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Deloitte Finance Club

The community for Financial Controllers and senior financial executives

Wednesday, 10th December 2014

Deloitte Finance Club

A few facts

- Established in **May 1997** as the *Financial Controllers' Club*, and renamed **Deloitte Finance Club** in 2013
- Provides an **annual programme of technical updates and hot topic briefings**
- Connects our members to relevant experts as well as over **2,200 members** across the country

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Our programme in 2014

- **Revenue recognition and the TMT sector** – Wednesday, 26 March 2014
- **Accounting for real estate and a Tax update** – Wednesday, 23 April 2014
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- **Football Finance and Fraud: an inevitable cost of doing business?** – Wednesday, 1 October 2014
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- **All change! Key trends and developments in the UK insurance market** – Wednesday, 19 November 2014
- **Holiday finance checklist 2014** – Wednesday 10 December 2014

2015 programme under development

Holiday finance checklist 2014
Agenda

- **Peter Westaway** – Annual report insights
- **Philip Barden** – Year-end reminders and regulatory hotspots
- **Sarah Waddington** – UK GAAP transition in practice
- **Stephanie Hurst** – New UK GAAP and Tax
- **David Cullington** – Executive remuneration
- **Tracy Gordon** – Corporate governance and Auditor reporting
- Panel discussion chaired by **James Bates**

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Annual report insights

Peter Westaway

Annual report insights 2014

Providing a clear steer

- Survey of 100 UK listed companies' annual reports published last week
- Examines narrative reporting, corporate governance disclosures and financial statements
- Regulatory overview and best practice examples

Booklet with survey highlights and ways to improve your report

Available at:
www.deloitte.co.uk/annualreportinsights

Annual report insights 2014
Narrative reporting

Findings

64% demonstrated some linkage in their report

80% discuss value creation in their reports

9 the average number of principal risks presented

Good practice examples

Linkage: **SEGRO**

Business model: **Rexam**

Risks: **Domino Printing Sciences**

How to improve

1. Comply with legal requirements e.g. strategic report approval
2. Clear linkage between strategy, KPIs and risks
3. Cut clutter e.g. performance review duplication
4. Take on board integrated reporting

LR 9.8

Annual report insights 2014

Corporate governance

Findings

57% reported full compliance with the Code

23% included the FBU statement process

15% of the directors in our sample were women

Good practice examples

Non-compliance explanation: **Johnson Matthey**

FBU: **Spectris**

Diversity: **M&S**

How to improve

1. Include statements of application and compliance
2. Discuss diversity in its broadest sense
3. Focus on the activities of the board and not just the process
4. Early adopt new risk reporting

Annual report insights 2014

Financial statements

Findings

68% used non-GAAP measure on the face of the P&L

44% included a net debt reconciliation

6/10 companies with goodwill but no sensitivity analysis had impairment as KSoEU

Good practice examples

Non-GAAP measures: **National Grid**

Tax governance: **Weir Group**

Key judgements: **Evraz**

How to improve

1. Adopt new IFRSs, including package of five
2. Clearly identify critical judgements and KSoEU that are consistent with other disclosures
3. Consider restructuring accounting policies
4. Volunteer a net debt reconciliation or tax governance info

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Year-end reminders and regulatory hotspots

Philip Barden

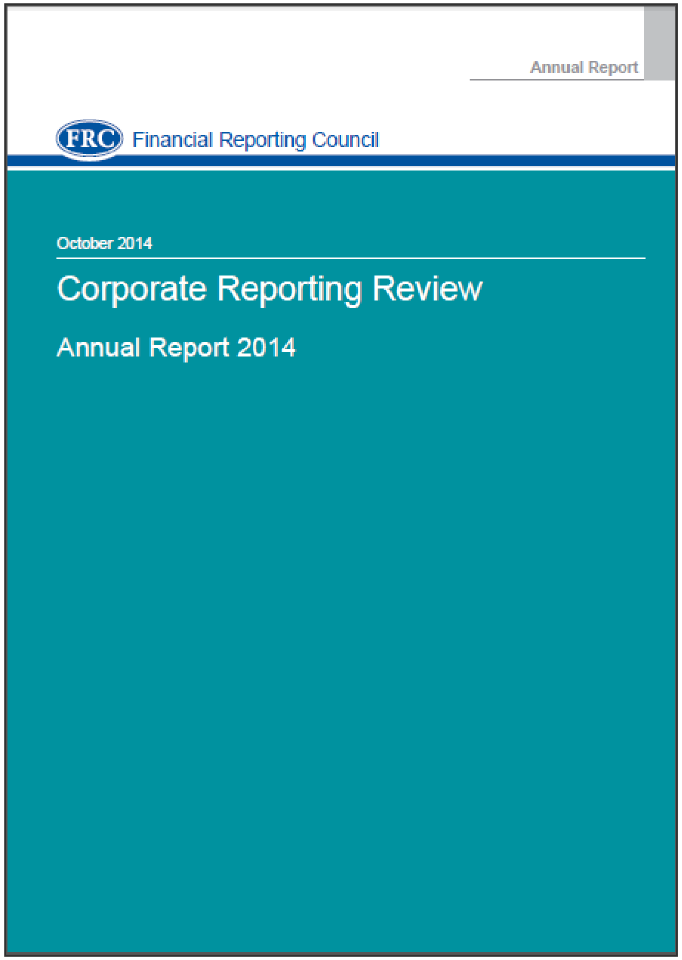
IFRS reminders for 2014 year-ends

Items newly effective for Dec 2014 year-ends

- Consolidation “package of five” for EU IFRS reporters, including investment entities amendments
- Amendments to IAS 32 on offsetting financial assets and liabilities
- Amendments to IAS 36 on impairment disclosures
- Amendments to IAS 39 on novation of derivatives and continuation of hedge accounting
- Annual improvements to IFRSs 2010-2012 – Amendments to IFRS 2 apply to share-based payments with a grant date after 1 July 2014 and amendments to IFRS 3 for business combinations after 1 July 2014 (other amendments effective p/c 1 July 2014)
- IFRIC 21 for those under IASB IFRSs – EU deferred effective date to p/c 17 June 2014

FRC Corporate Reporting Review

- Issued in October
- Provides information on:
  - Common areas of challenge
  - Emerging issues
  - Operating procedures
- Accompanied by slide deck of technical findings from 2013-14 reviews


Annual Report

FRC Financial Reporting Council

October 2014

Corporate Reporting Review

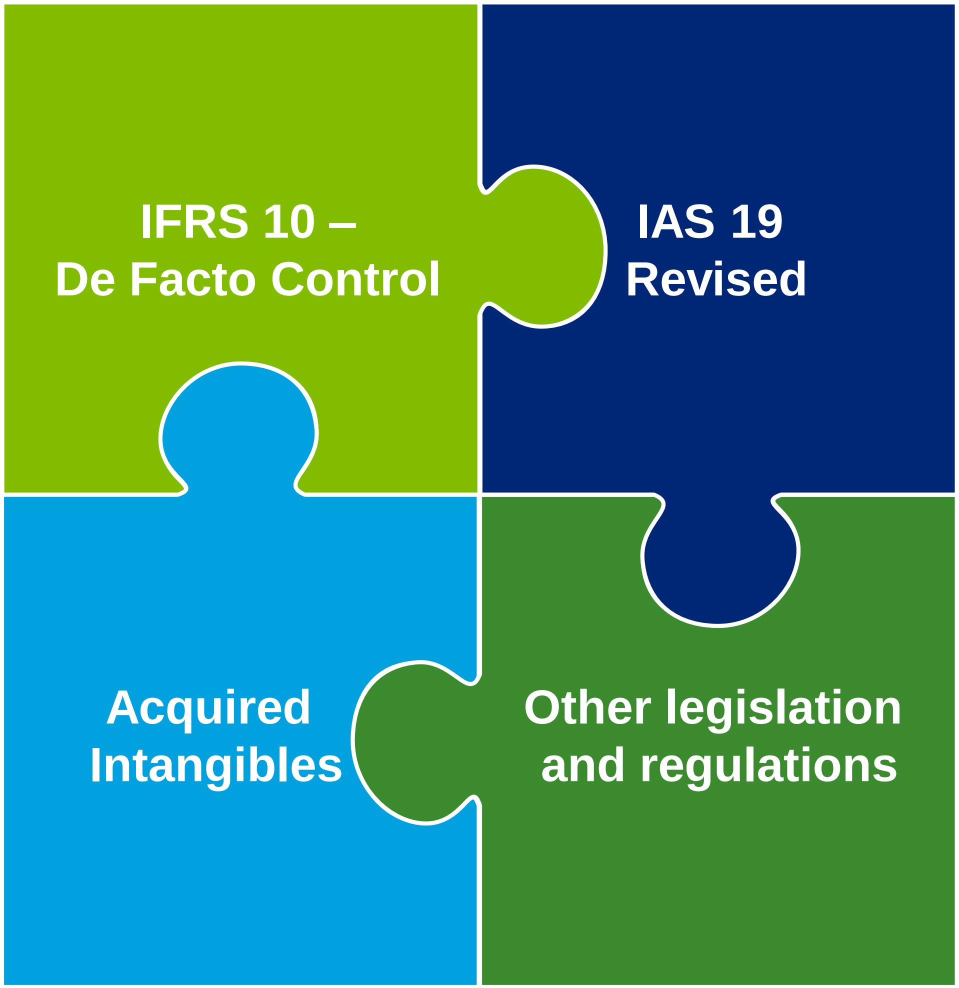
Annual Report 2014

FRC Corporate Reporting Review

Common areas of challenge

FRC Corporate Reporting Review

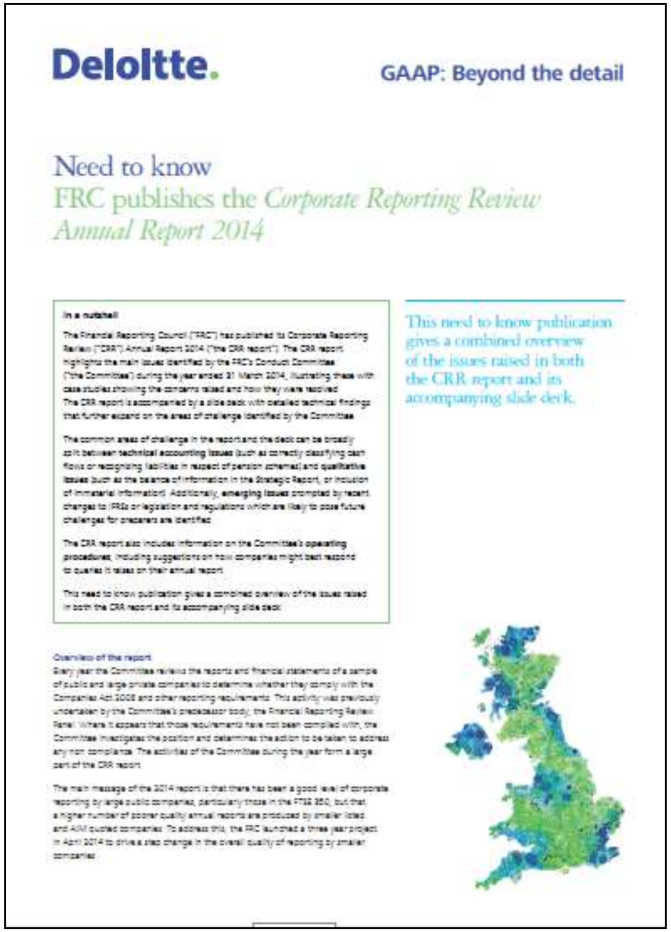
Emerging issues



Encouraging better disclosure on impact of new standards e.g. IFRS 15

FRC Corporate Reporting Review

- FRC slide deck has more detail and covers other areas
- Industry specific notes on
  - House builders
  - Resource companies
  - Property development
  - Investment trusts
- Financial reporting lab reminders issued in November with summary of reports issued in the year
- Need to know available now on www.ukaccountingplus.co.uk



Deloitte. GAAP: Beyond the detail

Need to know
FRC publishes the *Corporate Reporting Review Annual Report 2014*

In a nutshell

The Financial Reporting Council ("FRC") has published its Corporate Reporting Review ("CRR") Annual Report 2014 ("the CRR report"). The CRR report highlights the main issues identified by the FRC's Conduct Committee ("the Committee") during the year ended 31 March 2014, illustrating these with case studies showing the concerns raised and how they were resolved. The CRR report is accompanied by a slide deck with detailed technical findings that further expand on the areas of challenge identified by the Committee.

The common areas of challenge in the report and the deck can be broadly split between **technical accounting issues** (such as correctly classifying cash flows or recognising liabilities in respect of pension schemes) and **qualitative issues** (such as the balance of information in the Strategic Report, or inclusion of immaterial information). Additionally, **emerging issues** prompted by recent changes to IFRSs or legislation and regulations which are likely to pose future challenges for preparers are identified.

The CRR report also includes information on the Committee's **operating procedures**, including suggestions on how companies might best respond to queries it raises on their annual report.

This need to know publication gives a combined overview of the issues raised in both the CRR report and its accompanying slide deck.

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Overview of the report

Every year the Committee reviews the reports and financial statements of a sample of public and large private companies to determine whether they comply with the Companies Act 2006 and other reporting requirements. This activity was previously undertaken by the Committee's predecessor body, the Financial Reporting Review Panel. Where it appears that those requirements have not been complied with, the Committee investigates the position and determines the action to be taken to address any non compliance. The activities of the Committee during the year form a large part of the CRR report.

The main message of the 2014 report is that there has been a good level of corporate reporting by large public companies, particularly those in the FTSE 350, but that a higher number of poorer quality annual reports are produced by smaller listed and AIM quoted companies. To address this, the FRC launched a three year project in April 2014 to drive a step change in the overall quality of reporting by smaller companies.

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UK GAAP transition in practice

Sarah Waddington

CAA proposition

A dedicated team providing specialist accounting advice

CAA is a dedicated team of accounting specialists with experience in applying in-depth technical knowledge to commercial situations. We have a proven track record of advising clients on complex issues and supporting them in navigating an increasingly multi-faceted financial reporting environment.

Where we can help

We have experience across a broad range of topics, and of working cross functionally with our tax and corporate finance teams. Below are some of the most common areas where we asked to provide advice.

Group restructuring	**Corporate simplification**	**Distributable reserves and maximising dividend and cash extraction**
Remuneration strategies	**Due diligence support**	**Securitisation accounting**
Acquisition accounting	**Tax structuring support**	**Deal specific issues** e.g. revenue recognition, control and consolidation considerations
Establishing joint arrangements	**Debt classification and de-recognition**	**GAAP conversion**

Varied project size and format

We can provide support in a number of different formats – anything from formal accounting opinions to ad-hoc hotline style support or annotating a tax steps paper with accounting implications.

UK GAAP

Overview of key areas of change

- Goodwill & intangibles
- Borrowing & development costs
- Financial instruments
- Operating leases
- Financial guarantees
- Defined benefit pensions
- Presentation & disclosure
- Business combinations & consolidation
- Foreign currency
- Deferred tax
- Investment property
- Intercompany balances

TRANSITION OPTIONS

Accounting projects

What issues are we seeing in practice?

Debt restructuring

- Troubled debt restructuring
- Refinancing
- Hedging

Dividend/cash extraction

- Determining distributable reserves
- How can reserves be increased?
- What impact does new UK GAAP have?

Acquisitions and restructurings

- Consideration vs remuneration
- Internal restructurings – fair value vs carrying value
- Deemed distributions

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New UK GAAP and Tax

Stephanie Hurst

New UK GAAP – Nearing transition

How have regulators reacted?

Financial Reporting Council (FRC)

- Since the release of FRS 102, FRC have made editorial amendments and clarification statements e.g. scope of FRS 102, Financial instruments, accounting for income tax

HMRC

- Published two papers in January 2014 summarising their view on the likely tax implications of transitioning to a new GAAP
- Proposed changes to the Disregard Regulations and COAP Regulations in summer 2014

XBRL UK

- Final versions of three proposed new XBRL accounts taxonomies – FRS 101, FRS 102 and EU adopted IFRS released by FRC on 15 September 2014

New UK GAAP and Tax

Lessons learnt

- Cooperation with Finance essential
- More than tax and accounting
- Early adoption can be beneficial
- Early stakeholder management
- Ensure documentati on in place early
- Cash tax driver in GAAP choice
- Consider each material item on balance sheet

New UK GAAP and Tax
Key considerations

Cash Tax

- Assess cash tax impact
- Cash flow forecasting
- Stakeholder management

Tax accounting

- Alignment of group and entity-only reporting
- Choose new GAAP
- Assess DT impact

Tax compliance

- Tax elections and deadlines
- Budget for conversion e.g. iXBRL
- SAO – risk & controls

Tax operations

- Resource capacity
- Information systems sufficient for needs
- Transition timeline

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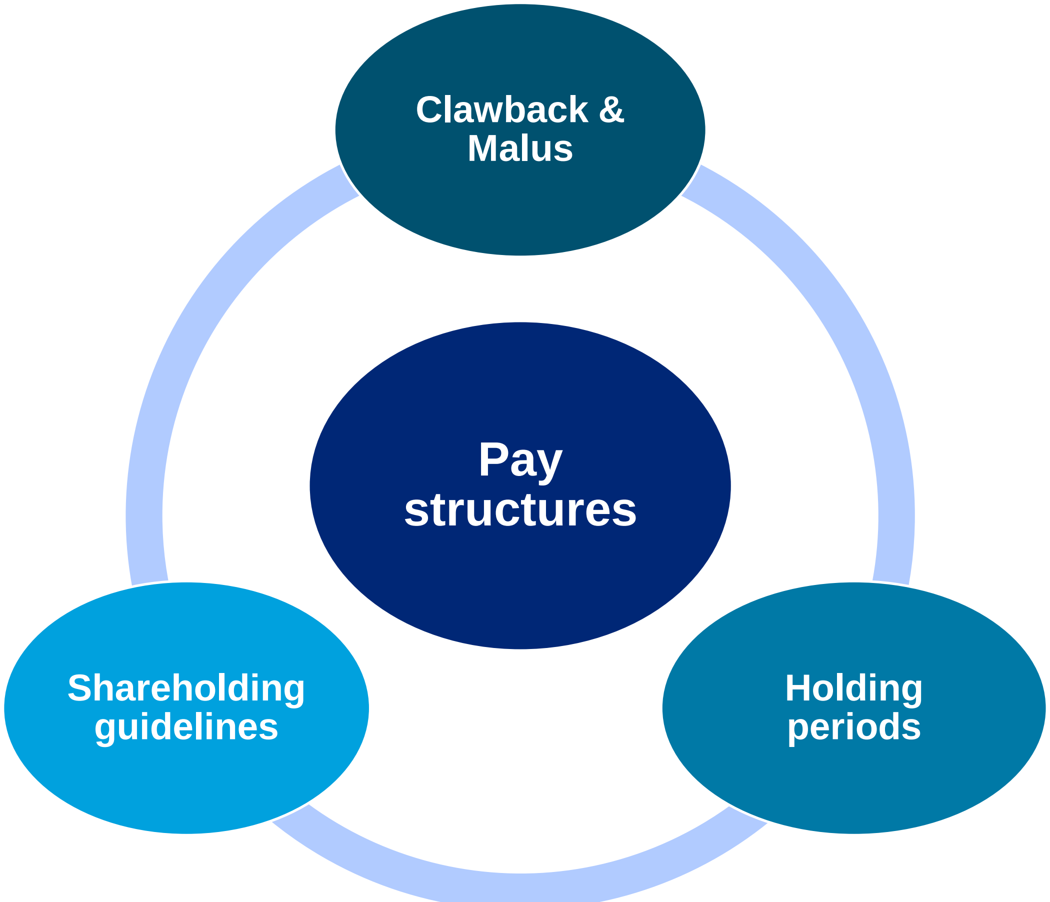
Executive remuneration

David Cullington

Executive remuneration
2014 in review

Executive remuneration
Outlook for 2015



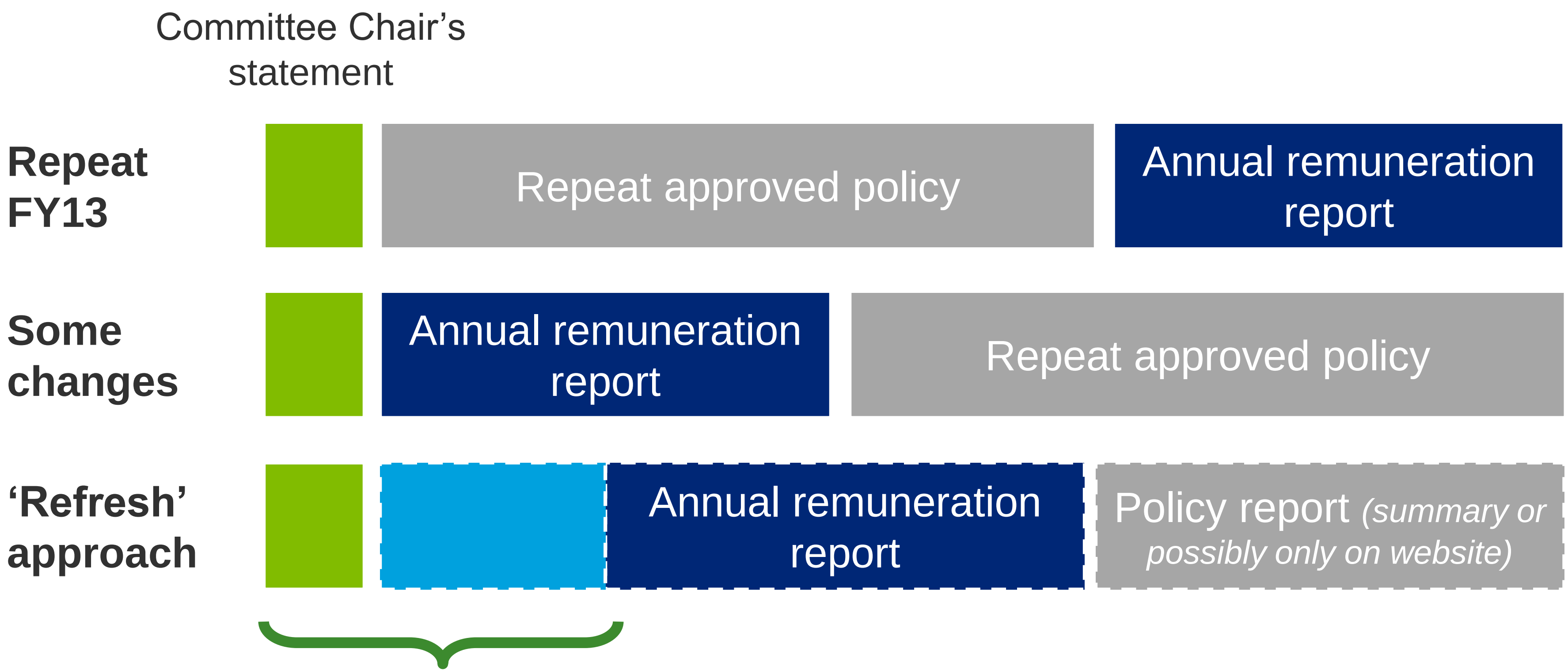
Remuneration report checklist

Annual Statements
- Improve explanation of decisions
- Make link to strategy clearer
- Avoid becoming an election issue – remain sensitive to “wider issues”

Policy Report
- In /out / summarised / reordered?

Annual Report on Remuneration
- Better retrospective annual bonus disclosure

Executive remuneration
DRR trends – revisiting the policy report



- Context and changes
- One page executive summary
- Policy for next year
- Single figure

Executive remuneration

DRR trends – bonus target disclosure

Performance measures	Threshold (0%)	Target (50%)	Maximum (100%)	Result vesting (% of target)
Profit before tax	£450m	**£570m**	£590m	**86%**
Revenue growth	6%	**8%**	12%	**33%**
Cashflow	£500m	**£600m**	£700m	**50%**
Overall performance				**56%**

Target bonus = 100% x **Performance ratio = 56%** x **Personal performance multiplier = 125%** = **70%**

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Corporate governance

Tracy Gordon

Risk management, internal control, going concern and longer-term viability

Corporate governance

Code amendments and new guidance are now effective

"The ability of the board to understand and address the risks facing the company is itself a major risk factor."

FRC consultation paper

Corporate governance

Changes to the UK Corporate Governance Code

The board is responsible for determining the nature and extent of the principal risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.

Code Principle C.2

Just a slight change to the Main Principle from “significant” to “principal” to bring the terminology in line with Strategic Report disclosure requirements

The directors should confirm in the annual report that they have carried out a robust assessment of the principal risks facing the company – including those that would threaten its business model, future performance, solvency or liquidity – describe those risks and explain how they are being managed or mitigated.

Taking account of the company’s current position and principal risks, the directors should explain in the annual report how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate. The directors should 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.

***NEW** Code Provisions C.2.1 and C.2.2*

A new provision in addition to the existing Code Provision requiring a statement from the board that the business is a going concern which has been amended to make a clearer link to the going concern basis of accounting.

The board should monitor the company’s risk management and internal control and, at least annually, carry out a review of their effectiveness, and report to shareholders that they have done so. The monitoring and review should cover all material controls, including financial, operational and compliance controls.

Code Provision C.2.3

This provision has been changed to reflect that the board’s review should not just be a one-off, annual exercise but an on-going monitoring responsibility

What is a principal risk?

Definition in the FRC Guidance on the Strategic Report (2014)

"A principal risk is a risk or combination of risks that can seriously affect the future prospects or reputation of the entity. These should include those risks that would threaten its business model, future performance, solvency or liquidity."

Will include strategic, financial, operational, reputational, behavioural, organisational, third party and external risks (over which the board has little or no direct control)

Board responsibilities

The guidance suggests the following responsibilities…

Determining the risk appetite	Design & implementation of risk management and internal control systems	Agreeing how principal risks should be managed
Monitor and review of the risk management and internal control systems	Ensuring appropriate culture & reward systems	Ensuring sound internal and external information and communication

But remember it is the **audit committee's** responsibility to review the company's internal control and risk management systems ***unless*** expressly addressed by a separate board risk committee <u>**comprised of independent directors**</u>, or by the board itself.

- Code provision C.3.2

The longer-term viability statement

Key considerations when making this statement

Reasonable expectation and period covered	• Reasonable expectation does not mean certainty but it is expected that the assessment can be justified • Except in rare circumstances the period should be significantly longer than 12 months • Factors to be considered: – The board's stewardship responsibilities – Previous statements made, especially in raising capital – The nature of the business and its stage of development – Investment and planning periods
Assessing the prospects of the company	• A focus on those risks that would threaten the business model, future performance, solvency or liquidity including those from severe but plausible scenarios • Should include sufficient qualitative and quantitative analysis – stress, reverse stress and sensitivity analysis techniques will assist • Will need to consider overall resilience to stress and adaptability

The longer-term viability statement

Key considerations when making this statement

Ability to continue in operation and meet liabilities as they fall due	• Directors need to think broadly as to relevant matters which may threaten the company's future performance • Need to consider the availability and likely effectiveness of actions that they would consider undertaking to avoid or reduce the impact or occurrence of a risk
Qualifications or assumptions	• When explaining these in the annual report, they will need to be specific to the company's circumstances • They will also need to be relevant to an understanding of the directors' rationale for making the statement • Should not include matters that are highly unlikely either to arise or to have a significant impact on the company

Key mobilisation steps

- Agree a **framework for risk appetite**.
- Revisit and **reassess those risks deemed to be principal risks**. Consider the likelihood of those principal risks and the **quantification of likely impact, both individually and in aggregate**.
- Review the organisation's risk and control governance structure in light of the new guidance to produce a **gap analysis**.
- Ensure **"ongoing monitoring" is built in** to the board/committee process and agendas from the start of the year.
- Agree **definitions for identifying material controls** and review the monitoring and reporting systems which **identify significant failings or weaknesses** in risk management and internal control systems. Also, consider whether there is a need to **revisit internal audit/risk scope and reporting** methodology.
- Agree a **clear accountability structure** and **timetabled action plan**.

Auditor reporting

Auditor reporting

Observations from emerging practice

Materiality is a new metric to consider and to understand

Analysts have said they prefer the longer reports which include findings, e.g. Rolls Royce

Analysts criticised one firm for including management override of controls and fraud in revenue recognition every time

Some firms include a positive statement on going concern to provide clarity of opinion

Both the IASB and PCAOB are looking to move towards the UK model

The general view is that the new reports are an improvement

Auditor reporting

Inclusion of findings – latest position

We welcome discussions with audit committees to discuss their appetite for inclusion of findings

Is not necessarily appropriate for all companies

EU audit reform legislation will require (from June 2016) the inclusion of "where relevant, key observations arising with respect to those risks"

Auditor reporting
Inclusion of findings – illustration

Accounting for risk and revenue sharing arrangements

Refer to page 81 (Key areas of judgement – Risk and revenue sharing arrangements), page 84 (Significant accounting policies – Risk and revenue sharing arrangements), page 11 (Chief Financial Officer's review) and page 44 (Audit committee report – Financial reporting)

- The risk The Group receives non-refundable cash payments under risk and revenue sharing arrangements (which are referred to as entry fees). The assessment of when these entry fees should be recognised in the income statement involves analysis of their commercial substance in the context of the agreement as a whole. As there is no single accounting standard that directly addresses these types of agreements, management has to apply very significant judgement in deciding how to apply the various provisions of accounting standards that are relevant to different aspects of the agreements. These arrangements are complex and have features that could be indicative of: a collaboration agreement, including sharing of risk and cost in a development programme; a long-term supply agreement; sharing of intellectual property; or a combination of these.

- Our response We independently analysed the agreements under which significant entry fees have been received to establish the range of possible accounting treatments that could be adopted and to assess which of these would in our view most appropriately reflect the requirements of accounting standards. The most significant accounting standards considered were IAS 8 *Accounting policies, changes in accounting estimates and errors*, IAS 18 *Revenue*, IFRS 11 *Joint arrangements* in terms of the timing of recognition of the entry fees and IAS 1 *Presentation of financial statements* in respect of their presentation as an offset against the expenditure to which they relate. We also had regard to the definitions of assets, liabilities, income and expenses in the IFRS *Framework* and, to the extent they did not conflict with Adopted IFRS, to pronouncements of other standard-setting bodies that more explicitly address accounting for payments from suppliers and collaborative arrangements. We examined correspondence between the Group and the Financial Reporting Council and attended meetings between them. We sought to identify the accounting applied in similar circumstances by other companies including the Group's direct competitors and compare these to the approach adopted by the Group and the requirements of Adopted IFRS. We assessed whether the change to the accounting policy made in the year was appropriate and recalculated the resulting amounts in the financial statements. We considered the appropriateness of the related disclosures.

- Our findings Our analysis indicated that in substance, from the point of view of both the Group and the risk and revenue sharing workshare partners, the entry fees represent the reimbursement of expenditure incurred by the Group as part of an engine development programme and that this represented a significant transfer of development risk from the Group to the partners that should be reflected in the income statement at the time the reimbursed expenditure is recognised. On that basis, we found that the revised accounting policy most appropriately reflects the commercial substance of the entry fees. So far as it was possible to tell, we found that the accounting applied by the Group was similar to the approach taken by others. We found that the change to the accounting policy made by the Group was appropriate given the incidence of entry fees in the year and the costs capitalised on the programmes to which these entry fees relate. We found that the disclosures in the financial statements properly describe the accounting treatment adopted by the Group and the directors' basis for applying that treatment.

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Panel discussion

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Contacts and resources

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- **Sarah Waddington** – 020 7007 9157 sawaddington@deloitte.co.uk
- **Peter Westaway** – 020 7007 9024 pwestaway@deloitte.co.uk

- **James Bates** – 020 7303 0094 jbates@deloitte.co.uk

Resources:

- Deloitte Finance Club home page: www.deloitte.co.uk/financeclub
- UK Accounting Plus (formerly IAS Plus): www.ukaccountingplus.co.uk
- Annual report insights 2014: www.deloitte.co.uk/annualreportinsights
- Future of UK GAAP: www.deloitte.co.uk/futureofukgaap

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