10 October 2017

Dear Audit Committee Chairs and Finance Directors

Summary of key developments for 2017/18 annual reports

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

New Accounting Standards

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

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

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

Strategic report

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

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

Non-financial reporting

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

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

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

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

Performance reporting

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

8th Floor, 125 London Wall, London EC2Y 5AS Tel: +44 (0)20 7492 2300 Fax: +44 (0)20 7492 2301 www.frc.org.uk

Risk reporting and viability statements

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

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

We encourage companies to consider developing their viability statements in two stages – first, to consider and report on the prospects of the company over a period reflecting its business and investment cycles, and second to state whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary. The Lab's project and the FRC's review of viability statements have identified some examples of good practice following this approach which clearly explain the underlying analysis that supports the statement.

UK referendum result

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

Financial statement disclosures

Statement of Cash Flows

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

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

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strongly encourage companies to provide detail of, and disclosure of reliance upon, these facilities.

Dividends

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

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

Critical judgements and estimates

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

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

Accounting policies

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

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

Business combinations

Business combinations can pose unusual and complex accounting questions for companies. In particular, the impact of contingent and deferred consideration arrangements can be difficult to determine as they rely on a high level of estimation and multiple assumptions,

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making clear disclosure imperative. Sometimes it is also not clear why few or no intangible assets, other than goodwill, were recognised in accounting for an acquisition.

Pensions

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

Audit quality and effectiveness

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

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

Yours sincerely

Paul George
Executive Director Corporate Governance and Reporting
Email: p.george@frc.org.uk

Publications and further information

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

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

FRC: Guidance on the Strategic Report (June 2014)
https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Strategic-Report.pdf

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

FRC: Draft amendments to Guidance on the Strategic Report (August 2017).
https://frc.org.uk/accountants/accounting-and-reporting-policy/clear-and-concise-and-wider-corporate-reporting/narrative-reporting/guidance-on-the-strategic-report

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

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

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

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

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

FRC: Corporate Reporting Thematic Review: Alternative Performance Measures (November 2016).
https://www.frc.org.uk/news/november-2016/improved-reporting-of-alternative-performance-meas

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

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