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Governance *in brief*

FRC issues advice on annual reports for 2017/18 reporting season

Headlines

- The FRC has issued its Annual Review of Corporate Reporting and its annual letter to finance directors and audit committee chairs covering its perspective on key developments for 2017/18 annual reports.
- The Annual Review of Corporate Reporting supports the FRC's updated mission 'to promote transparency and integrity in business' and is a full and detailed report covering many aspects of corporate reporting which will be useful to preparers and to directors.
- There are no surprises, and the key areas for this year's annual reports include:
  - the FRC's expectation for disclosures on the likely impact of new IFRS accounting standards;
  - areas of focus for the strategic report, including new non-financial reporting requirements, reporting on key aspects of the company's performance, risk reporting and viability statements, and analysis of risks relating to the UK referendum result; and
  - financial statement disclosure matters, including cash flow reporting, dividends, critical judgements and estimates, accounting policies, business combinations and pensions.
- Helpfully, the FRC has published well in advance of November and December audit committee meetings, and also explains where additional information is available or will be available in the near future, including its current consultation on the Guidance on the Strategic Report, upcoming consultation on the Code, and a comprehensive selection of thematic reviews and Financial Reporting Lab studies.
- The FRC indicates that the Audit Quality Review team will also consider the effectiveness of the auditor's response on several of these areas, including critical judgements, estimates and pensions.

Quality of corporate reporting

The FRC's report provides an overview of the Corporate Reporting Review (CRR) activities for the year ended 31 March 2017 and is written for those with board-level responsibility for preparing company reports and accounts. This year the CRR team reviewed 203 annual and interim reports and wrote to 44% of those companies with substantive queries.

Three companies have been required to publish details of the CRR's intervention in the annual report where they made a change following the CRR's communications, compared to two companies in 2015/2016. This provides public evidence of the Conduct Committee's engagement with a company. No Press Notices were issued this year or last.

60 out of the 203 reviews this year related to CRR thematic reviews where the companies were informed in advance that an aspect of their next report would be subject to review; the FRC notes that many of those companies improved that aspect of their report in response to the notification.

The top five areas where substantive queries were raised following CRR review this year related to judgements and estimates, the strategic report, accounting policies, business combinations and alternative performance measures. As a reminder, the top five areas in 2015/2016 also included revenue and impairment of assets, which continue to be in the top ten this year.

The likely impact of new IFRS accounting standards

The first area emphasised by the FRC in its letter is the importance of disclosing the likely impact of the three new accounting standards on the financial statements as soon as they can be reliably measured.

Implementation of IFRS 9 "Financial Instruments" and IFRS 15 "Revenue from contracts with customers" should be well advanced and the FRC advises that IFRS 16 "Leases" is expected to be endorsed by the end of 2017, permitting early adoption alongside IFRS 15 from 1 January 2018.

The FRC is looking for clear disclosure with reference to the company's existing accounting policies, including detailed quantitative disclosures supported by good explanations of the company's analysis, particularly for IFRS 15 and IFRS 9. It highlights that disclosures should be specific to the company's circumstances and transactions and describe key judgements management will need to make.

Areas of focus for the front half of the annual report

Strategic report

In the context of the strategic report having contributed to improvements in overall corporate reporting, the FRC explains that it is one of the areas which is most frequently challenged by the FRC's Corporate Reporting Review team (CRR).

Areas that will benefit from additional focus this reporting season include:

- explanations of relationships and linkages between different pieces of information, in particular ensuring that KPIs which are linked to executive remuneration are explained in sufficient detail;
- providing clarity on the reasons for changes to KPIs and the impact of this;
- where relevant, capturing the requirements to provide enhanced disclosures as part of implementation of the non-financial reporting directive, in respect of the environment, employees, social matters, respect for human rights and anti-corruption and anti-bribery matters;
- considering other areas addressed by the FRC in their draft updated Guidance on the Strategic Report, which will be finalised in the first half of 2018:
  - providing better information on how boards have fulfilled their duty under s172 when taking decisions to promote the long-term success of the company;
  - how they engage with key stakeholders;
  - how the allocation of resources will support the achievement of their strategy; and
  - disclosing sources of value or intangible assets and how those sources of value are managed, sustained and developed, whether or not they are recognised under traditional accounting requirements.

The changes the FRC is proposing encourage companies to include information that is material to the long-term success of the company, even where this goes beyond the legal requirements.

Our Governance in brief **FRC encourages broader reporting of company purpose and impact in proposed revisions to the Guidance on the Strategic Report** provides a helpful summary of ways to implement these new elements in a company's strategic report. Although the strategic report guidance is not finalised, as it reflects the intentions of the government's corporate reform agenda, we suggest companies use the FRC's draft as a useful reference point.

Risk, longer term prospects and viability

The FRC highlights recent improvements in risk reporting brought about since the introduction of viability statements and, based on its recent research, advises companies to consider developing their reporting on longer term prospects and viability in two stages, as envisaged in the original guidance:

1. Consider and report on the prospects of the company over a period reflecting its business and investment cycles; and

2. State whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary.

When setting the periods for reporting, the board should take into account investment and planning periods, the board's stewardship responsibilities, the nature of the business and its stage of development and previous statements made, especially in raising capital. The letter explains that the FRC's Financial Reporting Lab is currently carrying out a project on risk and viability reporting. The report is due to be published later this year and we understand it will provide practical guidance and also examples of how the two stage process can be applied in practice in annual reports.

As a reminder, the Investment Association has also encouraged companies to separate prospects from viability and differentiate the time horizons used for those assessments:

> *"It is helpful if the disclosures around prospects address the long-term strategic plans and look longer than the period over which viability is assessed... Investors want companies to give them an insight into their plans for the future which may be separate from the plans that support the viability statement. To facilitate this directors may wish to consider separating their assessment of prospects from their assessment of viability. The former then gives them the opportunity to demonstrate that they have considered the future of the business over the long-term."* [1]

The FRC also calls for companies to revisit their assessment of the risks and ongoing uncertainties regarding the effects of the EU referendum, making appropriate disclosures to reflect their latest analysis and how this has developed over the year. Further, it is recommended that these disclosures are kept current.

1 Guidelines on Viability Statements, The Investment Association

Financial statement disclosure matters

The financial statement disclosure matters are no surprise. They are areas that involve considerable thought and judgement and many have been regular features of the FRC's Corporate Reporting Review team's annual reports.

Area of focus	Description
Statement of cash flows	• Amendments to IAS 7 *Statement of Cash Flows* were effective 1 January 2017 – requiring an explanation of changes in a company's financing obligations over the period (e.g. a net debt reconciliation). • Investors are seeking clearer reporting on the use of financing facilities such as invoice discounting arrangements.There is concern that lack of disclosure may hide a company's reliance on this type of facility, especially where customer receivables are derecognised.
Dividends	• Further reporting on the capacity to pay dividends is encouraged, including any restrictions on profit distributions by subsidiary companies. • The FRC's Financial Reporting Lab issued a recent **report** on dividend disclosures and noted some improvement in FTSE 100 reports.
Critical judgements and estimates	• Critical to explain key judgements in management's accounting policy decisions and the extent to which assets and liabilities may change in the following year. • Company-specific disclosures should be provided, with granular information about a smaller set of judgements and estimates that had a significant impact on results. • This year, more companies heeded the FRC's call to clearly distinguish critical accounting judgements from key sources of estimation uncertainty, which have often mistakenly been merged together, despite IAS 1 requiring separate and different disclosure for each.
Accounting policies	• Accounting policies should be properly tailored to a company's circumstances, for instance, revenue policies covering each significant business stream.
Business combinations	• Focus on impact of contingent and deferred consideration arrangements, in particular clarity of disclosure around estimation and assumptions. • Concern over sufficiency of disclosure where few or no intangible assets, other than goodwill, were recognised in acquisition accounting.
Pensions	• The current low interest rate environment continues to require transparency on pension arrangements and valuations. • This includes a need for informative explanations of deficit funding arrangements, risk management strategies and scheme assets.

Audit quality and effectiveness

The FRC's Audit Quality Review team will be seeking evidence that the auditor has challenged management and reported clearly to the audit committee in several of the areas featured in the annual advice letter. Audit committees should therefore consider this as part of their assessment of audit effectiveness.

Upcoming consultations and publications

The FRC indicates there will be upcoming consultations and publications, which we highlight below for ease of reference:

Current and upcoming consultations

- Current consultation on updated Guidance on the Strategic Report (closing date for responses is 24 October 2017; final publication planned in H1 2018): **https://frc.org.uk/consultation-list/2017/consultation-on-guidance-on-the-strategic-report**

- Upcoming consultation on fundamental review of the UK Corporate Governance Code – November 2017

Upcoming FRC publications

- Thematic review on critical judgements and estimates – Q4 2017

- Thematic report on alternative performance measures – Q4 2017

- Thematic review on pensions – Q4 2017

- Financial Reporting Lab report on risk and viability reporting – Q4 2017

Deloitte view

- **We welcome the earlier publication of this advice for Audit Committee Chairs and Finance Directors and the FRC's continued focus on illustrating good practice in corporate reporting through thematic reviews and the Financial Reporting Lab.**

- **Whilst none of these areas are surprising, this provides a timely reminder for audit committee agendas for the reporting season ahead and the areas of FRC supervisory focus.**

- **The description of prospects over the business and investment cycle will challenge companies and auditors alike, but presents the opportunity to comment on positioning against industry trends and draw out other, longer-term, company-specific matters, such as technology disruption, pension funding and the like. Careful thought will be needed to navigate between inadvertent assurances about the future but also to avoid generic, bland disclosures.**

- **It is clear that disclosure expectations are increasing and audit committees should challenge bland and generic disclosures which are unchanged from the prior year, out of date, or irrelevant. Disclosures need to be company specific and year specific.**

Further information

The FRC's Annual Review of Corporate Reporting, Technical Findings supplement and press release are available at: **http://frc.org.uk/news/october-2017/corporate-reporting-standard-improving,-though-qua**

The FRC's letter and press release are available at: https://www.frc.org.uk/news/october-2017/advice-for-preparing-2017-18-annual-reports

The Financial Reporting Lab's report Disclosure of dividends: policy and practice can be found at: https://www.frc.org.uk/getattachment/3a7972af-35ae-4354-8136-0b395f5bbbba/Dividends-implementation-study-Lab.pdf

The Investment Association's Guidelines on Viability Statements: **https://www.ivis.co.uk/media/12490/Guidance-viability-statements-final2.pdf**

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Deloitte's Annual Reporting Insights 2017: www.deloitte.co.uk/annualreportinsights

The Deloitte Academy

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For further details about the Deloitte Academy, including membership, please email **enquiries@deloitteacademy.co.uk**.

Contacts – Centre for Corporate Governance

Tracy Gordon	**020 7007 3812 or trgordon@deloitte.co.uk**
Corinne Sheriff	**020 7007 8368 or csheriff@deloitte.co.uk**
William Touche	**020 7007 3352 or wtouche@deloitte.co.uk**

Designed and produced by The Creative Studio at Deloitte, London. J13860