Financial Reporting Council

CORPORATE REPORTING THEMATIC REVIEW

REPORTING BY SMALLER LISTED AND AIM QUOTED COMPANIES

NOVEMBER 2018

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Registered in England number 2486368.

Registered Office:
8th Floor, 125 London Wall, London EC2Y 5AS

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Corporate Reporting Thematic Review

Reporting by Smaller Listed and AIM Quoted Companies

November 2018

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Thematic reviews supplement the FRC's monitoring work conducted by Corporate Reporting Review (CRR). CRR monitors company reports and accounts for compliance with the Companies Act 2006, including applicable accounting standards, and other reporting requirements. The aim of thematic reviews is to identify and share examples of good practice reporting and highlight areas where improvements can be made.

This report shares our detailed findings from a targeted review of smaller listed and AIM quoted companies' disclosures. Companies can use this to assess and enhance their own disclosures to ensure they provide high quality information to investors in their annual reports and accounts.

Certain matters targeted in this review were covered by CRR's previous thematic reviews in 2016 and 2017, which focused on alternative performance measures ('APMs'), tax disclosures, judgements and estimates, and pension disclosures. The outcomes of the previous reviews together with the examples of better disclosures, which focused primarily on larger companies, remain appropriate for companies of all sizes. Therefore, we encourage all companies to use this report in combination with our previous publications.

CRR's thematic reviews are based solely on company reports and accounts and do not benefit from detailed knowledge of each company's business or an understanding of the underlying transactions entered into. They are, however, conducted by staff who have an understanding of the relevant legal and accounting framework. The FRC provides no assurance that the reports and accounts subject to review are correct in all material respects; the FRC's role is not to verify the information provided but to consider the quality of compliance with reporting requirements.

The outcomes of the previous thematic reviews, together with the examples of better disclosures, remain appropriate for companies of all sizes. We encourage all companies to use this report in combination with our previous publications.

1 BACKGROUND

In December 2017, the FRC wrote to 40 smaller listed and AIM quoted companies informing them that CRR would review certain aspects of reporting in their next annual report and accounts.

The FRC focuses its routine reviews on the FTSE 350, where potential failures in corporate reporting would have the most significant effect on stakeholder confidence. However, it also monitors reporting by smaller listed and AIM quoted companies ('smaller companies'). Previous findings that the quality of reporting by such companies was generally not as good as their larger peers prompted the FRC's discussion paper 'Improving the Quality of Reporting by Smaller Listed and AIM quoted companies'[1], published in June 2015 ('the 2015 paper'), which identified a number of initiatives. This year, we have undertaken a thematic review focusing exclusively on the quality of reporting by smaller companies.

We conducted thematic reviews in 2016 and 2017 to prompt improvements in the disclosure of tax, pensions, APMs, and judgements and estimates. We have included these aspects of reporting in this thematic review to consider the extent to which the messages given have been reflected in smaller company reporting. We have also included certain aspects of strategic reports, accounting policies and cash flow statement reporting, as investors in smaller companies have told us that they consider them to be an important source of information.

We announced the thematic review on 17 November 2017,[2] and explained our expectations in relation to each of the five selected topics. We notified 40 companies of the two aspects of corporate reporting, selected from the five, that we would review in their next report and accounts, resulting in 16 companies being selected for each topic. At the date of selection, the chosen companies comprised 22 listed companies outside the FTSE 350 and 18 AIM quoted companies, with year-ends ranging from 31 December 2017 to 31 March 2018.[3]

As with all our thematic reviews, the main objective is to encourage better quality reporting that better enables users to assess the quality of management's decisions. Our thematic reviews also provide preparers with examples of better disclosure.

Topics covered by the thematic review

- *APMs and Strategic Reports*
- *Pension disclosures*
- *Accounting policies, including critical judgements and estimates*
- *Cash flow statements*
- *Tax disclosures*

1 https://www.frc.org.uk/consultation-list/2015/consultation-improving-the-quality-of-reporting-b

2 https://www.frc.org.uk/getattachment/fdc1afd6-6838-4e40-a167-513d21dcbbc2/Smaller-listed-and-AIM-quoted-company-reporting-thematic-review.pdf

3 At the time of finalising this report, one AIM quoted company in our sample had not published its accounts. Consequently, our review of the company was not completed in time to include the results in this report.

2 KEY MESSAGES

We were encouraged to see that most of the companies in our selection responded to advance notification of our review by making some improvements to their disclosures. However, there is clearly still scope for further improvement.

We saw examples of improvements across all five topics selected, indicating that smaller companies can achieve higher quality reporting. The more significant improvements were seen in the larger companies in our sample. The most frequently improved disclosures related to APMs, and judgements and estimates. In addition, we were pleased to see that some companies were prompted to enhance their strategic report to provide commentary on all significant matters, including tax, pensions and cash flows. Other improvements included:

Narrative sections (Strategic Report, Chairman's statement or CEO's Review, etc)

- Some companies provided a better balance between APMs and IFRS measures than provided in previous years. For example, they added IFRS information to the APMs in their highlights section. More companies ensured that any commentary in the strategic report that focused on APMs was immediately followed by commentary on corresponding IFRS measures.
- Other improvements to APMs included: highlighting the limitations of APMs, better explaining individual adjustments and providing previously omitted reconciliations of APMs to corresponding IFRS measures.

Financial statements

- We saw some informative disclosures in relation to tax provision estimation uncertainties and tax reconciliations. These were characterised by clear explanations of the matters requiring estimation and the sources of uncertainty affecting them, with the relevant amounts quantified. The better reconciliations had specific descriptions of reconciling items, distinguishing between items with recurring and one-off impacts on the effective tax rate.
- We identified examples of good disclosures on pension risks, explaining the nature of each risk and how any changes would impact scheme assets and/or scheme obligations.
- We also noted additional disclosures that are not strictly mandated by IAS 19[4] but which we encourage. We were pleased to note details of amounts owed to deferred, active and retired members, valuations on a funding basis and amounts of future deficit repair contributions. The more informative disclosures explained that, for example, funding valuations directly determine future cash payments.

However, there is still clear scope for further improvement in reporting by smaller companies. The 'Annual Review of Corporate Governance and Reporting

We saw examples of improvements across all five topics selected, indicating that smaller companies can achieve higher quality reporting.

There is still clear scope for further improvement (see section 8 for helpful reminders).

4 IAS 19 'Employee Benefits'

2017/18'[5] identified 15 companies that had been required to refer to correspondence with the FRC following a restatement of one of their primary statements. Six of these were smaller companies, as defined in this report. The remainder were FTSE 350 or private companies. This is consistent with our previous findings that basic errors in compliance with accounting standards are more frequent in smaller companies. Over half of all the restatements related to misclassifications in cash flow statements.

In the spirit of continuous improvement, we identified some areas for disclosure improvement in almost all of the companies in our sample, with similar themes arising as identified by our routine reviews.

Narrative sections (Strategic Report, Chairman's Statement or CEO's Review, etc)

- Many companies did not use their strategic reports to provide a sufficiently comprehensive analysis of their accounts. For example, the reports did not fully discuss the effect of significant items on cash flows or items affecting the effective tax rate. The comprehensiveness of strategic reports is particularly important to investors in smaller companies, who may have limited alternative sources of information.

- There were some examples of APMs given more prominence than IFRS measures in the Chairman's Statement and the CEO's Review.

Financial statements

- We were disappointed to see that few companies provided sensitivity analyses or quantified ranges of possible outcomes when describing sources of estimation uncertainty. This information helps users of the accounts to understand the relevance and potential impact of estimates made by management. This issue was raised in our 2017 thematic review on judgements and estimates and we had hoped to see more significant improvements.

- Most companies disclosed future deficit repair contributions agreed with pension trustees. However, the majority did not explain how minimum funding requirements and trustees' rights affected amounts recognised, as required by IFRIC 14.[6]

- Some pension disclosures required by IAS 19 were omitted (for example, separate disclosure of quoted and unquoted investments and sensitivity analyses for all key assumptions).

- We were disappointed to note that our review of cash flow statements identified apparent errors such as the misclassification of cash flows between operating, investing or financing activities. The matters identified have been raised with relevant companies.

Of the 40 companies included in our sample, we wrote follow-up letters to 15[7] where we identified a substantive question relating to their disclosures. Correspondence with the companies is ongoing.

The detailed findings from the thematic review are set out in sections 3 to 7. We have also included a number of examples of disclosures that illustrate how companies could provide users with more useful information.

Section 8 reminds companies of our main findings, which we expect companies of all sizes to consider when preparing their next report and accounts.

We were disappointed to see that few companies provided sensitivity analyses or quantified ranges of possible outcomes when describing sources of estimation uncertainty.

There were some examples of APMs being given more prominence in certain sections (for example, the Chairman's Statement and the CEO's Review).

5 https://www.frc.org.uk/getattachment/f70e56b9-7daf-4248-a1ae-a46bad67c85e/Annual-Review-of-CG-R-241018.pdf
6 IFRIC 14 'IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction'
7 At the time of finalising this report, one AIM quoted company in our sample had not published its accounts. Consequently, our review of the company was not completed in time to include the results in this report.

3 APMs AND STRATEGIC REPORTS

In our view the Guidelines represent a codification of best practice, relevant for all companies.

3.1 FRC expectations

The FRC's expectations in relation to APMs and strategic reports are set out below. These reflect the strategic report requirements of the Companies Act 2006 and the European Securities and Markets Authority's ('ESMA') Guidelines on Alternative Performance Measures ('the Guidelines').[8] They also reflect the results of the FRC's APM thematic reviews conducted in 2016[9] and 2017[10] and the views of investors.

The 16 companies whose APMs and strategic reports we reviewed comprised eight small listed companies and eight AIM quoted companies.

Whilst compliance with the Guidelines is not mandatory for AIM quoted companies, we considered the extent to which their presentation was consistent with their requirements. This reflects our view that the Guidelines represent a codification of best practice. Application of the Guidelines is consistent with the provision of a fair, balanced and comprehensive strategic report.

FRC Expectations: Presentation of APMs and Strategic Reports	
Where companies choose to present APMs, the FRC expects these to be clearly defined, reconciled to the relevant IFRS numbers, accurately labelled and explained, and not given greater prominence than IFRS performance measures.	The FRC expects strategic reports to discuss all material aspects of the business's performance and financial position, including an explanation of relevant trends in balance sheet amounts such as pensions, and cash flows.
The disclosure of business models should explain how the company makes its money and be consistent with other information in the annual report and accounts.	Principal Risks and Uncertainties ('PRUs') should be tailored to the company, regularly reviewed and updated as its circumstances change.

8 https://www.esma.europa.eu/sites/default/files/library/2015/10/2015-esma-1415en.pdf
9 https://www.frc.org.uk/getattachment/3ff9a115-0a59-4b41-a86c-0ef3b8aefeb4/Improved-reporting-of-alternative-performance-meas.pdf
10 https://www.frc.org.uk/getattachment/ff987c01-416f-4635-8dba-fdda5530f4b5/091117-APMs-CRR-thematic-review.pdf

3.2 Principal findings

We were pleased to note that most companies took the opportunity to improve the presentation of their APMs:

- Companies made changes to increase the prominence of IFRS measures (for example, by presenting a wider range of IFRS measures and related commentary in sections such as the financial highlights and the Chairman's Statement).

- There were improvements in certain companies' explanations (for example, reasons for presenting APMs and why items were classified as exceptional or adjusting items).

- Some companies explained that they had updated their disclosures to ensure that they did not inaccurately refer to items as 'non-recurring'.

- Other companies provided reconciliations of certain APMs to IFRS measures, where these had been omitted in the previous year.

We observed that most of the improvements identified involved incremental changes to existing disclosures (for example, clarifying narrative elements, providing a better balance between APMs and IFRS measures and explaining the calculation of APMs), rather than major redrafting of the report and accounts. This indicates that most smaller companies can improve the quality of information available to investors.

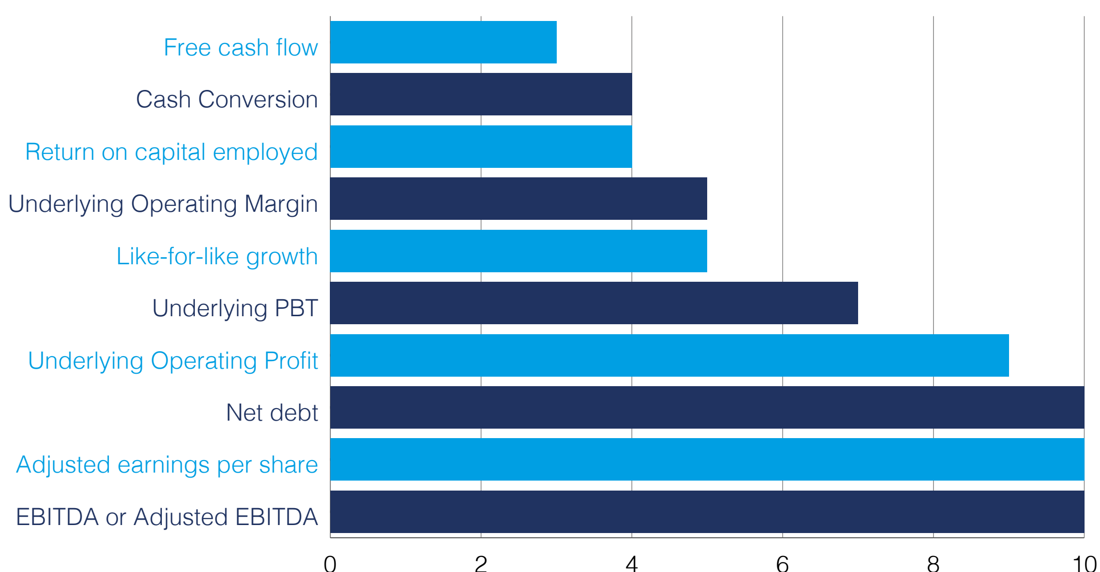
Notwithstanding the improvements, we continued to identify several inconsistencies with the reporting requirements, which indicates that there is scope for companies to further improve their presentation of APMs and strategic reports. The principal findings from our review are set out below.

3.2.1 Identification and prominence of APMs

The companies in our sample used a number of APMs. Figure 3.A provides an indication of the most frequent APMs in the companies that we reviewed.[11]

Our review highlighted that companies can make incremental improvements that do not require major redrafting of the report and accounts.

Figure 3.A: Frequency of APMs presented by the companies reviewed



11 Where companies used different labels for a similar APM, we have combined them under a single label. For example, the graph combines 'underlying operating profit' with 'adjusted operating profit' and 'operating profit before exceptional items'.

Most of the companies provided definitions for their APMs. Some provided these in a separate section of the strategic report or in a glossary.

The labels given to APMs were generally understandable, although one company used a label closely resembling a term commonly presented on the IFRS balance sheet, despite it being apparent that it was calculated on another basis.

The Guidelines clarify that APMs should be given meaningful labels to avoid conveying misleading messages to users.[12] We do not expect companies to use labels that are likely to be confused with terminology defined by IFRS or normally used in the context of IFRS reporting.

Some companies gave too much prominence to APMs, relative to IFRS measures. We identified one example where the financial highlights presented APMs while excluding directly equivalent IFRS measures that highlighted less favorable performance, including the fact that the company had made a net loss. In this context, we would have expected the company to present a corresponding IFRS measure highlighting its reported performance.

We accept that APMs often reflect the way directors monitor the business and that they may provide users with helpful additional information. However, we do not expect this to detract from the Companies Act requirement for a strategic report to provide a fair review of a company's business, which includes a balanced and comprehensive analysis of its performance and financial position.

In our review of cash flow disclosures, where companies presented cash-based APMs and/or KPIs, it was pleasing to see these measures being adequately explained and, in most cases where the derivation was not obvious, reconciled to the IFRS cash flow information.

Example 3.1 identified APMs with the symbol **A** to ensure that they could be clearly identified.

We identified one example where the financial highlights presented APMs while excluding directly equivalent IFRS measures showing less favorable performance.

12 Paragraph 22 of the Guidelines

Example 3.1: Coats Group plc, Annual Report 2017, page 31

Financial summary

Adjusted earnings per share ('EPS') Ⓐ for the year increased 30% to 6.4 cents (2016: 4.9 cents). This growth was driven by higher adjusted operating profits (11% CER growth) Ⓐ , a reduction in effective tax rate (4% reduction in underlying rate, including a $3 million deferred tax credit resulting from the recent US tax reforms), a $4 million reduction in the IAS19 pension finance charge (albeit offset to some extent by the related decrease in interest income on reduced parent group cash), and foreign exchange gains of $2 million (2016: $4 million losses) primarily relating to mark-to-market (MTM) adjustments. Excluding the year-on-year impact of the foreign exchange gains / losses (net of tax), and the deferred tax credit as a result of the recently announced US tax reforms, adjusted EPS growth would have been 17%. The Company generated a reported attributable profit from continuing operations of $81 million compared to $64 million in 2016, primarily due to the reasons set out above.

Adjusted free cash flow Ⓐ was $87 million in 2017, a 12% increase on 2016 ($78 million), driven by improved profitability, which was partially offset by the anticipated increase in capital expenditure to $50 million (2016: $40 million); the increase in which was predominantly in the second half. The reduction in net cash from $78 million at the end of 2016 to a net debt Ⓐ position at 31 December 2017 of $241 million primarily reflects the upfront deficit recovery payments made into the three UK defined benefit pension schemes in the first half of the year following settlement with the Trustees of those schemes (see later for further details). An important metric for the operating business is the leverage ratio of net debt (excluding parent group cash) to adjusted EBITDA, which further improved to 1.1x adjusted EBITDA at 31 December 2017 (31 December 2016: 1.3x).

Return on capital employed Ⓐ remained in line with 2016 at 35%, as higher adjusted operating profits and controlled working capital were offset by the anticipated increase in capital expenditure.

Ⓐ Alternative Performance Measures – see note 37 on page 143.

The extract in Example 3.2 illustrates how Laird PLC applied the Guidelines, integrating different elements into a single section explaining the overall context and providing detailed information for individual APMs (for example, the definition, rationale, reconciliation and comparative information for each APM).

Example 3.2: Laird PLC Annual Report & Financial Statements 2017, pages 26 and 27

Company's disclosures (excerpt)

FRC observations:

This document contains certain financial measures that are not defined or recognised under IFRS, including Covenant EBITA and Covenant EBITDA, net debt, cash interest expense, underlying profit before tax, underlying operating profit, underlying basic earnings per share, operating cash flow, free cash flow, organic constant currency metrics and figures relating to the reorganisation of the Group's divisions. These measures are unaudited and are not measures of financial performance under IFRS and should not be considered as alternatives to other indicators of the Group's operating performance, cash flows or any other measure of performance derived in accordance with IFRS. Accordingly, these non-IFRS measures should be viewed as supplemental to, but not as a substitute for, measures presented in the Laird Final Results and Laird Annual Report and Accounts, which are prepared in accordance with IFRS as adopted by the EU.

Identifies the different APMs using their labels; refers to limitations

Information regarding these measures is sometimes used by investors to evaluate the efficiency of a company's operations and its ability to employ its earnings toward repayment of debt, capital expenditures and working capital requirements. However, there are no generally accepted principles governing the calculation of these measures and the criteria upon which these measures are based can vary from company to company. These measures, by themselves, do not provide a sufficient basis to compare the Company's performance with that of other companies and should not be considered in isolation or as a substitute for operating profit or any other measure as an indicator of operating performance, or as an alternative to cash generated from operating activities as a measure of liquidity.

Identifies further limitations and states that APMs are not substitutes for reported measures

Underlying profit before tax and underlying operating profit

The Group uses underlying profit before tax (defined as profit before tax, adding back adjustments to the fair value of financial instruments, impairment of goodwill, amortisation of acquired intangible assets and exceptional items) and underlying operating profit (underlying profit before tax, adding back finance income, finance costs and other finance revenue – pension) as supplemental measures of the Group's profitability, which the Group considers useful due to the exclusion of specific items that are considered to hinder comparison of the underlying profitability of the Group's businesses.

Definition of APMs (paragraph 20 of Guidelines)

Rationale for APMs (paragraphs 33 and 34 of Guidelines), specific to these APMs

The table below sets out the reconciliation of the Group's underlying profit before tax and underlying operating profit from profit before tax…

Reconciliation of APM (paragraphs 26 and 38 of the Guidelines)

3.2.2 Rationale and explanations for APMs and adjusting items

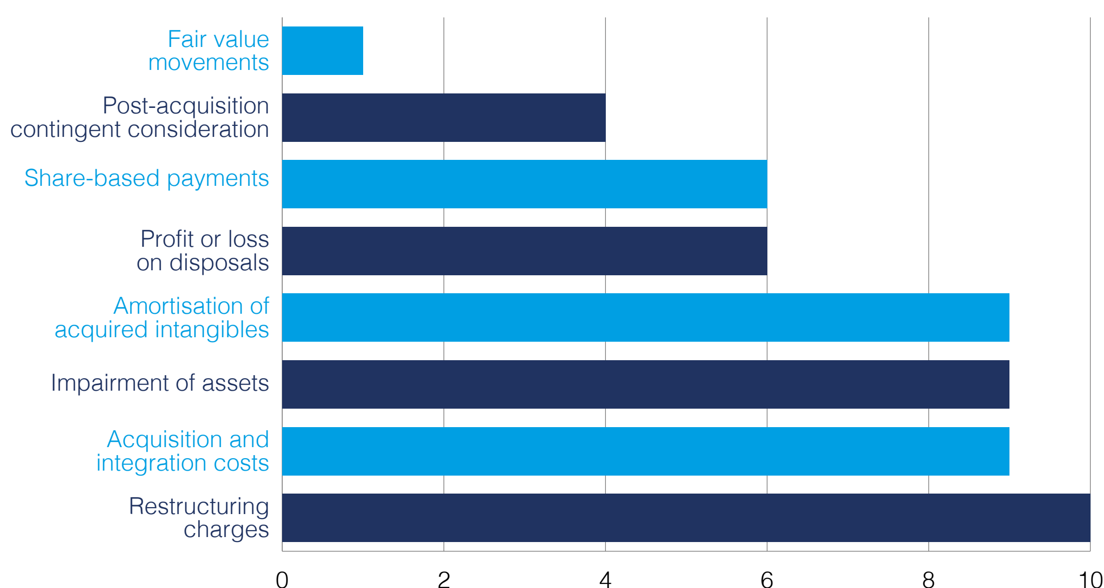
Companies provided varying degrees of granularity in their explanations for presenting APMs. Several companies explained that their APMs are used internally (for example, to manage the business, to monitor divisional performance or to determine employee bonuses). We were pleased to see that most companies who stated that APMs were used to manage the business also disclosed at least one of their APMs in their segmental report.

Almost all APM adjustments that we saw were in the eight categories shown in Figure 3.B.

It was not clear to us why share-based payment charges should be excluded from APMs as they appear to be a valid cost of the business and relieve companies of an alternative cash expense.

It was disappointing that only a few companies provided specific, rather than general, disclosures to explain their rationale for excluding certain items from an APM.

Figure 3.B: Frequency of APM adjustments



Disappointingly, only a few companies provided specific, rather than general, disclosures to explain their rationale for excluding certain items from an APM. One of the more common boilerplate disclosures was that certain items are excluded from adjusted profit 'based on their frequency, nature and significance'. In certain instances, users were left to infer which, if any, of the stated criteria applied to specific adjusting items. We expect companies to explain why individual items have been excluded from adjusted profit measures.

Two companies indicated that share-based payments are unconnected with their normal business while another company stated that it excluded defined benefit pension costs from adjusted profit because the directors are not able to influence the factors that drive the costs. We were not persuaded that these were adequate explanations for excluding items from an APM. In the FRC's previous APM thematic reports we explained that it was not clear to us why share-based payment charges should be excluded from APMs as they appear to be a valid cost of the business and relieve companies of an alternative cash expense.

Seven of the 16 companies used the term 'non-recurring', or a similar variant, when discussing adjusting items. Other terms used included 'infrequent', 'irregular' or items that are 'unlikely to recur'. We questioned the validity of treating costs as one-off when the circumstances indicated that they may well recur in the future or had occurred in the recent past. For example, one company described acquisition-related costs as non-recurring items, even though its strategic report indicated that it was likely to continue its acquisition-driven strategy. Another company stated that gains on property disposals were non-recurring even though its strategic report disclosed that it was actively marketing certain of its freehold properties for sale, and it had sold another property after the balance sheet date.

As stated in our 2017 APM thematic report, we recommend that companies remove descriptions such as 'non-recurring' from their APM definitions and select more accurate labels.

3.2.3 APM reconciliations and other quantitative aspects

Our review found that all but one company sampled presented an adjusted measure of profit. Each company that presented such a measure reconciled it to its IFRS equivalent. However, there were several instances where companies did not provide definitions or reconciliations for the wider population of APMs that were presented. Examples included constant currency and like-for-like metrics, Operating Assets Employed and ratios such as Return on Capital Employed and Net Funds to Equity. In this regard, we recommend that companies refer to section 4.4 of our report on the 2017 APM thematic review, which provides illustrative reconciliations for constant currency amounts and Return on Invested Capital.

We also identified that in most cases, the principal profit APM showed more favourable performance than the equivalent IFRS amount, including four cases where APMs reflected a profit whereas the corresponding IFRS measure was a loss.

There was scope for improvement in relation to the disclosure of the tax and cash flow effects of adjusting items. A significant number did not disclose the cash impact of adjusting items, even though the nature of the costs indicated that they would have a cash impact.

All companies that disclosed post-tax APMs also presented the aggregate tax on adjustments but only one company provided an analysis of the tax allocated between different adjusting items.

Most companies disclosed the amount of tax attributed to items identified as exceptional or non-recurring and excluded from measures of 'underlying' or 'headline' profit. However, where the applicable tax rate attributable to these items was different from the standard applicable tax rate, companies seldom explained how the rate for exceptional items had been calculated. In circumstances where different adjusting items have significantly different tax impacts, we expect disclosures to be provided to enable users to understand their impacts on the overall effective tax rate.

Example 3.3 discloses the effective rates for underlying and non-underlying profit, with narrative information on the impact of certain non-recurring items on the effective rate.

We recommend that companies remove descriptions such as 'non-recurring' from their APM definitions and select more accurate labels.

There were several instances where companies did not provide definitions or reconciliations for the wider population of APMs that were presented (for example, constant currency and like-for-like metrics, or ratios such as Return on Capital Employed).

In most cases, the principal profit APM showed more favourable performance than the equivalent IFRS amount.

Example 3.3: Marshall Motor Holdings plc, Annual Report & Accounts 2017, page 91

The analysis of the Group's effective tax rate between underlying and non-underlying activities is as follows:

	2017			2016		
	Underlying £'000	Non-underlying £'000	Total £'000	Underlying £'000	Non-underlying £'000	Total £'000
Profit before taxation	29,067	24,068	53,135	25,400	(3,249)	22,151
Taxation	5,270	(1,474)	3,796	5,153	(756)	4,397
Effective tax rate	**18.13%**	**(6.12%)**	**7.14%**	**20.29%**	**23.27%**	**19.85%**

Non-recurring items

The Group's total effective tax rate for 2017 of 7.14% was influenced by the significant non-taxable gain on disposal of a subsidiary, due to the chargeable gain falling within the substantial shareholding exemption. Excluding this item, the total effective tax rate for the year would have been 23.31%.

The prior year total effective tax rate of 19.85% was impacted by the change in future tax rates enacted during 2016, reducing the rate by 6.25%. This reduction was partially offset by a 1.95% increase in the rate resulting from non-deductible acquisition costs.

Our review of accounting policies identified only one company that explained its methodology for determining tax on adjusting items. We also noted that none of the companies' APM disclosures or accounting policies described the treatment of unusual tax items such as the impact of tax reforms on post-tax adjusted EPS.

3.2.4 Strategic report matters

We did not identify significant changes between companies' latest strategic reports and those presented in the previous year. Whilst this may have been expected in relation to the eight AIM quoted companies that we reviewed, we had expected the listed companies within scope to have updated their strategic reports to consider the new non-financial reporting ('NFR') regulations. The NFR regulations apply to Public Interest Entities with over 500 employees, for periods beginning on or after 1 January 2017. Therefore, the new requirements would have applied for the first time to the annual reports and accounts of six of the listed companies selected for the purposes of reviewing APMs and strategic reports (two listed companies had less than 500 employees). However, only one company in our sample referred to the NFR regulations and provided cross-references to demonstrate how the new requirements had been integrated into its strategic report.

The NFR regulations (Section 414CB(2) of the Companies Act) require a description of the company's policies in relation to each of the matters below, the outcomes of the policies, due diligence processes and certain information on principal risks.

- *Environment*
- *Employees*
- *Social matters*
- *Human rights*
- *Anti-corruption*
- *Anti-bribery*

Where the company does not pursue policies in relation to one or more of these matters, Section 414CB(4) requires it to provide clear and reasoned explanations for not doing so.

None of the companies' APM disclosures or accounting policies described the treatment of unusual tax items such as the impact of tax reforms on post-tax adjusted EPS.

Only one company in our sample referred to the NFR regulations and provided cross-references to demonstrate how the new requirements had been integrated into its strategic report.

We recognise that the strategic reports of the companies reviewed predated the revised strategic report guidance issued by the FRC in July 2018[13]. We expect companies to consider the guidance in all future reporting to comply with the NFR regulations and the strategic report requirements more generally. Although the remaining companies' strategic reports referred to the elements covered by the regulations (the environment, employees, social matters, human rights, anti-corruption and anti-bribery matters), the content did not address the precise requirements of the NFR regulations. For example, certain companies' disclosures only highlighted that they had policies without describing them.

In considering the overall comprehensiveness of strategic reports, we note that the quality of the discussion in relation to cash flow matters varied significantly. The weaker narratives failed to present a comprehensive view of the cash position or showed inconsistencies with the financial statements. Better examples specifically addressed the effect on cash flows of individually significant transactions separately from ongoing trends and provided supplemental information to support the analysis where required, such as that concerning deferred consideration in Example 3.4 (from the Chairman's Statement).

Example 3.4: Michelmersh Brick Holdings PLC, Annual Report 2017, page 2

Cash and Borrowings

At 31 December 2017, the Group had net debt of £17.5 million (at 31 December 2016: cash of £4.7 million). The acquisition of Carlton required the Group to seek new funding and after a competitive process, which resulted in the appointment of HSBC Bank plc as the Group's principal banker. HSBC has provided a range of facilities for a six-year term to meet the funding of the acquisition and provide working capital facilities for the Group. These facilities are described in more detail in the notes to the financial statements.

The net debt figure also includes some interest bearing deferred consideration (£1.75 million) of the original amount of £3.5 million, which formed part of the total acquisition consideration for Carlton. The first instalment of £1.75 million was due for repayment in June 2018, but surplus funds allowed this to be repaid early in November 2017. The remaining balance is due in equal instalments in June 2019 and June 2020.

We were pleased to see an example of the discussion of cash flows including commentary on historic and forecast capital expenditure (Example 3.5). The same company's narrative provided a thorough insight into the cash flow and capital funding.

13 https://www.frc.org.uk/getattachment/fb05dd7b-c76c-424e-9daf-4293c9fa2d6a/Guidance-on-the-Strategic-Report-31-7-18.pdf

Example 3.5: Vertu Motors plc, Annual Report & Financial Statements for the year ended 28 February 2018, page 23

The cash impact of capital expenditure and disposals during the period, along with the anticipated spend in future years, is set out below:

	Actual			Estimate	
	FY 2016 £'m	**FY 2017 £'m**	**FY 2018 £'m**	**FY 2019 £'m**	**FY 2020 £'m**
Purchase of property	6.3	5.3	4.3	1.6	-
New dealership build	1.8	10.4	4.3	4.6	2.5
Existing dealership capacity increases	4.5	5.9	8.2	13.1	4.4
Manufacturer-led refurbishment projects	3.2	2.4	3.0	9.9	4.6
IT and other ongoing capital expenditure	5.1	4.8	4.9	4.8	4.0
Movement on capital creditor	(0.4)	0.7	(0.6)	-	-
Cash outflow from capital expenditure	**20.5**	**29.5**	**24.1**	**34.0**	**15.5**
Proceeds from sale and leaseback and property sales	(1.1)	(1.0)	(14.3)	(4.6)	-
Net Cashflow from capital investment	**19.4**	**28.5**	**9.8**	**29.4**	**15.5**

The majority of the strategic reports included some discussion of tax. As with cash, however, the quality of the discussion varied significantly, with only a few companies giving a comprehensive picture of their material tax affairs. Some explanations were noticeably brief, omitting (for example) to explain significant differences between the tax charge and tax paid. It was particularly disappointing to find two instances of inaccurate explanations for changes in the tax position.

Example 3.6 provides three illustrations of better disclosure: (1) succinct commentary on the two most significant factors affecting the tax charge and (2) a helpful summary reconciliation, (3) cross-referenced to more detailed disclosure in the financial statements.

Example 3.6: M&C Saatchi plc Annual Report 2017, page 12

Tax

Most of the equity held by our entrepreneurs and our interests in subsidiary companies receives no tax credit in the event they are charged to the income statement via share-based payments; put option revaluations; revaluations of contingent payments and goodwill impairments. Such charges to the income statement can create large swings and variations to our statutory tax rate. (1)

The Group tax rate is different to the UK's corporate tax rate:

	2017	2016
UK corporation tax rate (2)	**19.3%**	20.0%
Headline adjustments:		
Higher overseas tax rates	**6.7%**	4.5%
US tax rate change	**1.1%**	-
US tax losses utilised	**(3.4)%**	(5.0)%
Under provision prior years	**2.2%**	(0.4)%
Other	**(1.2)%**	(1.8)%
Headline tax rate	**24.7%**	17.3%
Statutory adjustments:		
Higher overseas tax rates and profit mix	**(3.0)%**	(6.2)%
US tax rate change	**14.8%**	-
Put option charges	**14.4%**	26.8%
Impairments with no tax credits	**-**	12.9%
Statutory tax rate	**50.9%**	50.8%
Full reconciliation can be found in note 14. (3)		

In addition to the matters above, our review of strategic reports identified the following:

- Two companies did not provide gender diversity disclosures as required by section 414C(8)(c) of the Companies Act for quoted companies.
- Another company provided cursory PRU disclosures that were not likely to be informative to users and appeared to fall significantly short of the Companies Act requirement to provide a comprehensive strategic report.
- There was also a question as to whether one company had complied with the Companies Act, given that its strategic report focused almost exclusively on APMs. Sections 414C(2)(a) and 414C(3) of the Companies Act state that the strategic report must contain a fair review of the company's business and that review is required to be a balanced and comprehensive analysis of the company's business during the financial year and its position at the end of that year.

Section 8 of this report sets out the key points from our findings for companies to consider when presenting their APMs and strategic reports.

4 PENSION DISCLOSURES

4.1 FRC expectations

The FRC's expectations in relation to pension disclosures are set out below. These reflect the requirements of IAS 19, as well as the results of our 2017 thematic review on pension disclosures ('the 2017 pensions thematic review').[14]

Our 2017 pensions thematic report explained that pension disclosures should enable users of the accounts to understand the relationship between the pension expense, cash payments to the scheme and the surplus or deficit. They should also enable investors to appreciate the nature of scheme assets, the scheme's investment strategy, and the extent of its liabilities and associated risks.

FRC Expectations: Pension Disclosures
The FRC expects to see an appropriate level of information on the risks around pensions and their effect on future company cash flows.
The FRC expects meaningful disaggregated information to be provided on the assets held by the plan, including their bases of valuation. In addition, information should be provided on any asset-liability matching strategies.
Where net pension assets have to be considered, the FRC expects explanations of the basis on which the company expects to benefit, including judgements made when assessing trustees' rights.

4.2 Principal findings

11 of the 16 companies included in our review made improvements to previously reported information. One of the companies highlighted that its changes reflected consideration of the guidance provided in our 2017 pensions thematic report.

The improvements included:

- discussing pension deficits within companies' strategic reports;
- disaggregating scheme assets (for example, splitting corporate bonds into different investment grades);
- explaining how certain unquoted investments had been valued;
- enhancing pension risk disclosures, for example, by describing risk mitigation strategies;
- comparing the latest triennial funding valuations to the IAS 19 valuations; and
- providing previously omitted disclosure requirements (for example, the duration of pension obligations and analysis of net actuarial losses into those due to changes in demographic assumptions and changes in financial assumptions).

14 https://www.frc.org.uk/getattachment/538ec144-05a0-499c-99b4-3f93bd21ad0b/091117-Pension-Disclosures-CRR-thematic-review.pdf

4.2.1 Pension risks and impacts on future cash flows

12 companies provided information on their pension risks. Most of the disclosures addressed different categories of demographic and financial risk, including the effects of any changes on pension assets and/or obligations. Some companies discussed their risk mitigation strategies or cross-referred to the PRU disclosures, which described the various risks and how they are managed. Overall, the language used by companies was understandable and contained little jargon.

As identified in the 2017 pensions thematic review, companies which disclosed key valuation assumptions did not always provide the required sensitivity analyses. It was not always clear why this was omitted. For example, one company did not disclose the sensitivity of the pension obligation to changes in the proportion of members that would take early retirement, which was disclosed as a key assumption. One company helpfully provided a note to explain that the inflation-related sensitivity analysis covered multiple assumptions.

We also identified cases where companies did not explain their methodology for conducting the sensitivity analyses, as required by paragraph 145 of IAS 19.

In relation to pension contributions, all companies disclosed expected contributions for the next financial year, as required by IAS 19. Most companies disclosed the deficit repair contributions that they had agreed with the trustees in the accounts and in the strategic report. These generally disclosed the initial amounts, annual percentage increases and the expected duration of the payments. We did, however, identify two cases where companies mentioned that there was a schedule agreed with the pension trustees without any information on the agreed amounts and duration of payments. While IAS 19 does not specifically require the disclosure of future contributions beyond the next financial year, this information may be important to users' understanding of future cash commitments and we strongly encourage its disclosure.

4.2.2 Scheme assets and their valuation

All the companies that we selected had funded schemes. We were pleased to note that most disclosures disaggregated scheme assets into further sub-classes. An example of one of the better disclosures that we saw is provided in Example 4.1. This analyses equities into four sub-classes and debt instruments into three types of bonds that appear to have different characteristics.

Whilst most companies disclosed key pension valuation assumptions, they did not always provide the required sensitivity analyses.

While IAS 19 does not specifically require the disclosure of future contributions beyond the next financial year, this information may be important to users' understanding of future cash commitments.

Example 4.1: Coats Group plc, Annual Report 2017, page 110

As at 31 December 2017	Coats UK US$m	Coats US US$m	Staveley US$m	Brunel US$m	Other US$m	Total US$m
Cash and cash equivalents	61.1	2.1	17.0	8.8	4.9	93.9
Equity instruments:						
US	307.7	30.9	24.7	31.0	2.2	396.5
UK	74.2	2.9	9.5	5.2	-	91.8
Eurozone	98.1	8.1	7.1	10.3	-	123.6
Other regions	128.1	21.1	7.1	5.2	7.3	168.8
Debt instruments:						
Corporate bonds (Investment grade)	809.3	120.4	29.9	26.7	5.8	992.1
Corporate bonds (Non-investment grade)	72.4	1.3	72.4	19.2	-	165.3
Government/sovereign instruments	474.9	32.1	78.2	39.1	-	624.3
Global real estate	317.0	-	-	-	0.2	317.2
Derivatives:						
Total return, interest and Inflation swaps	(25.9)	-	-	(2.3)	-	(28.2)
Assets held by insurance company:						
Insurance contracts	2.9	0.5	0.5	0.6	1.3	5.8
Diversified investment fund	97.1	-	112.8	77.2	7.3	294.4
Other	-	6.8	-	-	0.4	7.2
Total market value of assets	**2,416.9**	**226.2**	**359.2**	**221.0**	**29.4**	**3,252.7**
Actuarial value of scheme liabilities	(2,495.2)	(145.4)	(357.3)	(251.2)	(140.2)	(3,389.3)
Gross net (liability)/asset in the scheme	**(78.3)**	**80.8**	**1.9**	**(30.2)**	**(110.8)**	**(136.6)**
Adjustment due to surplus cap	-	(22.8)	-	-	(3.8)	(26.6)
Recoverable net (liability)/asset in the scheme	**(78.3)**	**58.0**	**1.9**	**(30.2)**	**(114.6)**	**(163.2)**

We were also pleased to see instances of the disclosure of holdings in certain pooled investment funds being accompanied by additional information explaining the nature of the underlying assets within the funds. We did identify one company where the analysis of plan assets included the underlying assets held indirectly through the fund. However, we consider the nature and risks of investments held indirectly to be different to those held directly by the pension scheme.

It was disappointing that six companies did not disclose the total values of scheme assets that have a quoted price in an active market and those that do not, as required by IAS 19. However, in cases where this information was disclosed, most of the companies also explained their valuation methodologies for unquoted assets (for instance, see Example 4.2).

Some companies did not disclose the total values of scheme assets that have a quoted price in an active market and those that do not, as required by IAS 19.

Example 4.2: Coats Group plc, Annual Report 2017, page 113

Basis of asset valuation

Under IAS 19, plan assets must be valued at the bid market value at the balance sheet date. For the main asset categories:

- Equities and bonds listed on recognised exchanges are valued at closing bid prices;
- Other bonds are measured using a combination of broker quotes and pricing models making assumptions for credit risk, market risk and market yield curves;
- Global real estate assets are valued on either a fair value approach as provided by the investment manager or notional bid valuations provided by the investment managers due to investments being held within a single priced pooled investment vehicle;
- Certain unlisted investments, for example derivatives and insurance contracts, are valued using a model based valuation such as a discounted cash flow; and
- Diversified investment funds are valued at fair value which is typically the Net Asset Value provided by the investment manager.

4.2.3 Net pension assets and minimum funding requirements

As stated in section 4.1, when companies have to consider whether to recognise assets relating to all or part of their net pension surpluses, the FRC expects them to explain the basis of expected recovery, including any judgements made when assessing trustees' rights. We expect the assessment of trustees' rights to be made when there is a net pension surplus, as well as when total committed contributions under a minimum funding requirement exceed the net defined benefit liability. In the latter case, trustees' rights may determine whether an additional liability should be recognised in respect of the minimum funding requirement.

We identified four companies that recognised net pension assets, including two companies where the asset recognised was partially restricted. Our reviews of the four companies identified the following.

- All four companies discussed the basis on which surpluses were expected to be recoverable (for example, based on an unconditional right to a refund on the wind up of the relevant schemes).
- One company explained that, in assessing the recoverability of the gross surplus, it had considered the implications of trustees' rights to increase member benefits (see Example 4.3).
- The other three companies did not discuss trustees' rights. In this context, our 2017 pensions thematic report highlighted that there is currently diversity of practice regarding whether trustees' discretionary power to enhance benefits for scheme members (or to wind up a scheme without cause) should be considered when determining a company's unconditional right to a refund from a defined benefit plan. We expect companies to disclose any significant accounting judgements made when assessing trustees' rights.

The FRC expects companies to explain any judgements made when assessing pension trustees' rights.

We expect the assessment of trustees' rights to be made when there is a net pension surplus, as well as when total committed contributions under a minimum funding requirement exceed the net defined benefit liability.

Example 4.3: Premier Oil plc, 2017 Annual Report and Financial Statements, page 167

Reconciliation of funded status and amount recognised in balance sheet

	At 31 December 2017 US$ million	At 31 December 2016 US$ million
Fair value of Scheme assets	(46.3)	(39.0)
Present value of defined benefit obligation	32.4	29.5
(Surplus)/deficit	(13.9)	(9.5)
Unrecognised amount due to effect of IFRIC14[1]	13.4	8.9
Surplus	**(0.5)**	**(0.6)**

Note:
[1] The trustees have certain rights to grant benefit increases to members and, accordingly, it has been concluded the Group does not have an unconditional right to the surplus by way of a refund.

It was disappointing to find six companies providing accounting policies that had not been updated to reflect the latest version of IAS 19, which became effective in 2013.

We also identified that many of the companies with net pension liabilities had a range of deficit recovery plans (that is, minimum funding requirements) agreed with the trustees. However, only one company stated that it had considered the requirements of IFRIC 14 to determine whether the minimum funding requirement gave rise to an additional liability.

4.2.4 Other matters relating to pension disclosures

We were pleased that, subject to one exception, all companies provided pension-related information in their strategic report. The matters discussed included funding deficits and related funding arrangements, interactions with the Pensions Regulator, pension risks and the reasons for changes in the balance sheet position.

Although there were instances where information in the strategic report duplicated certain disclosures within the accounts, this was not a widespread issue. We encourage companies to consider using cross-references to make disclosures more concise.

It was disappointing to find six companies providing accounting policy descriptions that had not been updated to reflect the latest version of IAS 19, which became effective in 2013. For example, we identified accounting policies which referred to the deferral of past service costs on the balance sheet and the recognition of expected returns on plan assets in the income statement. However, it was clear from reading the accounts that the correct IAS 19 requirements had been applied in practice.

Paragraph 137 of IAS 19 suggests additional disclosures companies should consider providing, in line with the overarching disclosure objectives of the standard. Only a minority of companies provided the additional disclosures. For example, only four companies analysed their pension obligations into amounts owed to active members, deferred members and pensioners. We encourage more to do so.

Similarly, only seven companies explained the differences between the IAS 19 valuation and the funding valuation, as suggested in our 2017 pensions thematic report. Example 4.4 explains the qualitative and quantitative differences between the two valuations. It highlights that the funding valuation forms the basis for the company's cash contributions.

Example 4.4: Pendragon PLC, 2017 Annual Report, page 135 (excerpted)

…accounting standards require that the asset growth rate (the discount rate) should be estimated on a similar basis for every company, to enhance comparability and to assume a relatively low level of risk. The more realistic picture is provided by the actuarial valuation which considers what the best estimate of the asset growth rate should be and hence what the gap is that the Group will be required to fund through cash contributions. These actuarial valuations are conducted every three years (the triennial valuation). The last triennial valuation was conducted as at 31 December 2015 giving the following comparison:

As at 31 December 2015

	IAS 19 (Accounts) £m	Actuarial valuation £m
Assets	396.9	397.0
Liabilities	(440.3)	(432.1)
Pension deficit	(43.4)	(35.1)
Discount rate used	3.9%	4.2%
Inflation	2.1%-3.9%	1.8%-3.7%

Section 8 sets out the key points from our findings for companies to consider when preparing their pension disclosures.

5 ACCOUNTING POLICIES, INCLUDING CRITICAL JUDGEMENTS AND ESTIMATES

5.1 FRC expectations

The FRC's expectations in relation to accounting policies, including critical judgements and estimates, are set out below. These reflect the requirements of IAS 1, IAS 8, and of other standards dealing with the disclosure of estimation in specific areas.[15] They also consider the FRC's thematic review on judgements and estimates conducted in 2017[16] and the views of investors.

Investors pay particular attention to descriptions of significant accounting policies. These provide a helpful basis for assessing whether a company's policies are unusually aggressive or out of line with other similar-sized companies in the same industry.[17]

15 IAS 1 'Presentation of financial statements'; IAS 8 'Accounting policies; changes in accounting estimates and errors'; IAS 36 'Impairment of assets'; IAS 19, IFRS 13 'Fair value measurement', IAS 37 'Provisions, contingent assets and contingent liabilities'

16 https://www.frc.org.uk/document-library/corporate-reporting-review/2017/judgements-and-estimates-thematic-review

17 Page 14 of the 2015 paper

FRC Expectations: Accounting policies, including critical judgements and estimates	
We do not expect to see boiler-plate accounting policies, copied directly from IFRS or other literature, particularly where they do not appear to relate to material balances or transactions.	We expect companies to tailor accounting policies appropriately and to consider whether new policy disclosures are required for large or unusual transactions in the current year.
Companies should disclose revenue policies in sufficient detail to enable users of the accounts to link them to, and articulate, the business model, particularly where this is complex.	Policies should be removed if no longer relevant, so that they do not obscure other current information.
We expect judgements and estimates to be separately disclosed, giving detailed descriptions of the specific, material judgements made by the directors in applying their accounting policies and using clear and specific language, pinpointing the precise sources of uncertainty.	Companies should focus on estimates with a significant risk of a material change to the carrying value of assets and liabilities within the next year, identifying the specific amounts at risk of material adjustment.
Companies should explain changes in past assumptions and estimates.	We expect underlying estimates, and the sensitivity of carrying amounts to assumptions and estimates, and/or the range of reasonably possible outcomes within the next financial year, to be quantified to help users fully understand the estimates' effect.

5.2 Principal findings

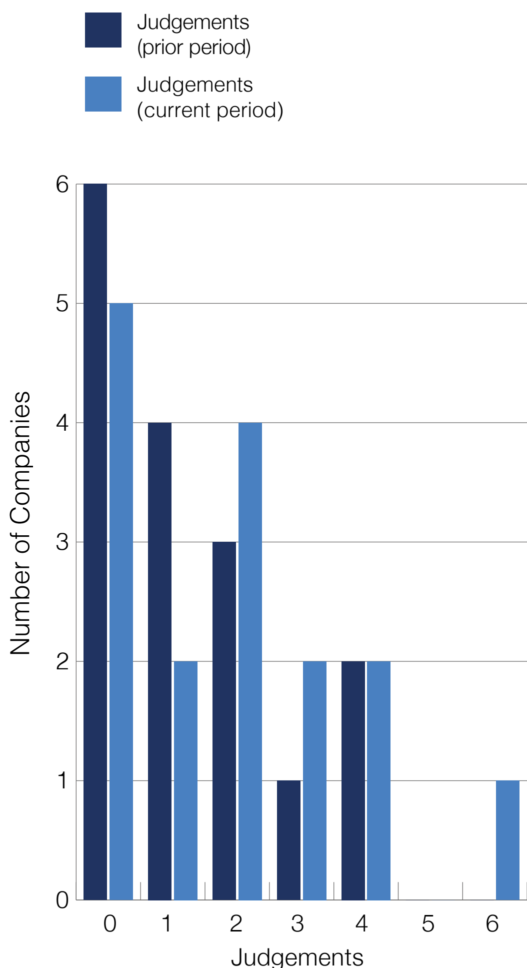
5.2.1 Judgements and estimates

Figure 5.A shows the number of significant judgements and estimates reported by the selected companies. As we found in our 2017 thematic review, there were markedly fewer judgements than estimates.

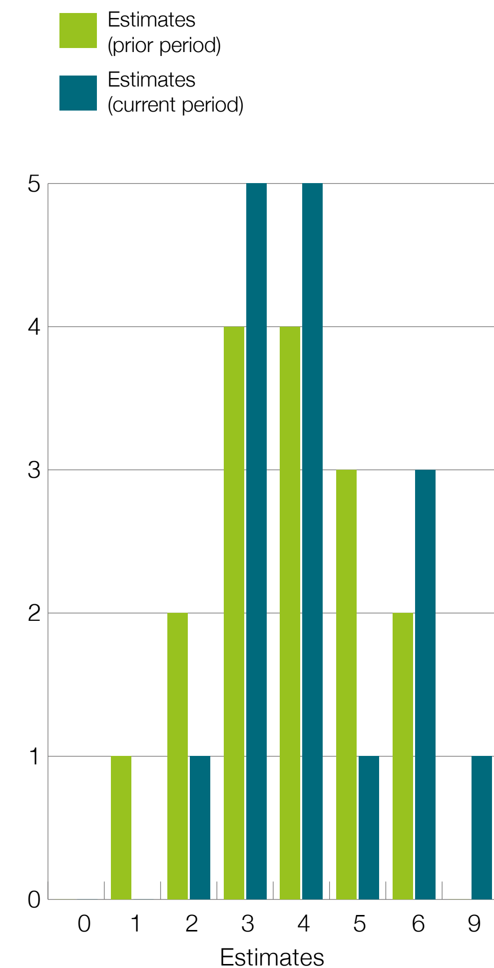
There was a slight increase in the average number of estimates disclosed following pre-informing. In contrast, the 2017 thematic review found an overall reduction in the number of estimates, attributed to the removal of disclosures in respect of less material amounts. If our sample is representative of the wider population it would suggest that smaller companies may be missing disclosures of significant judgements and estimates rather than disclosing less relevant matters. We would, nonetheless, remind companies to avoid unnecessary clutter when considering additional disclosure.

Figure 5.A: Frequency with which companies report significant judgements and sources of estimation uncertainty

Significant judgements (not involving estimation)



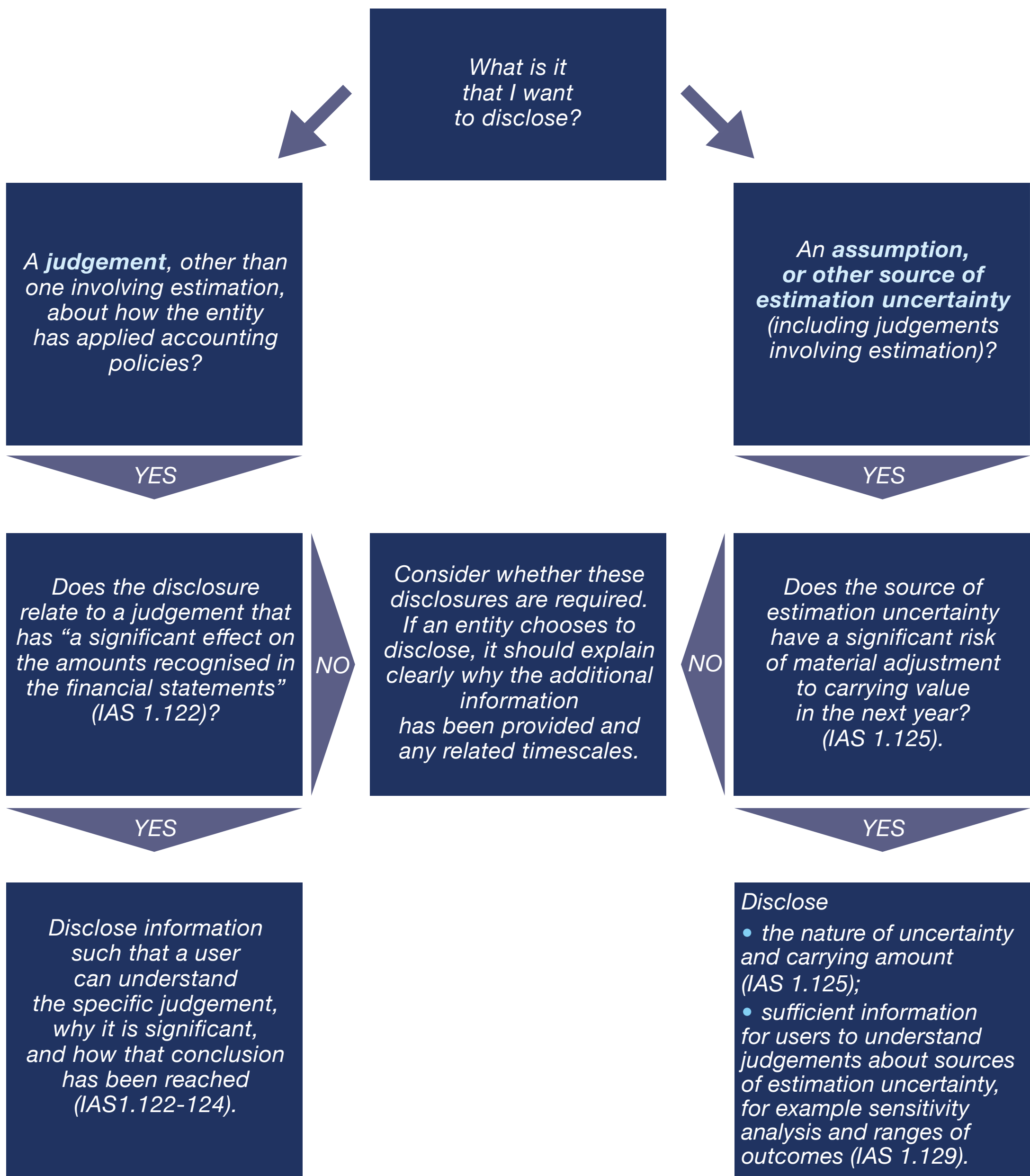
Sources of estimation uncertainty



Companies should differentiate between judgements that do not involve estimation uncertainty and those that do, as there are different reporting requirements. Often we see a single section relating to 'judgements and estimates' where the two cannot be distinguished. Figure 5.B shows how to identify the relevant requirements.

Companies should differentiate between judgements that do not involve estimation uncertainty and those that do, as there are different reporting requirements.

Figure 5.B: Decision tree for determining disclosure requirements for judgements and estimates, IAS 1 paragraphs 122 and 125



There were cases where the auditor's report included commentary on matters involving significant judgement or estimation by management that had not been disclosed as such in the accounts.

We challenged companies when there were indicators that there were balances subject to significant judgements or estimation uncertainty that were not disclosed as such in the accounts. We saw indicators in the strategic report (mainly PRUs), the Audit Committee report and the auditor's report.

For a quarter of the sample, the auditor's report included commentary on at least one matter involving significant judgement or estimation by management that had not been disclosed as such in the accounts. We would expect companies to consider the consistency of information provided in the report and accounts, making use of cross-referencing where appropriate.

It was helpful to see specific comment and explanations on previously disclosed judgements or estimates that were no longer considered necessary to disclose.

Most companies presented their judgements and estimates disclosure in narrative form, with accounting policies and general information at the start of the notes to the financial statements.

It was interesting to see alternative approaches being adopted. One company set out most of the disclosure in two tables (see Example 5.1 for the table setting out judgement disclosures); another used the accounting policies note to provide cross-references to each specific matter, dealing with it entirely in the relevant note for the matter. As the IASB has found in its disclosure initiative case studies,[18] considering more innovative presentation helps companies rethink whether information is truly material and encourages removing clutter.

5.2.2 Significant judgements

Reporting requirements

An entity shall disclose, along with its significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 125), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

IAS 1, paragraph 122

Some companies improved the explanations of the nature of the judgements made and the relevant impacts. However, a few did not adequately explain how the facts and circumstances were assessed against the reporting requirements.

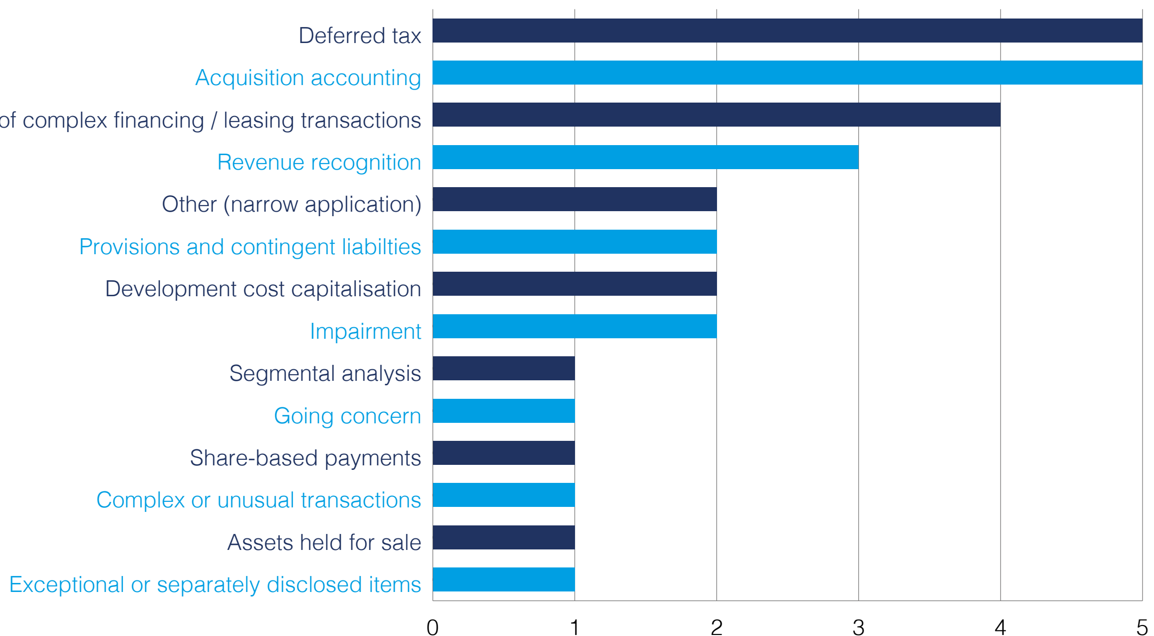
In contrast to the 2017 thematic review, the number of judgements disclosed increased over the prior year. The topics covered by the disclosures were wide-ranging, with a 'tail' of issues appearing once only in the selection, as shown in Figure 5.C. Topics such as deferred tax and acquisition accounting occurred more frequently than seen in the 2017 thematic review, perhaps reflecting a lower threshold for what is considered a complex or difficult matter of judgement.

18 https://www.ifrs.org/-/media/project/disclosure-initative/better-communication-making-disclosures-more-meaningful.pdf

We questioned companies where items disclosed as critical judgements did not appear to be significant based on the information contained elsewhere in the report. These items arose from a wide range of areas in the financial statements: revenue, leasing and financing, date of obtaining control in an acquisition, exceptional items, assessment of a possible prior year adjustment, and complex supplier arrangements.

Figure 5.C: Frequency of reported judgements by subject matter

Areas of Judgement



Some companies presented judgements separately from estimates, which is helpful given the different disclosure requirements.

In Example 5.1, the company adopted a clear tabular layout to describe each key judgement, the effect on the financial statements and the effect of adopting a different judgement. This approach provides an obvious distinction between these judgements and the estimates disclosed on the following page of the accounts, with headings for ‘Key estimate area’, ‘Key assumption’, ‘Potential impact within the next financial year’, ‘Potential impact in the longer term’ and ‘Note reference’ (to further information).

Example 5.1 is also notable for the detailed quantification of the amounts disclosed as a result of the actual judgement and a hypothetical alternative judgement.

Example 5.1: Pendragon PLC, 2017 Annual Report, page 80

Judgements

The Group applies judgement in how it applies its accounting policies, which do not involve estimation, but could materially affect the numbers disclosed in these financial statements. The key accounting judgements, without estimation, that have been applied in these financial statements are as follows:

Key judgements	Effect on Financial Statements	Alternative accounting judgement that could have been applied	Effect of that alternative accounting judgement
Contract hire vehicles:			
The Group leases vehicles to third party customers under undisclosed agency agreements. In legal terms, the Group has disposed of vehicles to third party banks, leases those vehicles as undisclosed agent of the bank to third party customers and agrees to repurchase those vehicles from the bank at the end of the lease term. The Group has determined that it has retained substantially all of the significant risks and rewards of ownership so recognises in full the related assets and liabilities.	Sale of vehicle to third party bank derecognised; recognition of contract hire vehicles within fixed assets – carrying value £153.7m; recognition of contract hire buyback commitments within trade and other payables of £79.5m and £74.9m within deferred income. Profit on disposal to third party bank deferred over term of lease.	If the Group had determined that substantially all of the significant risks and rewards of ownership had been transferred then there would have been full recognition of the sale of the asset.	No recognition of asset or related liabilities and no deferral of income.
Deferred tax assets:			
No recognition of certain deferred tax assets as the Group believes their recovery to be too uncertain.	No recognition of potential assets of £8.3m relating to unutilised tax losses of £13.8m and unrecognised net capital losses of £35.0m.	If the Group had determined that the utilisation of the losses was more certain then full or partial recognition of deferred tax assets would have taken place.	Recognition of assets within the range £0-£8.3m.
Assets held for sale:			
The Group has announced its intention to dispose of its US business and reduce its premium franchise locations. Only two locations for the affected businesses are shown in assets held for sale at the year end.	Assets held for sale was increased by £5.6m for a business which we were actively selling at 31 December 2017. The disclosure of the assets and liabilities relating to the other businesses which we expect to sell remain unchanged.	If the Group had determined that some or all of the planned disposals were sufficiently advanced to meet the criteria to be classified as assets held for sale then other businesses could have been classified as assets held for sale.	Reclassification of further businesses as assets held for sale.
Intangibles:			
Internally generated intangible assets relate to activities that involve the development of dealer management systems by the Software operating segment.	Capitalisation of development expenditure is completed only if development costs meet certain criteria. Full detail of the criteria is in note 3.1.	Not capitalising development costs.	Reduction of £6.1m of asset carrying value.

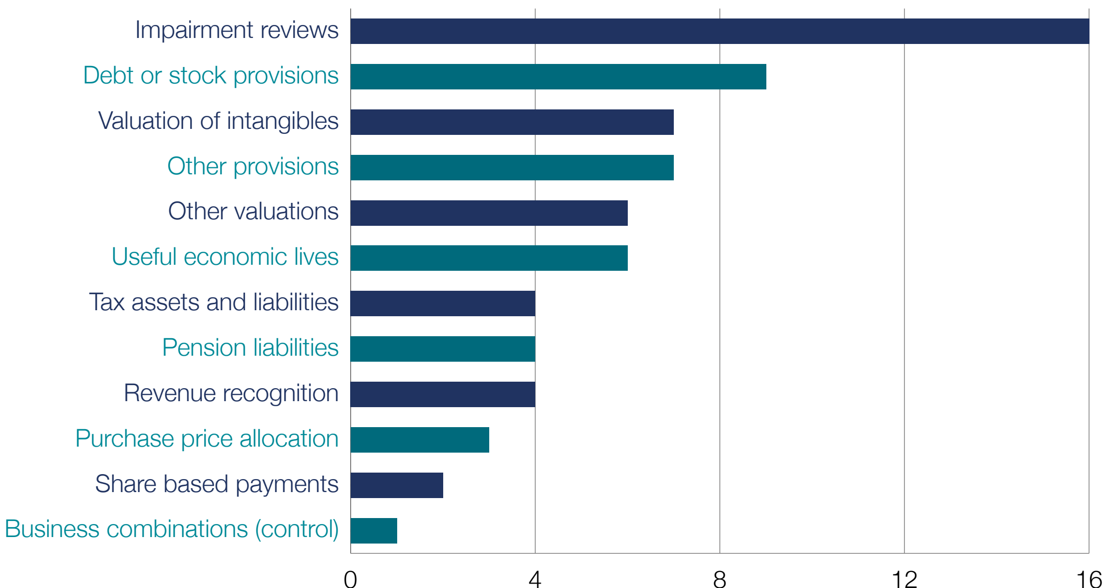
For a third of relevant companies in the selection, their judgement disclosures included matters involving estimation, which are subject to different reporting requirements. We wrote to companies to highlight where clarity could be improved between the two, emphasising the importance of providing relevant information, such as quantification and sensitivity analysis, where estimation uncertainty underlies the exercise of judgement.

5.2.3 Key sources of estimation uncertainty

> ***Reporting requirements***
>
> *An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of:*
>
> *(a) their nature, and*
>
> *(b) their carrying amount as at the end of the reporting period.*
>
> ***IAS 1, paragraph 125***

The most commonly disclosed areas of estimation uncertainty are shown in Figure 5.D. Compared to the thematic review of 20 FTSE 350 companies undertaken in 2017, tax and pensions feature less frequently, with more references to debt and stock provisions, valuation of intangible assets and other valuations.

Figure 5.D: Frequency of estimates by subject matter



Companies did not always make it clear whether their estimation uncertainties presented significant risk of a material adjustment to carrying amounts specifically in the next financial year or over a longer period. While it may be useful to users of the accounts to provide information on matters with potentially material impact in the longer term, it is important to distinguish clearly the short-term uncertainties, to which the full disclosure requirements of IAS 1 paragraphs 125-131 apply, from voluntary disclosures of other matters, as demonstrated in Example 5.2.

Example 5.2: The Gym Group plc, Annual Report and Accounts 2017, page 75

Goodwill impairment

The Group is required to test, on an annual basis, whether goodwill has suffered any impairment based on the recoverable amount of its CGUs. …More information, including key assumptions and carrying values, is included in note 13. While the Directors have currently assessed that reasonably possible changes in key assumptions are unlikely to cause an impairment, in the goodwill allocated to the The Gym chain of gyms estimates of future cash flows and the determination of discount rates applied to those cash flows could change in the longer term such that an impairment arises.

Six companies disclosed estimates that did not appear to involve the use of significantly difficult, subjective or complex assumptions and judgements. We expect companies to remove unnecessary clutter from their accounts as it obscures the disclosures of estimations that are the most difficult, subjective or complex.

All companies disclosed the carrying value of the asset or liability affected by the estimation uncertainty, either as part of the disclosure or elsewhere in the accounts. Where the affected asset or liability was only a component of the amount disclosed in a note, we were pleased to see some disclosures of the component.

A number of companies did not provide ranges of outcomes or sensitivities for items disclosed as significant estimates, or only did so where other standards required it, such as for pensions (IAS 19) or goodwill impairment (IAS 36). Some companies explained either that the estimates were not sensitive to reasonably possible changes or that it was impractical to measure the uncertainties. We challenged companies where it was unclear from the report why this would be the case without further explanation, or where only limited disclosure of the assumptions underlying estimates had been provided. Where an estimation uncertainty is not materially sensitive to reasonably possible changes, we question the basis for disclosing it.

We were pleased to see instances of disclosure of sensitivity information for matters not covered by specific requirements of other standards, such as inventory valuation, in Example 5.3.

It is important to distinguish clearly the short-term uncertainties, to which the full disclosure requirements of IAS 1 paragraphs 125-131 apply, from voluntary disclosures of other matters.

We challenged companies where only limited disclosure of the assumptions underlying estimates had been provided.

Example 5.3: Marshall Motor Holdings plc, Annual Report & Accounts 2017, page 82

Company's disclosures

Inventory valuation

Inventories are stated at the lower of their cost and their net realisable value (being the fair value of the motor vehicles less costs to sell). Fair values are assessed using reputable industry valuation data which is based upon recent industry activity and forecasts. Whilst this data is deemed representative of the current value of vehicles held in inventory it is possible that the price at which the vehicles are actually sold will differ from the vehicles' industry valuations. Where this is the case, adjustments arise in the Consolidated Statement of Comprehensive Income on the sale of vehicles held in inventory.

Industry valuations are sensitive to rapid changes in regulatory and market conditions which are difficult to anticipate. In light of the materiality of the inventory balance in the Consolidated Statement of Financial Position, this uncertainty is considered to represent a key source of estimation uncertainty. The inventory provision as at 31 December 2017 represents 2.1% of the gross inventory balance (2016: 2.4%). A 100bps change in this ratio in 2017 would have changed the charge to the Income Statement by approximately £4 million.

FRC observations:

This opening statement explains clearly and in detail application of the general rule to the specific circumstances of the business

This states the impact in principle of the uncertainty on the financial statements

This explains the nature of the uncertainty and scope for rapid change (i.e. risk of adjustment in the next year)

Quantum of carrying value and sensitivity to change clearly stated, indicating the potential impact in practice

5.2.4 Accounting policies

In most cases where we identified standard wording in policy descriptions, this was limited to areas of the accounts where there is little scope for tailoring. For example, the classification of financial assets, drawing directly on language from IAS 39[19], and the definition of borrowings barely varied from company to company, which is to be expected.

Following our advance notification, 11 companies added and/or removed at least one accounting policy. One company had expanded its disclosures significantly to include not only more detailed explanation of key accounting policies, but also a number of policies of doubtful relevance to users. We remind preparers that companies should not obscure their significant accounting policies with irrelevant disclosures.

19 IAS 39 'Financial Instruments: Recognition and Measurement'

We noted one instance in which a company simply referred to the relevant IFRS, giving no insight into the application of the relevant standard's principles in that company's specific circumstances. We do not consider this to meet the requirement of IAS 1 to disclose significant accounting policies.

We were pleased to see tailored explanations for more complex accounting and company-specific treatments, such as Example 5.4 from Findel plc. Its policy for impairment of trade receivables, representing a large volume of customer accounts, describes the specific approach adopted for measuring impairments as well as the general principles from IAS 39 for determining that impairment is indicated.

Example 5.4: Findel plc, Annual Report & Accounts 2018, page 90

Company's disclosures (excerpted)

Impairment of financial assets

Loans and receivables are assessed for indicators of impairment at each balance sheet date. Financial assets are impaired where there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial asset, the estimated future cash flows of the investment have been impacted.

Objective evidence of impairment could include:

- significant financial difficulty of the issuer or counterparty; or
- default or delinquency in interest or principal payments; or
- it becoming probable that the borrower will enter bankruptcy or financial reorganisation.

For trade receivables in Express Gifts, assets that are not individually significant are assessed for impairment on a collective basis. When assessing for collective impairment, the Group estimates incurred losses using a statistical model which multiplies the probability of default ("PD") for each class of customer (using a balance scorecard for the relevant stage of debt) by the loss given default ("LGD") multiplied by the exposure at default ("EaD") to arrive at the projected expected loss. An emergence period is incorporated to provide the estimated level of incurred losses at each reporting date.

An adjustment is made to discount the expected cash flows from the impairment model, at the assets' original EIR, to arrive at the recorded collective provisions.

The model's results are adjusted for management's judgement as to whether current economic, political and credit conditions are such that actual losses are likely to differ from those suggested by historical modelling, increasing model risk within the impairment.

The carrying amount of the financial asset is reduced by the impairment loss directly for all financial assets with the exception of trade receivables, where the carrying amount is reduced through the use of an allowance account…

FRC observations:

The note provides a clear summary of the principles of IAS 39 and of the key evidence used as indicators of impairment

The specific disclosure explains how the estimated level of incurred loss is quantified.

It also explains the application of judgement in specific areas

We identified one example where elements of the business' revenue mentioned in the strategic report were not addressed by the revenue recognition policy. This referred to the various situations in which revenue would be recognised (delivery, title passing, etc.) but these were not matched to the circumstances of sales as described. We expect companies to ensure such matters are described consistently throughout the report and accounts.

Accounting policies for measurement and recognition of current income tax were described similarly across the selection. We did see some variation in the disclosure of policies relating to deferred tax and, in the minority of companies for whom this was relevant, tax provisions.

As most companies in the selection disclosed no or only immaterial provisions or contingent liabilities for tax, disclosures relating to uncertainty of detection risk and accounting policies for penalties and interest on overdue tax were not generally expected. We did find, however, that these disclosures were omitted from those few companies with material tax provisions. We also expect preparers to consider the impact of IFRIC 23 'Uncertainty over income tax treatments', which will be effective for financial years beginning on or after 1 January 2019.

For the principal policies on recognition and measurement, there was little variation from standard language. Example 5.5 gives one instance where disclosure was combined effectively with an explanation of the company's specific circumstances.

IFRIC 23 clarifies the recognition threshold to be applied, namely whether it is probable that the tax authority will accept an uncertain tax treatment. It also prescribes one of two methodologies for reflecting the effect of uncertainty, most likely outcome or probability-weighted expected value; an entity should use whichever better predicts the resolution of the uncertainty.

Example 5.5: Laird PLC Annual Report & Financial Statements 2017, page 111

Tax expense

The tax expense represents the sum of current and deferred taxes.

Current taxes

Current tax is the amount of tax payable on this year's taxable profits, as adjusted for items upon which we are not required to pay tax, or in some cases for items which we are required to pay additional tax in respect of tax-disallowed expenditure.

Current tax assets and liabilities are measured at the amount expected to be recovered from or paid to the taxation authorities, based on tax rates and laws that are enacted or substantively enacted by the balance sheet date. The majority of the Group's taxable profits arise in countries, including China, where the estimated tax liabilities are paid in on account instalments during the year to which they relate and are largely paid at the balance sheet date. The current tax liability of £29.9m (2016: £33.9m) includes £1.2m directly associated with assets classified as held for sale. The liability of £31.1m represents £8.2m (2016: £5.6m) tax due on profits of the current and prior years as well as £22.9m (2016: £28.3m) provisions for tax uncertainties.

Income tax is charged or credited directly to equity if it relates to items that are credited or charged to shareholders' equity. Otherwise income tax is recognised in the income statement or statement of comprehensive income.

Section 8 sets out the key points from our findings for companies to consider when presenting their accounting policies, judgements and estimates.

6 CASH FLOW STATEMENTS

6.1 FRC expectations

The FRC's expectations in relation to cash flow statements and associated disclosures are set out below. These reflect the requirements of IAS 7[20]. Strategic report requirements of the Companies Act 2006, as they pertain to cash flow matters, are addressed in section 3.

Investors are particularly interested in a company's ability to generate cash.[21] Fund managers agree that the cash flow statement and the related disclosures and explanations around it are an area to which they pay great attention, as it helps them assess the company's ability to convert its profits into cash.

FRC Expectations: Cash flow statements	
Stakeholders stress the importance of quality information about cash flows in smaller companies.	We expect companies to pay particular attention to the classification of unusual or one-off items in the cash flow statement.
We expect companies to identify investing and financing cash flows correctly, consistent with the IAS 7 definitions.	We expect companies to provide useful disclosures concerning financing and the impact of non-cash transactions on their liabilities.

20 IAS 7 'Statement of Cash Flows'
21 Page 12 of the 2015 paper

6.2 Principal findings

Pre-informing companies of the review had the least impact in this area, with only one company showing an appreciable improvement in disclosure over the prior year.

6.2.1 Strategic report discussion of cash

Our review considered companies' commentary on cash and related matters in the strategic report, as well as financial statement disclosures. Most of the reports reviewed included some discussion of cash flows within their strategic reports; we expect this of all companies. We expect every company to address its key cash flows and cash position in the strategic report, to give a fair, balanced and comprehensive view. This information is most powerful when linked to business model factors (for example, investment in acquisitions or plant), relevant KPIs (for example, net debt, cash conversion) and PRUs explained in the strategic report.

Our further findings in respect of companies' treatment of cash flow in the strategic report are in set out in section 3.2.4.

6.2.2 Cash flow statement and notes

We were pleased that most companies appeared to have correctly classified cash flows as arising from operating, investing or financing activities. However, we identified some apparent inconsistencies with the requirements of IAS 7 to follow up with individual companies, such as items classified as financing activities that do not appear to relate to changes in the size or composition of the contributed equity and borrowings. In one case, the cash impact of restructuring costs (comprising salaries and IT-related costs) was incorrectly classified as an investing activity on the cash flow statement. We remind companies that items should not be classified outside cash flows from operating activities just because they relate to unusual transactions.

IAS 7 definitions

Operating activities *are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.*

Investing activities *are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.*

Financing activities *are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.*

IAS 7, paragraph 6

All companies in the sample used the indirect method for presenting their cash inflow/outflow from operating activities, reconciling it to the reported profit by reference to non-cash items (for example, depreciation) and working capital movements (inventory, trade and other receivables and payables). We found a number of instances where users would have benefited from increased clarity over significant changes in cash flows. This was particularly the case where disclosed cash flows were not obviously consistent with movements in the balance sheet such as working capital or taxes paid, where significant acquisitions or other unusual transactions had occurred but their impact on cash flows had not been fully explained.

Example 6.1 shows how additional information might be presented to assist users in understanding the relationships between the cash flow statement and the balance sheet.

Companies should explain key cash flows and their cash position in the strategic report.

We identified cases where the classification of cash flows appeared to be inconsistent with IAS 7 requirements.

Example 6.1: Vertu Motors plc, Annual Report & Financial Statements for the year ended 28 February 2018, page 107

Cash flow from movement in working capital

The following adjustments have been made to reconcile from the movement in balance sheet heading to the amount presented in the cash flow from the movement in working capital…

2018	Inventories (Note 20) £'000	Current trade and other receivables (Note 22) £'000	Trade and other payables £'000	Total working capital movement £'000
Trade and other payables (Note 24)			(663,404)	
Deferred consideration (Note 17)			(100)	
Deferred income (Note 28)			(8,877)	
At 28 February 2018	558,386	66,272	(672,381)	
At 28 February 2017	506,470	52,545	(619,741)	
Balance sheet movement	(51,916)	(13,727)	52,640	
Disposals (Note 17)	(432)	(24)	155	
Deferred consideration on acquisitions (Note 17)	-	-	1,181	
Movement excluding business combinations	**(52,348)**	**(13,751)**	**53,976**	**(12,123)**
Pension related balances				(197)
Increase in capital creditors				(784)
Increase in interest accrual				(54)
Increase in share repurchase accrual				(174)
Movement as shown in Consolidated Cash Flow Statement				**(13,332)**

We were disappointed to find that all but one of the eight accounts reviewed disclosing 'exceptional items' did not specify the cash flow effect of those items. We encourage preparers to refer to points of best practice highlighted in our December 2013 press notice, 'FRC seeks consistency in the reporting of exceptional items' (PN108[22]).

We identified a few companies that disclosed cash flows on a net basis but which did not appear to meet the criteria for offsetting in IAS 7, paragraph 22. We challenged the treatment where the amounts involved appeared to be material.

22 https://www.frc.org.uk/news/december-2013/frc-seeks-consistency-in-the-reporting-of-exceptio

6.2.3 Other IAS 7 disclosures

Most of the reports reviewed disclosed the classification of overdrafts as cash and cash equivalents. However, a number held amounts in overdraft where it was not apparent whether the balance had fluctuated between positive and negative in the year. A recent IFRS Interpretations Committee Agenda Decision observed that 'if the balance of a banking arrangement does not often fluctuate from being negative to positive, then this indicates that the arrangement does not form an integral part of the entity's cash management and, instead, represents a form of financing.' It concluded that such arrangements were financing activities rather than cash and cash equivalents.

We were particularly pleased to see that two-thirds of companies reviewed disclosed the amounts of undrawn credit facilities available, which is a helpful disclosure encouraged by IAS 7.

It was disappointing to note that only three-quarters of companies for whom it was relevant had implemented the new requirements of IAS 7, paragraph 44A, to disclose changes in liabilities arising from financing activities, including both cash and non-cash changes. In all cases the disclosure was met by presentation of a tabular reconciliation between opening and closing balances in the statement of financial position. Example 6.2 is notable for its disaggregation of cash and non-cash movements.

We were surprised to note there was only one reference to reverse factoring/ supplier financing arrangements, as we understand such arrangements to be common.

Two-thirds of companies reviewed disclosed the amounts of undrawn credit facilities available, which is a helpful disclosure encouraged by IAS 7.

Example 6.2: Inspired Energy PLC, Annual Report & Accounts 2017, page 51

Reconciliation of liabilities arising from financing activities

	Long-term borrowings £	Short-term borrowings £	Total £
At 31 December 2016	8,286,462	3,337,500	11,623,962
Cash flows			
Repayment	(12,633,125)	(3,516,429)	(16,149,554)
Proceeds	21,923,019	2,036,984	23,960,003
Non-cash			
Acquisition	–	178,929	178,929
Foreign exchange differences	92,877	–	92,877
Debt issue costs releases	139,274	–	139,274
At 31 December 2017	**17,808,507**	**2,036,984**	**19,845,491**

We were surprised to note that there was only one reference to reverse factoring/ supplier financing arrangements, as we understand such arrangements to be common. We remind companies of the reporting requirements for complex supplier arrangements, including reverse factoring, as highlighted in the Corporate Reporting Review Briefing in June 2018[23] and a December 2014 press notice.[24]

Section 8 sets out the key points from our findings for companies to consider when presenting their cash flow statements.

23 https://www.frc.org.uk/getattachment/2fb49770-462b-4470-8d35-1682ed53586e/Corporate-Reporting-Review-Briefing-June-2018.pdf, page 3
24 https://www.frc.org.uk/news/december-2014/frc-urges-clarity-in-the-reporting-of-complex-supp

7 TAX DISCLOSURES

7.1 FRC expectations

The FRC's expectations in relation to tax disclosures are set out below. These reflect the requirements of IAS 12[25] and the strategic report requirements of the Companies Act 2006, as they pertain to tax matters. They also reflect the results of the FRC's thematic review on tax disclosures[26] and the views of investors.

Our 2016 thematic report encouraged discussion of tax in the strategic report and outlined the characteristics of an informative explanation of the effective tax rate. It found scope for companies to articulate better how they account for tax uncertainties by explaining the bases for recognition and measurement, and to improve the usefulness of their disclosure of significant judgements and estimation uncertainties relating to tax.

FRC Expectations: Tax disclosures	
We expect sufficient information to be given to help stakeholders understand the company's effective tax rate and the factors likely to affect it in the future.	We expect to see disclosures around the particular tax issues that could have a material effect on the accounts, and for material uncertain tax provisions to be quantified and appropriate sensitivities provided.
We expect companies to explain both large differences between the tax charge and tax paid, and significant changes in the prior year assessment of tax liabilities.	We expect companies to discuss the tax effect of exceptional or non-recurring items, such as the effect of an acquisition of a subsidiary with its own deferred tax assets and liabilities.

25 IAS 12 'Income Taxes'
26 https://www.frc.org.uk/document-library/corporate-reporting-review/2016/corporate-reporting-thematic-review-tax-disclosur

7.2 Principal findings

Fewer companies made changes to their tax disclosures in response to pre-informing than was observed for the other topics, aside from cash. Nonetheless, just over half the selection had made improvements.

7.2.1 Effective tax rate reconciliation

We found that 11 of the selected companies presented their reconciliation clearly. The same proportion provided information to show how sustainable the effective tax rate was expected to be and what factors would tend to increase or decrease it over time. Most of those companies with overseas profits conveyed the impact of their overseas operations on the effective tax rate, albeit in varying levels of detail (see section 7.2.3 for examples of the better disclosures).

We observed a number of reconciliation schedules using informative labels and/or additional descriptions for reconciling items or grouping items to provide greater insight into the sustainability of the period's effective tax rate into the future (e.g. presenting a group of non-recurring items together, distinct from adjustments arising every year).

Examples 7.1 and 7.2 show that narrative disclosures are as important as numerical schedules; note the details in Example 7.2 given regarding the prior year under provision and the impact of changes of law overseas, and those for disallowable expenses and the adjustment in respect of prior years in Example 7.1.

Example 7.1: Vp plc, Annual Report and Accounts 2018, page 68

Company's disclosure

The corporation tax rate for the year ended 31 March 2018 was 19% (2017: 20%). The rate of tax is expected to reduce to 17% in the year ending 31 March 2021 and this has been reflected in the deferred tax balances carried forward. In the prior year this reduction was not reflected as it was expected a substantial proportion of the balance would have reversed by 31 March 2020.

The main reconciling items are:

- The impact of the tax rate changes; reflects the future reduction in the tax rate to 17% in the UK
- Expenses not deductible for tax purposes; primarily professional fees associated with capital transactions and customer entertaining
- Non-qualifying depreciation and amortisation; mainly relates to depreciation on land and buildings
- Gains covered by exemptions/losses; primarily relates to chattels exemptions on the disposal proceeds of fleet items
- Overseas tax rates; the rates in Australia and Germany are higher than the UK tax rate
- Adjustments in respect of prior years; reflects the differences between the tax calculation for accounts purposes and the final tax returns. The main areas were recoverability of overseas tax and the assumption for disallowed expenses and capital gains
- Impairment of intangibles; this relates to the write down of goodwill where there is no tax relief.

The reconciling items relating to the tax rate change and impairment of intangibles are non-recurring in the normal course of business, all the other items will be expected to re-occur on a regular basis, albeit the prior year adjustments will vary from year to year. On this basis the effective tax rate before any prior year adjustments would be expected to be about 1% over the standard rate of tax.

FRC observations:

Insight into forecast unwinding of temporary differences

Specific classes of disallowable expenditure and non-taxable gains described

Useful details of the specific drivers for the prior year adjustment

Clear differentiation of recurring and non-recurring items, with a quantified view on the rate excluding a volatile element

Example 7.2: M&C Saatchi plc, Annual Report and Accounts 2017, page 55

Company's disclosure

As can be seen above, the largest driver of headline tax charge is our local entities profitability, local tax rates, and recognition of previously unrecognised tax losses.

In December 2017 legislation was passed that reduced US federal tax rate from 35% to 21% from 1 January 2018, this has caused a revaluation of all deferred tax at the year end. This has resulted in a short term effect of increasing the tax charge by £292k, and by a further £1,373k due to the remeasurement of deferred tax on intangibles and shares awards.

In previous periods, there was volatility in US earnings. However, due to the continued strength of the US business, notably the operations of M&C Saatchi Mobile and certain acquisitions, the previously unrecognised US deferred tax assets have now been recognised in full.

The adjustments made for current tax under provisions in prior periods reflects amendments made to the 2016 tax provisions following completion of the related returns to the Authorities. The largest portion of the adjustment relates to the treatment of profits in the US, where the Alternative Minimum Tax applies.

While there remains some uncertainty over how Brexit may impact tax legislation, the combination of a reduction in the UK and US Corporation tax rates are likely to mean that our tax rate (both headline and statutory measures) are likely to reduce slightly in future periods.

FRC observations:

'Above' there is a detailed numerical reconciliation using both reported and headline profit

Separate drivers for increasing and decreasing the deferred tax charge are identified and explained

Prior year under provision explained in greater than typical detail

Insight into the longer term trend for the effective rate

We challenged companies where significant movements in the tax charge were labelled 'other', potentially reducing the usefulness of the analysis of the charge (or credit) for the period or the reconciliation to a standard applicable rate. A quarter of the selected companies did not disaggregate types of temporary differences included in the deferred tax charge (or credit) to profit and loss. We also saw examples where significant amounts of deferred tax assets and liabilities were disclosed as 'other' temporary differences, potentially concealing significant individual items that would require separate disclosure in the balance sheet notes.

7.2.2 Other observations

Almost all the companies selected for review separately disclosed 'exceptional' or 'non-underlying' items in profit and loss, based on the nature of the income or expense. It was, however, uncommon for material tax charges or credits, which seemed to meet the applicable definition for separate disclosure, to be treated in that way. This may be because 'exceptional' or 'non-underlying' items are primarily used to compute pre-tax alternative performance measures, such as adjusted EBITDA and, accordingly, exceptional tax items may be overlooked. We would expect large or unusual tax items to be treated consistently with other 'exceptional' items.

Findings relating to the tax effect of adjusting items in calculating APMs and the discussion of tax matters in the Strategic report are also addressed in sections 3.2.3 and 3.2.4.

Tax often has a significant effect on the performance and financial position of a company, and there is often associated risk or uncertainty. However, very few of the selected companies made explicit reference to contingent tax liabilities or provisions.

We note that the areas of estimation uncertainty identified in section 5.2.3 (with a largely different selection of companies) show that taxation features as one of the less common topics, appearing approximately half as often as in the selection of FTSE 350 companies reviewed for the 2017 thematic report.[27] While smaller companies may have less complex tax affairs, significant judgements and estimates may still be required to be discussed, particularly where companies have recognised deferred tax assets with respect to losses. Better examples in this area provide a clear explanation of the matters requiring estimation, the amounts in question and the sources of uncertainty affecting them. Other key messages from the general findings of the judgements and estimates review set out in section 5 apply to those concerned with tax.

7.2.3 International tax

Despite significant changes in the international tax scene over recent years, we found relatively little discussion, even among the multi-national groups, of the implications for future tax charges of issues such as: restricted relief for interest expenses, US tax reform and the European Commission's investigations into illegal state aid. Taxation in its own right featured among PRUs for only one company in the selection, probably reflecting less complicated tax affairs than tend to be found among FTSE 350 companies. A number of companies mentioned risks arising from Brexit, including increased indirect tax costs.

These issues have increased the importance of understanding where, in the world, taxable profits are generated. This was not always made clear, even taking account of geographic information given as part of segmental analysis (usually by region rather than individual country). An example of better disclosure on this point not only stated where tax payable largely arises, but also explained why a territory with substantial accounting profits did not have taxable profits (Example 7.3).

Example 7.3: Laird PLC Annual Report & Financial Statements 2017, page 31

> Profits in the US in the period were sheltered by amortised goodwill deductions resulting from acquisitions and interest expense. As a result, Laird's tax payable largely arises in China, the Czech Republic, Korea and Malaysia. An analysis of the total tax charge is given in note 11 to the financial statements.

Coupled with no or limited disclosure as to where tax is paid in nearly half the multi-national companies selected, we noted a general reliance on the UK statutory rate as the starting point for effective tax rate reconciliations. More meaningful information may be given by use of either a blended rate reflecting the geographic spread of taxable profits or a single non-UK rate that was most relevant to the location of operations on which tax was payable.

It was disappointing to find two cases of a change in UK tax rate being reflected in the deferred tax amounts a year after the new rate had been substantively enacted.

Section 8 sets out the key points from our findings for companies to consider when preparing their tax disclosures.

Better tax disclosures provided a clear explanation of the matters requiring estimation, the amounts in question and sources of uncertainty affecting them.

27 We have identified 4 instances from 16 companies in the current review; for the 2017 report, there were 11 instances identified from 20 companies.

8 REMINDERS

The following table reminds companies of the main findings from this review that we expect companies of all sizes to consider when preparing future annual reports and accounts. It is not an exhaustive checklist of the relevant reporting requirements but an aide memoir to assist companies in considering the requirements of the Companies Act and relevant IFRSs.

What we expect	What to include
Strategic reports: Should contain a fair review of the business. The review should be a balanced and comprehensive analysis of performance and the position at the end of the year.	• Commentary on the income statement, balance sheet and cash flow statement. • Information on funding arrangements and committed pension contributions. • Commentary on the effective tax rate or material differences between the tax charge and tax paid. • PRUs classified according to likelihood and potential impact. • Information required by NFR regulations where relevant (for example, policies, due diligence and outcomes).
Presentation of APMs: Should be transparent, reliable and understandable. APMs should not distract from the presentation of measures directly stemming from financial statements.	• Balanced presentation and discussion of APMs and IFRS measures within the Chairman's Statement and CEO's Review. • Clear signposting of APMs versus IFRS measures when discussing financial performance and position. • Definitions, reconciliations and explanations for all APMs; remember financial ratios. • Specific explanations for individual adjusting items. • Items labelled as 'non-recurring' only in the rare situations when items will genuinely not recur.
Pension disclosures: Should enable users to understand the relationship between the pension expense, cash payments to the scheme and the surplus or deficit. They should also enable investors to appreciate the nature of scheme assets, the scheme's investment strategy, the extent of its liabilities and associated risks.	• Explanations of pension risk, potential impacts and risk mitigation strategies. • Plan assets categorised into sub-classes with differing characteristics. • Explanation of impact of trustees' rights on recognition of pension assets and on recognition of additional liabilities. • Disclose quoted and unquoted scheme assets and explain their valuation. • Clear link between key assumptions and sensitivity analyses of those assumptions. • Pension accounting policies based on current version of IAS 19.

What we expect	What to include
Accounting policies: Should explain the application of the principles set out by relevant standards to the entity's specific circumstances.	• Revenue recognition policies that align with the business model, covering all material sources of revenue. • Removal of redundant policies as soon as they cease to be relevant. • Prompt inclusion of new policies to cover new circumstances.
Judgements and estimates Disclosure of judgements should provide an understanding of complex judgements made in applying accounting policies and enable a comparison of judgements made by different companies. Disclosure of assumptions and sources of estimation uncertainty ('estimates') should enable users to understand the potential impact of any changes on reported results.	• Clear distinction between judgements and estimates, with relevant disclosures for each category. • Clear identification of those estimates with a **significant risk** of a **material adjustment in the next year**, with quantification of the relevant amounts. • Explanation of why any other estimates have been disclosed; for example those where a longer-term impact is possible. • Quantified disclosures around ranges of outcomes or sensitivity analyses. • Specific explanations of the judgements made by the company – not just a statement that a judgement exists. • Explanations for changes to previously disclosed judgements and estimates where this would be helpful.
Cash flow statements: Should separately present operating, investing and financing activities to allow users to assess their impact on the financial position of the entity and the amount of its cash and cash equivalents.	• Cash flows should only be presented as **investing activities** where they result in a recognised asset. • Cash flows should only be presented as **financing activities** when they result in changes in the company's equity and borrowings. • Cash flows from **operating activities** should include those that do not meet the definition of investing and financing activities. • Information on available undrawn credit facilities. • Cash effect of exceptional items should be disclosed. • Information on changes in liabilities arising from financing activities, as required by IAS 7, paragraph 44A.
Tax disclosures: Should show the current and future tax consequences of the recovery (settlement) of the carrying amount of recognised assets (liabilities), as well as the current and future tax consequences of current period transactions and other events.	• Explanation of the reported and future effective tax rates. • Effective tax rate reconciliations with informative labelling. Additional narrative on material reconciling items may be helpful. • The tax reconciliation should apply the most appropriate tax rate to pre-tax profit. This may not be the UK statutory rate for a company with overseas operations. • Explanations for the recognition of deferred tax assets where there is a history of losses. • Disclosure of tax on items in other comprehensive income and equity.

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