that period.

We question whether standard setters have fully considered the rationale of using a framework of mandatory disclosure to encourage what is effectively voluntary compliance. We do not find anything which suggests concealment or bias. A more likely explanation is that the mandatory framework is open-ended and practical constraints of available space apply, so that companies have to use individual discretion and experience to identify what is likely to be of interest to users.

However we do find that a lack of guidance on the preferred location of disclosures has led to a multiplicity of destinations and descriptions and has hindered ready comparison of information across the annual reports reviewed. Although flexibility is justified by a desire to allow company managers the freedom to choose the manner of disclosure that best suits their circumstances, such flexibility for preparers may be achieved at the expense of ready comparability for users.

The multiple sources of regulation of narrative disclosures seem to be an unfortunate development. There are separate requirements or recommendations from the International Accounting Standards Board (IASB), the European Union (EU) Commission (via company law directives) and the UK Accounting Standards Board (ASB). A ‘one-stop shop’ for narrative reporting would rationalise the present duplication and overlap.

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1 The phrase "The shifting legal and regulatory background" is used in the report A review of narrative reporting by UK listed companies in 2006, ASB (2007).


Finally the specific nature of this study leads us to reflect on the broader ‘principles not rules’ debate in accounting. The guidance and regulation of disclosure of objectives, policies and processes has been principles-based and remains so in IFRS 7. However IFRS 7 brings in guidance and it seems likely that the guidance may take on the role of a rule. If so it is likely we will see more disclosure by volume but there is no guarantee of more proportionate to what could be disclosed.

In section 2 we describe the regulatory framework and the changes that have taken place from 2004 to 2007. Section 3 describes the method of analysis used. The low response limits the ability to generalise but we aim to provide a flavour of disclosure practice against which readers may compare their own experience. The risk management objectives, policies and processes are described in section 4. The nature and extent of disclosure in annual reports is described in section 5. Section 6 outlines the response to change from 2004 to 2005 annual reports in the context of the introduction of IAS 32 and the business review. Section 7 provides conclusions and comments.
2. The regulatory framework

For accounting periods beginning on or after 1 January 2007, companies complying with International Financial Reporting Standard IFRS 7, *Financial Instruments: Disclosures* must disclose their objectives, policies and processes for managing each type of risk arising from financial instruments. The disclosure must be included in the financial statements or incorporated by cross reference from some other statement, such as a management report, that is available with the financial statements.

For UK companies this is the latest stage in a trail of continuous change in regulation and guidance on the disclosure of objectives, policies and strategies for the management of interest rate risk and foreign exchange risk. Such disclosure has been governed partly by accounting standards, partly by company law and partly by non-mandatory, but very persuasive, guidance.

We focus on the period of transition to IFRS for UK companies, covering the years 2004 to 2006, adding to the findings of a previous ASB survey by focusing on the management of risk rather than the description of risk and tracing in more detail the varied locations of relevant information.

We extend our previous research covering reports published in the late 1990s, where we found that management, in reporting objectives, policies and strategies for interest rate risk and foreign exchange risk, disclosed on average approximately 50% of the information that they could make available. Such evidence supports the view developed in academic analysis that increased mandatory regulations may result in a reduction in voluntary disclosure so that the overall information content of disclosures is not substantially altered.

UK companies implementing IFRS 7 have experienced continual regulatory change since 2004. For reporting years ended in 2004 the requirements of Financial Reporting Standard FRS 13 were in force. A section in FRS 13 deals with disclosure of objectives, policies and strategies focusing on the risks that arise and how they have been managed but with a voluntary tone in the wording ‘it is envisaged but not required’. Non-mandatory guidance was provided by the ASB in the Operating and Financial Review (OFR). The OFR could also be the location of the relevant FRS 13 disclosures.

UK listed companies reporting in years starting on or after 1 January 2005 were required to comply with the disclosure requirements of International Accounting Standard IAS 32. For reporting periods beginning on or after 1 April 2005 the same companies were also required to comply with the Statutory Instrument setting regulations for the business review to be included within the directors’ report. There was also non-mandatory guidance in the revised OFR. The business review required a description of the principal risks and uncertainties facing the company. The OFR guidance recommended disclosure of similar risks and also a description of the treasury position and objectives.

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6 IFRS 7, Appendix B Application guidance, para B6 and BC 40-46.
7 ASB (2007).
13 ASB (2003). *Non-mandatory guidance, Operating and Financial Review*, para 27. The 2003 version was operative at the time of our study.
16 The business review was introduced in 2005 by section 234ZZB of Statutory Instrument 2005 No. 1011. The Companies Act 1985 (Operating and Financial Review and Directors’ Report etc.). For reporting periods commencing on or after 1 October 2007 the business review is regulated by the Companies Act 2006 sections 417 and 496.
3. Method of analysis

We sent out 370 UK questionnaires, all to named individuals within the finance or treasury function of a listed company. The questionnaires were mailed in mid-2005, asking about strategies, policies and practices in place during 2004. Unfortunately, policies of not responding to such enquiries are widespread. Thirty UK companies responded with usable information. The respondents were 18 corporate treasurers, 11 finance directors or equivalent and one company secretary. Rather than attempt any statistical testing we focus on a description of the detail of our sample data.

From electronic searching of the annual reports of the 30 companies for 2004, 2005 and 2006, for information about treasury management policies and practices, we found relatively little change between 2004 and the subsequent years. Accordingly we report 2004 in detail and comment on any changes in 2005 and 2006.

We counted the number of information items in the annual report that matched the information items in the respective questionnaire (see Figure 1). Only one company disclosed more than 50% of the potential detail available.

**Figure 1: Distribution of quantity scores, 2004 data**

<table>
<thead>
<tr>
<th>Quantity Score</th>
<th>Number of Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>1</td>
<td>7</td>
</tr>
<tr>
<td>2</td>
<td>11</td>
</tr>
<tr>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>5</td>
<td>1</td>
</tr>
<tr>
<td>Up to 20</td>
<td>1</td>
</tr>
<tr>
<td>21 - 30</td>
<td>2</td>
</tr>
<tr>
<td>31 - 40</td>
<td>4</td>
</tr>
<tr>
<td>41 - 50</td>
<td>5</td>
</tr>
<tr>
<td>51 - 60</td>
<td>5</td>
</tr>
<tr>
<td>61 - 70</td>
<td>6</td>
</tr>
</tbody>
</table>

Note: One company gave only one item of information in the questionnaire and this was clearly disclosed in the annual report. This score of 100% is omitted from the table.

It may be argued that companies could not disclose all the detail known to managers because of the limitations of space and the need for balance. We therefore measured disclosure quality by focusing only on the items that the managers chose to disclose. Where there was a close match between the information in the annual report and the related item in the questionnaire, we gave a score of 2. Where there was a partial match we gave a score of 1. Where the annual report was silent but we knew from the questionnaire that an item of information was available, we gave a score of 0 (see Marshall and Weetman, 2007).

We have provided some quotes in section 5 as an illustration of how the responses in the questionnaire were communicated in the annual report. There are examples of the higher quality more comprehensive disclosures labelled ‘score 2’ and the less fulsome but still informative disclosures labelled ‘score 1’. In attempting to judge ‘quality’ of disclosure we go beyond the requirements of standards or guidance because standards and guidance do not indicate how effusive the information should be. However we attempt to indicate with the differential scoring those companies that appear to provide more than the minimum on any particular item.

Five companies showed quality scores above 50% (see Figure 2) but the majority were below 50%.
One company gave only one item of information in the questionnaire and this was clearly disclosed in the annual report. This score of 100% is omitted from the table.

Table 1 summarises the average values and range for the quantity and quality scores.

<table>
<thead>
<tr>
<th>Table 1: Average scores and range, 2004 data</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quantity score</td>
</tr>
<tr>
<td>----------------</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Quality score</td>
</tr>
</tbody>
</table>

In previous research on a different set of 30 UK companies, carried out when FRS 13 was newly introduced, we found a mean quantity score of 46.5% and a range from 7.7% to 85.7%. It seems that greater familiarity with FRS 13 in 2004 did not lead to any general increase in relative disclosure.

We considered the question of whether companies that have a larger quantity of relevant information to disclose will provide proportionately more items of information. Splitting the sample and comparing median scores we found no significant differences. Although the managers with more potential information to convey will provide more information in absolute terms, the proportion they provide is not significantly different.
4. Is there a story to tell?

To set the scene we asked about the potential significance of foreign exchange and interest rate risks. The replies indicated that there was a story to tell by reference to the exposure horizon, the potential impact of unexpected market rate changes, risks covered, the percentage hedged, the range of currencies hedged and the frequency of trading in interest rate derivatives. These replies were confirmed in varying degrees by information in the annual reports (see Table 2). Further confirmation of the significance of these risks was given by answers on the general reasons for hedging, specific reasons for foreign exchange hedging, risk-reducing activities in response to interest rate changes, and decisions that would be affected by unexpected changes in foreign exchange rates.

In the annual reports information on the occurrence of risk is found more frequently than information on motivation for undertaking transactions.

**Table 2: Summary of background information**

<table>
<thead>
<tr>
<th>Item</th>
<th>Items in questionnaire</th>
<th>Items in annual report</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Functional currency</td>
<td>26</td>
<td>24</td>
<td>92.3</td>
</tr>
<tr>
<td>How often did you transact?</td>
<td>35</td>
<td>24</td>
<td>68.6</td>
</tr>
<tr>
<td>What currency was used for hedging?</td>
<td>49</td>
<td>27</td>
<td>55.1</td>
</tr>
<tr>
<td>Exposure horizon</td>
<td>29</td>
<td>6</td>
<td>20.7</td>
</tr>
<tr>
<td>Impact without derivatives</td>
<td>21</td>
<td>4</td>
<td>19.0</td>
</tr>
</tbody>
</table>
5. Objectives, policies and processes

We compare the responses to our questionnaire with examples of disclosures in the annual report.

Table 3 indicates that in the 2004 annual reports there was a stronger focus on policies and processes than on objectives. There was little indication of how the management evaluated the success of the policies. Descriptions of derivatives were more common than explanations of how they were used. We have no evidence on which to interpret this observation but we speculate that it may reflect the day-to-day working experience of those who are asked to provide the information for the annual report. They are probably more likely to be devising the policies and processes than determining objectives.

**Table 3: Items in the annual reports 2004 as a percentage of items in the questionnaire, reported for each question**

<table>
<thead>
<tr>
<th>Section</th>
<th>Items in questionnaire</th>
<th>Items in annual report</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Objectives</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.1.1 Goals of risk management policy</td>
<td>136</td>
<td>26</td>
<td>19.1</td>
</tr>
<tr>
<td>5.1.2 Emphasis on types of risk</td>
<td>56</td>
<td>23</td>
<td>41.1</td>
</tr>
<tr>
<td><strong>Policies</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.2.1 Overall policies</td>
<td>27</td>
<td>18</td>
<td>66.7</td>
</tr>
<tr>
<td>5.2.2 Key players in determining policy</td>
<td>75</td>
<td>55</td>
<td>73.3</td>
</tr>
<tr>
<td>5.2.3 Methods to evaluate success of policy</td>
<td>37</td>
<td>3</td>
<td>8.1</td>
</tr>
<tr>
<td><strong>Processes</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.3.1 What kinds of derivatives for interest rate risk?</td>
<td>39</td>
<td>26</td>
<td>66.7</td>
</tr>
<tr>
<td>5.3.2 Kinds of derivatives used</td>
<td>41</td>
<td>31</td>
<td>75.6</td>
</tr>
<tr>
<td>5.3.3 How often did you use internal hedging?</td>
<td>57</td>
<td>12</td>
<td>21.1</td>
</tr>
<tr>
<td>5.3.4 Methods to measure risk exposure</td>
<td>71</td>
<td>7</td>
<td>9.9</td>
</tr>
<tr>
<td>5.3.5 Foreign denominated debt</td>
<td>30</td>
<td>3</td>
<td>10.0</td>
</tr>
<tr>
<td>5.3.6 Managing economic risk</td>
<td>13</td>
<td>2</td>
<td>15.4</td>
</tr>
</tbody>
</table>

5.1 Objectives

5.1.1 Importance of goals of risk management

We asked in the questionnaire: ‘What importance did your firm attach to each of the following overall goals of risk management policy in 2004?’ The range of answers, shown in Table 4, points to a focus on minimizing fluctuations in earnings and cash flows, protecting liquidity and protecting firm value. This focus is perhaps a reflection of the direct responsibilities of those whom we targeted with the questionnaire (those with an involvement in treasury management function). An objective such as ‘protect the appearance of the financial statement’ might lie in a different area of responsibility in the organisation.
5.1.2 Emphasis on types of foreign exchange risk

We know from our previous research that companies differ in their views of translation risk, transaction risk and economic risk. Translation risk is a concern about the appearance of the financial statements – the risk of reporting apparent losses caused purely by the method of accounting translation. In contrast the transaction risk and economic risk are real risks of loss through fluctuations in foreign exchange rates. For the purpose of the survey we made it clear that the economic exposure we were investigating was the longer-term exposure through which future cash flows could be affected by changing exchange rates. Transaction exposure, as a short-term view of exposure of cash flows to changing exchange rates, is a subset of economic exposure. Table 5 indicates lowest emphasis on economic risk with the emphasis on translation and transaction risks being broadly similar.
Company 27 (score 2) gives a clear statement of its position in the annual report.

**Questionnaire**
Translation risk is moderately important, transaction risk is very important, economic risk is not important.

**Annual report**
Material cross-border trading contracts or forecast commitments are hedged at inception by appropriate derivative financial instruments, with the company’s core banks as counterparties. Whilst the trends of foreign currency movements cannot be eliminated, this hedging programme reduces the volatility on the results and protects the cash-flow and margin. Moreover, we largely manufacture in countries whose currency is linked to the currency of its sales revenue, and hence gross transactional exposures are around £300m annually, before hedging. We protect our reserves from foreign currency fluctuations by ensuring that at least 75% of the total net overseas operational assets are offset, either by borrowings in the respective currency or by currency swaps.

Our overseas earnings are translated at average currency rates for the year which smooths the effect of currency volatility. However, we are increasingly exposed to the US dollar due to its significant North American presence. Following the interim results, a short-term hedging contract was entered into to protect against further dollar exchange rate volatility on the translation of US earnings for the remaining part of the year. This contract produced a £1.4m profit and cash inflow.

Company 15 (score 1) in its annual report describes translation and transaction risk, hinting also at economic risk, but does not indicate the relative importance of each.

**Questionnaire**
Translation risk is not important, transaction risk is very important, economic risk is moderately important.

**Annual report**
Translation exposures arise on the earnings and net assets of business operations in countries other than those of each parent company. These exposures are hedged, to a significant extent, by a policy of denominating borrowings in currencies where significant translation exposures exist, most notably US dollars. Currency exposures on transactions denominated in a foreign currency are required to be hedged using forward contracts. In addition, recurring transactions and future investment exposures may be hedged, within defined limits, in advance of becoming contractual. The precise policy differs according to the commercial situation of the individual businesses.
5.2 Policies

5.2.1 Statements of policy

The statement in the annual report of company 19 (score 2) is specific about the nature of management of both foreign exchange and interest rate risk and matches the response given in the questionnaire.

**Questionnaire response**

With regard to foreign exchange the group hedges all firm transactional exposures as well as managing anticipated economic exposures. The group’s current interest rate management policy is that a minimum of 25% and a maximum of 75% of debt is at fixed rate.

**Annual report**

In order to protect itself against currency fluctuations, the group’s policy is to hedge all firm transactional exposures as well as to manage anticipated economic cash flow exposures over a five-year period... The group’s current interest rate management strategy is that a minimum of 25% and a maximum of 75% of debt is maintained at fixed interest rates.

In contrast, company 28 (score 1), in its annual report, makes a general statement in the annual report but, compared to the questionnaire response, does not indicate the nature of the risks.

**Questionnaire response**

The only major treasury risks in 2004 were: ensuring availability of funding; interest rates; minimal currency exposure; and managing energy costs from 2005 onwards.

**Annual report**

The primary objectives of treasury policy are to ensure that adequate and cost-effective funding arrangements are maintained to finance current and planned future activities and that exposure to financial risk is minimised.

5.2.2 Key players

We asked in the questionnaire: ‘Which of the following were the key players in the active determination of this policy?’ (inviting respondents to select as many as were appropriate). The responses are summarised in Table 6.

**Table 6: Key players in determination of policy**

<table>
<thead>
<tr>
<th>Key players</th>
<th>Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Board decision</td>
<td>19</td>
</tr>
<tr>
<td>(b) Finance director</td>
<td>23</td>
</tr>
<tr>
<td>(c) Senior management makes the decision</td>
<td>8</td>
</tr>
<tr>
<td>(d) Senior management delegates competence and responsibility</td>
<td>0</td>
</tr>
<tr>
<td>(e) The treasurer alone</td>
<td>1</td>
</tr>
<tr>
<td>(f) The treasurer after consulting with finance director/CEO</td>
<td>15</td>
</tr>
<tr>
<td>(g) The treasurer after consulting the board</td>
<td>10</td>
</tr>
<tr>
<td>(h) Don’t know</td>
<td>0</td>
</tr>
<tr>
<td>(i) In this firm the decision rests with…</td>
<td>2</td>
</tr>
<tr>
<td>A board-appointed committee; the audit committee</td>
<td></td>
</tr>
</tbody>
</table>
From those 29 who answered this question, the key players in the active determination of policy were disclosed in full by 23, in part by 4 and not at all by 2 companies.

Company 2 (quality score 2) makes clear the responsibility taken by the board of directors.

**Questionnaire response**
Board decision, finance director and treasurer after consulting with the board.

**Annual report**
Treasury policies have been approved by the board for managing each of these exposures including levels of authority on the type and use of financial instruments.

In contrast, company 6 (quality score 1) refers to the ‘treasury function’ although the questionnaire response indicates board responsibility.

**Questionnaire response**
Board decision.

**Annual report**
[The group’s] treasury function is principally responsible for managing certain financial risks to which the group is exposed.

### 5.2.3 Evaluating success of risk management policies

We asked in the questionnaire ‘How did you evaluate the success of your risk management policy?’ The responses listed in Table 7 indicate that reduced volatility is the most frequent response.

**Table 7: Success of risk management policy**

<table>
<thead>
<tr>
<th>Indicator of success</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Reduced volatility relative to a budget/plan</td>
<td>17</td>
</tr>
<tr>
<td>(b) Increased profit (reduced costs) relative to a budget/plan</td>
<td>5</td>
</tr>
<tr>
<td>(c) Realised outcomes compared to another internal benchmark</td>
<td>4</td>
</tr>
<tr>
<td>(d) Absolute profit/loss</td>
<td>4</td>
</tr>
<tr>
<td>(e) Rates at the beginning of the risk management programme</td>
<td>3</td>
</tr>
<tr>
<td>(f) Risk adjusted performance</td>
<td>0</td>
</tr>
<tr>
<td>(g) Other</td>
<td>8</td>
</tr>
</tbody>
</table>

The responses under ‘Other’ were:
- Substantial cash generated from $ weakness applied to hedges
- Assessed by effect on WACC of interest rate fluctuations
- Comparison with external (interest) benchmark
- Annual treasury compliance reporting to audit committee to demonstrate
- Project based – each project has a financial model with a fixed interest rate, so will have expected profit by period. Actual is compared to that.
- Not relevant as we restructured our balance sheet.
- Insurance against the possibility of rising interest rates
- Outcomes as expected, although not ‘scientifically’ tested or formally reported on their own.
Company 23 (score 2) confirms in the annual report the budget-based approach described in the questionnaire.

**Questionnaire response**
Project based – each project has a financial model with a fixed interest rate, so will have expected profit by period. Actual is compared to that.

**Annual report**
However, there are significant levels of non-recourse borrowing within the PFI/PPP project companies in which the group invests. In almost all circumstances the financing agreements of the project companies require the debt to be on a fixed interest rate basis or, where variable rate debt has been arranged, to be swapped to fixed rate for the full value and term of the loan.

Company 18 (score 2) reflects both responses to the questionnaire in the annual report.

**Questionnaire response**
(a) Reduced volatility relative to a budget/plan
(g) Substantial cash generated from dollar weaknesses applied to hedge

**Annual report**
During the year, several cross-currency swaps and foreign exchange forwards hedging the US dollar net assets matured, resulting in cash receipts of £140 million and were replaced with new cross-currency swaps with maturities between 2007 and 2010. As well as this, $1,500 million of cross-currency swaps were cancelled in conjunction with the $1,500 million bond issue by [the company] which replaced the swaps as a hedge of the US dollar net assets and resulted in cash receipts of £92 million. These cash receipts resulted from the weakness of the US dollar since the hedges were put in place.

5.2.4 Communicating risk policies
We asked: ‘What importance did your firm attach to communicating its policy of risk management to each of the following parties in 2004?’ The responses, listed in Table 8, indicate an overall perception of high importance and recognition of the range of interested stakeholders. We noted in discussing Table 4 (section 5.1.1) that the responses may reflect the level of responsibility carried by the questionnaire respondents, most of whom were most closely involved in the treasury management function. While they might be involved personally in communicating with the CEO, finance director and board of directors, they might have less direct contact with institutional investors, financial analysts and the press. This might explain the apparently lower importance attached to these parties in the responses.
Company 24 (score 2) confirmed in the annual report the information given in the questionnaire.

**Questionnaire response**
Great importance: CEO finance director; board of directors. Average importance: stockholders; debtholders; financial analysts.

**Annual report**
The group treasury department reports formally on a monthly basis to a treasury committee under the chairmanship of the group finance director and quarterly to the board committee on treasury which also includes two non-executive directors.

Company 26 (score 1) provided an indication of the communication policy set out in the questionnaire response.

**Questionnaire response**
Great importance: CEO; finance director; stockholders, debtholders; institutional investors; financial analysts. Average importance: board of directors.

**Annual report**
The financing decision group, a sub-committee of the executive committee, is the primary forum for discussing and approving all day-to-day treasury strategy and policy matters and for submitting proposals to the board.

### 5.3 Processes

#### 5.3.1 Derivatives used to hedge interest rate exposure
We asked what kind of derivatives were used to hedge interest rate exposure, looking for a narrative style of explanation rather than merely a tabulation of data.
Company 11 (score 2) provided an explanation similar to the response given in the questionnaire.

**Questionnaire**
Interest rate caps and floors used occasionally, material in amount.

**Annual report**
The company also entered into interest rate floors of £80m at 4.73% from July 1999 to January 2006 and on a further £80m at 4.80% from January 2006 to September 2009.

Company 12 (score 1) confirmed one of the instruments but did not indicate the frequency.

**Questionnaire response**
Forward contracts and swaps used to manage interest rate risk, frequently.

**Annual report**
The group uses interest rate swaps to help manage its interest rate risk.

### 5.3.2 Derivatives used to hedge currency risk exposure
We asked what kind of derivatives were used to hedge currency risk exposure in respect of transaction exposure and translation exposure (Table 10). (Economic risk is dealt with in section 5.3.6.)

<table>
<thead>
<tr>
<th>Table 9: Derivatives used to hedge interest rate exposure</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Never</strong></td>
</tr>
<tr>
<td>(a) Forward contracts (over the counter (OTC))</td>
</tr>
<tr>
<td>(b) Futures contracts (exchange traded)</td>
</tr>
<tr>
<td>(c) Swaps</td>
</tr>
<tr>
<td>(d) OTC options</td>
</tr>
<tr>
<td>(e) Exchange-traded options</td>
</tr>
<tr>
<td>(f) Other: caps</td>
</tr>
</tbody>
</table>

Never Occasionally Frequently Total
Company 19 (score 2) provided a description in the annual report which, read in the context of more detailed information on hedging foreign exchange exposure, reflected the information provided in the questionnaire.

Company 14 (score 1) provided outline information but no sense of the frequency of use of derivatives, taking account of the overall context of less detailed disclosure.

Tables 9 and 10 indicate a low use of exchange-traded derivatives to manage risk by UK companies in comparison to OTC alternatives. Despite some advantages that exchange traded instruments offer (in particular liquidity) our finding is consistent with prior surveys and may be due to the desire for tailor-made derivatives in comparison to the standardised contracts in the exchanges. Also anecdotal evidence suggests that there still remains some ignorance of exchange-traded products and some fear that they are viewed primarily as a speculative derivative.
5.3.3 Use of internal hedging

We asked how often internal hedging was used (Table 11).

**Table 11: Frequency of using internal hedging**

<table>
<thead>
<tr>
<th>Method of internal hedging</th>
<th>Never</th>
<th>Occasionally</th>
<th>Frequently</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Leading and lagging</td>
<td>14</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>(b) Matching inflows and outflows (timing of settlement)</td>
<td>5</td>
<td>9</td>
<td>9</td>
</tr>
<tr>
<td>(c) Inter-company netting of receipts and payments</td>
<td>7</td>
<td>3</td>
<td>10</td>
</tr>
<tr>
<td>(d) Specific choice of currency for sales or purchase invoices</td>
<td>10</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>(e) Adjustment clause in sales contracts</td>
<td>13</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>(f) Transfer pricing agreements</td>
<td>12</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>(g) Natural hedge</td>
<td></td>
<td></td>
<td>1</td>
</tr>
</tbody>
</table>

Table 11 shows that a number of UK companies are not using internal hedging methods at all and the only internal hedging methods being used frequently are matching and netting. The frequent use of matching and netting is not surprising given they are often the simplest and first choice for any company facing foreign currency risk. Although there is some use of most of the other methods the level of use is not high. This could be explained by the business structures of the firms surveyed which may make some of these methods redundant and the increasing reliance on the use of derivative instruments.

Company 21 (score 1) indicates in the annual report the matching of inflows and outflows mentioned in the questionnaire but does not indicate the use of transfer pricing agreements.

**Questionnaire**

Matching inflows and outflows used occasionally but material in amount; transfer pricing agreements used occasionally but material in amount.

**Annual report**

The group does not consider it necessary to enter into foreign currency or forward contracts since it primarily deals with stable currencies. The group’s strategy to minimise foreign exchange risk is to invoice in the group’s functional currency, US dollars, draw all significant borrowings in US dollars and hold bank accounts in US dollars within operations with a different local currency. Furthermore, the group is a net purchaser of soft currencies due to the natural hedge achieved through its structuring of certain offshore contracts.

5.3.4 Methods used to measure risk exposure

We asked which methods are used to measure risk exposure (Table 12).
5.3.5 Use of foreign denominated debt

We asked how often foreign denominated debt was used (Table 13).

Table 13: Frequency of using foreign denominated debt

<table>
<thead>
<tr>
<th>Approach taken</th>
<th>Never</th>
<th>Occasionally</th>
<th>Frequently</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Hedge transaction of foreign accounting statements</td>
<td>11</td>
<td>3</td>
<td>7</td>
</tr>
<tr>
<td>(b) Hedge foreign repatriations</td>
<td>16</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>(c) Hedge contractual commitments</td>
<td>15</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>(d) Hedge anticipated transactions &lt;= 12 months</td>
<td>15</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>(e) Hedge anticipated transactions &gt; 12 months</td>
<td>14</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>(f) Arbitrage borrowing rates across currencies</td>
<td>16</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>(g) Speculate</td>
<td>16</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Company 2 (score 2) explained the method as indicated in the questionnaire response.

**Questionnaire**
Methods used include size of risk exposure.

**Annual report**
Based on the year end debt each 1% increase in interest rates would cost the group approximately £1.0m.

Company 19 (score 1) provided a quantified measure as indicated in the questionnaire response, but added the wording ‘mitigated in part’ which limited the value of the initial quantification.

**Questionnaire**
Methods used include size of risk exposure and sensitivity analysis applied to identified exposures.

**Annual report**
Using average net debt of £350 million, a one per cent change in interest rates would have an impact of around £2.5 million on reported profit, mitigated in part by interest rate swaps.
Company 6 (score 2) explains how borrowing is used to hedge translation exposure.

**Questionnaire**  
Hedge translation of foreign accounting statements occasionally, material in amount.

**Annual report**  
Overall balance sheet euro translation exposure is substantially hedged by maintaining a proportion of the group’s debt in euro. However, the translation of overseas earnings (primarily euro) into sterling is not hedged... To mitigate the effect of currency translation exposures arising from overseas investments, the group’s policy is to borrow in the local currencies of its principal operating subsidiaries.

Company 13 (score 1) provides a more specific indication in the questionnaire and a broader statement of practice in the annual report.

**Questionnaire**  
Hedge translation of foreign accounting statements frequently, contractual commitments frequently; anticipated transactions occasionally.

**Annual report**  
It is our policy to hedge between 50% and 100% of our investment in foreign currency denominated net assets. This is achieved in the first instance with foreign currency denominated debt, the interest on which reduces our translation exposure on net earnings in that currency, and then with forward foreign currency contracts.

5.3.6 Managing economic risk

We asked about methods used to manage economic risk (Table 14).

**Table 14: Methods used to manage economic risk**

<table>
<thead>
<tr>
<th>Method</th>
<th>Number of companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Did not manage economic risk</td>
<td>13</td>
</tr>
<tr>
<td>(b) Pricing strategy</td>
<td>7</td>
</tr>
<tr>
<td>(c) Promotional strategy</td>
<td>2</td>
</tr>
<tr>
<td>(d) Product strategy</td>
<td>3</td>
</tr>
<tr>
<td>(e) Shifting production among plants</td>
<td>2</td>
</tr>
<tr>
<td>(f) Locate plant in countries where currencies has devalued</td>
<td>0</td>
</tr>
<tr>
<td>(g) Raising productivity</td>
<td>1</td>
</tr>
</tbody>
</table>

Company 19 (score 2) explained its approach to managing economic risk.

**Questionnaire**  
Managing economic risk: Use forward foreign exchange fx controls.

**Annual report**  
In order to protect itself against currency fluctuations, the group’s policy is to hedge all firm transactional exposures as well as to manage anticipated economic cash-flow exposures over the medium term.
Company 17 (score 1) describes the economic risk but is not specific in the annual report about the use of pricing strategy to manage this risk.

**Questionnaire**
Managing economic risk: Pricing strategy.

**Annual report**
The group sells approximately 75% of its sales outside the UK much of which is non-sterling and therefore subject to foreign exchange movements as all products are manufactured in the UK.
6. Responding to change – IAS 32 and the business review

The transition from FRS 13 to IAS 32 applied for accounting periods starting 1 January 2005. The mandatory requirement for a business review applied for accounting periods starting on 1 April 2005. The ‘good practice’ guide in the form of the reporting statement on the OFR came into effect at the same time. This created complexity in achieving compliance but also provided companies with a potential opportunity to increase the information provided about management of financial risk.

Companies could exercise the freedom to decide how they would comply with the new business review requirements in relation to the description of principal risks and uncertainties. Although the treasury objectives and strategies are not required by the business review, they do remain in the OFR recommendations. One potential source of confusion in 2005 is that the decision of the Chancellor of the Exchequer to dispense with the compulsory OFR came late in the day for those companies reporting in December 2005, so that the information on treasury objectives and strategies may have already been prepared on the presumption of a compulsory OFR.

Because of mismatch of effective dates it was necessary to review annual reports for 2005 and 2006 to see the full effect of IAS 32 and the business review on our sample of companies. We found that most of the companies having year ends of 31 December 2005 or 31 March 2006 had satisfied the business review requirements for financial risk management even before these became compulsory and had included a suitable cross reference in the directors’ report.

We compared the 2004 annual reports with those of 2005 and 2006 for 27 and 23 companies respectively. Three from our initial sample were delisted through acquisition in 2005 before they issued their first IFRS financial statements and four more were delisted before issuing 2006 annual reports.

Our initial intention was to repeat the full analysis set out in sections 4 and 5 but we found the quantity and quality of disclosure in most cases was relatively unchanged from 2004 to 2005 and 2006. Three companies increased the information provided in 2005 compared with 2004 but they were relatively low scoring in 2004 and were therefore catching up rather than forging ahead. Two companies provided less information in 2005 under the combination of IAS 32 and the business review but this seems more likely to be inadvertent due to the rearrangement for the Business Review requirement.

The most significant challenge lay in the variety of locations of information in the 2005 annual reports, which then remained mainly unchanged in 2006 (Table 15). In some cases, as the business review became mandatory, the heading ‘business review’ took on more prominence in the contents table, covering what would previously have been labelled ‘operating review’ and ‘financial review’. In other cases the heading ‘directors’ report’ took on more prominence and became the main heading for sections that included a business review, operating and financial review and remuneration report.

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18 We define ‘2005’ as the first reporting period for which the IAS Regulation applied and ‘2006’ as the second reporting period under the IAS Regulation.
19 We considered the possibility of audit firm policy influencing disclosure but we did not detect this in our data.
Table 15: Reporting financial risk management in 2005 and 2006 annual reports, compared to previous year

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>A (10 companies in 2005, 7 in 2006)</td>
<td>Ten provided the same type and amount of information in 2005 as in 2004. The surviving seven provided the same type and amount in 2006. The requirement for a business review was satisfied in both 2005 and 2006 by full cross referencing from the directors’ report to the operating and financial review (4 companies in 2005, 1 in 2006), OFR and notes to the financial statements (3 companies), OFR re-labelled ‘business review’ (2 companies) and the finance director’s review (1 company).</td>
</tr>
<tr>
<td>B (7 companies)</td>
<td>The requirement for a business review was satisfied in both 2005 and 2006 by full cross referencing to notes to the financial statements on financial risk management financial instruments, where these notes included a policy explanation. In four companies the notes were similar in 2005 to those of 2004, in two cases the note was newly created in 2005, or expanded, by transferring information from the previous year’s OFR, and in one case the information in the note was entirely new in 2005. In all cases the content in 2006 was similar to that of 2005.</td>
</tr>
<tr>
<td>C (1 company)</td>
<td>In 2005 the directors’ report cross referenced a ‘review of activities’ to the corporate governance statement. This provided new information in 2005, not given in 2004. In the year ended 31 March 2006, when the business review became mandatory, the description ‘business review’ was used as a prominent heading and also cross referenced in the directors’ report. The risk management information remained the same in content but gained a new heading of ‘Performance and risk management’.</td>
</tr>
<tr>
<td>D (4 companies)</td>
<td>In 2005 the financial risk management policy and risk were described in the directors’ report. In two cases the information was similar to that of the 2004 OFR or financial review, in one case the information was disclosed for the first time, and in one case the information was similar to the Notes of 2004.</td>
</tr>
<tr>
<td>E (2 companies)</td>
<td>Business risk management was described in the directors’ report, with further cross referencing to a note on financial instruments. In one case this provided information comparable to that of the previous year’s OFR but in the other case the result was less information than in 2004.</td>
</tr>
<tr>
<td>F (2 companies)</td>
<td>In 2005 there was no mention of risks or business review in the directors’ report. One company provided the information in the OFR, the other spread the information between the OFR and notes to the financial statements, both giving overall similar information to the 2004 OFR. In 2006 when the business review became mandatory both added suitable cross references in the directors’ reports but did not change the content relating to risk management strategy, policies and processes. One introduced a more prominent heading for ‘risks’.</td>
</tr>
<tr>
<td>G (1 company in 2005)</td>
<td>In 2005 there was no specific heading for ‘risks’ in the directors’ report but the regulated items were included within a section headed ‘business review’, covering information similar to that described in the 2004 OFR. The company was taken over before the business review became mandatory in 2006.</td>
</tr>
</tbody>
</table>
7. Conclusions and comment

We found that the move from FRS 13 to IAS 32 in the UK did not see any great change in the nature of the information disclosed but it did increase the confusion over the diverse locations of risk management information. We also found that in the final period of application of the UK standard FRS 13 the information disclosed by companies on the objectives, policies and process of risk management of interest rate and foreign exchange risk remains on average at less than 50% of that available to managers, relatively little changed from the percentage we observed in earlier research when FRS 13 was new. The disappointing response to our survey makes it impracticable to provide more in-depth analysis of the potential causes of the relative levels of disclosure across companies.

In terms of the detail of disclosure we found that information on the occurrence of risk is observed more frequently than information on the motivation for undertaking transactions. We also found a stronger focus on policies and processes rather than on objectives. We have no evidence from which to explain these observations but it could be that those responsible for preparing the information for the annual report are more familiar with the policies and processes and therefore write more readily about these.

We have noted that one limitation of our study is the low response to our questionnaire survey. Another limitation may lie in the timing. We asked in mid-2005 about strategies, policies and practices in place in 2004. This allowed us to make comparisons with the annual reports published for 2004, which were appearing in printed form around the time of the survey or soon after. However it may be that the apparent agreement between some responses and the annual report were influenced by the respondents also being involved in preparation of relevant sections of the annual report. A further limitation of questionnaire responses is that they represent the viewpoint of the respondent and not the organisation as a whole, as discussed particularly in sections 5.1.1 and 5.2.4.

We conclude by commenting on four policy-related aspects of this survey.

7.1 Mandatory regulation for voluntary compliance

We are left questioning the expectations of regulators when using mandatory procedures to prescribe narrative disclosures. Our findings are similar to those of our previous research – on average companies disclose less than 50% of the information that they could provide on objectives, policies and processes for risk management. We ask whether it is likely that IFRS 7 will change that balance and, indeed, whether increased disclosure is desirable.

The International Financial Reporting Group of Ernst & Young note that at a high level the qualitative disclosures set out in IFRS 7 are similar to those required by IAS 32, although the guidance in IFRS 7 is more detailed. However when we look at the wording of the guidance it takes the form ‘...the entity might disclose...’ or ‘...the entity might consider...’. There is no compulsion to take the detailed guidance as definitive. Paragraph B3 of the standard says ‘An entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this IFRS, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics.’

If the regulators accept that there is unlikely to be full disclosure of every detail known to management on matters such as objectives, policies and processes, then it seems unlikely that increasing the guidance notes will have the outcome predicted by the Ernst & Young Group. The quotation from paragraph B3 of the standard suggests that the IASB is not expecting full disclosure and wants the company to choose the degree of...
detail and emphasis applied. That points to voluntary compliance within a regulatory framework, which may be effective in countries having the disciplinary forces of a well-established capital market. It may be less effective where the capital market is new or non-existent.

The issue of materiality is also relevant in considering whether it is a concern or a relief that companies are selective in their choices for disclosure. Annual reports in paper form are regularly well over 100 pages in length – some reach 400 pages or more. We were scoring individual items of disclosure in this analysis, rather than giving an overall impression. However we did not feel that any company was concealing any material information and most seemed to be making a reasonable attempt to communicate the essence of some part of their strategy, policies or processes. If the overall result is that each company is making a considered choice of disclosure then it might be most effective to continue to let the market decide whether disclosure is adequate. One interesting source of information for future research would be the additional information made available through presentations to analysts and conference calls. Such sources would indicate the extent of supplementary questions caused by any apparent omissions.

7.2 Location of narrative disclosures

The lack of guidance on the preferred location of disclosures is not helpful to readers who wish to find particular items of information, such as the nature and management of principal risks and uncertainties. We have found the information located variously under headings of the business review, the directors’ report, the operating and financial review, the chairman’s statement, the chief executive officer’s review, the finance director’s review, the corporate governance report and the notes to the financial statements. The profusion of locations increased with the advent of the business review requirement, pointing to a concern about a potential ‘competition for content’ between the mandatory business review and the best practice OFR. It may be that for 2005 this is a predictable outcome of the confusion caused by the short-lived mandatory status of the OFR. On the other hand the OFR continues in non-mandatory form alongside the business review which may be incorporated by cross reference to other narrative documents. We have seen in our previous study of US firms that the management discussion and analysis (MD&A) is not an ideal model for disclosure because the SEC Regulations also allow for cross referencing. There is often duplication of information between the MD&A and the notes to the financial statements. One answer may be to provide a better index to the annual report. Moves from paper documents to electronic information may allow greater facility of searching for key words.

7.3 Multiple sources of regulation for narrative reporting

Narrative reporting has become an essential aspect of the corporate annual report but it is in danger of being swamped not only by the volume of information required but also by the multiple sources creating recommendations and regulations.

We suggest that a ‘one-stop’ shop for narrative disclosure would be a welcome improvement to UK reporting. At present each source of regulation is emphasising its own particular viewpoint rather than giving a combined overview. For example, in its review of narrative reporting by companies with years ending in March 2006, the ASB (2007) commented on the expectation that companies will explain their management of risks and uncertainties and recommended best practice examples geared to the reporting statement. Separately the UK government’s Department for Business, Enterprise and Regulatory Reform discussed the business review without reference to the OFR.21

Neither referred to either IAS 32 or IFRS 7, both of which in principle are flexible as to the location of the disclosures they provide but in practice impose obligations on auditors who are confirming compliance with IFRS.

7.4 Principles-based regulation or detailed guidance

Our impression is that in the UK we do not yet have the best solution for reporting ‘soft’ information in narrative form. There is a limitation that we do not have a unified source of narrative regulation for UK reporting and there is an uncertainty that we do not know whether having companies report 50% of what they know provides too much, too little, or just the right amount of information that is needed for informed decision making. There is no evidence that increasing the complexity of the regulation has any impact on the extent of disclosure when compared to what could be disclosed. IFRS 7 contains elements of a principles-based approach in the main body of the standard. That is acceptable if we trust companies to select relevant information for disclosure. However IFRS 7 also contains a pathway towards a rules-based approach if the detail contained in the guidance becomes regarded as a part of the standard. That carries the danger of subordinating relevant selection of information to uniformity of disclosure. Regulators may need to consider the balance of quantity and quality of disclosure.
References


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About the authors

Andrew Marshall

Andrew Marshall is a Professor of Finance at the University of Strathclyde and is the current Head of Department. He joined the department in 1991 as a research assistant after a spell in industry with KPMG. Teaching interests include risk management, derivatives, corporate finance and international finance. His research is focused on risk management, insider trading derivatives and international finance. He has published in many international journals including recently *Journal of Economics and Business*, *Journal of Multinational Financial Management*, *European Financial Management*, *Journal of Corporate Finance and Journal of Business Finance and Accounting*. Andrew has taught accounting and finance extensively on overseas and domestic MSc and MBA programmes in Hong Kong, Singapore, Shanghai, Malaysia, Tanzania and Greece.

Pauline Weetman

Pauline Weetman is Professor of Accounting at the University of Glasgow, having previously held professorial appointments at Stirling, Heriot-Watt and Strathclyde Universities. Her research interests include corporate communications and the use of narrative reporting, with a particular interest in the motivation of management to make voluntary disclosures. She received the Distinguished Academic Award of the British Accounting Association in 2005.

Contact details:
Professor Pauline Weetman
Department of Accounting and Finance
University of Glasgow
West Quadrangle
University Avenue
Glasgow G12 8QQ
Tel: 00 44 (0)141 330 2039
Fax: 00 44 (0)141 330 4442
Email: p.weetman@accfin.gla.ac.uk

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