Technical findings

of the

Conduct Committee's

Financial Reporting Review Panel

2015 – 2016

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Executive Summary

- This presentation describes the accounting and corporate reporting issues most often raised by Corporate Reporting Review activity conducted in the year ended March 2016.

- It supplements the wider discussion of the quality of corporate reporting in the UK in the 'Annual Review of Corporate Reporting'.

- While certain matters have been raised for a number of years, we believe compliance with the accounting framework in the UK remained generally good for the 2016 year.

- All matters reported in last year's presentation remain relevant.

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Most frequent areas of questioning

- Strategic Report
  - Business Reviews
  - Other
- Accounting policies
- Critical judgements
- Estimation uncertainties
- Clear & Concise
- Revenue recognition
- Impairment
- Consolidation

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Strategic Report: Business Reviews

- Companies should provide a fair review of the business that is balanced and comprehensive (Section 414C of CA 2006).

- We challenged companies where the review did not appear appropriately balanced; eg:
  - Positive narrative but numbers presented a negative trend in parts of the business;
  - The profitability of an ancillary part of the business was not discussed;
  - No discussion of material impairment charges;
  - Too much focus on non-IFRS financial results, eg:
    - Focus on proportionally consolidated information for JVs when the IFRS information was on equity-accounting basis; and
    - Only discussion of pro-forma numbers, as if acquisition had taken place at the beginning of the period.

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Strategic Report: Business Reviews

- We challenged companies where the review did not discuss all relevant aspects of performance; eg:
  - Focus on UK operations when international customers were also relevant;
  - No discussion of non-financial KPIs, e.g. status of order book; and
  - Effect of tax credits in reducing effective tax rate.

- We challenged the comprehensiveness of the review of financial position; eg:
  - No discussion of working capital movements;
  - Unclear how assets acquired in a business combination were valued;
  - Lack of discussion of effect of material change in pension discount rate; and
  - No reference to financial position at all (smaller companies).

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Strategic Report: Other

- We have seen improvements in the reporting of principal risks and uncertainties (PRUs). However, we continued to challenge where:
  - There was a question whether all PRUs disclosed were genuinely principal; or
  - There was no discussion of how risks were managed or mitigated.

- Key performance indicators (KPIs) are required ‘to the extent necessary’ to provide an understanding of a company’s position or operations.

- We challenged companies where there was a lack of linkage between KPIs and strategic elements of business, or KPIs were not adequately identified and discussed.

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Accounting policies

- We questioned:
  - Lack of policies for transactions or balances that were material to the business; eg:
    - Transfer of business to associate;
    - Recognition of pension assets;
    - Cash-settled share-based payments;
    - Inclusion of common-costs in inventory;
    - Invoice factoring arrangements; and
    - Mobilisation costs for long-term contracts
  - Accounting policies that had not been updated for new standards, such as IFRS 10 and IAS 19 (revised).
- We expect companies to replace boilerplate statements lifted from accounting standards with tailored, relevant disclosures.

Accounting policies

- As part of our drive for company reporting to be more 'Clear & Concise' we informed companies where we identified:
  - Accounting policies for items or transactions that were immaterial, no longer relevant or non-existent; eg: equity accounting, when there were no associates or joint ventures.
  - Unnecessary repetition of accounting policy descriptions and other narrative; eg, separate policies for impairment of goodwill and of indefinite-lived intangible assets.

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Critical judgements

- We expect critical judgement disclosures to state explicitly what those judgements are and differentiate them from estimates. We challenged general references to critical judgements being included in accounting policies when no further details were provided.

- We queried lack of disclosure where needed to understand how management applied its most significant accounting policies, eg:
  - Classifying companies as associates, joint ventures, joint operations or subsidiaries; eg whether investor' rights were participative or protective;
  - Applying the percentage of completion basis to revenue;
  - EPS – why shares issued at a discount contained no bonus element;
  - Whether long-term contracts contain an embedded lease; and
  - Cash versus equity share-based payments.

Estimation uncertainties

- Some companies did not disclose the relevant amounts or provide other useful information, such as sensitivities.

- Where a company’s Audit Committee report or audit report mention judgements and estimates not identified in the financial statements we may ask whether these disclosures should have been expanded in the notes.

Clear & Concise

- We wrote to companies noting:
  - that tables with immaterial information could be replaced by narrative or eliminated;
  - financial statement notes for immaterial items; e.g. share-based payments or operating leases;
  - information that was repeated in financial statements but that could be cross-referenced; and
  - disclosures that are no longer required in the Directors' Report, e.g. charitable donations and creditor payment policy.

Revenue recognition

- We challenged companies whose accounting policies are ‘boilerplate’ and insufficiently tailored to all the significant revenue streams in their business model; e.g. bundled products or gift cards.
- We continued to challenge companies that did not explain how they applied the percentage of completion model to long-term contracts.
  - One company identified an error in applying this methodology and restated its accounts to recognise revenue later.
- We continued to identify failures to disclose revenue by category.

Impairment

- Discount rate(s) should reflect current market assessments of time value of money and asset-specific risks. Pre-tax rate(s) should be disclosed.
- We challenged the level at which the company identified its CGUs and the levels at which it tested for goodwill impairment if these appeared to be at higher than operating segment level.
- A description is required of each key assumption driving the cash flow projection determining value in use. The discount and terminal growth rates were often incorrectly identified as the only key assumptions.

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Impairment

- A description is also required of the approach to determining the values attributed to assumptions, including how past experience or external sources of information have been used.
- We challenged where companies had little ‘headroom’ but goodwill sensitivity disclosures were not given.
- We noted a lack of sensitivity disclosures for impairment tests for PP&E and associates where this information was relevant (IAS 1.129).

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Other common areas of questioning

- Business combinations
- Financial instruments
- Exceptional and other items
- Income taxes
- Complex supplier arrangements
- Pensions
- Cash flow statements
- Capital management
- Intangible assets
- Other

Business combinations

- All identifiable assets, subject to qualifying conditions, should be recognised separately from goodwill.
- We challenged where we did not see the separately recognised intangibles that we would have expected; eg: technology-related intangibles or customer/ brand intangibles.
- We challenged:
  - the basis for measuring customer intangibles and whether they were based on market participant assumptions; and
  - whether deferred revenue liabilities reflected the fair value of the obligations.

Business combinations

- We challenged when a business combination appeared to be an asset acquisition. We asked for the difference between the two to be described more clearly.
- We queried when only aggregated disclosures were given but a particular acquisition appeared to be material.
- Details of a post-balance sheet acquisition were not disclosed.
- Separate disclosure of all material assets and liabilities recognised is required – we challenged a lack of tax balances appearing in these disclosures.

Financial instruments

- We raised a number of queries regarding fair value disclosures for 'level 3' instruments; eg:
    - disclosure of unobservable inputs, such as estimated rental values for a property company or assumptions around extension options on swaps;
    - description of valuation process; and
    - narrative disclosures around sensitivities.

- We noted a lack of fair value disclosures for assets held at amortised cost.

Financial instruments

- Financial instrument disclosures should be sufficient to understand the risks the company faces. We identified:
  - A company that closely monitored its covenants due to the risk of failure but did not disclose the terms and covenant measures;
  - An ageing analysis for trade receivables that did not separately identify impaired balances;
  - Disclosure of maximum credit exposure that did not include all financial assets; and
  - Missing descriptions of the nature of complex financial instruments and hedging arrangements and associated risks.

- Following our intervention, a company reclassified deposits that did not meet the definition of cash and cash equivalents, and derecognised customer deposits when it did not have a right to the cash.

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Exceptional and other items

- We expect companies to explain their accounting policy for identifying exceptional items. If companies separately present ‘other’ items, in addition to exceptional items, we expect the basis to be disclosed.
- We challenged companies that did not include non-recurring credits in their exceptional items, eg one-off tax credits.
- We identified companies that only presented exceptional items separately if they were a component of operating profit. Financing and tax items require separate presentation too, where material.
- If we are unable to reconcile adjusted profit measures, such as EBITDA, we will ask for them to be reconciled.

Income taxes

- 'Corporate Reporting Thematic Review – Tax Disclosures', issued in October 2016, sets out our detailed findings from the follow up of our Press Notice – 'FRC calls for transparent disclosure of tax risks in corporate reports'
- We challenged a number of companies with material tax provisions where the accounting policy did not explain the recognition and measurement basis applied.
- The nature of evidence supporting a deferred tax asset is a required disclosure when its use depends on future profits and the company is loss-making.
- We challenged when it was not apparent why exceptional and non-exceptional items had materially different effective tax rates.

Income taxes

- We challenged companies' effective tax rate reconciliations where:
  - the description of reconciling items was unclear;
  - it was based on a non-IFRS measure; or
  - the linkage between the effective tax rate reconciliation and the discussion of tax in the Strategic Report was unclear.

Complex supplier arrangements

- We wrote to a number of companies following publication of our Press Notice: 'FRC urges clarity in the reporting of complex supplier arrangements by retailers and other businesses'

- As a result, several agreed to separately disclose accruals of income from suppliers.

Pensions

- We asked companies to justify their basis for recognising a pension surplus as an asset – in some cases this should have been identified as a significant accounting judgement.

- We wrote to companies where their pension funding strategy was unclear, or the nature and valuation methodology of the assets in the fund was not sufficiently transparent; eg a lack of information about a liability-matching strategy in a closed fund.

Cash flow statements

- Having raised cash flow statement matters for several years, we were pleased to identify fewer issues this year.
- However, we still identified some items misclassified between operating, investing and financing activities; eg, acquisitions of financial assets classified as financing.
- We reminded one issuer of the IAS 7 requirement to disclose the assets and liabilities of a disposed of subsidiary.

Capital management

- We have challenged capital management disclosures for several years and have seen improvements in the narrative disclosures and quantitative information.

- However, we continue to see examples of boilerplate capital management policies or descriptions which contain metrics that differ from KPIs disclosed in the strategic report.

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Presentation of financial statements

- We challenged the aggregation of accruals and deferred income as these liabilities are different in nature and liquidity. Similar challenges were made in respect of prepayments and accrued income. This is particularly relevant to companies with long-term contracts where revenue recognition is a critical judgement.

- We challenged a company that had incorrectly presented the impairment of an associate as an accrual balance rather than a reduction of the carrying value of the associate.

Intangible assets

- We challenged the disclosure of missing or unclear:
  - Amortisation methods selected; and
  - Amortisation periods.

- We wrote to companies that had aggregated different types of intangibles into a single class of ‘acquired intangibles’ despite these being different in nature and use.

Consolidation

- We have a continuing focus on whether companies should consolidate investments based on 'de facto' control.

- A property company was required to restate its accounts to consolidate a structured entity previously accounted for as a joint venture.

- A company taking the investment entity exemption enhanced its accounting policy to better explain how it estimated the fair value of its investments; eg, the nature of adjustments made to their net asset value.

Other

- We reminded companies that contingent assets, such as those arising from a legal claim, should only be recognised when virtually certain of being realised.

- A general description of leasing arrangements should be disclosed where material and relevant; eg, cost of exercising extension options, contingent rents. We challenged boilerplate disclosures.