



Financial Reporting Council

ANNUAL REVIEW OF CORPORATE REPORTING 2016/2017

OCTOBER 2017

CHARACTERISTICS OF GOOD CORPORATE REPORTING

9

Nine characteristics of good corporate reporting

A Good Annual Report and Accounts:

Beyond basic compliance with the fundamental requirements of the law and accounting standards and the need for complete and accurate publication of accounting information, there are characteristics of corporate reporting which we believe make for 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 performance and position, 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 boiler-plate text 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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1 EXECUTIVE SUMMARY

The FRC's mission is promoting transparency and integrity in business. We do this in part by promoting high quality corporate governance and reporting. Good governance and transparent reporting are fundamental to building trust and the long-term success of UK companies and the wider economy.

This report provides our assessment of corporate reporting in the UK based on broad outreach and evidence. Our assessment was informed primarily by the FRC's own monitoring work on cases opened in the year to 31 March 2017 and from more recently performed thematic reviews.

The standard of corporate reporting in accordance with the Companies Act 2006 ("the Act") and applicable standards, particularly by the largest listed companies, remains generally good. Even so, the quality of reporting is not always as high as it could be. We have seen some improvements in strategic reports, for example in respect of APMs, but our findings in respect of the financial statements are broadly consistent with last year. There is room for further improvement in the clarity and completeness of explanations companies provide. Clarity of reporting builds confidence in the way in which companies are run.

Companies should pay particular attention to the following four areas:

- properly explaining and quantifying key judgements and estimates;
- providing a fair and balanced assessment of performance and prospects that covers both positive and negative aspects;
- ensuring the links between the financial statements and discussions of strategy, performance including Key Performance Indicators ("KPIs"), financial position and cash flows, including the use of APMs, are clear; and
- providing information that is company-specific and material to an understanding of the business, its performance and prospects.

The FRC's Monitoring Programme

We reviewed 203 annual and interim reports and accounts as part of our 2016/17 monitoring activities including three thematic reviews. 56% of those reviews were closed without the need for follow-up action. The rest resulted in letters to the relevant company raising substantive queries that required a response. The topics on which questions were most frequently raised of companies are detailed in section three.

The standard of corporate reporting in accordance with the Companies Act 2006 ("the Act") and applicable standards, particularly by the largest listed companies, remains generally good. Even so, the quality of reporting is not always as high as it could be.

Financial Statements

The most significant findings on financial statements in 2016/17 include:

- **Judgements and Estimates**

Investors rely on disclosures of the key judgements and estimates management make when preparing their accounts. This helps them to understand the extent to which assets and liabilities may change in the next twelve months. The disclosures also give them a sense of the quality and impact of management's accounting policy decisions. In recent years, our routine monitoring had identified many examples of generic disclosures that did not describe the specific judgements a board had made or that failed to explain the extent to which changes in estimates could have a material effect on the following year's accounts.

This year, we pre-informed 20 companies that we would review the disclosures of significant accounting judgements and estimates in their next annual report and accounts. Most of the companies improved their disclosure, for example by providing more granular information about a smaller set of judgements and estimates that had a significant impact on results. However, boiler-plate text still lingered, doing little to explain why certain assets were subject to significant risk of material change.

- **Accounting Policy Disclosures**

Following a period of relative stability in the accounting framework, three new international accounting standards are soon to be implemented, with potential for significant impact on financial results. We conducted a focused review in relation to IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers* to assess the disclosures made by companies of the likely impact of these new accounting standards on their financial statements. There were significant variations in the information



provided. We encourage companies to provide informative disclosures by reference to their existing accounting policies, as tailored to their specific circumstances and transactions, and to disclose any key judgements that management would need to make in complying with the new standards.

- **Pensions**

In view of last year's concerns about the need for increased transparency in pensions reporting, we conducted a thematic review, pre-informing 20 companies that we would review their disclosures. Many stepped up to the challenge and improved their reporting, for example by providing additional information about their pension schemes and their plans to reduce any deficits, which was often supported by extended commentary in their strategic reports.

- **Business Combinations**

Business combinations can pose unusual and complex accounting questions for companies. The impact of contingent and deferred consideration arrangements, in particular, can be difficult as they rely on a high level of estimation and multiple assumptions. Some reviews left us unclear why few or no intangible assets, other than goodwill, were recognised in accounting for an acquisition. Companies can expect to be challenged on their judgements and decisions in this area.

Boiler-plate text still lingered, doing little to explain why certain assets were subject to significant risk of material change.

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Strategic Reports

There are few items of required content for the strategic report. They provide an opportunity for boards to present a single, coherent narrative which explains a company's performance. The strategic report continues to be one of the areas which is most frequently the subject of challenge in the course of our reviews. Companies can expect to be questioned and encouraged to improve where the report is lacking in balance.

Our reviews commonly identified reports where it appeared that not all key aspects of performance had been considered. Changes in performance measures were sometimes reported, for example changes in KPIs, but not the reasons for the changes or their impact. Most questions were prompted by a lack of clarity where disclosures were not sufficiently specific or descriptions were vague.

Our thematic review of the use of APMs found that most companies, all of whom had been pre-informed of the review, had enhanced the quality and consistency with which performance was reported.

Our monitoring of how companies are dealing with the effects of the EU referendum, found that the majority of companies reviewed reported on the continuing uncertainties. A consistent theme was that it was too early to measure the longer term effects of the decision and how business strategies would be impacted. However, many are beginning to identify in more detail, the specific nature of the likely risks.

External reviews of annual reports and accounts have found a slight improvement in the quality of narrative reporting particularly around risk reporting.¹ The introduction of viability statements in the 2014 UK Corporate Governance Code ("the Code") has brought a greater focus on risk management at board level which has contributed to this improvement.

The FRC's Financial Reporting Lab ("the Lab") is currently carrying out a project on risk and viability reporting to provide practical guidance for companies on ways to further improve reporting in this area. The Lab's report, which will be published later this year, is expected to conclude that, whilst investors recognise improvements in risk reporting, viability statements could be enhanced to show more clearly how companies have assessed their prospects and viability.

Much of the commentary around viability reporting has focused on the period over which the directors have chosen to make their statement. In the majority of cases this has been three years. The period selected is often chosen as it reflects a company's medium term business plan. However, the FRC's *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* suggests that other factors should be taken into account, for example investment and planning periods, the board's stewardship responsibilities, the nature of the business, its stage of development and previous statements made, especially in raising capital. Industries such as mining and property investment companies typically have longer term investment strategies and funding arrangements. Investors are calling for greater differentiation of the time periods used by different companies and sectors.

We encourage companies to consider developing their viability statements in two stages – firstly, to consider and report on the prospects of the company taking into account its current position and principal risks, and secondly to 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.

The Lab's project has identified some examples of good practice following

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We encourage companies to consider developing their viability statements in two stages

¹ PwC Accountability in changing times August 2017; EY Annual Reporting in 2016/17.

this approach which clearly explain the underlying analysis that supports the statement. However, further improvements are needed as much of the disclosure has become boiler-plate and lacks proper explanation of how the company has carried out its analysis.

We are considering whether assessments of the quality of disclosures made for the purposes of complying with the Code could be incorporated into our monitoring processes. This would allow us to make enquiries of companies where there are concerns about the quality of their reporting; or where there are apparent inconsistencies in their governance reporting. This extension of monitoring activity would support the stewardship activities of investors.

We are also encouraged to see further developments in how companies are reporting their dividend policies and

level of distributable reserves. A recent implementation study carried out by the Lab noted a significant increase in the number of companies that are reporting on distributable reserves. 48% of the FTSE 100 are now reporting information on the level of distributable reserves or that distributable reserves are sufficient or significant. Progress in the FTSE 250 has been less significant with 30% of companies making some disclosure on distributable profits.

This area continues to attract investor focus and we urge companies to adopt the recommendations in the Lab's implementation study which was published in October 2017 **and can be found here**. In particular, we encourage further adoption of reporting on the capacity to pay dividends, including how distributions might flow to the top company from its subsidiaries and the extent of any restrictions.

We are also encouraged to see further developments in how companies are reporting their dividend policies and level of distributable reserves.



Other Developments

The FRC is aware of concerns regarding a lack of trust in big business and that companies need to take account of wider stakeholder interests and has responded by:

- updating its mission to take account of the evolving demands on the framework for corporate governance and reporting;
- issuing a consultation on an update to the Guidance on the Strategic Report; and
- undertaking a fundamental review of the Code, on which it will consult later in 2017.

At the same time, the corporate reporting environment is shifting and expectations of corporate reporting are rising. Two areas in particular have moved into the spotlight over the past year.

Firstly, the importance for the long-term success of the company of engagement with employees, customers, suppliers and other stakeholders. We believe that companies can be more transparent about these relationships, for example by explaining their strategy for engaging with their various stakeholders and for distributing the value they create amongst different groups of those stakeholders, such as in the form of dividends, pay and benefits, capital investment and tax.

Some companies are already featuring this in their reporting, not least as a result of companies reporting in a more integrated way, both through narrative reporting and through quantitative disclosures either in their strategic or remuneration reports. More companies are giving a flavour of their purpose and engagement with stakeholders while a handful refer explicitly to how they perform their duty under section 172² of the Act.

Figure 1

UK Companies Act 2006, Section 172

- 1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:
 - a) the likely consequences of any decision in the long term,
 - b) the interests of the company's employees,
 - c) the need to foster the company's business relationships with suppliers, customers and others,
 - d) the impact of the company's operations on the community and the environment,
 - e) the desirability of the company maintaining a reputation for high standards of business conduct, and
 - f) the need to act fairly as between members of the company.

Secondly, the need to communicate how a company generates and preserves value. Stakeholders want to understand how companies manage, sustain and develop those assets and other sources of value whether or not they are recognised under traditional accounting requirements. This is crucial for investment decisions. We believe that companies need to be transparent as to what they consider to be the key sources of value, how they are managed and how value is likely to be generated in the future.

The annual report and accounts continues to increase in size, mainly as a result of regulatory requirements imposed by government or regulators, including the FRC, namely remuneration reports, the inclusion of lists of subsidiaries and the extended auditor report. This presents a challenge for companies who must review carefully each year whether information in annual reports is material to shareholders and is presented clearly and concisely. Regulators, including the FRC, should ensure that the benefits of new requirements justify any downside such as additional length.

We believe that companies need to be transparent as to what they consider to be the key sources of value, how they are managed and how value is likely to be generated in the future.

² Refer to Figure 1

UK GAAP

In relation to UK GAAP, we are focused on (i) gathering evidence of implementation issues to provide a foundation for our first review of FRS 102; and (ii) revising FRS 102 for major changes to IFRS and to remove unnecessary complexity.

Evidence gathered by the ICAEW's Quality Assurance Directive (QAD) during its reviews of some of the first audits performed on FRS 102 financial statements shows that the transition to FRS 102 has created challenges for companies and their auditors, especially where their financial reporting resources were limited. These challenges are set out in more detail in section four.

IFRS

A number of new accounting standards will come into effect in 2018 and 2019 which will pose significant challenges to companies and could impact the quality of reporting in the short-term. Companies have started implementing IFRS 9 and IFRS 15. The FRC expects endorsement of IFRS 16 to be complete by the end of 2017. And, subject to endorsement, IFRS 17 *Insurance Contracts* will replace IFRS 4 from 1 January 2021.

Implications of Brexit for the UK's Accounting Framework

We are providing input to BEIS on the form and content of the post-Brexit accounting framework for the UK. The FRC's current view is that the UK accounting framework should continue to be based on IFRS, should have a UK process for endorsing new and amended IFRS issued by the IASB with the FRC as the endorsement body, and that any departure from standards issued by the IASB should only occur under strict and agreed criteria.

Guidance on the Strategic Report

Our recently published consultation on revised *Guidance on the Strategic Report* implements the requirements of the EU Non-financial Reporting Directive ("the NFR Directive"), and aims to strengthen both (i) the link between section 172 and the purpose of the strategic report; and (ii) the focus on non-financial information and long-term value. The revisions encourage better reporting through the use of qualitative and quantitative disclosures, in particular:

- how directors have considered the wider impact of their activities and discharged their section 172 responsibilities;
- how they generate value in the long-term; and
- how they develop and maintain intangible assets not recognised in the balance sheet under current reporting requirements.

The Government has indicated that it will amend secondary legislation to require all companies of significant size to explain how their directors comply with the requirements of section 172 as well as pay ratio reporting. The draft legislation will likely result in further changes to the strategic report requirements in due course. The Government also proposes strengthening reporting requirements on stakeholder engagement perhaps through more detailed guidance on the strategic report.

In the meantime, the changes we are currently proposing are aimed at encouraging companies to include content that goes beyond the law where information is material to the long-term success of the company. We will also consider how changes to the Code might support more meaningful reporting by companies on how they engage with different stakeholders.

We summarise key areas of focus for annual reports annually in a letter issued to companies in October. Our latest year-end advice letter to audit committee chairs issued in October 2017 can be found at Appendix A.

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2 INTRODUCTION

In 2017 the FRC updated its mission, which is *'to promote transparency and integrity in business'*. Promoting high quality corporate governance and reporting and encouraging trustworthy information and behaviour are central to achieving these aims.

The FRC undertakes a range of activities to underpin a robust framework for corporate reporting in the UK and to promote improvements in the quality of reporting which, in turn, increases investor confidence. In particular it:

- monitors companies' compliance with the Act and applicable accounting standards;
- influences the development of IFRS;
- sets UK accounting standards; and
- supports clear and concise reporting throughout its activities but particularly through our work on the strategic report and the activities of the Lab to bring together investors and companies and develop good practice.

Objectives of the Report

This report provides our assessment of corporate reporting in the UK based on our monitoring work on cases opened in the year to 31 March 2017 and thematic reviews conducted more recently. The broad range of outreach and evidence gathering undertaken by the FRC provides detailed insights into the practical application of the corporate reporting framework which help inform our monitoring, standard-setting and other activities.

As the report aims to help companies to improve the quality of their reporting, the key audiences for the report are preparers and auditors. We hope also that it will be of interest to investors.

Structure of the Report

The report is structured around our overall assessment of corporate reporting and in particular the two key elements of the report and accounts, the financial statements and the strategic report, which fall within the scope of our reviews. The appendices provide more information on our monitoring activities and procedures.

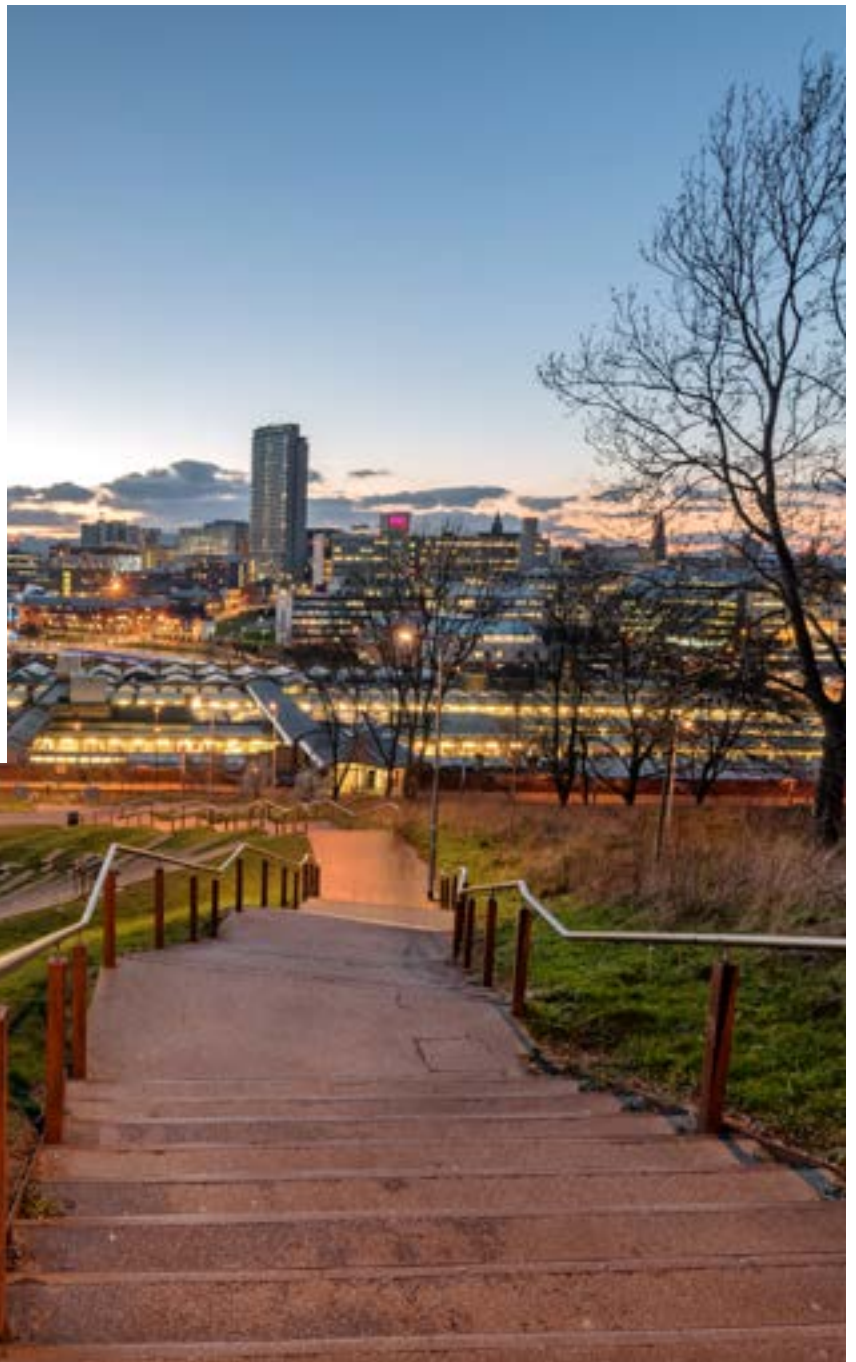
Section three sets out our assessment of how companies who report under IFRS are performing in practice and explains our findings in respect of the financial statements and the strategic report.

Section four provides information on the development of reporting by those companies using UK GAAP. Section five provides an overview of recent enforcement activity against company directors. And section six of the report sets out our views on current and future developments.

3 ANNUAL ASSESSMENT OF CORPORATE REPORTING

The FRC drives improvements in the quality of reporting under the existing corporate reporting framework through:

- highlighting good practice, while also identifying areas which require correction or improvement;
- engaging with companies to support compliance and encourage improvement;
- undertaking thematic reviews into areas of emerging risk;
- providing guidance to support companies with their reporting;
- encouraging greater transparency, such as through company reporting of interactions with our Corporate Reporting Review team (“CRR”); and
- bringing together companies and investors through the work of the Lab.



The FRC is aware of concerns regarding trust in big business and that companies need to take account of wider stakeholder interests. It has responded to these developments by:

- updating its mission to take account of the evolving demands on the framework for corporate governance and reporting;
- issuing a consultation on an update to the *Guidance on the Strategic Report*; and
- undertaking a fundamental review of the Code, on which it will consult later in 2017.

This report sets out our assessment of corporate reporting in the UK based on a broad spectrum of outreach and evidence. Key to that assessment are the results of our monitoring work undertaken on reviews opened in the year to 31 March 2017 and from recently performed thematic reviews. The FRC does not have powers to support effective monitoring of remuneration reports and does not conduct its own reviews in this area. Nor does it review corporate governance statements although we are considering how we can introduce monitoring in this area. Evidence gathered and analysed by others is, however, a useful source of information about reporting trends and quality in these areas.

Significant changes to corporate reporting requirements introduced in recent years, such as the requirement for companies to prepare a strategic report, have had a significant impact on the overall quality of corporate reporting in the UK. We believe that, in some areas, information that falls outside what is required by law or regulation, would be useful for investors and other stakeholders. The changes we are currently proposing are aimed at encouraging companies to include content that goes beyond the law where information is material to an understanding of the long-term success of the company.

Assessment of Overall Quality

The standard of corporate reporting in accordance with the Act and applicable accounting standards, particularly by the largest listed companies, remains generally good. Of 203 reviews undertaken, none has so far resulted in sufficiently serious issues to merit a specific Press Notice³ and only three companies were required to publish details of our intervention.

As in previous years, some of the most common areas of challenge as a result of our monitoring were in relation to judgements and estimates, accounting policies, business combinations and strategic reports. Companies can expect to continue to be challenged on their strategic reports and encouraged to improve where a compliance focused approach leads to a report that lacks balance.

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The FRC's clear and concise philosophy, which runs through all our activities, aims to encourage good communication in corporate reporting by:

- ensuring that information in the annual report is relevant to investors;
- encouraging greater emphasis on the application of materiality; and
- considering other digital channels for reporting information.

The FRC does not expect companies to include information that is immaterial or irrelevant. Some characteristics of good quality reporting that directors can consider when preparing reports and accounts are on the inside cover of this report.

³ One Press Notice was issued in respect of Sports Direct International, a case started in 2015/16.

The FRC's Monitoring Programme

The FRC's monitoring work focuses on those aspects of corporate reporting where we have delegated powers to monitor compliance with the law, principally the financial statements and strategic and directors' reports. Key areas not covered by our monitoring work include the corporate governance statement and the remuneration report.

Monitoring activities include reviews of annual and interim reports together with thematic reviews of particular topics. Monitoring seeks to identify areas of non-compliance and to drive improvements in the quality of corporate reporting more generally.

On 1 April 2017, we revised our Operating Procedures. This followed a review of the effectiveness of the procedures in 2015 and reflected comments obtained in a public consultation. These revisions also provided an opportunity to improve the clarity and readability of the Operating Procedures.

The main changes were around the process to be followed for higher profile and more complex cases and increased transparency around outcomes. Details of the changes are outlined in Appendix B.

During the year, as part of a European wide inspection programme, the FRC was subject to a review of its compliance with certain aspects of ESMA's guidelines on enforcement of financial information. A summary of ESMA's findings is included in Appendix C.

Thematic Reviews

Following the thematic review of tax disclosures reported on last year, we have conducted three further thematic reviews, namely: (i) the disclosure of significant accounting judgements and estimation uncertainty; (ii) pension disclosures; and (iii) the use of Alternative Performance Measures ("APMs"). Our summary findings are outlined below. The detailed findings will be published in separate reports in the fourth quarter of 2017. This report includes the findings from our focused reviews of companies' disclosures of the uncertainties relating to Brexit and the low interest rate environment and on certain new accounting standards.

Thematic reviews typically involve pre-informing a selection of companies that we will review a certain aspect of their next report and accounts. A large majority of the companies we approached in this way took the opportunity of improving the quality of the relevant disclosures in the knowledge that they would be reviewed. Our commitment to publishing extracts from the sample to illustrate 'what good can look like' provides other preparers with a benchmark against which they can assess their own disclosures. Pre-informing has proved to be an effective mechanism for changing behaviour and is likely to remain an important part of our monitoring programme.

The selection of topics for thematic reviews builds on our findings from previous years. Account is also taken of concerns expressed by investors and others. Thematic reviews facilitate further improvements through the publication of more detailed comments and recommendations on areas of particular focus.

A large majority of the companies we approached in this way took the opportunity of improving the quality of the relevant disclosures in the knowledge that they would be reviewed.

Review Outcomes

We reviewed 203 annual and interim reports and accounts as part of our 2016/17 monitoring activities. 56% of these reviews were closed without the need for follow-up action. The rest resulted in letters to the relevant company raising substantive queries that required a response. The topics on which questions were most frequently raised with companies are detailed on page 13.

We aim to resolve our enquiries informally by agreeing voluntary improvements to companies' reports and accounts. As in previous years, almost all queries were resolved through correspondence and informal meetings, with no new Review Groups⁴ being set up this year, reflecting the generally constructive approach of companies in responding to our enquiries.

On rare occasions, however, it is necessary to invoke our statutory power to receive information and explanations in order to progress an enquiry. No letter was required this year; in 2015/16 one such letter was sent (2014/15: two). In exceptional cases, where an unusually high number of corrections to the audited accounts is identified, or where their effect is significant, we write to the senior partner or chairman of the relevant audit firm. No such letters have been issued in the last three years.

More detail about our monitoring activities during 2016/17 can be found in Appendix C.

Public Reporting

The resolution of our queries results in improvements to a company's future reporting in virtually all cases. Investors tell us that they are interested to know the extent of the FRC's dialogue with companies and the outcomes of our reviews.

The FRC's Guidance on Audit Committees (revised April 2016) expects companies complying with the Code to explain the nature and extent of interaction (if any) with the FRC. While we expect all companies to be transparent about their interactions with us, sometimes we ask companies to publicise the outcomes of reviews including those relating to companies not required to comply with the Code.

We have read the relevant sections of the Audit Committee reports of a sample of those companies whose accounts we have reviewed recently and who issued their reports after the change to the Audit Committee guidance. Most companies have referred to correspondence with the FRC. Better disclosures explained the nature of the issues discussed and the outcomes. However, we also identified some examples of boiler-plate, brief and vague disclosures. We will continue to monitor these disclosures in future years.

In a small number of cases, we believe that the nature of the outcomes requires additional publicity. In these cases, we issue press notices or ask companies to provide specific references to its interventions in their next published accounts. Press Notices and Committee References⁵ provide appropriate transparency of the more significant company specific findings and action required.

⁴ Initially, the FRC raises questions with a company where there is, or may be, a question as to whether the accounts comply with relevant accounting and reporting requirements. Most matters are resolved through correspondence. If, after considering additional information and explanations, the FRC believes that there is still a possibility of a significant breach of accounting or disclosure requirements, then it will open a Review Group of FRRP members to consider the matters.

⁵ **Press Notices** are usually only issued where a significant change to published accounts is being made and may include an agreed significant change to future accounts. When the FRC considers, for example, that the change is sufficiently material to the annual report and accounts taken as a whole, or is a material error, which investors, other preparers and their advisors or the public ought to be aware of, a press notice would generally be issued. In some cases, we may ask a company to refer to its discussions with the FRC in the report and accounts in which it makes a change to a significant aspect of its reporting following our intervention. This is known as a **Reference**. The FRC asks for a Reference where it considers that investors and other preparers ought to be aware of the correction or changes in disclosures provided by a company but it is not necessary to inform the market at large.

Press Notices

We will generally only issue a press notice where there is a significant material change such as, for example, to a primary statement, or the content of the strategic report. One press notice was issued this year in relation to Sports Direct International plc (“Sports Direct”), a review that started in 2015/16 (2015/16: none; 2014/15: three).

The main issue raised with Sports Direct concerned whether the strategic report was balanced and comprehensive. Although Sports Direct’s international stores represented a significant proportion of the total number of stores, no commentary was provided on their performance.

Following our intervention, Sports Direct, in its subsequent reporting, has included additional commentary on the development and performance of its international stores in the strategic report and restated its segmental disclosures. The changes to the strategic report were considered to be significant and an FRC press notice was issued to inform the market.

References

In instances where the outcome is less significant, but a degree of publicity is still appropriate, we ask companies to refer to our intervention in their next published accounts. This year three companies (2015/16: two; 2014/15: six) were required to refer to the corrective action taken.

The three references the FRC required of companies this year were:

- **Learning Technologies Group plc** restated the comparative amounts in its 2016 accounts to:
 - include as remuneration expense contingent consideration for an acquisition that was dependent on future employment; and
 - recognise in equity the tax deduction on share options in excess of remuneration expense in the income statement.
- **Ingenta plc** restated its parent company accounts to recognise an impairment loss on intercompany loan receivables.
- **Eden Research plc** made a restatement to equity account for an investment in an associate, and to include additional explanation on a sale transaction and the costs of a loan settlement.

One press notice was issued this year in relation to Sports Direct International plc.



Key Findings

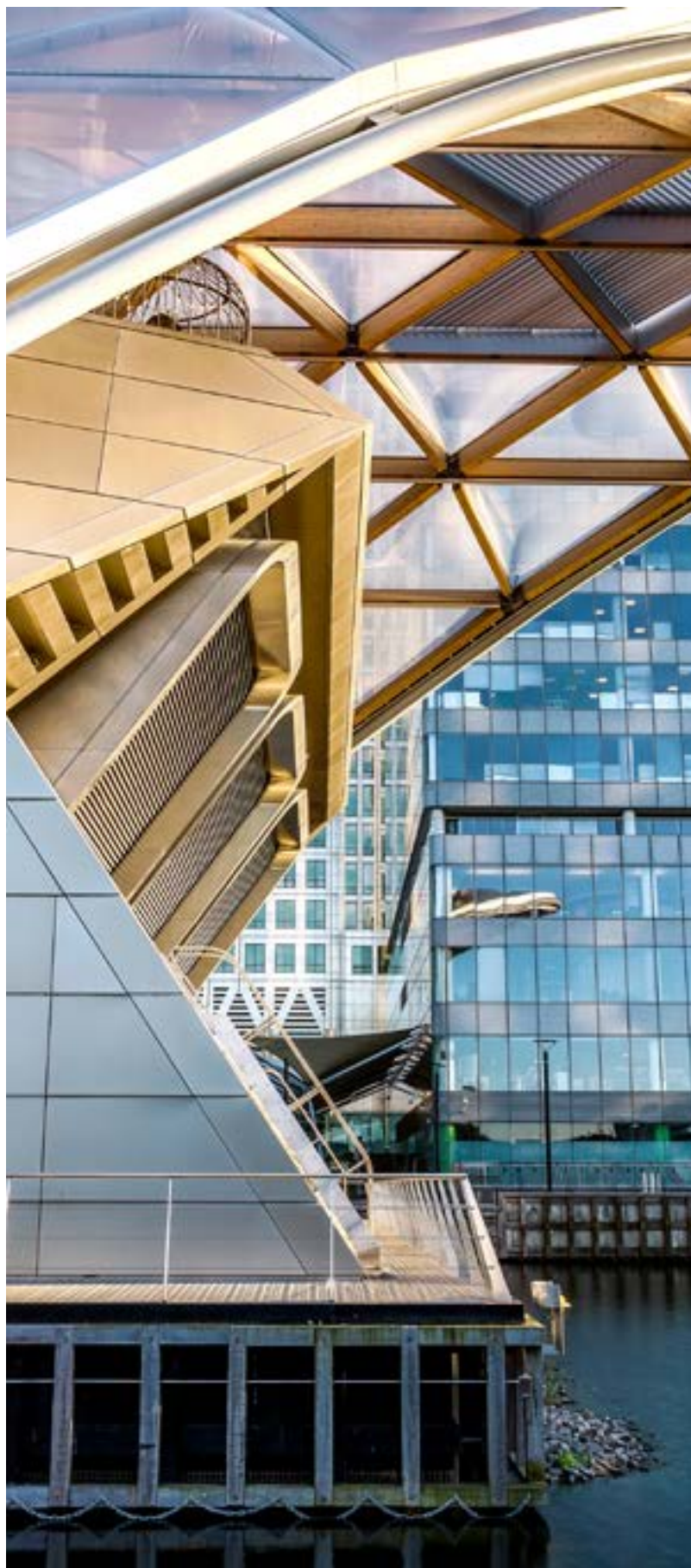
The more significant findings from this year's monitoring activity relating to (i) the financial statements and (ii) the strategic report are detailed in separate sections below.

Table A ranks the topics where substantive queries were most frequently raised with companies following reviews. While the table provides a useful insight on the topics where questions have commonly been raised, individual rankings year-on-year are not necessarily indicative of any trend or concern.

The findings from our routine reviews also reflect the focus on the topics covered by the thematic reviews on significant accounting judgments and sources of estimation uncertainty and pension disclosures.

Table A: Most commonly raised issues

Topic	Ranking	
	2016/17	2015/16
Judgements & Estimates	1	1
Strategic Report	2	3
Accounting Policies	3	6
Business Combinations	4	-
Alternative Performance Measures (APMs)	5	-
Revenue	6	2
Impairment of Assets	7	4
Financial Instruments: Disclosures	8	8
Fair Value Measurement	9	9
Statement of Cash Flows	10	-



Financial Statements

This section sets out how we expect companies to address the most commonly raised challenges on financial statements arising from routine reviews, plus the findings from our thematic reviews on aspects of the financial statements, namely:

- significant accounting judgements and sources of estimation uncertainty;
- pension disclosures; and
- APMs disclosed in financial statements.

A summary of our more detailed observations, 'Technical Findings 2016/17', is available on the FRC website **and can be found here**.

Judgements and Estimates

Investors tell us that they value disclosures of judgements and estimates that enable them to evaluate a company's financial position and results and their sensitivities to changes in assumptions.

In December 2016, we wrote to 20 listed companies informing them that we would be reviewing the disclosures of significant accounting judgements and sources of estimation uncertainty in their next annual report and accounts.

The objective of the review is to encourage better quality reporting that enables readers to assess the quality of management's accounting policy decisions.

We were encouraged to see that most of the companies in our sample responded to advance notification of our review by making some improvements to their disclosures. These improvements were not as wide-ranging as we had hoped but there were signs that, in general, companies were focusing on the right areas. The following paragraphs are a summary of our detailed findings, which will be reported in full in a separate report to be issued in the fourth quarter of 2017.

Many companies in our sample had reconsidered which judgements, assumptions and other areas of estimation uncertainty are genuinely the most difficult, subjective or complex to report.

A far greater proportion of the companies clearly distinguished judgements from estimates than in their prior year accounts.

The better quality reports identified a smaller number of judgements and estimates but provided much richer information about the supporting assumptions and sensitivities. Users of these reports would have a clearer picture of which decisions taken by the board had a significant impact on the company's performance. It was particularly helpful when companies explained the reasons for changes in the list of judgements and estimates considered to be key from those disclosed in the previous year.

The average number of estimates disclosed by the companies reviewed decreased when compared with their previous annual report. However, we still identified a significant number of estimate disclosures that did not appear to have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next year. Information about longer term uncertainties may be useful for users of financial statements. However, these additional disclosures should be clearly identified and explained.

Most companies in the sample improved the granularity and level of detail of their disclosures. However, it was disappointing that a significant minority still used elements of boiler-plate text, which could apply to any company and gave no additional useful information to users of the accounts. In many such cases, the audit committee report or auditors' report provided more granular information regarding the significant judgements made. We would like to see similar depth in the notes to the financial statements.

Most companies reviewed had improved the granularity and level of detail of their disclosures.

We still identified a number of cases where the audit committee or auditor's report provided much richer information about the judgements made.

Of the 20 reports included in our sample, we wrote follow-up letters to five companies where there was a substantive question relating to their disclosure of significant accounting judgements and sources of estimation uncertainty. Correspondence with these companies is ongoing.

Accounting Policy Disclosures

Users rely upon accounting policies to interpret information in the rest of the report and accounts and assess the comparability of companies with their peers. We queried policy disclosures that did not appear to be complete or sufficiently tailored to the company's circumstances. Examples included:

- allocation of site-wide infrastructure costs to property sales in a housebuilder;
- uncertain tax provisions;
- licence fees for investment properties under construction; and
- contingent consideration on business combinations.



Consistent with the FRC's clear and concise philosophy, we highlight to companies accounting policy disclosures that appear to be out of date, irrelevant, immaterial or to be based on boiler-plate text taken from the standard. This tends to be more common in the accounts of smaller listed companies. Common examples that we identified included references to the old consolidation rules and a long list of new accounting standards and interpretations that will not have any effect in the company's circumstances.

Impact of New Accounting Standards

A focused review was performed on a sample of companies with December 2016 and March 2017 year-ends to evaluate their disclosures on the expected impact of issued accounting standards that are not yet effective. The selected companies' annual reports were also compared to their most recent interim accounts, where available, to evidence any improvements in these disclosures.

The principal findings of the review are as follows:

- only 2 companies out of our sample of 24 disclosed quantified estimates of the expected impact of either the new financial instruments standard (IFRS 9) or the new revenue standard (IFRS 15);
- there were variations in the level of detail included in the qualitative disclosures. For example, most of the banks stated that the most significant impact of IFRS 9 would be the new expected credit loss model. In some cases, however, it was not highlighted that impairment charges would be recognised earlier and be more volatile than under the existing standard;
- companies did not always indicate the extent to which the adoption of IFRS 15 is expected to impact their primary statements; and
- a significant number of companies did not provide qualitative disclosures tailored to their specific circumstances and transactions. For example,

companies did not always disclose the impact by reference to their own particular accounting policies, or explain any key judgements that management would need to now make, and disclose, in complying with the new standards.

IFRS 9 and IFRS 15 become mandatory for annual periods beginning on or after 1 January 2018. We expect detailed quantitative disclosures regarding their effects to be included in the last accounts before the implementation date.

Business Combinations

Our reviews include consideration of the accounting for business combinations as, by their nature, such transactions can be complex and the accounting issues may differ from those that applied to a company's previous acquisitions. There may also be a finely balanced judgement as to whether a business or a group of assets has been acquired.

Some transactions include complex contingent and deferred consideration arrangements. We have questioned the accounting for these arrangements where the disclosures of the treatment adopted and its effect are unclear, as illustrated by the case study below. In particular, we have queried whether contingent consideration linked to future employment should have been charged to the post acquisition income statement rather than be included as part of the cost of the acquisition.

Contingent consideration based on companies' future performance is likely to require a high degree of estimation. However, we do not always identify the disclosures around assumptions and sensitivities that we would expect.

We continue to challenge companies where it is unclear why few or no intangible assets other than goodwill are recognised in accounting for an acquisition; for example, when disclosure elsewhere in the report and accounts suggests the company has acquired leases on favourable terms.

IFRS 9 and IFRS 15 become mandatory for annual periods beginning on or after 1 January 2018. We expect detailed quantitative disclosures regarding their effects to be included in the last accounts before the implementation date.

We continue to challenge companies where it is unclear why few or no intangible assets other than goodwill are recognised in accounting for an acquisition.

Case Study Business Combinations

Background	Company's initial view
<p>A company acquired a subsidiary during the year. The accounts explained that a component of the consideration is contingent on the future performance of the business. The fair value of this contingent consideration was included within the allocation of the purchase price to the assets and liabilities acquired, which had the effect of increasing the goodwill recognised.</p> <p>The accounts explained that the founder and major shareholder of the acquiree had been appointed as a director of the company. However, the company did not disclose its accounting policy for determining whether contingent payments due to former shareholders of an acquired subsidiary were consideration for the business acquired or were employee compensation.</p>	<p>The company explained that approximately half of the contingent consideration was payable to shareholders who were not employed by the company and was, in substance, consideration for the business.</p> <p>It acknowledged that the consideration paid to the founder was dependent on his continuing employment with the company. However, it argued that there was no automatic forfeiture if the founding shareholder left the company. It would only occur in certain 'bad leaver' circumstances and the company believed it was highly unlikely that he would leave the combined group as he already held shares in the company.</p>
FRC's view	
<p>IFRS 3⁶ contains specific criteria for assessing whether payments to employees or selling shareholders are consideration for a business or, for example, consideration for employment. However, it is clear that arrangements in which the contingent payments are automatically forfeited if employment terminates are remuneration for post-combination services.⁷ This was confirmed by an IFRS IC decision.⁸</p> <p>The FRC noted that, in this case, the 'bad leaver' provisions were standard employment provisions in which the</p>	<p>consideration would be forfeited if the founding shareholder left for alternative employment. The FRC concluded that this was evidence that the contingent payments to the founding shareholder were forfeit on termination of employment and that they should have been accounted for as an employee expense.</p> <p>The contingent payments to the other shareholders had been accounted for appropriately as consideration for the business.</p>
Company's amended view	FRC focus points
<p>The company accepted the FRC's view and agreed to apply IFRS 3 correctly to future transactions. It also agreed to amend its accounting policy to explain its treatment of contingent consideration paid to vendors when service conditions were attached. As half of the contingent consideration was payable to shareholders that had not been subsequently employed by the company, it was able to demonstrate that the effect of restating the prior year comparative information would be immaterial. Therefore, the FRC did not pursue the restatement.</p>	<p>Companies should pay particular attention to the accounting for complex, unusual or non-recurring contracts where they may be unfamiliar with the accounting requirements. Accounting judgements may be finely balanced and rest on the interpretation of particular terms of contracts, such as sale and purchase agreements. The FRC expects accounting policies to be disclosed for unusual or non-recurring transactions, where material, and any significant judgements made in their application to be disclosed.</p>

⁶ IFRS 3 Business Combinations paragraph 52(b) and paragraphs B54 to B55 of the Application Guidance.

⁷ Paragraph B55 (a) of the Application Guidance to IFRS 3 Business Combinations.

⁸ IFRIC Update January 2013.

Revenue

The continuing number of questions on this topic highlights the importance of companies considering the clarity and comprehensiveness of their existing disclosures as they assess the likely effect of IFRS 15.

We challenge companies where there is an apparent disconnect between the description of revenue streams in the narrative sections of the annual report and the accounting policies disclosed in the financial statements. Questions most frequently raised with companies concerned the lack of clarity of communication of the policy and any areas of complexity.

The accounting policies should clearly describe how revenue is recognised for each significant business stream. We expect to see an explanation of the company's assessment of when the risks and rewards are transferred to the customer and the judgements made.

Examples of the questions we raised with companies this year included:

- how revenue was allocated across multiple components of a contract;
- when the risks and rewards transfer to the customer on sales made through distributors;
- the application of the revenue policy relating to percentage of completion accounting used for service contracts; and
- the circumstances in which the company acts as a principal or agent.

Impairment of Non-financial Assets

Although we have seen a general improvement in the quality of disclosures, continued market uncertainty around Brexit and other macroeconomic issues highlight their relevance.

Disclosures around the key assumptions made by management give investors an insight into any underlying level of optimism. For example, companies are required⁹ to explain how the assumptions used to assess an asset's value-in-use were determined, including whether they reflect past performance or external sources of information.

We raised questions with companies where it was not clear what the key assumptions were or where wide-ranging assumptions covering multiple Cash Generating Units ("CGUs") were disclosed. Where material, we expect the assumptions specific to each CGU to be identified.

We also challenged companies who did not explain why the assumptions used, such as the discount rate, had changed significantly from the previous year. A number of companies were reminded that the discount rate used in the value-in-use projections is required to be a pre-tax rate that reflects the risks of the CGU concerned.

The standard requires¹⁰ additional sensitivity disclosures where a reasonably possible change in a key assumption would result in an impairment. If the combined impact of varying individual assumptions might result in an impairment, we consider that it may be helpful to users if this is also disclosed.

Financial Instruments Disclosures

We expect disclosures to provide sufficient explanation of the risks to which the company is exposed through its financial instruments. We raised questions where:

- the descriptions of the risk classes and disclosure of the loan impairment process were generic or unclear; or
- the maturity analysis for significant accrued income receivable was omitted.

The accounting policies should clearly describe how revenue is recognised for each significant business stream.

⁹ IAS 36, Impairment of Assets, paragraphs 134 (d)(i) and (e)(i).

¹⁰ IAS 36, Impairment of Assets, paragraphs 134(f) and 135(e).

Fair Value Measurement

Following the introduction of IFRS 13¹¹, companies are required to give more informative disclosures about how fair values are estimated and the effect on the financial statements. We expect the disclosures to clearly explain the valuation techniques used and, where relevant, the unobservable inputs.

We questioned companies where it was unclear whether the fair value of liabilities for deferred consideration payable on business combinations had been reassessed at the balance sheet date. We also challenged companies where the basis for the classification of investments within the fair value hierarchy set out in IFRS 13 was unclear or appeared inappropriate.

Cash Flow Statements

Investors consider reported operating cash flows to be an important indicator of a company's current, and potential future, performance. It is, therefore, important for cash flows to be accurately presented as 'operating', 'investing' or 'financing'.

This year we identified a number of companies where cash flows relating to operating income had been classified as 'investing' rather than 'operating' such as the purchase of assets rented out to customers and business acquisition expenses included in the income statement.

We reminded companies that transactions with shareholders, such as the purchase of shares by the group from non-controlling interests, are required to be classified as 'financing' rather than 'investing' cash flows.

We challenged the classification of movements in factoring balances as 'operating'. We would expect the movement in balances included as borrowings in the balance sheet to be classified as 'financing' in the cash flow statement. Where the arrangement is

non-recourse and receivables have been derecognised (rather than borrowings shown) we think it helpful to identify the cash inflows as having been received from the factor rather than from the customer. In addition, the existence of, and the reliance upon, these types of arrangements should be clearly disclosed.

Pensions

Our questions on pensions accounting and disclosures usually relate to defined benefit arrangements. As many companies do not have these arrangements, questions are raised relatively less frequently on this topic. Nevertheless the issues, when raised, are often significant.

The disclosures required by IAS 19 *Employee Benefits* are key to helping users understand the significant factors that could affect the future pension expense and cash flows of the company and the security of future payments to pensioners. Continued low interest rates and the economics of defined benefit pension arrangements have increased the need for companies to improve the transparency of their pension arrangements.

We challenge companies whose pension disclosures do not provide sufficient transparency of the nature and risks to which the schemes expose the company. More granular explanations of deficit funding arrangements, risk management strategies and scheme assets commonly result from our intervention.

Reflecting our continuing focus on this topic, we conducted a thematic review of pension disclosures with the aim of encouraging more transparent reporting of the relationship between a company and its pension schemes. The following paragraphs are a summary of our detailed findings, which will be reported in full in a separate report to be issued in the fourth quarter of 2017.

This year we identified a number of companies where cash flows relating to operating income had been classified as 'investing' rather than 'operating'.

The disclosures required by IAS 19 *Employee Benefits* are key to helping users understand the significant factors that could affect the future pension expense and cash flows.

¹¹ IFRS 13, Fair Value Measurement, applicable to annual periods beginning on or after 1 January 2013.

Most companies responded positively to our advance notification by improving certain aspects of their pension disclosures. The accounting periods under review coincided with the adoption of much lower discount rates applied to liabilities and higher inflation rates. Many of the companies reviewed reported sharply increased deficits. We welcomed the commentaries provided by most in their strategic reports focusing on how the deficit would be addressed.

Most companies disclosed information about contributions expected to be paid for several years into the future, distinguishing between those made to cover the deficit and those in respect of current service. This is helpful for investors because it provides an understanding of the future cash payments that a company expects to make to its pension scheme. However, companies could usefully explain that these are reviewed as part of each funding valuation.

In explaining the current and future cash contributions to be made to their schemes, a number of companies disclosed that, going forward, an increase in dividend payments to shareholders would trigger an increase in the pension scheme contributions. This appears to be an increasingly popular mechanism for securing the funding of pension schemes.

Some companies used graphics creatively to present complex information.

A small number of the companies sampled provided more informative disclosure about the assets held by their pension schemes by disaggregating the analysis of quoted and unquoted assets into further sub-classes.

There is scope for companies to better articulate their scheme's strategy for matching assets and liabilities, in particular how they use liability driven investments. Many companies in the survey had increased investment in such asset classes. Typically, the reasons for their use were well explained. However, whilst their purpose was clear, users were less well informed about the underlying nature of the investments and, too often, were left to infer the underlying valuation basis. We will continue to challenge companies who do not provide clear disclosures about the nature and valuation basis of all material asset classes.

Companies with material net pension assets explained why they considered the asset to be recoverable in terms of IAS 19 and IFRIC 14. Until the IASB's amendments IAS 19 and IFRIC 14 are finalised, we expect companies in this position to also set out, clearly and simply, the judgements they have made about trustee rights as required by paragraph 122 of IAS 1.

We saw evidence of improved pension disclosures in strategic reports. Good practice was identified by those companies who:

- provided more information about the risks and uncertainties they face arising from their pension scheme; and
- gave a simple explanation of the reasons for the marked increase in deficits and discussed the actions being taken to remedy them.

Of the 20 reports included in the sample, we wrote follow-up letters to two companies where there was a substantive question relating to their accounting for pensions and the related disclosures. Correspondence with these companies is ongoing.

Some companies used graphics creatively to present complex information.

Consolidation

The revised consolidation standard, IFRS 10, became effective in 2014. As companies have become familiar with the requirements of IFRS 10, we have raised fewer questions on this topic.

We have, however, continued to raise questions where investment fund managers own significant minority stakes in a fund they manage. In some cases, it was unclear whether the fund manager had control, or the extent to which complex judgements were required to make this assessment.

Strategic Reports

This section sets out our assessment in relation to strategic reports based on our:

- routine monitoring work;
- Lab initiatives;
- thematic reviews; and
- other FRC activities.

The requirement to prepare a strategic report is widely regarded as having contributed to a higher standard of

corporate reporting since its introduction in 2013. The strategic report is expected to give a clear articulation of the company's purpose, its strategy and business model, the principal risks to that model and how they are being mitigated, and to describe the key elements of performance. It offers companies a means of presenting a single, coherent narrative which explains and supports performance, both in its narrow and broadest sense.

In December 2016, the government published new regulations to implementing the NFR Directive. The regulations are effective for financial years beginning on or after 1 January 2017. The FRC is therefore currently consulting on an update to the *Guidance on the Strategic Report* primarily to reflect the legislative changes arising from the implementation of the NFR Directive. The changes proposed also aim to highlight the link between the purpose of the strategic report and the section 172 duty of directors to promote the success of the company and to strengthen disclosures to meet that purpose. More detail on this can be found in section six.



CRR findings on strategic reports

The strategic report continues to be one of the areas which is most frequently the subject of challenges. We continue to pursue better communication around performance, trends and the extent to which the report is sufficiently balanced and comprehensive.

Business Reviews

In considering whether a company's strategic report is fair, balanced and comprehensive¹², we commonly challenged companies where it appeared that not all aspects of performance had been covered. Examples queried this year included strategic reports with little or no discussion of:

- a major source of revenue;
- a significant product line;
- brands that accounted for around 50% of revenue;
- significant variations in the profitability of certain segments;
- the extent to which unusually high levels of capital expenditure were expected to continue in the future; and
- the financial position and cash flow, such as changes in working capital.

Key Performance Indicators ("KPIs")

Where necessary to an understanding of the company's performance, the Act requires the review of the business to include analysis using KPIs. We expect that, where used, KPIs should be clearly described and explained and will raise questions with companies where this is not the case.

This should include the basis for, and information used in, the calculation and any changes in how KPIs are reported. We also questioned companies where changes to KPIs had been made but the reasons for this were not explained.

Principal Risks and Uncertainties ("PRUs")

We challenged companies where:

- the description of the PRUs was unclear or insufficiently detailed;

- the judgements made by the directors in determining the reported PRUs were unclear or omitted, such as risks relating to climate change in an energy company;
- only one PRU was disclosed; and
- it was unclear from the disclosures which risks the company considered to be principal.

Although not a requirement, there were good examples of explanations of why risks were considered to be principal or not.

Environmental Issues

In complying with the Act's requirement for the strategic report to be fair, balanced and comprehensive, we expect reference to be made to the impact of climate change where relevant for an understanding of the company's activities.

We challenged a number of energy companies where little or no reference to the possible impacts of environmental issues had been made and it was, therefore, unclear whether the strategic report was sufficiently comprehensive.

Dividends and Distributable Reserves

Whilst not directly related to a company's annual report, we draw attention to potential breaches of the Act requirements for the payment of dividends. The Act requires Interim Accounts to be filed prior to the payment of a dividend from profits arising subsequent to the last annual accounts.

This year, following the FRC's observations, a number of companies discussed this issue with their professional advisors in order to determine how best to resolve matters.

We challenged a number of energy companies where little or no reference to the possible impacts of environmental issues had been made.

¹² Companies Act 2006, paragraph 414C (2) and (3).

INSIGHTS FROM THE LAB

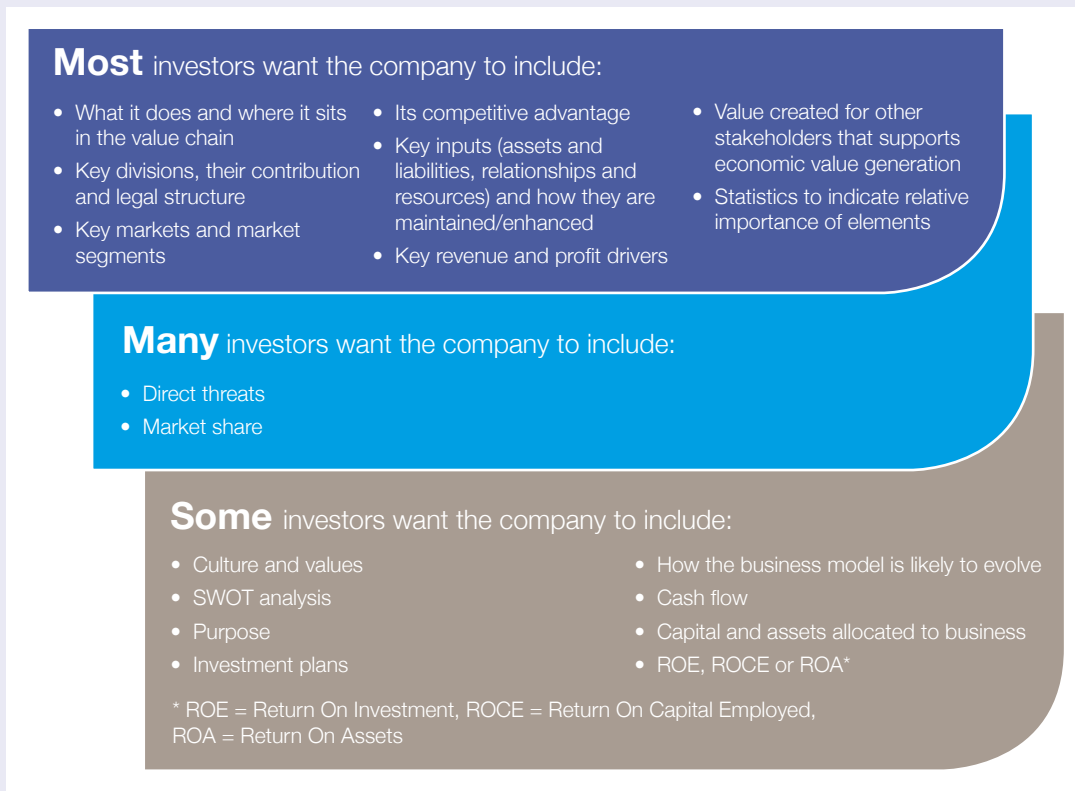
Business Model Reporting

The Lab is a key part of the FRC's strategy to encourage continuous improvement in corporate reporting. Through discussions with companies and the investment community the Lab seeks to provide an environment to develop pragmatic solutions to the latest corporate reporting challenges.

The Lab continues to focus its work on the strategic report, publishing its report on *business model reporting* in October 2016. This concluded that investors consider the business model information to be fundamental to their analysis and understanding of a company and its performance, position and prospects. However, they are looking for improvements in linkage and consistency between the business model and other information in the annual report, and also think that natural linkage can be achieved if the key drivers of the business are clearly articulated in the business model disclosure.

[Investors] are looking for improvements in linkage and consistency between the business model and other information in the annual report.

Figure 1: Hierarchy of Business Model Attributes

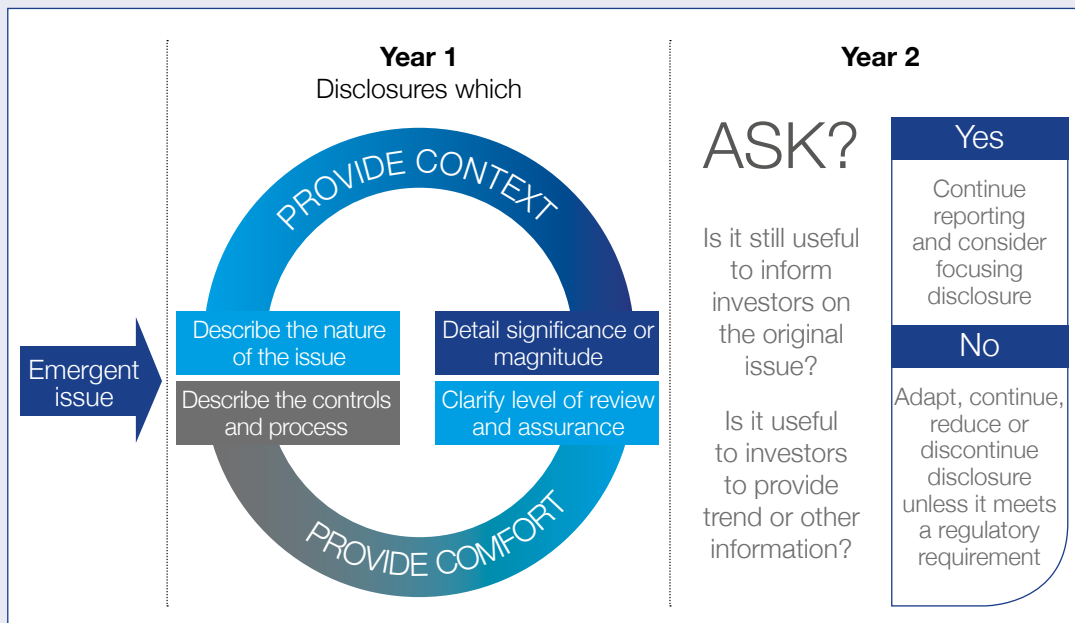


One aspect of good business model reporting is the ability to be able to identify and articulate the nature of key relationships and dependencies. During 2016, the Lab carried out a project with WM Morrison Supermarkets plc (“Morrison’s”) to seek ways to enhance the way it disclosed its relationships with suppliers. This was an area of particular focus to investors following accounting issues identified at Tesco plc in 2014 and the FRC’s subsequent press notice encouraging companies to consider disclosures around commercial income. The project looked at how Morrison’s responded to the increased focus in this area and the case study report issued in January 2017 set out the changes the company made in its reporting in the face of an emergent industry issue.

Investors were positive about the consistency of reporting across Morrison’s annual report on this issue. The nature of the issues were set out in the CFO’s report and the company’s accounting policies. Their significance and magnitude were set out in the financial review and notes to the accounts and the controls and processes were set out in the Audit Committee report. Investors considered Morrison’s approach to be a good way of responding to an industry issue with appropriate transparency of reporting.

Investors considered Morrison’s approach to be a good way of responding to an industry issue with appropriate transparency of reporting.

A Model for Reporting Emergent Issues



INSIGHTS FROM THE LAB

Dividend Disclosure

One area of continued interest to companies and investors has been the disclosure of dividend policy and practice. Since issuing its original report on dividend disclosure in November 2015, the Lab has carried out two implementation studies, the most recent of which was published in October 2017 **and can be found here**. The study considered the extent to which FTSE 350 companies had implemented the recommendations set out in the report.

It found that:

- 132 companies have now implemented some of the disclosure recommendations in the Lab's dividend report.
- A key area of improvement has been companies making reference to distributable profit or distributable reserves with 58% of the FTSE 100 making some level of disclosure (up from 40% in 2015), and 48% disclosing:
 - the specific level of distributable reserves of the holding company; or
 - the breakdown of distributable reserves; or
 - the reserves that are not distributable; or

- that distributable reserves are sufficient or significant.
- Progress in the FTSE 250 has been less significant with 30% of companies making some disclosure on distributable profits / reserves.
- Some companies (across the FTSE 350) have improved disclosure of the risks to dividend or the factors that were considered in setting the dividend policy.
- Some companies (across the FTSE 350) have enhanced descriptions of what the stated dividend policy means in practice, although further improvements could be made in this area.

The implementation studies have shown continuing improvements made by preparers. We are particularly pleased to see companies responding to investor calls to add clarity to disclosures around distributable profit/reserves.

We urge companies to further enhance dividend disclosures such as information on distributable reserves, risks and constraints to the dividend policy and links to viability.

We are particularly pleased to see companies responding to investor calls to add clarity to disclosures around distributable profit/reserves.



Strategic Reports - Thematic Reviews

Our monitoring of strategic reports was supplemented with thematic reviews on APMs and the effects of the EU referendum decision.

Alternative Performance Measures

APMs can provide valuable insight into a company and the extent to which its business model is successful and its objectives achieved. However, undue prominence given to APMs, such as adjusted profit, over the equivalent IFRS measures can call into question the balance of the strategic report.

The presentation of any APMs is therefore an important factor in the FRC's assessment of whether a company's strategic report meets the Act's requirement to be fair, balanced and comprehensive.¹³

The European Securities and Markets Authority's Guidelines on Alternative Performance Measures¹⁴ ("the ESMA Guidelines") became effective on 3 July 2016 and set out best practice in this area.

In the past year, as part of the FRC's routine and thematic reviews, particular attention was paid to APMs and the extent to which companies asserted that their disclosures were consistent with the ESMA Guidelines. The preliminary findings from the thematic review, outlined below, are in line with this year's findings from routine reviews.

Following last year's thematic review of the use of APMs in interim statements, a further thematic review has since been carried out on a sample of 20 annual reports with year ends from 31 December 2016 to 31 March 2017. This second review examined the use of APMs in the very different context of annual reports and at a point where companies would have had the opportunity to consider the points made in our first review.

In our reviews of reports and accounts, we consider whether strategic reports are consistent with the ESMA Guidelines.

Where there are material inconsistencies, companies are asked for explanations. Such inconsistencies are taken into account when deciding whether strategic reports are fair, balanced and comprehensive.

Many of the concerns expressed in our first study had been addressed in the annual reports examined as part of the second study. Our current review found that APMs were used by all companies in the sample and that compliance with the ESMA Guidelines was generally good. In particular:

- Definitions were given in all cases. Labels used generally conveyed an accurate description of each APM, although we are aware, from our regular reviews, of instances where it was not always clear where a measure used was an APM rather than an IFRS measure.
- Explanations for the use of APMs were given in all cases, although two companies only asserted that the APMs were the 'most meaningful' such measures without explanations as to why. We saw a number of good examples and also noted helpful 'health warnings' being inserted by several companies. We also found far fewer explanations using either cursory or boiler-plate wordings than in our previous review.
- Reconciliations were given by all companies, but not necessarily for all APMs used, the most frequently omitted being ratios such as return on capital and cash conversion. Reconciliation disclosures can be lengthy where a company uses several APMs and we saw a number of good approaches to presenting these in a clear and concise way.
- Most of the reports in the sample gave, taken as a whole, equal prominence to APMs and IFRS measures. Equal prominence was, however, more of an issue in sections such as the chairman's statement or chief executive's review than it was with the presentation of highlights or in financial reviews or equivalent.

The presentation of any APMs is therefore an important factor in the FRC's assessment of whether a company's strategic report meets the Act's requirement to be fair, balanced and comprehensive.¹³

Compliance with the ESMA Guidelines was generally good.

¹³ Paragraph 414C (2) and (3).

¹⁴ The ESMA Guidelines apply to regulated information and prospectuses of listed companies with the exception of APMs disclosed in the financial statements.

Our main concern arising from the review is the use of the term ‘non-recurring’ and similar terms, for example, ‘unusual’, ‘infrequent’ and ‘one-off’ in connection with items such as restructuring costs and impairment charges. For larger companies in particular, there will be few occasions when there is only one event in a period of years which drives such charges. We accept that there will be some cases where more than one year is affected, for example, a very substantial restructuring that is part of a single plan with a defined cost. However, we recommend that, in general, companies remove such terms from their definitions of APMs and select more accurate labels.

85% of companies in the sample stated that APMs were used by management in evaluating performance but only 40% referred to their use in determining management and executive remuneration. However, our review did not involve reviewing remuneration committee reports to assess the extent that disclosed APMs were used in determining management remuneration.

All but one of the companies in the sample had made at least minor changes to the presentation of APMs in the year, with some changes being extensive. The most common improvements were to explanations for the use of APMs followed by a better balance being achieved between APMs and IFRS measures and presenting clearer reconciliations.

Adjusted Measures of Profit

In considering the quality of explanations for the use of APMs, we noted that the great majority of the companies in the sample used either ‘adjusted’ or ‘underlying’ as the principal description for their adjusted measure of profit (85% of the sample). The adjusted measure appeared as a line item in the income statement for 65% of the sample.

As with the earlier review, there was significant commonality in items excluded from the corresponding IFRS measure to arrive at the adjusted measure. Amortisation of acquired intangibles, at least some restructuring charges and profit or loss on disposal of investments or businesses were near universal adjustments. However we noted that share-based payments were only added back in three cases.

We saw relatively few explanations as to why individual items were added back with the exception of amortisation of acquired intangibles and restructuring costs.

For restructuring costs, companies often linked the costs in the year to identified programmes or initiatives that were discussed elsewhere in the report and accounts. In all but three cases, the adjusted measure of profit was higher than the IFRS equivalent. The FRC’s detailed findings from this further review will be included in a separate report due to be issued in the fourth quarter of 2017.

The most common improvements were to explanations for the use of APMs followed by a better balance being achieved between APMs and IFRS measures and by clearer reconciliations.

Effects of the EU Referendum Decision

Our reviews continued the analysis, begun last year, into how companies were reporting on the UK's decision to leave the EU. We looked to see what messages were being conveyed in 2016 annual reports and 2017 interim reports.

All companies reviewed made reference to Brexit in their strategic reports, either as part of the risk narrative or when commenting on the company's performance, with a majority also referencing an increased level of economic uncertainty in the chairman's statement. All said that they would continue to monitor the Brexit developments with some establishing committees with the specific objective of assessing the longer term impacts.

The majority of companies reviewed reported on the uncertainties created, with the continuing theme being that it was too early to measure the longer term effects of the decision and how business strategies would be impacted going forward. However, companies are beginning to discuss some of the potential risks that the decision could lead to, such as access to skilled workers, a change in the taxation and legislative environments as well as some industry specific factors such as access to European markets.

Many companies attributed some element of their year-on-year performance to this decision. Some of those with an international footprint referenced the volatility seen in foreign exchange markets and the impact on retranslating the results of overseas operations, as well as commenting on the increase in the cost of imports. Some noted that they had seen a temporary pause in demand as consumers and businesses took stock of the decision but that this was not necessarily indicative of future trends.

We expect companies to provide increasingly focused disclosures, identifying the company specific risks and opportunities as the economic and political effects of the vote develop and become more certain.



We expect companies to provide increasingly focused disclosures, identifying the company specific risks and opportunities as the economic and political effects of the vote develop and become more certain.

Other Strategic Report Issues

Risk Reporting and Viability Statements

Risk-related disclosures in the strategic report should focus on the principal risks and uncertainties the company specifically faces and describe them and their potential impact clearly and concisely, making links to KPIs and delivery of strategy. In identifying the company-specific risks and uncertainties, directors should consider a broad range of circumstances, including in the environment in which the company operates, such as cyber-crime and climate change.

The Lab is running a project on risk and viability reporting, considering current practice in this area of reporting and the extent to which disclosure of a company's principal risks and uncertainties is linked to its business model and strategy. It is also considering the effectiveness of viability statements, which were introduced in the revisions to the Corporate Governance Code in 2014 and which the FRC commented on in *Developments in Corporate Governance and Stewardship 2016*, published in January 2017. The new requirements introduced reporting of a longer term view of a company's prospects in a viability statement and whether solvency, liquidity or other risks may impact the long-term viability of the business.

The Lab's report is due to be published later this year. It is expected to conclude that the changes in the Code have brought about significant improvements in the consideration of risk by boards and has contributed to improved reporting of principal risks.¹⁵ However, with companies preparing to report for the third time under the 2014 Code, similar improvements have not been widely identified in the quality of

companies' viability statements, and investors are therefore getting limited value from this disclosure. Investors would welcome further explanation of the factors taken into account when making an assessment of viability including explaining why a company has selected its period of assessment and how this aligns to the business cycle, the potential exposure of different parts of the business model to one or more risks materialising, and an explanation of the extent of resilience of the company as a result.

The period selected is often chosen because it reflects a company's medium term business plan. However, the FRC's *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* suggests that other factors should be taken into account, for example investment and planning periods, the board's stewardship responsibilities, the nature of the business and its stage of developments and previous statements made, especially in raising capital). Industries such as mining and property investments typically have longer term investment strategies and funding arrangements. Investors are calling for greater differentiation of the time periods used by different companies and sectors based on these sorts of other factors.

We encourage companies to consider developing their viability statements in two stages – firstly, to consider and report on the prospects of the company taking into account the company's current position and principal risks, and secondly to 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.

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¹⁵ Black Sun plc The Real Drivers of Value Lost & Found?



Monitoring of Corporate Governance Statements

Our response to the Government's Corporate Governance Green Paper requested powers to monitor corporate governance reporting and hold to account directors who are not members of a profession where we have concerns about aspects of financial reporting and conduct.

At present, our corporate governance monitoring consists of an annual disclosure in our *Developments in Corporate Governance and Stewardship* report of the level of compliance with the comply or explain requirement in the Code. This is drawn from external sources; analysis of the data about provisions 'least complied with'; and an assessment of a small sample of explanations in these areas.

Reporting on the Code is a requirement of the Listing Rules. Premium-listed companies must make a statement about how the company has applied the Main Principles of the Code in a manner that would enable shareholders to evaluate how they have been applied; whether the company has complied with the relevant Provisions in the Code and, where it has not, provide an explanation for non-compliance.

Whilst the Government does not intend at this stage to consider amending the regulatory structure for corporate governance reporting we are considering how we can increase our monitoring activity. Regardless of statutory powers, informal conversations with some FTSE 100 Chairs indicate that private contact and encouragement to improve is likely to be effective.

Further monitoring of corporate governance reporting would not be implemented until the revised Code is in place. However, we are considering whether assessments of the quality of reporting against the Code could be incorporated into our Corporate Reporting Review process. This would lead us to make enquiries about companies' disclosures where we have concerns about the quality of their reporting against the Code or there are apparent inconsistencies in their governance reporting. The intention would be for this monitoring to assist the stewardship activities of investors.

Whilst such monitoring should encourage reporting improvements, we will not have the ability to require changes to reporting or specific governance structures. Instead we would use reporting as a base to assess how the principles in the Code are being applied and question the nature of the reporting in order to encourage improved disclosure.

Remuneration Reporting

Reporting requirements in this area are set out in legislation and the FRC currently has no statutory powers to monitor compliance. However, the remuneration report falls within the scope of the requirement in the UK Corporate Governance Code to prepare annual reports which, when taken as a whole, are fair, balanced and understandable. The communication principles set out in the FRC's *Guidance on the Strategic Report* can equally be applied to remuneration reports.

Remuneration reports should be clear, concise and provide transparent disclosure without adding to the length of annual reports unnecessarily. Stakeholders continue to report that remuneration reports are opaque, too long and complex and not sufficiently focused. Investors continue to call for more transparency and simpler remuneration structures that are easier to understand.

Prescription in the 2013 Regulations can fuel a compliance mind-set amongst companies, whose focus is on meeting the requirements rather than thinking about how to explain remuneration clearly in a way that effectively tells the story and makes clear linkages to strategy.

We rely on evidence gathered during reviews of annual reports by external parties to shape our view of the quality of remuneration report. These reviews suggest that there has been no particular improvement in remuneration reporting this year, although some companies appear to have made an effort to improve accessibility and clarity. This is disappointing particularly as other parts of the annual report, notably strategic reports, are improving incrementally and companies engage extensively with shareholders on remuneration.

In 2016/2017 the length of remuneration reports increased again, reaching an average of 21.5¹⁶ pages in the FTSE 350, up from 18 in 2015/2016. One important factor in the overall length is the inclusion or not of the remuneration policy within the remuneration report. Many companies are submitting their remuneration policy to a shareholder vote this year, which may explain some of the additional length.

There is considerable scope for companies to improve the quality of the discussion in annual reports around the link between strategy and remuneration. In 2016 fewer than 25% included a table or diagram showing how performance metrics in the remuneration report link to strategy, while around 40% included boiler-plate narrative and around 35% included no reference to strategic alignment.¹⁷ Companies can improve users' understanding of how directors are incentivised to deliver the strategy by clearly articulating the links between KPIs, long-term objectives and performance-related pay-outs.

Remuneration committee chairs can improve overall quality by using their reports to demonstrate accountability and justify the remuneration of their executives, explaining more about why the chosen remuneration levels and structures are appropriate.

Very few companies have addressed the impact on executive pay of broader societal issues such as fairness or explained how executive pay links to pay and conditions across the wider workforce. A handful of companies are voluntarily disclosing CEO to average UK employee pay ratios.¹⁸

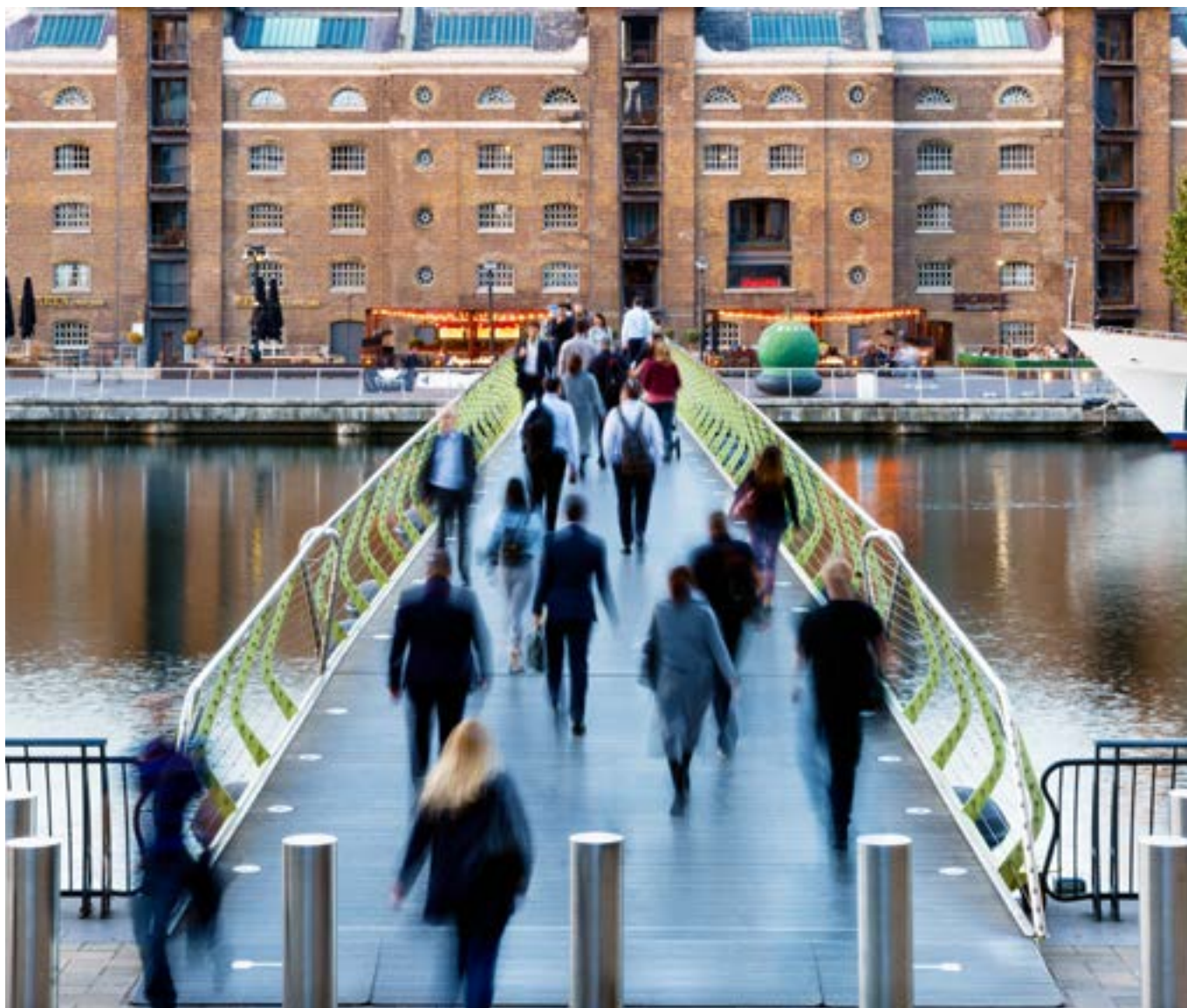
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¹⁶ EY Annual Reporting in 2016/17.

¹⁷ PricewaterhouseCoopers LLP.

¹⁸ EY Annual Reporting in 2016/17.



The Government response to the green paper consultation on corporate governance reform includes proposals for secondary legislation to require companies “to report annually in their remuneration report, the ratio of CEO pay to the average pay of their UK workforce, along with a narrative explaining changes to that ratio from year to year and how the ratio relates to pay and conditions across the wider workforce.” We expect more companies will choose to voluntarily disclose this information in advance of the legislation coming into force.

We do not believe that publishing pay ratios alone will have a discernible impact on levels of executive remuneration. Encouraging companies to justify quantum on the other hand, may encourage remuneration committees to think harder about what is proportionate and just. A dual approach of published pay ratios and an expanded remit for remuneration committees to oversee pay and incentives across the wider workforce would encourage greater focus on the strategic rationale for executive pay levels in a broader context and on the linkages between remuneration and the discussion on strategy and KPIs in the strategic report.

4 UK GAAP

First Time Implementation of New UK GAAP

New UK GAAP, which is now comprised of a suite of six standards, FRSs 100-105, became mandatory for all companies, other than those eligible for small companies exemptions, for accounting periods beginning in 2015. Small companies, including those eligible for the micro-entities' regime, were required to first apply new UK GAAP for accounting periods beginning in 2016.

Whilst companies were applying the new standards for the first time, especially FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland, the FRC called for evidence of implementation issues via a dedicated email address. We received over 50 submissions which, alongside issues brought to our attention via our UK GAAP Technical Advisory Group, provided the foundation for the first review of FRS 102.

The submissions showed a high level of support for the new standard as a whole, but provided insights into specific areas of uncertainty over the requirements of the standard and a small number of sources of complexity and implementation difficulties that we have since sought to address. FRED 67 set out our proposals to improve the standard. We are currently reviewing

responses to that consultation and aim to issue final amendments before the end of 2017 (see Developments in UK GAAP for further details).

Alongside the evidence received directly from stakeholders, we are grateful for work done by the ICAEW's Quality Assurance Directive (QAD) who have been reviewing some of the first audits performed on FRS 102 financial statements and carried out desktop reviews of a substantial sample of other audited FRS 102 financial statements filed at Companies House.¹⁹

Clearly, the transition to FRS 102 created challenges for companies and their auditors, especially where their financial reporting resources were limited. Whilst the QAD's findings showed that most companies and their auditors had generally met these challenges, with only minor issues being identified, there was a notable minority of financial statements where more significant issues were identified. These, unsurprisingly, arise in the areas where FRS 102 most significantly diverges from old UK GAAP, such as:

- the format and presentation of the primary financial statements;
- changes to accounting policy notes; and
- accounting for business combinations and goodwill, financial instruments and deferred tax.

¹⁹ The ICAEW summarises the findings in a report on the QAD's 2016 audit monitoring activities at:

https://www.icaew.com/-/media/corporate/files/technical/audit-and-assurance/working-in-the-regulated-area-of-audit/icaew_audit-essentials_2017_webupdated.ashx?la=en

The ICAEW notes that problems with the implementation of FRS 102 within audit firms have tended to stem from weaknesses at a whole-firm level, such as insufficient CPD, over-reliance on accounting software and policies around financial statement preparation and review.

It is disappointing that some audit firms and accountants in practice were ill-prepared for the implementation of FRS 102 in 2015/16 given it was first issued in March 2013, especially as the areas of key differences have been well signposted in training courses and widely available literature. Many of them are also covered in Staff Education Notes issued by the FRC and available on our website.²⁰

It is incumbent on companies, their accountants, and advisors and auditors to update their knowledge and awareness of changes to financial reporting requirements and identify areas

for improvement as they continue to report under FRS 102. The application of such knowledge and professional judgement cannot be supplanted by the use of software and other tools.

We will continue to gather evidence on the implementation of FRS 102 in subsequent years and support the process of continual improvement. This begins with revising the standard where unnecessary complexity could be avoided, and FRED 67 included such revisions. We have brought together the accounting professional bodies and major accounting software providers to share insights and support preparers, and will be providing them with earlier insights on the direction of travel of changes to the standards to support their development efforts. Once the current revision of FRS 102 is complete, we will develop further focused educational material to provide additional guidance on areas where implementation difficulties have been identified.

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We will continue to gather evidence on the implementation of FRS 102 in subsequent years and support the process of continual improvement.



²⁰ FRC Staff Education Notes are available at:

<https://frc.org.uk/Our-Work/Corporate-Governance-Reporting/Accounting-and-Reporting-Policy/New-UK-GAAP/Staff-Education-Notes.aspx>

Developments in UK GAAP

When FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* was issued in March 2013, the FRC indicated that it would be reviewed every three years, although the first review was subsequently delayed for one year due to the staggered application of new company law legislation for companies eligible for small and micro-entities' regimes.

The process for reviewing the standard brought together evidence from a number of sources:

- the FRC's UK GAAP Technical Advisory Group, formed of representatives from large, medium and small accounting firms, professional bodies, public benefit entities and other technical experts. This group has provided invaluable insights into the understanding and implementation of new UK GAAP since its launch;
- direct stakeholder outreach by FRC staff;
- dedicated email address to which preparers and their advisors could provide insights into implementation issues as they first applied the new standards; and
- review of developments in the requirements of the IFRS for SMEs and full IFRS.

It should be noted that any changes to international standards do not automatically result in changes to UK GAAP. Instead they represent developments in current thinking on financial reporting that the FRC will review and consider in developing UK standards. Whilst consistency with international accounting standards is one of the principles for developing UK GAAP, it is balanced against other principles such as stability, proportionality, cost-effectiveness and the specific needs of users of FRS 102 financial statements.

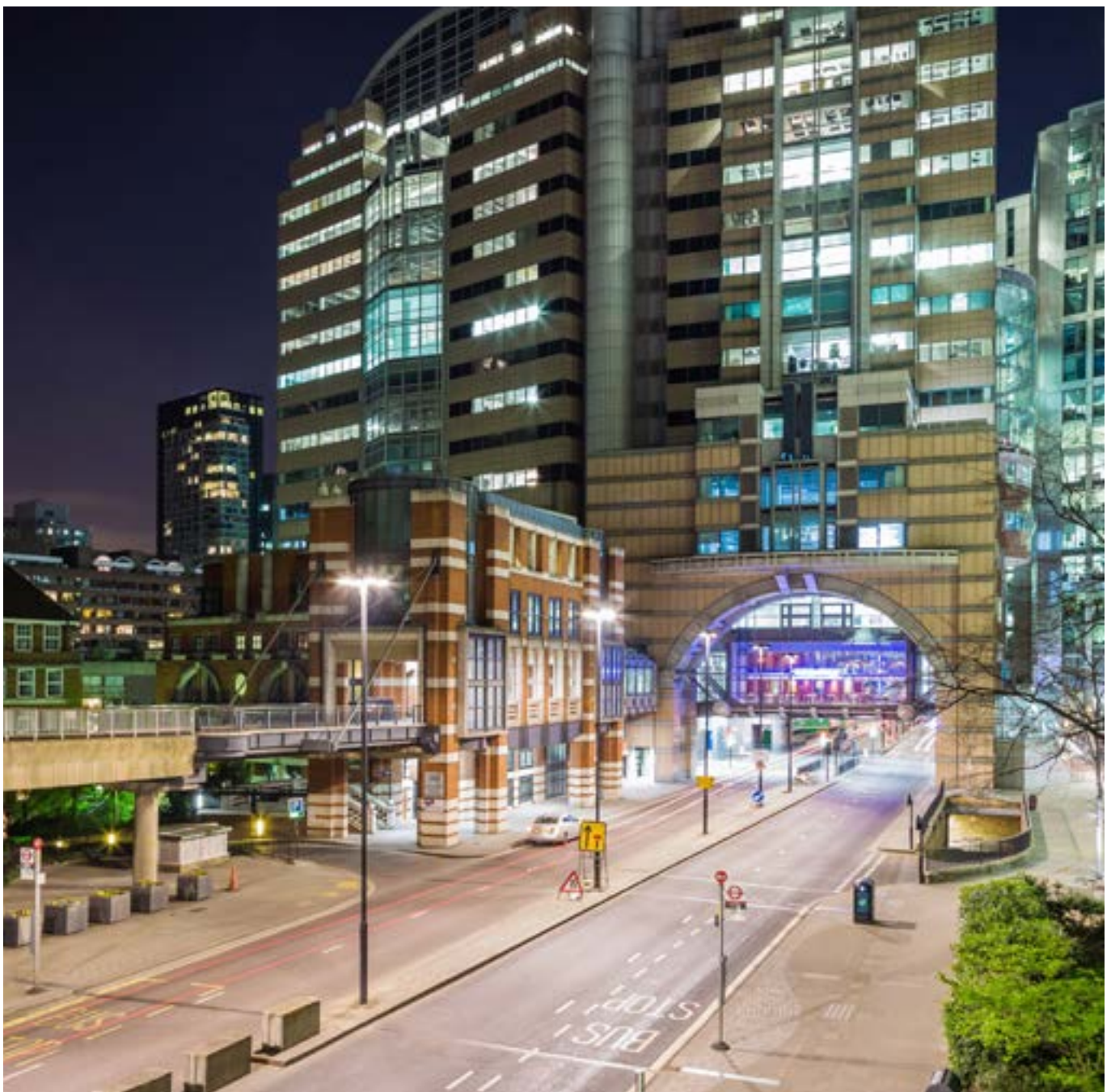
In September 2016, we issued a consultation on how FRS 102 should be developed in response to major changes in IFRS, including the publication of IFRS 9 *Financial Instruments*, IFRS 15 *Revenue from Contracts with Customers* and IFRS 16 *Leases*. Respondents to this consultation generally recognised the benefits of greater convergence of UK GAAP with these standards over time, but they cautioned against doing this before the standards had been implemented by full IFRS preparers. A convincing case was made for waiting for experience of full implementation which would inform the development of simpler and proportionate models for UK GAAP preparers, so the FRC will not be issuing changes to reflect these standards until further evidence is gathered over the coming years. Similarly, no proposals will be made to change FRS 103 *Insurance Contracts* in response to IFRS 17 *Insurance Contracts* (issued by the IASB in May 2017) without first gathering evidence on its practical implementation.

In March 2017, we issued FRED 67 *Draft amendments to FRS 102* which focused on incremental improvements and clarifications developed in response to the broad range of evidence gathered. The five most notable changes relate to:

- definition of a financial institution for disclosure purposes;
- distinction between basic and other financial instruments;
- extent to which intangible assets should be separately recognised on business combinations;
- measurement of investment property, especially where rented to a fellow group company; and
- measurement of loans to a company from one of its shareholder/directors.

The responses to these proposals have been generally favourable and we are currently re-deliberating ahead of final amendments being issued before the end of 2017.

Once these are finalised, we will begin work on developing further educational guidance to support continual improvement of reporting under UK GAAP. Whilst the FRC will consider the need for changes to the standard if significant issues arise that must be addressed urgently, this will be balanced with the benefits of a stable reporting framework until the next periodic review of the standard.



5 ENFORCEMENT

Enforcement is an integral part of the FRC's work to improve integrity and transparency in business, providing a deterrent to directors reporting information that they know or should know was factually incorrect, furnished recklessly or misleading. This section provides a summary of the disciplinary cases which the FRC has concluded since 1 April 2016 to the extent that they relate to Members in business. A brief summary of each case is provided in Appendix D.

Members in business investigated by the FRC commonly hold senior positions within organisations and have significant influence on the preparation of the financial statements. An investigation into a Member in business often arises where the FRC is conducting a parallel investigation relating to the audit of the financial statements. The investigations are often complex and can take a number of years to conclude. Accordingly, the outcome of cases closed in any one year does not necessarily reflect the quality of

current reporting. Considerable resources have been invested by the FRC in recent years to conclude cases quickly.

Since 1 April 2016, we have concluded investigations into a total of eight Members in business. Investigations into two Members in business were closed without a complaint of misconduct being filed. Investigations into six Members in business resulted in an admission of misconduct and the sanctions set out below:

Company	Member	Date commenced	Outcome	Date	Sanction	Fine ²¹	Contribution to costs
Connaught plc	Stephen Hill	29-Nov-10	Settled	14-Jul-16	Exclusion 5 years		£133,397
Connaught plc	David Wells	29-Nov-10	Settled	19-Jul-16	Exclusion 3 years		£125,198
RSM Tenon Group plc	Andy Raynor	13-Aug-12	Settled	10-Oct-16	Reprimand	£40,000 reduced to £26,500	£50,000
The Cup Trust	Anthony Mehigan	09-Dec-13	Settled	17-Oct-16	Exclusion 10 years	£100,000 reduced to £70,000	£80,000
The Co-Operative Bank plc	Barry Tootell	20-Jan-14	Settled	19-Sep-16	Exclusion 6 years		£20,000
RSA Insurance Ireland Limited	Rory O'Connor	07-Jul-15	Settled	19-Dec-16	Exclusion 3 years	£50,000 reduced to £35,000	£18,000
Tech Data Limited	Philip John James	12-May-14	Settled	09-Aug-17	Exclusion 10 years	£100,000 reduced to £35,625	

²¹ Fines may be reduced for early settlement/ mitigating factors/ financial means.

Powers

The FRC has certain enforcement powers with respect to the conduct of auditors, chartered accountants and actuaries. Those apply to directors of listed companies and other Public Interest entities, as well as to individuals in public practice. However, our powers are limited to those directors who are also members of participating bodies. In our response to the Government Green Paper in February 2017 we recommended that our powers in this area be extended to enable us to investigate and prosecute all directors for financial reporting breaches.

Such an extension would require primary legislation and based on recent Government announcements this is unlikely to be forthcoming in the short-term. In the meantime we are engaging with the Financial Conduct Authority and the Insolvency Service, both of which have powers to investigate and sanction directors. We believe there is scope for the three regulators to work more closely together on matters of mutual interest in the enforcement sphere.

We are in the process of identifying overlaps and gaps in the regulatory framework as it applies to directors and intend to make a joint submission to ministers with our findings – and suggestions for resolving any outstanding issues – in early 2018.



6 CURRENT AND FUTURE DEVELOPMENTS

The landscape for corporate reporting is being shaped by changes in a number of areas, particularly by amendments to the underlying framework of legislation, standards and guidance, by the changing demands of stakeholders and by developments in technology. This section outlines current developments that will very soon be making an impact and future developments whose effects are less certain but have the potential to be highly significant in the medium-term.

Implications of Brexit for the UK's Accounting Framework

The current accounting framework in the UK is based on European law, as follows:

- (a) The IAS Regulation:
- (i) requires that IFRS as adopted in the EU are applied in the group financial statements of UK companies listed on regulated markets in the EU; and
 - (ii) permits IFRS to be applied in the individual financial statements of all companies and the group financial statements of companies that are not listed.

The UK has reflected both these options in the Act.

- (b) The requirements of the Accounting Directive are reflected in the Act requirements for the preparation of financial statements and are applicable to all other UK companies that have not used the option to apply IFRS as adopted in the EU.

The FRC is providing input to BEIS on the form and content of the post-Brexit accounting framework for the UK. We consider that key objectives in the development of a post-Brexit accounting framework is to maintain London's

pre-eminent position as an international capital market and to maintain the UK's status as an international centre of excellence for accounting and reporting. A prerequisite for these objectives are that we have high-quality globally recognised accounting standards. Reflecting these objectives, and stakeholder preferences (as expressed in our discussions and their public statements), the case for an IFRS-based accounting framework for domestic UK listed companies is clear.

Our current view is that the UK accounting framework should:

- (a) continue to be based on IFRS;
- (b) have a UK process for endorsing new and amended IFRS issued by the IASB, with the FRC as the endorsement body;
- (c) require domestic UK listed companies to apply IFRS as adopted in the UK in their group financial statements;
- (d) permit IFRS as adopted in the UK to be applied in the individual financial statements of all companies and the group financial statements of companies that are not listed; and
- (e) only depart from standards issued by the IASB under clear criteria.

Our current view is that the UK accounting framework should require domestic UK listed companies to apply IFRS as adopted in the UK in their group financial statements.

Current Developments on the Guidance on the Strategic Report

In August 2017 the FRC published a consultation on proposed amendments to its *Guidance on the Strategic Report*.²² These proposals reflect the new regulations for non-financial reporting. They require certain large companies to provide enhanced disclosures in respect of the environment, employees, social matters, respect for human rights and anti-corruption and anti-bribery matters.

These regulations are effective for financial years beginning on or after 1 January 2017, therefore we aim to finalise the updated guidance to companies as soon as possible. The European Commission has also published non-mandatory guidelines on the NFR Directive²³ which note that companies may use other reporting frameworks for reporting non-financial information such as the FRC's *Guidance on the Strategic Report*.

The Purpose of the Strategic Report and Section 172

The proposed amendments also reflect the desire amongst stakeholders to improve the effectiveness of section 172 of the Act. Section 172 requires directors to have regard to a number of matters including the long-term impact of any decisions, the interests of stakeholders and non-financial matters in pursuing their duty to promote the long-term success of the company. Consequently, our proposals also encourage companies to provide better information on how companies have fulfilled this duty to improve accountability to shareholders and other stakeholders when taking decisions to promote the long-term success of the company.

There was little explicit discussion of section 172 in FTSE 100 annual reports in 2017, with only 11% of FTSE 100 companies specifically outlining

stakeholder expectations in their annual reports. Detailed discussion around stakeholder engagement was included by 32%, while 33% included no discussion at all.²⁴ We expect broader stakeholder interests to be an area of increasing focus for company reporting over the next few years given the proposals for legislative change in this area and our own updates to the *Guidance on the Strategic Report*.

Value Generation

The proposed amendments also place a greater emphasis on the strategic report including information relating to sources of value that have not been recognised in the financial statements and how those sources of value are managed, sustained and developed, for example a highly trained workforce, intellectual property or internally-generated intangible assets, as these are relevant to an understanding of the company's development, performance, position or impact of its activity.

We are also encouraging companies to describe how their allocation of resources will support the achievement of their strategy and impact on stakeholders, for example what proportion of resource is directed to investing in research and development, to capital investment, or to dividends. This information could be provided using qualitative and quantitative analysis and we are aware that a few companies are already providing this kind of information in their annual reports.

We have also been mindful of the developments relating to risk reporting such as the publication of the Task Force on Climate-Related Financial Disclosures Recommendations²⁵ and the focus on cyber risk when proposing amendments to the *Guidance on the Strategic Report* and stress the importance of companies' disclosing their principal risks. We have therefore followed up with a focus on risk in our monitoring and Lab work.

²² This consultation can be accessed here:

<http://frc.org.uk/getattachment/9e05c133-500c-4b98-9d76-497172387bea/;aspx>

²³ These guidelines can be accessed here:

[http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52017XC0705\(01\)&from=EN](http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52017XC0705(01)&from=EN)

²⁴ Black Sun plc The Real Drivers of Value Lost & Found?

²⁵ These recommendations can be accessed here:

<https://www.fsb-tcfd.org/publications/>

The update to the *Guidance on the Strategic Report* provides an opportunity to make targeted improvements to certain areas of the guidance to reflect key developments in narrative reporting such as the ESMA Guidelines on Alternative Performance Measures.

Smaller Company Reporting

Following our focus over the last three years on improving the quality of reporting by smaller listed and AIM companies, we intend to assess whether there has been any discernible change in reporting by these companies as part of our corporate reporting and audit monitoring work in 2018/19. We will report the results of our monitoring and other outreach in the 2018/2019 Annual Review of Corporate Reporting.

New IFRSs and their Adoption in Europe

Under the IAS Regulation new or amended IFRS Standards must go through an endorsement process before EU companies are able to apply them. We continue to be an active participant in this process through our membership of European Financial Reporting Advisory Group (EFRAG), which is the organisation that provides advice to the European Commission on endorsement.

IAS 7 Statement of Cash Flows

We draw attention to the amendments to IAS 7 Statement of Cash Flows (effective for periods beginning on or after 1 January 2017) requiring an explanation of changes in a company's financing obligations over the period. Providing a net debt reconciliation as many UK companies currently do, would be consistent with these requirements. Some investors have expressed concerns about disclosures concerning the use of financing facilities such as invoice discounting. The new requirements provide an opportunity for companies to improve the clarity of these disclosures.

It is sometimes not clear whether operating cash inflows recorded represent cash received from the customer or cash received from the financial provider of these facilities. This distinction can be important to investors when assessing metrics such as cash realisation, and when comparing the financing structures of different companies. The lack of disclosure in this area, particularly in non-recourse arrangements where the customer receivables are derecognised, may hide reliance that a company has on facilities such as these.

IFRS 9, IFRS 15 and IFRS 16

A number of new accounting standards will come into effect in 2018 and 2019 which will pose significant challenges to companies and could impact the quality of reporting in the short-term.

The endorsement process for these Standards has been quite protracted and, although companies have already started their implementation of IFRS 9 and IFRS 15, the regulations endorsing them were only published in late 2016.

IFRS 16 is effective for annual periods beginning on or after 1 January 2019 and is still going through the endorsement process. It is expected to be endorsed by the end of 2017 to enable companies to early adopt this standard, if they wish to do so, to coincide with the implementation of IFRS 15 which is effective on 1 January 2018.

IFRS 17 Insurance Contracts

IFRS 17 *Insurance Contracts* was issued by the IASB in May 2017. It is effective for annual periods beginning on or after 1 January 2021. It replaces IFRS 4—an interim standard that permits companies to use national GAAP for the measurement of the insurance contracts they issue. IFRS 17 will introduce consistent principles for accounting for insurance contracts. This will enable investors, analysts and others to compare companies, contracts and industries within and across

We draw attention to the amendments to IAS 7 Statement of Cash Flows (effective for periods beginning on or after 1 January 2017) requiring an explanation of changes in a company's financing obligations over the period.

jurisdictions for the first time. It will also mean that UK insurance companies with international business will be using the same accounting requirements across the group.

Consequently, this standard is expected to have a significant impact on accounting by insurance companies globally and we expect a long and contentious EU endorsement process, which is expected to commence before the end of 2017.

In addition to our participation in EFRAG's endorsement activities we are planning to set up a project group of external stakeholders to provide input into UK-specific endorsement activities and to discuss issues relating to the endorsement of IFRS 17.

Future Work of the IASB

IASB's Work on Wider Corporate Reporting

The IASB has held preliminary discussions on its role in wider corporate reporting (which is a broad term used to refer to any reporting by companies that falls outside the primary financial statements and the notes, and includes integrated reporting, sustainability reporting, strategic report, etc.). Some of the IASB's stakeholders are encouraging it to be more active in this area highlighting that non-financial information and the societal impacts of business are of growing importance to investors. It has also been noted that the current corporate reporting landscape has a large number of voluntary codes and guidance in this area and perhaps there is a need for a consistent global reporting framework. One of the options the IASB may consider is to update its non-mandatory Practice Statement Management Commentary in view of developments in this area.

It seems likely that the statement will remain non-mandatory so as not to conflict with national or regional regulation.

IASB's Better Communication Initiative

The IASB has identified the provision of more relevant information and improving the communication of that information as primary objectives for their work in the coming years. The 'Better Communication' initiative, which has similar objectives to the FRC's clear & concise philosophy, brings together a number of long-standing research projects, including a project on the structure and content of the *Primary Financial Statements* and the *Principles of Disclosure* discussion paper aimed at improving the relevance of disclosures by moving to a more principles-based approach. This initiative also includes a project to develop non-mandatory guidance on materiality, which was published in September 2017, and a continuation of the development of the IFRS Taxonomy.

Other Reporting Issues

Preliminary Earnings Announcements

The FRC's research on corporate reporting is not exclusively focused on the financial statements. We are currently undertaking a project on Preliminary Earnings Announcements (PEAs). This project seeks to compare the content, tone and language of PEAs with those of the annual report as PEAs continue to be a major part of the corporate reporting landscape in the UK. This might identify possible improvements to the framework for annual reports or PEAs, or both, that can be expected to enhance communication with investors.

Outreach has been conducted with investors with the aim of identifying how preliminary reporting has changed over recent years and developing a better understanding of the importance placed on preliminary reporting by investors and how investors use the information contained in preliminary announcements to make investment decisions. This research drew some preliminary conclusions from investors which will be tested with auditors and companies.

Concurrently, our Audit Policy Team is undertaking research on the role of auditors in connection with preliminary announcements and it issued a Discussion Paper in April 2017 on this topic.

The preliminary conclusions from this research are set out below. Our detailed findings are included in a separate report due to be issued in the fourth quarter of 2017.

Preliminary Conclusions

Based on our various research, outreach and consultation activities to date, there seems little evidence of market abuse in current arrangements for preliminary reporting, nor any evidence of figures changing between the time of publication of preliminary announcements and the annual financial statements. Feedback suggests that any changes to corporate reporting requirements and auditor guidance should be co-ordinated, and that the primary responsibility for the preparation of trustworthy information should remain with the directors of companies. The majority of companies on the UK main market currently issue preliminaries based on audited information, and some investors would like all companies to adopt this as a best practice approach.

Investors tend to place importance on preliminary reporting. The timeliness of reporting is key, whether the primary purpose of reporting is to trade on news as soon as it is announced, or to make decisions about longer term

investments or to form an assessment of management's stewardship of the company.

The degree of importance attached to the preliminary announcement relative to the annual report can differ depending on the nature of the investment (e.g. debt v equity) and the analyst resources available to the investor. For some members of the investor community, the annual report is primarily used as an update for any intervening events and for confirmatory purposes.

Some changes to the style and manner of reporting is accepted by investors between the time of release of the preliminary announcement and the annual report. Such alignment in communication does not appear to be significant to the market as long as the financial information and key messages have not changed.

The research results from the corporate reporting and audit policy teams will be co-ordinated so that any proposed changes are complementary.

Digital Reporting

Technology is significantly changing how corporate data is collected, accessed and analysed. This has benefits for companies, employees and the public. For example, it has enabled improvements in public accessibility of corporate reporting data through company websites and pdf versions of annual and other reports. However, these benefits are still not widely exploited. The volume of data available about companies is increasing fast; technology can greatly enhance how this information is presented and communicated so that it can be of greatest use to stakeholders.

Corporate reporting is becoming increasingly influenced by digitalisation. In 2015 the Lab reported that investors preferred the annual report in a PDF format as it combined the best elements of hard copy annual reports with the benefits of digital searchability.

there seems little evidence of market abuse in current arrangements for preliminary reporting, nor any evidence of figures changing.

Technology is significantly changing how corporate data is collected, accessed and analysed.

However, these benefits are still not widely exploited.

Characteristics of Future Digital Reporting



However, whilst PDF often works for investors, it does not easily support open, reusable and engaging reporting which future and current emerging technologies promise. To investigate this further the Lab is running a project on how technology might impact corporate reporting in the future.

The first output of the project was a framework of characteristics which are important to embed in any current or future corporate reporting ecosystem.

The Lab will follow up with further investigations into differing technologies and their potential for corporate reporting.

Whilst much of the impact of technology on reporting is in the future there are some shorter term changes that may significantly impact companies.

From 2020, companies listed on EU markets will be required to file XBRL tagged consolidated financial statements embedded within an HTML document of the annual report. The SEC will also

require all foreign private issuers that prepare their financial statements under IFRS to submit their financial data in XBRL using the IFRS Taxonomy for periods ending on or after 15 December 2017.

Whilst individual statutory companies in the UK are currently required to file their accounts along with their tax return to HMRC using iXBRL and are permitted to file to Companies House, there is very limited adoption of iXBRL in UK consolidated accounts. Furthermore the use of HTML for corporate reporting is particularly unpopular in the UK (with around 15% of FTSE 350 companies producing an HTML annual report) and on a downward trend.

**APPENDIX A:
FRC YEAR-END
ADVICE LETTER TO
AUDIT COMMITTEE
CHAIRS AND
FINANCE DIRECTORS**

APPENDIX A



10 October 2017

Dear Audit Committee Chairs and Finance Directors

Summary of key developments for 2017/18 annual reports

I am writing ahead of the 2017/18 reporting season with the FRC's perspective on aspects of annual reports that companies should aim to improve and to highlight changes to UK reporting requirements.

New Accounting Standards

Three new international accounting standards are soon to be implemented. Companies have now started implementing IFRS 9 'Financial Instruments' and IFRS 15 'Revenue from contracts with customers'. IFRS 16 'Leases' is effective for annual periods beginning on or after 1 January 2019, with endorsement expected to be completed by the end of 2017. This will enable companies that choose to early adopt IFRS 16 to implement it alongside IFRS 15 from 1 January 2018. These standards have the potential to have a significant impact on many companies' results and financial position.

Given their significance it is important for companies to disclose the likely impact of the new accounting standards on their financial statements as soon as they can be reliably measured. The FRC encourages companies to provide clear disclosures with reference to their existing accounting policies. In the last set of financial statements before the implementation date we expect to see detailed quantitative disclosure regarding the effects of the new standards. We expect companies to have made a step change in the quality of their disclosures this year, particularly in respect of IFRS 15 and IFRS 9.

These quantitative disclosures should be accompanied by informative and sufficiently detailed explanations of the company's analysis. Disclosures should be tailored to the company's specific circumstances and transactions, and describe any key judgements that management will need to make in complying with the new standards.

Strategic report

The requirement to prepare a strategic report is widely regarded as having contributed to a higher standard of corporate reporting since it was first introduced in 2013. Quality can be further improved by ensuring that strategic reports explain the relationships and linkages between different pieces of information. For example, explaining the linkages between Key Performance Indicators (KPIs) and remuneration policies can provide valuable context for investors' assessment of management stewardship. The Guidance on the Strategic Report describes principles of good communication that can help boards to use their strategic report to tell their story most effectively, and in a way that is fair, balanced and understandable as required by the UK Corporate Governance Code.

A company's strategic report continues to be one of the areas which is most frequently subject to challenge through the FRC's monitoring activity. We encourage companies to improve where a compliance focused approach leads to lack of coverage or the report appears to be lacking balance.

Non-financial reporting

In August 2017, the FRC published a consultation proposing amendments to its Guidance on the Strategic Report. These proposals reflect the new regulations for non-financial reporting (which implement the EU Directive on non-financial and diversity information). The new regulations require certain large companies to provide enhanced disclosures in respect of the environment, employees, social matters, respect for human rights and anti-corruption and antibribery matters. As the regulations are effective for financial years beginning on or after 1 January 2017, we aim to finalise the revised Guidance for companies in the first half of 2018. In the interim, the FRC has published a factsheet to assist companies with determining the impact of the new regulations on their reporting.

Our proposed amendments to the Guidance also look to improve the effectiveness of section 172 of the Companies Act 2006. This requires directors to have regard to a number of matters when taking business decisions; including the interests of specific groups of stakeholders and non-financial matters. Our proposals encourage companies to provide better information on how boards have fulfilled this duty when taking decisions to promote the long-term success of the company.

These developments are consistent with the government's evolving agenda for Corporate Governance Reform. The FRC is undertaking a fundamental review of the UK Corporate Governance Code, on which we will consult in November 2017.

The FRC is also encouraging companies to consider the broader drivers of value that contribute to the long-term success of the company, including disclosures relating to sources of value that have not been recognised in the financial statements and how those sources of value are managed, sustained and developed (for example, a highly-trained workforce, intellectual property or internally-generated intangible assets, where these are relevant to an understanding of the company's development, performance, position or impact of its activity). Companies may wish to describe how they engage with key stakeholders and how the allocation of resources will support the achievement of their strategy and impact on stakeholders (for example, what proportion of resource is directed to investing in research and development, to capital investment, or to dividends).

Performance reporting

The FRC's reviews of reports and accounts commonly identify reports where it appears that not all key aspects of performance have been considered. The reasons for changes to KPIs and the impact of this should be explained. Companies should ensure that disclosures are sufficiently case specific and that descriptions are clear and informative. Particular focus should be given to ensuring that KPIs which are linked to executive remuneration are explained in sufficient detail. Boards are encouraged to take note of the FRC's publications on alternative performance measures which provide guidance on how to meet the requirements of ESMA's 'Guidelines on Alternative Performance Measures'. A further thematic report is due to be published by the FRC in Q4 of 2017.

Risk reporting and viability statements

The introduction of viability statements in the 2014 UK Corporate Governance Code has brought a greater focus on risk management at board level which has contributed to recent improvements in risk reporting. Further improvements in this area remain a key priority for investors and the Financial Reporting Lab ("the Lab") will publish a report on risk and viability reporting later this year, to provide practical guidance for companies.

In addition to the Lab's project, the FRC has so far reviewed around a quarter of FTSE 350 viability statements published in January 2017. Much of the commentary around viability reporting has focused on the period over which the board has chosen to make its statement which, in the majority of cases, has been three years. The period is often selected to reflect a company's medium-term business plan. However, other factors should be taken into account; for example, 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. Investors are calling for greater differentiation of the time periods used by different companies and sectors, in light of these other factors.

We encourage companies to consider developing their viability statements in two stages – first, to consider and report on the prospects of the company over a period reflecting its business and investment cycles, and second to 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. The Lab’s project and the FRC’s review of viability statements have identified some examples of good practice following this approach which clearly explain the underlying analysis that supports the statement.

UK referendum result

The majority of reports recently reviewed by the FRC included disclosure on the continuing uncertainties regarding the effects of the EU referendum. A consistent theme was that it was too early to measure the longer-term effects of the decision and how business strategies would be impacted. However, many are beginning to identify, in more detail, the specific nature of the likely risks. Companies should consider how their assessment of the potential impact on their business has developed over the year and make appropriate disclosures to reflect their latest analysis. These disclosures need to be kept under review.

Financial statement disclosures

Statement of Cash Flows

Investors have an interest in good quality net debt reconciliations that clearly identify cash and non-cash drivers of changes. In addition to the new standards issued by the IASB, we draw attention to the amendments to IAS 7 ‘Statement of Cash Flows’ (effective for periods beginning on or after 1 January 2017) which require an explanation of changes in a company’s financing obligations over the period.

The new requirements provide an opportunity for companies to improve the clarity of their disclosures, particularly in those areas where investors have voiced disappointment; for example, on the use of financing facilities such as invoice discounting arrangements. It is sometimes not clear whether operating cash inflows recorded represent cash received from the customer or cash received from the financial provider of these facilities. The lack of disclosure in this area, particularly in non-recourse arrangements where the customer receivables are derecognised, may hide reliance that a company has on such facilities. We strongly encourage companies to provide detail of, and disclosure of reliance upon, these facilities.

Dividends

The FRC is encouraged to see further developments in how companies are reporting their dividend policies and level of distributable profits/ reserves. There has been a significant increase in the number of companies that are reporting on the level of their distributable profits/ reserves, particularly within the FTSE 100. However, progress in the FTSE 250 has been less significant with only 30% of companies making such disclosures.

This continues to be an area of investor focus and the FRC urges companies to adopt the recommendations in the Lab’s implementation study on this topic that was published this month. In particular, the FRC encourages further adoption of reporting on the capacity to pay dividends, including the extent to which profits can be distributed by subsidiary companies and the extent of any restrictions.

Critical judgements and estimates

Investors rely on disclosure of the key judgements and estimates management make when preparing their accounts. This helps them to understand the impact of management’s accounting policy decisions and the extent to which assets and liabilities may change in the next twelve months and which can be factored into investor forecasts. There are some situations where management may need to quantify the key assumptions underlying their estimates in order for investors to understand the positions taken and facilitate intercompany comparison; for example, the commodity price assumptions adopted by companies in the extractive industries.

Boilerplate and generic disclosures should be avoided. Information value can be improved by providing more granular information about a smaller set of judgements and estimates that had a significant impact on results and explaining why certain assets were subject to significant risk of material change. The FRC has carried out a thematic review on this topic which will be published in Q4 2017.

Accounting policies

Some accounting policy disclosures reviewed by the FRC appear to be out of date, irrelevant, immaterial or based on boilerplate text taken from the standard. This tends to be more common in the accounts of smaller listed companies. Companies should ensure that their disclosures are sufficiently tailored to their circumstances. For example, revenue accounting policy disclosures should cover each significant business stream.

At a very specific level we are aware of some investor concern around the transparency of disclosure in relation to the accounting for ‘teaser rates’ to encourage consumers to transfer credit card debts. Similar issues may apply to mortgage rate offers. If such activity is material, we encourage companies to be transparent about the method applied to their income recognition.

Business combinations

Business combinations can pose unusual and complex accounting questions for companies. In particular, the impact of contingent and deferred consideration arrangements can be difficult to determine as they rely on a high level of estimation and multiple assumptions, making clear disclosure imperative. Sometimes it is also not clear why few or no intangible assets, other than goodwill, were recognised in accounting for an acquisition.

Pensions

Continued low interest rates and the economics of defined benefit pension arrangements have increased the need for companies to improve the transparency regarding their pension arrangements. Pension disclosures should provide sufficient transparency of the nature and risks to which the schemes expose the company, including informative explanations of deficit funding arrangements, risk management strategies and scheme assets. The FRC has carried out a thematic review on this topic which will be published in Q4 2017.

Audit quality and effectiveness

The FRC monitors the quality of public interest entity audits and the role of audit committees in assessing audit effectiveness. In our monitoring of 2017/18 year end audits we will be seeking evidence that the auditor has challenged management and reported clearly to the audit committee in several of the areas featured in this letter, including critical judgements, estimates and pensions. Our practice aid supports audit committees in assessing audit effectiveness.

We hope that you find this letter useful. Further information on the areas covered above, including sources of FRC guidance and best practice examples, are noted overleaf. The FRC will also shortly publish a detailed review of corporate reporting in 2016/17.

Yours sincerely



Paul George

Executive Director Corporate Governance and Reporting

Email: p.george@frc.org.uk

Publications and Further Information

FRC: Annual Review of Corporate Reporting 2016/17
(to be published shortly).

FRC: Financial Reporting Lab project reports
<https://www.frc.org.uk/Lab/Reports>.

FRC: Guidance on the Strategic Report (June 2014)
<http://frc.org.uk/getattachment/697745ed-d991-4360-a32c-857dc28fb949/Guidance-on-the-strategic-report-2014.pdf>

FRC: Non-financial reporting factsheet (July 2017).
<https://frc.org.uk/getattachment/3dfe0ac6-ac6d-41a0-91bf-df98cbba0ad6/Non-Financial-Reporting-Factsheet-Final.pdf>

FRC: Draft amendments to Guidance on the Strategic Report (August 2017).
<http://frc.org.uk/getattachment/b61e5875-1332-4bd0-a786-5bfb16a89b85/Staff-draft-Guidance-on-the-Strategic-Report.pdf>

FRC: Developments in Corporate Governance and Stewardship (January 2017).
<http://frc.org.uk/getattachment/ca1d9909-7e32-4894-b2a7-b971b4406130/Developments-in-Corporate-Governance-and-Stewardship-2016.pdf>

FRC: UK Corporate Governance Code (April 2016).
<https://www.frc.org.uk/directors/corporate-governance-and-stewardship>

Department for Business, Energy and Industrial Strategy: Corporate governance reform, government response (August 2017).
<https://www.gov.uk/government/consultations/corporate-governance-reform>

ESMA: Guidelines on Alternative Performance Measures (June 2015).
<https://www.esma.europa.eu/press-news/esma-news/esma-publishes-final-guidelines-alternative-performance-measures>

FRC: FAQs on the application of ESMA's Guidelines on Alternative Performance Measures (May 2016).
<https://www.frc.org.uk/news/may-2016/faqs-on-esma-apm-guidelines>

FRC: Corporate Reporting Thematic Review: Alternative Performance Measures (November 2016).
http://frc.org.uk/getattachment/3b030929-b2ba-4f07-85f8-00e5eb1f1403/Corporate-Reporting-Thematic-Review_APMs-v2-1.pdf

FRC: Audit Quality: Practice aid for audit committees (May 2015).
<https://www.frc.org.uk/auditors/audit-assurance/promoting-audit-quality>

APPENDIX B: OPERATING PROCEDURE CHANGES

APPENDIX B

In 2015 we conducted an effectiveness review of our AQR and CRR activities with input from external consultants. This included a number of suggestions on how to improve the effectiveness and transparency of CRR's work, providing a more useful information set for investors. The changes to our operating procedures required to implement these suggestions were consulted upon during 2016 and have been effective since 1 April 2017. The main changes in the operating procedures are summarised below:

Publicity

The FRC's *Guidance on Audit Committees* (revised April 2016)²⁶ expects companies complying with the Code to explain the nature and extent of interaction (if any) with CRR.

Under the revised guidance,²⁷ we will publish the names of those companies whose accounts were reviewed in any year once the relevant reviews have been closed and the companies' next accounts have been published. Companies who were required to respond to any substantive queries will be separately identified.

This gives all companies the opportunity to disclose the nature and extent of their interaction with the FRC when a company has been selected for review. The inherent limitations of the scope of the CRR's reviews are discussed on our website.

Changes to Reflect more Executive-led Decision-making

Decision-making is now more executive-led and additional senior staff have been recruited to support this approach. The non-executive FRRP Chairs focus on reviews containing more significant potential issues and on higher-profile companies.

²⁶ This consultation can be accessed here:

[https://frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Audit-Committees-\(2\).pdf](https://frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Audit-Committees-(2).pdf)

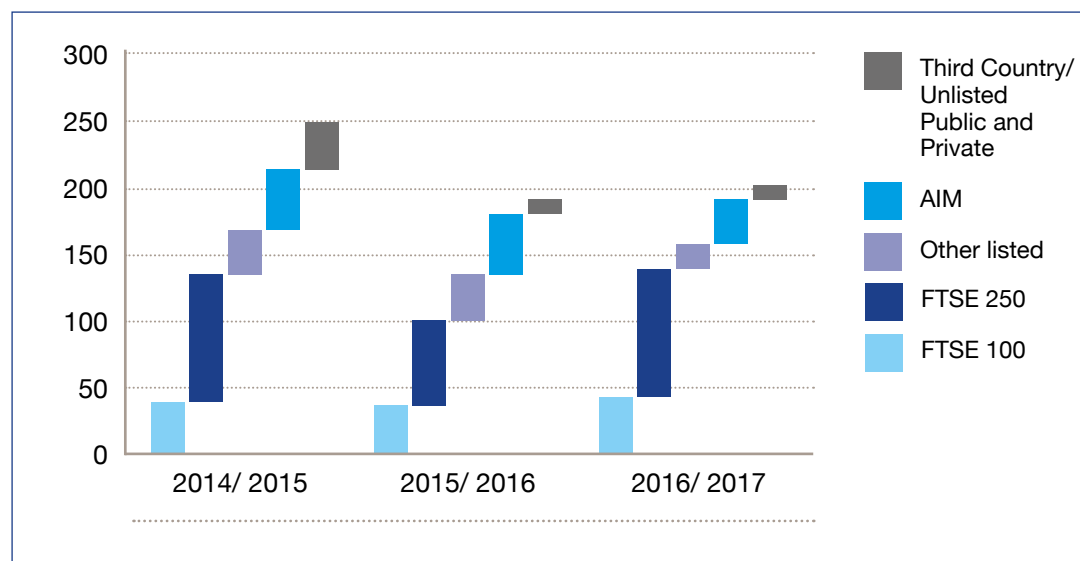
²⁷ The FRC's *Guidance on Audit Committees* (revised April 2016) is effective from 17 June 2016.

APPENDIX C: FRC MONITORING ACTIVITIES

APPENDIX C

This section provides an overview of the FRC’s monitoring activities during 2016/17, which informs our views on the quality of corporate reporting in the UK. In 2016/17 we reviewed 203 sets of accounts (2015/16: 192; 2014/15: 252).

Table B: Reviews by Market



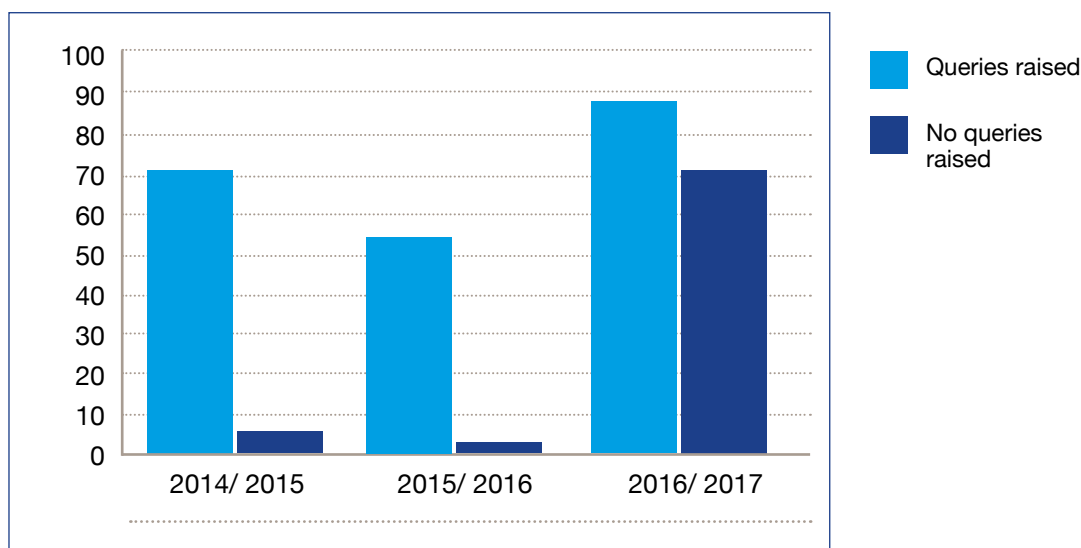
We select companies for review through a combination of a rotational approach to FTSE 350 companies, referrals and complaints received, FRC-wide priority sectors and random selection.

We seek to review the report and accounts of FTSE 350 companies at least every five years and supplement this in the intervening years by including them in the scope of certain thematic reviews.

We target the completion of reviews in time for agreed improvements to be reflected in the companies’ next reports

and accounts, ensuring that better quality information is in the public domain at an early opportunity. In 2016/17 83% of cases (2015/16: 69%) where we raised substantial queries were completed before the next set of reports and accounts were due for publication. In 2015/16, this percentage was reduced by complaints and referrals received late in the reporting cycle.

98% of 2016/17 reviews were completed by the date of this publication (95%: 2015/16; 93%: 2014/15).

Table C: Approaches to Companies

We write to companies raising substantive queries and also where we identify less significant matters but do not raise substantive queries. The table above shows the numbers of each type of letter we wrote over the past three years.

Letters to companies emphasise that we do not expect them to include information in their published reports that is immaterial or irrelevant and letters should not be read as a suggestion that they do so. A question about the materiality of disclosures no longer provided is not an implied suggestion that they be reinstated. Directors are expected to have sufficient confidence in their own decisions to justify them.

Queries Raised with Companies

Where we identify substantive issues with a company's annual report and accounts we raise these directly with the company to seek a resolution to our concerns.

We wrote to 89 companies raising substantive queries on which a response was sought (2015/16: 56; 2014/15: 71), which is 44% (2015/16: 29%; 2014/15: 28%) of the reports reviewed.

Historically, we have tended to write letters raising substantive queries on approximately 30% to 40% of reports reviewed. We do not consider that this increased rate of substantive queries is necessarily indicative of a change in the underlying quality of the reports and accounts reviewed and in part is reflective of changes in our own procedures described earlier.

No Queries Raised with Companies

We also write letters to certain companies where we do not identify substantive queries but include an appendix of less significant matters where the company may not have complied with the relevant legal, accounting or reporting requirements or existing disclosures could potentially be improved.

This year, as part of our drive for increased transparency, we have also written to companies to inform them when we have performed a review of their report and accounts but not identified substantive queries nor an appendix of more minor points. This has resulted in an increase in total number of letters issued.

Pre-informing Companies of Thematic Reviews

When performing our thematic reviews, we write to a sample of companies prior to their year-end informing them that we will review the disclosures subject to the thematic review in their next published reports. We select companies in accordance with our usual selection methodology, where we believe the thematic review topics will be particularly relevant. This provides those companies with an opportunity to focus on the matters highlighted in advance of publication, thereby prompting targeted improvements.

Review Groups

Our operating procedures provide for a Review Group of FRRP members to be set up where an enquiry by peers into a company's report and accounts is likely to be better placed to progress a review – whether because of the complexity of the issue involved or because it has not been possible to reach a common understanding of the issue with the company.

The Review Group of FRRP members set up in 2015/16 on RAK Petroleum plc remained ongoing throughout 2016/17. However, RAK Petroleum plc announced in September that, in consultation with the FRC, it had decided that DNO, an investee company, should be consolidated in the Group's annual report for the year ended 31 December 2017. On the basis of this undertaking, the Review Group has closed its enquiry. No other Review Groups were established this year.

Response Times

Companies are asked to respond to our initial letters within 28 days, so that potential matters are addressed promptly. Reasonable requests for extensions are granted. We welcome the improvement in the average response time for our letters since 2013, when a 28 day response was introduced. The average response time to all letters is now 30 days (2015/16: 33 days; 2014/15: 36 days).

Where possible, we respond to companies' letters within 28 days. However, the response time increases on more complex cases. The average for 2016/17 was 30 days (2015/16: 29 days; 2014/15: 34 days).

Complaints and Referrals

A substantial amount of time is allocated to considering complaints and referrals received.

20 complaints were received in 2016/17 (2015/16: 9; 2014/15: 24) of which 4 were referred from other regulators (2015/16: 1; 2014/15: 9).

We welcome complaints that are well-informed and provide additional insight that may not be observable from a review of the report and accounts. Further information on how we address complaints and referrals is available on our website.²⁸

Feedback

For 2017/18, we will follow up closed reviews by asking for feedback on the process from the companies approached. This focuses on the efficiency and effectiveness of the review process and the clarity of communications with a view to identifying ways to introduce further improvements.

²⁸ <https://frc.org.uk/Our-Work/Corporate-Governance-Reporting/Corporate-Reporting-Review/FAQs.aspx>

Working with Other Regulators

Working with Audit Regulators

Our CRR and Audit Quality Review (AQR) teams collaborate when they are able to assist each other's reviews. CRR advises AQR if it has concerns around the quality of the audit work performed. Where AQR reviews an audit and identifies potential issues with a set of accounts, CRR will then consider whether to open correspondence with the company.

We also receive referrals regarding company accounts stemming from audits inspected by the ICAEW's Quality Assurance Division. The insights into companies' accounts that other regulators can bring are valuable and we welcome their referrals.

ESMA

Negotiations over Brexit have only recently commenced and the terms of the withdrawal agreement will likely not be known for some time. In the meantime, we continue to be an active participant in the European Enforcers' Coordination Sessions ('EECS'), the committee established by ESMA for European National Enforcers to deliver its mandate in strengthening European Supervisory convergence. We contribute to discussions on significant emerging issues and enforcement decisions that affect the broader European Market. ESMA publishes a selection of these decisions twice a year.

Each year, ESMA issues European Common Enforcement priorities, which it identifies after consultation with the National Competent Authorities. We reflect these in our reviews and report the results to ESMA. For reviews undertaken in 2016/17 the priorities were:

- impact of financial markets conditions on the financial statements;
- statement of cash flows and related disclosures; and
- fair value measurement and related disclosures.

Our work did not identify any new concerns about these topics.

We actively participate in working groups set up by ESMA to consider particular aspects of financial reporting. The working group on IFRS 13 issued its report in July 2017.²⁹ We are currently a member of the working group considering the application of IAS 12 *Income Taxes*.

ESMA's Peer Review

During the year, as part of a European wide inspection programme, the FRC was subject to a review of its compliance with certain aspects of ESMA's Guidelines on enforcement of financial information.³⁰

The ESMA review made a number of positive observations about CRR's work. A summary of its findings was published in July.³¹ The ESMA review team believed that a higher proportion of CRR's reviews should be of smaller listed companies and debt issuers. We continue to believe that the most effective use of resources is to focus on the FTSE 350, where confidence in individual companies' reporting has the biggest impact on overall market confidence. The ESMA review team also observed that our statutory powers were relatively limited compared to other European enforcers.

²⁹ <https://www.esma.europa.eu/press-news/esma-news/esma-reviews-application-ifrs-13--fair-value-measurement-requirements>

³⁰ https://www.esma.europa.eu/sites/default/files/library/esma71-99-521_peer_review_guidelines_on_enforcement.pdf

³¹ https://www.esma.europa.eu/sites/default/files/library/esma42-111-4138_peer_review_report.pdf

Other UK Regulators

Regular meetings are held with the FCA to share the outcome of our work on regulated companies and discuss ongoing matters of joint interest. Where the work relates to interim reporting or the reports of non-UK companies, our findings are passed to the FCA under the Companies (Audit, Investigations and Community Enterprise) Act 2004 for

further consideration. The FCA may refer corporate reporting matters to the FRC when we are best suited to investigate further.

We also liaise with the Prudential Regulation Authority on matters of mutual interest regarding financial institutions and may share information, for example on complaints that affect both corporate and prudential reporting.



APPENDIX D: SUMMARY OF DISCIPLINARY CASES CONCLUDED SINCE 1 APRIL 2016

APPENDIX D

Connaught plc

The case related to the conduct of Stephen Hill and David Wells in relation to the incorrect accounting of a £4 million short-term loan in Connaught plc's 2010 interim financial statements. The FRC's Executive Counsel accepted that neither Mr Hill nor Mr Wells acted dishonestly in failing to account accurately for the sums in question. However, Mr Hill admitted that his conduct was sufficiently reckless to have amounted to acting with a lack of integrity. Mr Wells admitted that he failed to act in accordance with the ICAEW's fundamental principles of objectivity and professional competence and due care.

RSM Tenon Group plc

Andrew Raynor admitted that his conduct fell significantly short of the standards reasonably to be expected of a member of the ICAEW in relation to the approval of the financial statements of RSM Tenon Group plc. Mr Raynor admitted that he failed to obtain the level of assurance, in relation to the accounting treatment of bonus accruals and a lease, necessary to sign off on the financial statements of RSM Tenon Group plc.

The Cup Trust

Anthony Mehigan was a director of a company that acted as corporate trustee of The Cup Trust, a UK charity. The charity had been established by a business associate with whom Mr Mehigan had a long association and common financial interests. This relationship compromised Mr Mehigan's ability to consider properly matters relating to a tax avoidance scheme that was proposed to the charity by the same associate, where Mr Mehigan's duty was to act solely in the interests of The Cup Trust. On a number of occasions, Mr Mehigan allowed this conflict of interest to override his professional judgement. In addition, Mr Mehigan failed to act with professional competence and due care in approving financial statements which did not give a true and fair view.

The Co-operative Bank plc

The settlement followed Adverse Findings made by the Prudential Regulation Authority, which amount to conclusive evidence of Misconduct under the Accountancy Scheme. During the period between 1 January 2009 and 10 May 2013, Barry Tootell breached Statement of Principle 6 of the Statements of Principle and Code of Practice for Approved Persons, which provides that an approved person performing an accountable function must exercise due skill, care and diligence in managing the firm for which he is responsible in his accountable function. Also between 22 July 2009 and 10 May 2013, Mr Tootell was knowingly concerned in the contravention by Co-op Bank of Principle 3 of the Principles of Business, in that it failed to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

RSA Insurance Ireland Limited

Rory O'Connor, former Chief Financial Officer, admitted that his conduct fell significantly short of the standards reasonably to be expected of a Member of CIMA, when he, amongst other things, approved materially inaccurate financial statements for the financial years ended 31 December 2010 to 31 December 2012 inclusive. He admitted that he thereby breached the fundamental principles of Integrity and Objectivity in the CIMA Code of Ethics.

Tech Data Limited

Philip John James, the former Finance Director of Tech Data Limited (formerly known as Computer 2000 Distribution Limited (C2000)), admitted 12 allegations that his conduct fell significantly short of the standards reasonably to be expected of a member of the Association of Chartered Certified Accountants (ACCA). Mr James breached the ACCA's Fundamental Principle of Integrity, which required him to be straightforward and honest in all professional and business relationships and not to be knowingly associated with information that he knew to be false or misleading.



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