Corporate Reporting Review

Technical Findings 2018/19

October 2019

Financial Reporting Council

Contents

Introduction

This document highlights the matters more frequently identified by the FRC's corporate reporting monitoring activities, as conducted by its Corporate Reporting Review ('CRR') function.

It highlights the top 10 areas where the FRC asked questions of preparers relating to reports reviewed in the year to March 2019 and builds on the themes identified in the 'Annual Review of Corporate Reporting 2018/19' ('annual report').

Two areas, financial instruments and fair value measurement, have moved this year into the top 10. The top three areas identified in CRR's work continue to be: judgements and estimates, strategic reports and APMs. These top three issues represent just under one third of the total questions asked by CRR during the year.

We expect preparers to reflect on these findings, and consider what improvements can be made to their reporting. We have used a to highlight the most important messages.

CRR's top 10 areas of questioning

1. Judgements and estimates
2. Strategic report
3. Alternative Performance Measures (APMs)
4. Impairment of assets
5. Statement of Cash Flows
6. Income taxes
7. Provisions and contingencies
8= Financial instruments: recognition and measurement
8= Fair value measurement
10. Revenue

Judgements and estimates

Judgements and estimates continues to be the most common area of questioning as part of CRR routine reviews. Encouragingly, we identified improvements in some areas identified by our previous thematic where compliance was less than satisfactory, although there remains significant scope for improvement.

The aim of the judgements and estimates disclosure requirements of IAS 1 is to inform users of the most subjective judgements (paragraph 122), and the sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying value of assets or liabilities in the next financial year (paragraph 125).

We identified some improvements in the following areas covered by previous guidance and thematic reports :

- companies failing to distinguish judgements from estimates;
- instances of boilerplate language; and
- matters not disclosed as key judgements or estimates despite indicators to the contrary.

Disclosures relating to estimates specified by standards other than IAS 1, such as impairment disclosures (IAS 36) and fair value (IFRS 13), continued generally to be of a higher standard than those where no such specific requirements apply.

Despite the improvements noted, we continued to raise questions on:

- lack of sensitivity analysis or information regarding the range of possible outcomes for areas of estimation uncertainty;
- estimation uncertainties disclosed which did not appear to give rise to a significant risk of material adjustment to the related balances within the next year;
- generic descriptions with lack of information specific to the company’s circumstances; and
- items such as uncertain tax provisions, contingent consideration not disclosed as significant judgements or estimates, despite evidence in the annual report to the contrary.

Judgements and estimates: consolidation judgements

Several of the most complex recent cases have involved consolidation judgements and, in particular, judgements around control of another entity.

IFRS 10 requires an entity to consider various factors when determining whether it controls another entity and in some cases considerable judgement has to be exercised. While judgements on consolidation is not one of the top ten issues raised by CRR as part of routine reviews, it has been raised in a number of the most complex cases.

Judgements around consolidation often have a material effect. Where they do, we expect to see the disclosure required by paragraph 122 of IAS 1.

Areas we questioned included:

- the control of trusts;
- the determination of joint control in a situation where one party holds a majority of voting rights;
- de facto control, in a situation where a company and its associate have several directors in common;
- the point at which control passed when a “locked box” arrangement was used; and
- unclear disclosure of what the specific areas of judgement are in relation to the assessment of control of subsidiaries or seed investments.

Other examples of judgements that may require disclosure are:

- the nature of rights arising from contractual arrangements in addition to voting rights;
- whether rights are substantive or protective; and
- whether voting rights held by other parties are sufficiently dispersed to give de facto control.

Judgements and estimates: sensitivities

Disclosures relating to estimates specified by standards other than IAS 1, such as impairment, pensions and fair value, continued to generally be of a higher standard than those where no such specific requirements apply.

Although IAS 1 does not explicitly require sensitivity analysis, paragraph 129 requires disclosures to be given to help users to understand the judgements made about the future and about other sources of estimation uncertainty. In our view, it would be difficult for users to understand the significance of management estimates without information regarding sensitivity or range of outcomes. We continue to challenge companies where appropriate sensitivities or ranges of outcomes are not disclosed.

Examples where companies have agreed to expand their disclosures include:

- quantification and ranges of possible outcomes for uncertain tax provisions;
- range of reasonably possible outcomes and indication of expected timeframe for resolution of loss-making contracts;
- sensitivity analysis for valuation of investment properties;
- quantification of assumptions and sensitivities for sales returns and rebates; and
- quantification of sensitivity of inventory valuation to sales growth rates.

Judgements and estimates: what to consider for your next disclosures

We expect preparers to reflect on their judgement and estimation uncertainty disclosures and consider whether they provide sufficiently granular information about the judgements and estimates that could have a material effect on the financial statements. The following questions may help avoid CRR challenge, and improve users' understanding.

Are all the disclosures still valid?

- if a former source of estimation uncertainty no longer presents a material risk of adjustment in the next year, should it be removed?
- if it is still considered helpful to disclose, for example because it is expected to have a material impact beyond the next 12 months, it should be clear these are not the disclosures required by IAS 1.125.

We challenged cases where key areas of estimation uncertainty had been obscured by disclosures where there was no risk of material adjustment. IAS 1 states that understandability should not be reduced by obscuring material information with immaterial information. In some cases, impairment testing was disclosed as a key source of estimation uncertainty, yet other disclosures indicated no reasonably possible change in key assumptions would lead to an impairment.

Is presentation consistent with other information in the financial statements?

If other disclosures suggest that risk in an area has reduced, would it be helpful to explain why it still remains a source of estimation uncertainty or judgement? If the audit committee and auditors have highlighted a particular area of estimation uncertainty for focus, we, and users, expect this to be identified as a source of estimation uncertainty – or expect some explanation as to why it is not.

Does the disclosure of estimation uncertainty convey meaningful information to the user?

We challenged disclosures about estimation uncertainty that failed to include sufficiently granular information to explain the nature and timing of estimation uncertainty, and its possible financial implications. Boilerplate text or omission of information required by IAS 1.129 are matters which we continue to challenge. We expect amounts to be quantified and sensitivities and/or range of outcomes to be disclosed.

Strategic report: non-financial information statement

We asked a number of questions about preparers' compliance with the non-financial information statement.

The Non-Financial Information Statement applies to Public Interest Entities with over 500 employees for years beginning on or after 1 January 2017. This requires companies to publish a separate non-financial information statement containing information on the company's development, performance and position and the impact of its activity, relating to environmental matters, employees, social matters, human rights and anti-bribery and corruption (NFR matters).

Where information can be found throughout the annual report, we expect a title and series of cross references to be provided in the main body of the strategic report.

While most companies referred to the NFR matters in their annual report we raised a number of questions where companies fell short of full compliance.

Some examples of matters raised are:
- references to information published on a website, and not produced in the annual report as required;
- no disclosure of the impact of the company's business on the environment; and
- no separately identifiable non-financial information statement.

The NFR regulations require disclosure of the impact of the company's business on the environment, as well as the risks that environmental matters pose to the company.

Strategic report: fair, balanced and comprehensive

We continued to raise questions on PRU disclosures where they do not appear to reflect the main risks faced by the company.

Typical examples were:

- no disclosure of specific business or macroeconomic risks which may impact the company;
- no disclosure of tax risk, despite audit committee and auditor focus in this area;
- disclosed risks and uncertainties comprising only financial risks, with no operational or strategic risks discussed;
- no discussion of risks associated with reliance on a significant joint venture partner; and
- principal risk disclosures taking the form of a list of general headings without pinpointing the specific risks to the group.

We challenged companies whose business models are at significant risk from climate change, but where this was not discussed in the annual report.

Alternative Performance Measures (APMs)

APMs remain one of the most common areas of challenge arising from our reviews.

ESMA's Guidelines on Alternative Performance Measures were published in 2015, and apply to listed company reports published from July 2016. The FRC published its thematic review on APMs in November 2017. Although, strictly, the Guidelines only apply to listed companies, we consider them to be best practice for all companies who use APMs in their communications with investors and, consequently, expect full compliance.

We continued to raise questions in this area across our routine reviews. We were pleased to note an improvement in the labelling of APMs, and degree of prominence compared with IFRS measures.

Reconciliations were generally provided for the principal APMs although often omitted for more minor APMs or ratios.

The most common area of questioning continues to relate to absent or unclear definitions of APMs and/or reconciliations to the closest equivalent IFRS line item.

We expect that APMs will continue to be an area of focus for CRR.

We continue to challenge unclear or missing definitions and reconciliations for APMs.

Prominence

Examples we challenged included:
- Financial highlights only referenced APMs, without giving IFRS equivalents
- Strategic report discussed performance using APMs only, with no discussion of IFRS equivalent. Sections of annual report referred exclusively to APMs

We expect preparers to review the strategic report and challenge themselves whether sufficient prominence has been given to reporting and discussing IFRS measures.

APMs should not be displayed with more prominence, emphasis or authority than measures stemming directly from financial statements. (ESMA Guidelines, paragraph 35)

Exclusion rationale

We queried why items had been treated as non-recurring, or excluded from adjusted profit. The most common examples were:
- Share based payments
- Intangible amortisation
- Losses on long term contracts
- Costs such as restructuring recognised in several consecutive periods but described as non-recurring

In a number of cases the exclusion was justifiable – but had simply not been explained.

"Issuers or persons responsible for the prospectus should not mislabel items as non-recurring, infrequent, or unusual.* (ESMA Guidelines, paragraph 25)

Reconciliation to IFRS figures

We saw a number of good examples of clear reconciliations of APMs to financial statement line items. We continued to challenge:
- Reconciliations not provided for all APMs
- Reconciliations or calculations not provided for ratios (eg ROCE), and growth- based APMs (e.g. organic/constant currency growth)

"A reconciliation of the APM to the most directly reconcilable line item, subtotal or total presented in the financial statements of the corresponding period should be disclosed, separately identifying and explaining the material reconciling items." (ESMA Guidelines, paragraph 25)

Mislabelling of APMs

We challenged the mislabelling of APMs. Misleading labelling, even where an appropriate reconciliation has been provided, can lead to users being unable to distinguish IFRS figures from APMs. Examples we continued to challenge included:

- APMs with IFRS terms, or terms similar to IFRS;
- absence of "adjusted" from some narrative disclosure discussing APMs, or APM incorrectly described as "reported".

"APMs disclosed should be given meaningful labels reflecting their content and basis of calculation in order to avoid conveying misleading messages to users." ESMA Guidelines, paragraph 22.

Definitions

Definitions are required for all APMs. Examples of definitions not provided include:

- Adjusted income tax expense
- ROIC
- Net asset return

We also questioned when the calculation of an APM did not appear consistent with its definition, and where the calculation of an APM changed year on year without disclosure of this change.

"Issuers or persons responsible for the prospectus should disclose the definition of all APMs used, in a clear and readable way." ESMA Guidelines, paragraph 21.

Explanation

In some cases APMs were presented without a clear explanation of why they were helpful or even relevant to users of the accounts.

A good explanation is one which sets out why an APM is helpful or meaningful, rather than simply asserting that it is, and clarifies whether the APM is used internally, by whom and for what purpose.

"Issuers or persons responsible for the prospectus should explain the use of APMs in order to allow users to understand their relevance and reliability." ESMA Guidelines, paragraph 21

Impairment of assets

We continued to ask questions on impairment as part of our routine reviews. Increased focus on impairment has been partly driven by macroeconomic risks, as well as sector specific factors in areas such as retail, leisure and business support services. In addition we have carried out a thematic review of impairment disclosures for the 2018/2019 accounts.

We encourage all preparers to review the thematic review findings, which are consistent with our findings from our routine reviews:

https://www.frc.org.uk/getattachment/4daee650-59fe-43b0-904c-ba9abfb12245/CRR-Thematic-Review-Impairment-of-Non-financial-Assets-final.pdf

Areas we questioned included:

- lack of clarity as to whether sensitivity analysis relates to reasonably possible changes in estimate;
- the use of post-tax rather than pre-tax discount rates for value in use calculations;
- adequacy of disclosures relating to growth and discount rates, including: the disclosure of the growth rates applied and relevant period, explanation for the growth rates selected, and lack of explanation for significant changes in growth and discount rates; and
- lack of explanation of whether an impairment review was performed where a parent's net assets exceeds the market capitalisation of the group.

Where a parent's net assets exceeds its market capitalisation we expect disclosure of how this has been considered in assessing the recoverability of the investment.

Statement of Cash Flows

We expect companies to comply with the detailed requirements of IAS 7 when classifying cash flows. Where judgement is required, we expect to this disclosed where material. However, we rarely see judgments or accounting policies disclosed in practice.

Since we published our last technical findings document, we required four companies to refer to discussions with the FRC in the context of correcting cash flow statement errors.

Areas we questioned included:

- classification of cash flows; for example, restructuring and post-acquisition cash flows incorrectly classified as investing rather than operating cash flow;
- non-cash movements, such as entering into new leases, incorrectly included in the cash flow statement;
- misclassification of cash flows to and from joint ventures;
- classification of deposits maturing in more than three months as cash equivalents; and
- lack of separate disclosure of dividends from associates and joint ventures.

Most preparers of financial statements for years ending 31 December 2018 have included the disclosures required by IAS 7 (paragraphs 44A-44E) on changes in liabilities arising from financing activities, with only a few found to be missing or otherwise not compliant.

Income taxes

Areas we questioned included:

- the adequacy of disclosure about the basis for the recognition of deferred tax assets in relation to losses, particularly where the company has a history of losses;
- the lack of disclosure or explanation of significant reconciling items affecting the relationship between income tax expense and accounting profit multiplied by the applicable tax rate (IAS 12.81(c));
- insufficient granularity of disclosure of temporary differences (IAS 12.81(g)); and
- lack of disclosure of the basis for measuring research and development credits or the judgement whether they should be accounted for as tax credits.

The more detailed guidance published in the FRC's tax thematic continues to be relevant.

https://www.frc.org.uk/getattachment/d15d079f-bbd1-46ba-979c-cbc776f8042b/Corporate-Reporting-Thematic-Review-Tax-Disclosures-Oct-2016.pdf

Provisions and contingent liabilities

Areas that we questioned included:

- timing of recognition of onerous lease provisions due to planned store closures;
- presentation of movements in provisions net, rather than disaggregated into increases, utilisation and releases;
- no disclosure of the potential financial effect of contingent liabilities; and
- judgement whether insurance recoveries were virtually certain of being recovered and should have been recognised as assets.

The disclosure requirements of IAS 1.125 and IAS 1.129 on the nature of estimation uncertainty, assumptions and sensitivities will be relevant to provisions when they represent a major source of estimation uncertainty.

Financial instruments: recognition and measurement

Initial application of IFRS 9 was the subject of one of our thematic reviews during the period. However, we also raised issues on annual reports on financial instruments recognised and measured under IAS 39. The majority of matters raised under IAS 39 will continue to be relevant on adoption of IFRS 9.

Areas we questioned included:

- recoverability of trade receivables where credit risk is increasing; for example, a deteriorating aging profile;
- lack of clarity on how movements on derivatives relate to amounts shown in the primary financial statements;
- lack of clarity on whether a debt restructuring was treated as a significant modification, due to lack of accounting policy;
- initial measurement of intercompany and related party loans where they appear to have non-commercial terms; for example, term loans with below market interest rates;
- recoverability of intercompany loans, where the net assets of the parent exceeds the market capitalisation of the group.

CRR will continue to monitor the application of IFRS 9. Following up last year's thematic review of disclosures in June 2018 interim accounts is a second thematic review of disclosures in 2018 annual reports.

https://www.frc.org.uk/getattachment/4998f20e-30e1-47a8-a9e7-f15654fa0e03/IFRS-9-thematic-final.pdf

Financial instruments: disclosures

We also raised a number of questions on the disclosure of financial instruments and associated risks.

Areas we questioned included:

- whether the company participated in reverse factoring arrangements, where other indicators suggest this is the case
- lack of disclosure of liquidity risk and how the risk is managed or mitigated
- lack of disclosure of amounts pledged as security

We continue to have concerns about the level of transparency of disclosures provided for supplier financing arrangements, also known as reverse factoring.

Where companies are using material supplier financing arrangements we expect disclosure of:

- the amount of the facility and usage;
- the accounting policy applied;
- whether the liability to suppliers is derecognised;
- whether the liability is included within KPIs such as net debt;
- the cash flows generated by such arrangements; and
- the existence of any concentrations of liquidity risk which could arise from losing access to the facility.

Fair value measurement

We encourage preparers to review their fair value disclosures and consider whether sufficient information is disclosed, particularly where there are large, unusual or highly subjective items included in the financial statements.

Areas we questioned included:

- the nature of valuation techniques used;
- incomplete or no disclosure of significant unobservable inputs or sensitivities;
- the basis for the categorisation of investments into the three levels of the fair value hierarchy; for example, where the categorisation appeared inconsistent with the description of the items;
- instances where it appeared that material level 3 balances had been omitted from the fair value disclosures; for example, contingent consideration payable;
- whether companies made adjustments to the fair value of derivative liabilities to reflect own credit risk in circumstances where other factors suggested that such an adjustment could be material.

The main reason for us asking for additional information was the apparent omission of disclosures required by IFRS 13 paragraph 93, including valuation techniques, inputs and sensitivities.

Revenue

Initial application of IFRS 15 is the subject of one of our thematic reviews during the period. However, we continued to raise issues on annual reports on revenue recognition under IAS 18. The majority of matters raised under IAS 18 will continue to be relevant on adoption of IFRS 15.

We have continued to challenge companies on:

- agent versus principal, where it was not clear why a particular treatment had been selected;
- absence of detail as to how the stage of completion was assessed on long term contracts; and
- lack of detail and 'boiler plate' accounting policies.

The next year end will be the second year of IFRS 15 and so companies have the opportunity to reflect on whether the disclosures added fully reflect the disclosure objectives of the new standard.

Where companies have early-adopted IFRS 15, questions have been raised on:

- missing disclosure of costs to obtain contracts with customers;
- lack of disclosure on judgement of having a single performance obligation;

CRR will continue have an increased focus in this area, and has published a thematic review on disclosures in the 2018 annual accounts.

https://www.frc.org.uk/getattachment/498aa4b3-85b2-4d4c-8f5a-3d0d28db9237/IFRS-15-thematic-PDF.pdf

Information about the Financial Reporting Council can be found at:
https://www.frc.org.uk

Follow us on Twitter @FRCnews or

The FRC's mission is to promote transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

The Financial Reporting Council Limited is a company limited by guarantee. Registered in England number 2486368.

Financial Reporting Council