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Governance *in brief*

FRC's CRR report calls for more tax and stakeholder reporting as well as better business model, risk and judgment disclosures

Headlines

- Compliance with the accounting framework is generally good and the introduction of the strategic report has improved the quality of narrative reporting.
- Not all companies provide sufficient balance in their reporting and this undermines the quality of corporate reporting and erodes trust.
- The summary findings of the recent thematic review on tax reporting highlights the importance of high quality information in effective tax rate reconciliations and clear articulation of how companies account for tax uncertainties.
- The report encourages companies to consider how they might report on how the directors have discharged their duty under s172 of the Companies Act (to promote the success of the company for the benefit of its members whilst having regard to other stakeholders).
- Looking forward, Brexit could have significant implications for both individual company reporting and for the future adoption of IFRS.
- Separately, the FRC has issued a year-end advice letter to audit committee chairs and finance directors, highlighting key areas for consideration during the preparation of the annual report this coming reporting season, which are also covered in this report.

Quality of corporate reporting

The FRC's report provides an overview of the Corporate Reporting Review (CRR) activities for the year ended 31 March 2016 and is written for those with board-level responsibility for company reports and accounts. This year the CRR team reviewed 192 annual and interim reports and wrote to one third of those companies with substantive queries. They also provide a list of nine characteristics of good corporate reporting, reproduced in the Appendix to the report which directors may wish to review.

Just two companies were required to include a Committee Reference in their annual report where they made a change following the CRR's communications, compared to six companies in 2014/2015. A Committee Reference provides public evidence of the Conduct Committee's engagement with a company. No Press Notices were issued, compared to three in the previous year.

In the recent update to their Guidance on Audit Committees and in this report, the FRC encourages companies to explain their interaction with the FRC on the quality of their reporting. To facilitate this explanation, the FRC now also writes to companies to acknowledge when their annual report and accounts have been reviewed with no substantive queries arising.

The FRC also continues to focus on its Clear & Concise initiative aiming to encourage good communication in corporate reporting. It explains that directors should give "the same level of attention to removing immaterial disclosures [from the annual report] as to ensuring that all material information is included" and that, although some points may continue to be raised in FRC letters, directors are expected to have sufficient confidence in their own decisions to justify them.

Common findings from the review

Financial statements

There were four areas considered to represent the most significant findings on financial statements in 2015/16.

- **Accounting policies** should be specific and granular, particularly around revenue recognition. Revenue recognition policies should link clearly to the company's business model disclosures in the strategic report, for instance they should cover each distinct and significant revenue stream that is mentioned as part of the business model. Complex long-term contracts such as outsourcing contracts should be explained in detail, including exactly when and how revenue is measured.
- When reporting on **critical judgements and sources of estimation uncertainty**, reporting should be specific and quantified, with specific, concise explanations covering the specific judgements the board has made and how uncertainty or changes to estimates could affect the next year's accounts, including sensitivities or ranges of potential outcomes.
- When **reporting on tax**, companies should disclose the amount of uncertain tax provisions and explain tax uncertainties more clearly by explaining the bases for recognition and measurement. The thematic review of companies' tax disclosures highlighted the value of greater visibility of the factors underlying effective tax rate reconciliations.
- **Pension disclosures** should adequately explain the risks to which the company is exposed by the pension plan and the disclosure of the plan's assets should clearly reflect the nature of the plan's investments. For example, this might include an explanation of the methodology used to esimate fair values for complex financial instruments such as insurance contracts.

Strategic reports

- One of the most common areas of challenge was whether reports are **sufficiently balanced and comprehensive**. This refers to including information of particular interest to investors, such as effective tax rates and non-financial key performance indicators, in addition to not giving too much emphasis to alternative performance measures (APMs) or pro-forma information prepared on a non-GAAP basis. ESMA's Guidelines on APMs apply on or after 3 July 2016. The findings of the FRC's thematic review of APMs in interim reporting will be available in November 2016.
- Companies are encouraged to provide better explanations of how they carried out the process underlying their **viability statement** and the supporting analysis. The FRC highlights that in a review they have undertaken, around 75% of companies chose to use a three-year time horizon and encourages companies not to view this as a default option, but to consider reviewing their company's particular circumstances.

- **Areas for further improvement in strategic reports** include:
  - a fair and balanced assessment covering both positive and negative aspects of performance and developments;
  - linkage between discussions of performance, position and cash flows and the financial statements;
  - more company-specific information on the business, its environment and the risks it faces;
  - removing immaterial items; and
  - linkage between information such as strategic objectives, KPIs and risks.

Other areas of interest

Other areas the FRC mentions as important, although not necessarily areas where many queries have been raised, are:

- Clear articulation of the **business model**.
- The quality of reporting around **principal risks and uncertainties**.
- **Tax arrangements**, including tax strategies, whether tax rates are sustainable and whether any material tax risks are clearly described in the annual report.
- Sufficient explanation around **dividend disclosures**, where better disclosure would link how dividend policies operate in practice to risks and capital management decisions.
- Reporting the risks of the **UK decision to exit the European Union**.
- Sufficiently meeting the needs of wider stakeholders, which could include a clear description of the company's **culture, values and behaviour expectations** and an assessment of how they are measured.
- Reporting concisely on how directors have discharged their duty to have regard to **other stakeholders**, as required by section 172 of the Companies Act 2006.

Areas of future focus

The FRC has also issued a letter of advice sent to audit committee chairs and finance directors, which has been included as an appendix to the CRR report. In addition to the areas discussed above, the letter highlights:

- The potential impact of **low interest rates** on the amounts reported in the financial statements – in particular long term assets and liabilities, with perhaps the greatest impact on pension scheme liabilities and suppressed returns on pension scheme assets.
- The need for **disclosures regarding major IFRS standards that will become effective in the near future**, in particular IFRS 15 Revenue from Contracts with Customers, IFRS 9 Financial Instruments and IFRS 16 Leases. Comparative periods for IFRS 15 and IFRS 9 will commence from 1 January 2017 and the FRC expects that companies will have made substantial progress on implementation and should provide information on this and any significant likely impacts of the new standards.

Although corporate governance is not part of the CRR's monitoring remit, the letter also draws out:

- **Remuneration reporting**, focusing on the need for clarity and conciseness and encouraging attention to be paid to the revised GC100 and Investor Group **Directors' Remuneration Reporting Guidance.**
- **Audit committee reporting**, in particular the significant issues that the audit committee has considered, including issues in relation to the financial statements and their interaction with the FRC on the quality of their reporting and audit.

A further point to note, although not one that is likely to affect companies in the short term, is the future of IFRS in the UK post-Brexit. The FRC looks ahead to a time when the UK may need to assess international standards for adoption itself, rather than relying on the EU's assessment for EEA members, although it states that it "continues to support the application of a single set of high quality global financial reporting standards by listed companies."

Deloitte View

- **In this report, the FRC is reflecting the political agenda and the social mood by encouraging business to enhance tax disclosures and include disclosures on wider stakeholder considerations set out in the Companies Act in the reporting of the discharge of director responsibilities.**
- **There is a welcome call for a focus on culture, values and human capital – reflecting investor recognition that human capital is fundamental in value creation.**
- **The FRC is right to begin to comment on the dangers of the low interest rate environment within the context of the IFRS fair value framework.**
- **There is also a focus on quantifying judgements and uncertainties which, with increased economic uncertainty, is a useful communication tool for directors and investors regarding key assumptions used in judgements about the future.**
- **Alternative Performance Measures are going to see further scrutiny this year, in part because the ESMA guidelines which took effect for public statements published on or after 3 July enhance regulatory focus on these.**
- **Finally, it is good to see the ongoing progress in corporate reporting being recognised – annual reports have certainly come on a long way in the last few years.**

Further information

The Corporate Reporting Review annual report is available on the FRC's website:
https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Annual-Review-of-Corporate-Reporting-2015-16.pdf

The FRC's year-end advice letter to audit committee chairs and finance directors
https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Letter-Year-End-Advice-to-Preparers-2016.pdf

The revised GC100 and Investor Group Directors' Remuneration Reporting Guidance can be found at:
http://uk.practicallaw.com/2-632-2324

Deloitte's Annual report insights 2016: A clear vision is available at
www.deloitte.co.uk/annualreportinsights

Deloitte's Need to know series has recently covered several of the key topics raised by the FRC:
Tax – Focusing on tax transparency in annual reports and accounts:
http://www.iasplus.com/en-gb/publications/uk/need-to-know/2016/ntk-ias-12

APMs – Alternative performance measures: a practical guide:
http://www.iasplus.com/en-gb/publications/uk/need-to-know/2016/ntk-apms

Brexit – UK referendum on membership of the European Union – Financial reporting implications:
http://www.iasplus.com/en-gb/publications/uk/need-to-know/2016/ntk-uk-referendum

The CRR's FAQs – My company has received a corporate reporting review letter is available at:
https://www.frc.org.uk/Our-Work/Conduct/Corporate-Reporting-Review/FAQs/FAQs-My-company-has-received-a-corporate-reporting.aspx#Review5

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Appendix: Characteristics of good corporate reporting

The FRC has identified nine characteristics of good corporate reporting, which we replicate below, over and above basic compliance with the law and accounting standards. They believe these characteristics typify a good annual report:

1. A single story
- The narrative in the front-end is consistent with the back-end accounting information.
- Significant points in the financial statements are explained in the narrative reports so that there are no surprises hidden in the accounts.

2. How the money is made
- The strategic report gives a clear and balanced account which includes an explanation of the company's business model and the salient features of the company's position and performance, good and bad.

3. What worries the board
- The risks and uncertainties described in the strategic report are genuinely the principal risks and uncertainties that concern the board.
- The descriptions are sufficiently specific that the reader can understand why they are important to the company.
- The report also describes the mitigating actions taken by the board to manage the impact of its principal risks and uncertainties.
- The links to accounting estimates and judgements are clear.

4. Consistency
- Highlighted or adjusted figures, key performance indicators (KPIs) and non-GAAP measures referred to in the strategic report are clearly reconciled to the relevant amounts in the accounts and any adjustments are clearly explained, together with the reasons why they are being made.

5. Cut the clutter
- Important messages, policies and transactions are highlighted and supported with relevant context and are not obscured by immaterial detail.
- Cross-referencing and signposting is used effectively.
- Repetition is avoided.

6. Clarity
- The language used is precise and explains complex accounting and reporting issues clearly.
- Jargon and boilerplate are avoided.

7. Summarise
- Items are reported at an appropriate level of aggregation and tables of reconciliation are supported by, and consistent with, the accompanying narrative.

8. Explain change
- Significant changes from the prior period, whether matters of policy or presentation, are properly explained.

9. True and fair
- The spirit as well as the letter of accounting standards is followed.
- A true and fair view is a requirement of both UK and EU law and applies equally to accounts prepared in accordance with UK GAAP and IFRS.

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