Financial Reporting Council

October 2014

Corporate Reporting Review

Annual Report 2014

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

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1 Key Messages

Overview

This report is written primarily for those with Board-level responsibility for preparing company reports and accounts. It provides an overview of the corporate reporting review ("CRR") activities of the Financial Reporting Council ("FRC") for the year ended 31 March 2014.

Our report includes our assessment of the state of corporate reporting in the UK based on our findings for the year. It highlights the main issues identified by our work and supports these with case studies illustrating the types of concerns we raised and how they were resolved.

Our report also identifies the areas likely to pose future challenges for preparers and where Finance Directors and Audit Committee members should have particular focus when planning their next report and accounts. This year, we have included a section on emerging issues where we discuss our initial impressions of how boards are responding to new reporting requirements and identify issues requiring their early consideration.

Quality of Corporate Reporting

Findings

This year we have seen a good level of corporate reporting by large public companies, particularly FTSE 350 companies. We are pleased to observe that this is consistent with comments made in our previous annual reports. Details of the issues that most commonly arose are set out in Section 4. We tend to raise fewer questions on straightforward issues in relation to FTSE 350 companies than for smaller companies. Those issues that we do raise often involve unusual or complex transactions, difficult judgements or particularly subjective estimates, which require careful consideration of the facts and circumstances.

We continue to see a higher number of poorer quality accounts produced by smaller listed and AIM quoted companies than by their larger counterparts. We do not believe that simply reviewing more reports from these types of companies and asking questions of their boards with a view to improving their next set of accounts is an adequate regulatory response to our concern. The FRC has, therefore, set up a project aimed at driving a step change in the overall quality of reporting by companies in this part of the market within the next three years. The initial phase of this project seeks to identify the root causes of the particular challenges faced by smaller public companies and is discussed further in Section 2.1.

Areas of future focus

From our work during 2013/14, we have identified the following areas of focus for the current year:

- We will look closely at pension structures designed to achieve an accounting effect, such as reducing pension obligations – continuing the substantive discussions we have had in recent years around various pension-related issues. The closure of three long-standing Review Groups[1] on pension accounting involving the use of Scottish Limited Partnerships culminated in the issue of a

[1] Formed from members of the Financial Reporting Review Panel – see Appendix A. Defined in:

https://www.frc.org.uk/Our-Work/Conduct/Corporate-Reporting-Review/FAQs.aspx generic Press Notice explaining the reasons why we found the particular arrangements to be inappropriate. We also published a Press Notice[2] on a newly identified issue regarding a company's minimum pension funding obligation.

- Our statutory remit is to monitor compliance with the financial reporting requirements of the Companies Act 2006. Where we become aware that a company has not complied with legislation or regulations that companies are required to comply with when preparing annual reports and accounts, we will draw that failure to the company's attention and seek confirmation that the relevant requirements will be complied with in the future.

- We will keep under review the manner in which companies report exceptional items and will investigate any apparent departures from the approach referred to in our December 2013 Press Notice[3].

- We will consider the circumstances in which the test of 'de facto' control may apply under the newly introduced IFRS 10, 'Consolidated Financial Statements', to ensure that the application of this new requirement has been carefully and objectively applied to the particular circumstances.

- As the reports of the Audit Committee and Auditor respectively are increasingly likely to explain the approach each has taken to reaching conclusions on key judgements and estimates, we will monitor the appropriateness of the related disclosures in the accounts, including the extent and clarity of information provided.

- We will encourage companies to report the likely effect of the changes to be introduced in 2017 by IFRS 15, 'Revenue from Contracts with Customers', as soon as this is, or should be, reasonably estimable (in accordance with IAS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors').

- As business combinations are likely to increase in an improving economic environment, we will investigate circumstances where, without appropriate explanation, the goodwill recognised is substantially in excess of the identified intangible assets.

Clear & Concise Reporting

In June 2014, the FRC announced its 'Clear & Concise' initiative bringing together a number of activities aimed at ensuring that reports and accounts provide the most relevant information for investors. The initiative builds on the concept of 'cutting clutter', which has been a feature of the corporate reporting agenda as reflected in our correspondence with companies.

The Financial Reporting Lab's 'Towards Clear & Concise Reporting'[4], provides information on the practical steps companies can take to make their reports clearer and more concise.

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[2] Defined in: https://www.frc.org.uk/Our-Work/Conduct/Corporate-Reporting-Review/FAQs.aspx

[3] https://frc.org.uk/News-and-Events/FRC-Press/Press/2013/December/FRC-seeks-consistency-in-the-reporting-of-exceptio.aspx

[4] https://frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/FRC-Lab-Towards-Clear-Concise-Reporting.pdf

The report emphasises that the initiative is broader than mere identification of immaterial or irrelevant information in corporate reports. It is about good communication with users and includes aspects such as placement and integration of disclosures as identified in the Lab's earlier report 'Accounting policies and integration of related financial information'[5].

CRR activities have always included consideration of how clearly a company has explained its accounting policies, key judgements and estimation uncertainties. Our interventions often result in improvements to the clarity and adequacy of these disclosures.

In this context, we emphasise that our letters of enquiry discourage boards from including immaterial matters in their reports and explain that only disclosures that are material or relevant should be included. We raise specific 'cutting clutter' issues with boards where we believe that the usefulness of their accounts could be enhanced by removing or revising unnecessary disclosures. We close substantive issues with companies only when their disclosures and policies are clear for future reporting. Further details about our approach are set out in Section 4.

We have welcomed the obvious steps taken by some boards to cut clutter in their reports and accounts in order to focus their communications on the most important points. There are many more that have yet to do so.

Company responses

We are often asked how companies should respond when they receive a letter from us. There are a number of good practices we have experienced which, if followed, tend to result in earlier closure of the matters under review:

- Responses that address all of the questions raised;
- Not just answering the question asked in our first letter, which is based on the accounts, but raising our understanding of the issue to that of the company;
- Responses that explain fully the board's judgements and how they comply with the requirements of IFRS;
- Board and, where applicable, Audit Committee involvement;
- Full and early engagement with auditors;
- Correspondence that clarifies that these parties have been involved; and
- A willingness to consider alternative viewpoints expressed by the FRC.

We also expect companies to work cooperatively with the FRC in successive rounds of correspondence to ensure that users of the company's next accounts can rely on cases having been closed with issues satisfactorily addressed.

A comprehensive and thoughtful approach to a response to our first letter is an indication that the board is taking our enquiry seriously, as we expect. Overseas companies are encouraged to provide timely correspondence to the same standard as UK companies. Further details on how to respond to our letters are available on our website.[6]

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[5] https://frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/Accounting-policies-and-integration-of-related-fin.pdf

[6] https://www.frc.org.uk/Our-Work/Conduct/Corporate-Reporting-Review/FAQs.aspx

Looking forward

IFRS is about to go through some of its most significant changes since it became mandatory for UK listed companies to adopt EU-endorsed IFRS in 2005. 2013 saw the introduction of IFRS 13, ‘Fair Value Measurement’, as well as changes to the way pensions are accounted for under IAS 19, ‘Employee Benefits’. 2014 will see the introduction of new standards[7] that change the way in which companies assess whether entities should be included in consolidated accounts and account for joint ventures and associates. The IASB has also published a new standard on revenue, IFRS 15, which will have far-reaching implications for some companies when it first applies. It will be mandatory from 2017; however, we will be monitoring compliance by those companies that choose to adopt early, subject to EU endorsement.

Companies should consider the effects of these new standards early and estimate and report the possible effect of their implementation if they are likely to impact significantly their reports and accounts. We plan to challenge companies that do not make this disclosure, where material or relevant.

We have commented on those emerging issues that we have identified relating to IAS 19, IFRS 10 and IFRS 13 in Section 3.

[7] IFRS 10, IFRS 11 ‘ Joint Arrangements’ and IFRS 12, ‘ Disclosure of Interests in Other Entities’

2 Reflections on 2013/14

2.1 Recent Developments

Effect of FTSE 350 prioritisation

Our CRR resource is directed towards the reports of companies of greatest economic significance where a material error could have implications, not just for the individual company, but for the market as a whole. As FTSE 350 companies represent the major part of investment in UK-listed companies we review their report and accounts on a regular basis. We review those of FTSE 100 companies at least once every three years and FTSE 250 companies are reviewed at least once every four years.

This year, we prioritised the reviews of the largest companies and performed them earlier with a view to completing our enquiries within the companies' annual reporting cycle. Earlier completion enables agreed corrections or improvements to be reflected in the company's next set of accounts. The drawback of this approach, combined with significant work in progress brought forward from the previous year, is that we tended to write to smaller companies later in their reporting cycle. This presents a greater challenge in resolving issues prior to publication of their next report and accounts.

We have completed 90% of our 2013/14 cases by the date of publication of this report; the rest are in correspondence.

Timeliness of correspondence

As part of our initiative to accelerate the speed with which we conclude our enquiries, we aim to reply to companies within 28 days of receiving their responses. We generally expect boards also to respond to our letters within 28 days, particularly where the questions we raise are likely to have been discussed by the company and its auditors. In 2013, we started referring to this expectation in our initial letters. We do strive to be reasonable in our dealings with companies and, where there is due cause, properly explained and where we are notified in advance, we accept company responses outside this time-frame.

In 2013/14, 45% of the companies we wrote to responded to our initial letters within 28 days. This increased to 66% for letters written once we included specific reference to our 28 day expectation. The average response time for all letters was 40 days. Where we did not receive timely responses from companies, we noted that a significant percentage were either overseas companies or had management based overseas.

Our average turnaround time for responding to company letters was 35 days. This reflects a number of complex cases that required detailed consideration of significant amounts of data. We aim to improve the timing of our responses next year.

Changes to our operating procedures

Our engagement with companies is evidenced by FRC Press Notices and by references in companies' financial statements to the intervention of the Conduct Committee (known as 'Committee References'). We require Committee References when we believe that a company should publicly disclose the fact that the changes it is making to its reporting were prompted by our review. We issue a Press Notice when the changes are material to the accounts as a whole, represent an emerging trend or set a precedent. For the first time, our 2012/13 report identified the companies that had published Committee References since our last public report.

In April 2013, we published a consultation paper proposing a small number of changes to our operating procedures, principally to formalise the existing practice of Committee References. A key change was around the transparency of our regulatory decisions.

Following consideration of the responses received to that Consultation Paper, on 7 October 2104 we updated our operating procedures to explain that our Annual Report will include the names of companies that have published Committee References since our last report. We will, however, continue to provide companies with the opportunity to comment on the proposed wording of our reference to the matters at issue. This year, all nine companies in Appendix B with Committee References agreed to be named.

Guidance on when we request Committee References has been added to the FAQs on our website.

Interaction with the FRC's Codes and Standards division

Observations arising from our CRR activities are shared with the FRC's Codes and Standards division and inform its standard setting and influencing activities. During the year, we contributed to several of the Financial Reporting Lab's projects on potential improvements to UK corporate reporting.

In June 2014, the FRC issued a statement reconfirming that the presentation of a true and fair view remains a fundamental requirement of financial reporting. We will continue to consider companies' compliance with this requirement as part of our procedures.

Liaison with Audit Quality Review

This year, the CRR team sought to build on our collaborative working relationship with the Audit Quality Review ('AQR') team. We enhanced our review programme to include the concurrent scheduling of some reviews to consider how initial findings from each review might be best addressed. Information and further findings were shared as our reviews progressed and suggestions were made that informed our correspondence with companies. Where relevant, matters arising from AQR reviews will also be referred to explicitly in our correspondence.

Smaller listed and AIM quoted companies

In April 2014, the FRC started a three-year project to drive a step change in the quality of financial reporting by smaller listed and AIM quoted companies.

The project is currently in its initial phase, which involves gathering and assessing evidence of the root causes of the issues and exploring ways in which we can support companies to make improvements. The project will move on to implement possible supporting actions and, finally, will assess whether the quality of reporting has improved as a result.

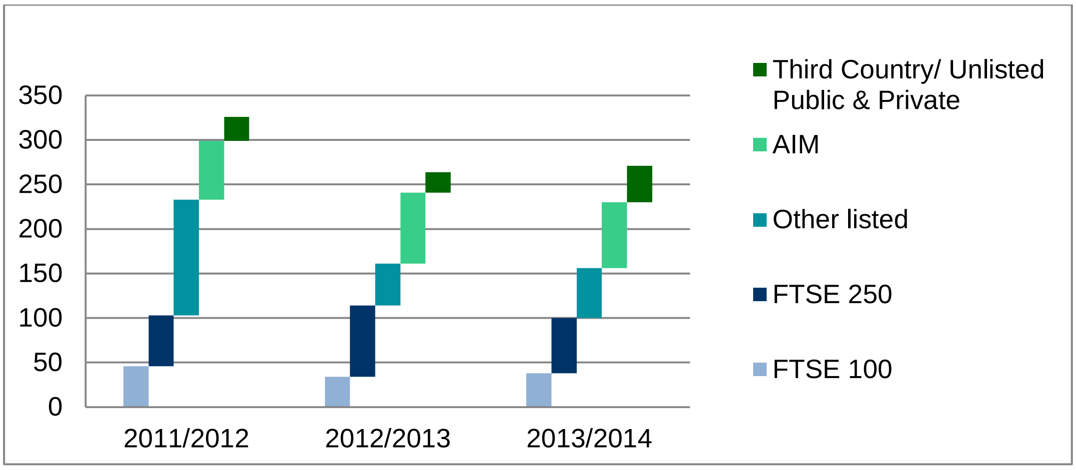
The CRR team is supporting the initial phase of the project by reviewing recent reviews undertaken under its normal operating procedures to identify any common issues. Initial findings are that smaller listed and AIM companies often struggle to account for complicated transactions; for example, innovative capital products or derivatives. These issues can also challenge their larger peers who may be more aware of their legal obligations.

As noted above, our focus on the FTSE 350 led to our reviewing the reports of smaller listed and AIM quoted company reports and accounts later in the year. Correspondence regarding a number of these companies is ongoing.

2.2 Summary of Activities

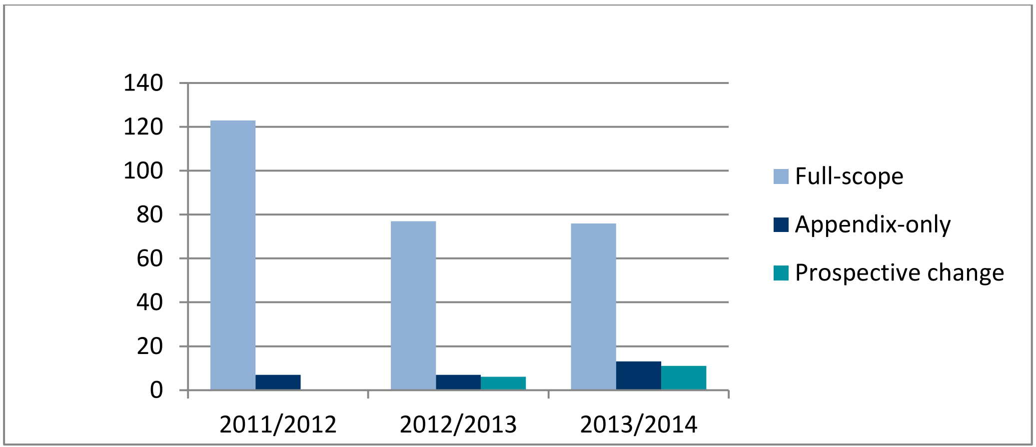
In 2013/14, we reviewed 271 sets of reports and accounts (2012/13: 264; 2011/12: 326)

Table A: Reviews by market



After reviewing a set of accounts we consider whether any potential matters identified are significant enough to require additional explanation or information from the company. Our letters take different approaches depending on the type and number of issues raised. The various approaches are described in more detail on our website[8]. Full-scope and prospective change letters require substantive responses from companies, the latter once the company has published its next report and accounts. We do not require boards to provide a substantive response to appendix-only letters, although some choose to do so.

Table B: Approaches to Companies



This year, we wrote to 100 companies (2012/13: 91; 2011/12: 130), which is 37% (2012/13: 34%; 2011/12: 40%) of the total number of reports reviewed.

[8] https://www.frc.org.uk/Our-Work/Conduct/Corporate-Reporting-Review/FAQs

We closed four long-standing Review Groups that had been set up in 2013. Three cases involved questions around the interest held by a company's pension fund in a Scottish Limited Partnership controlled by the company. The fourth had a focus on revenue recognition. No new Review Groups were established in the period. When advised that we were minded to set up a Group as the next stage in a review, three boards reconsidered their initial position to the extent that they were able to accept our view and we closed the cases. Our Review Group procedures are explained on the FRC website[9].

In 2013/14, 16 reviews were prompted by complaints and referrals (2012/13: 8, 2011/12: 9). Although these are a small proportion of our cases, we take complaints and referrals seriously. We are able to respond more quickly to complaints that clearly identify the concerns regarding the corporate reporting or accounting matter in question.

We inform complainants of the outcome of the cases they raise with us. We do not, however, engage in extended correspondence explaining the basis on which we concluded as this is generally not possible due to the correspondence between ourselves and the company having to remain confidential. Where we decide not to pursue a matter raised by a complainant, we write giving reasons for our decision.

Outcomes

Virtually all of our correspondence results in companies agreeing to make some change to their next reports and accounts. These range from the less significant; for example, replacing generic language in an accounting policy with wording tailored to the company or adding explanation to the strategic report, to, less frequently, amending figures in the primary statements or correcting other significant data, like earnings per share.

Of the 79 company reviews that were closed in the reporting year following exchange of correspondence, we accepted 252 undertakings from 78 companies to make specific improvements or changes to their future reporting.

We follow up all undertakings and, where the promised improvements are not evidenced, we pursue the matter with the company.

We have issued two company-specific FRC Press Notices since our last annual report. One related to estimating the fair value of biological assets. The other was in relation to pension accounting. Common areas of concern around pension accounting are discussed in Section 4.

We issued two generic FRC Press Notices. One summarised the outcome of our Review Groups on pension funds in Scottish Limited Partnerships. The second set out the FRC's concerns regarding the disclosure of exceptional items in financial statements (see Section 4).

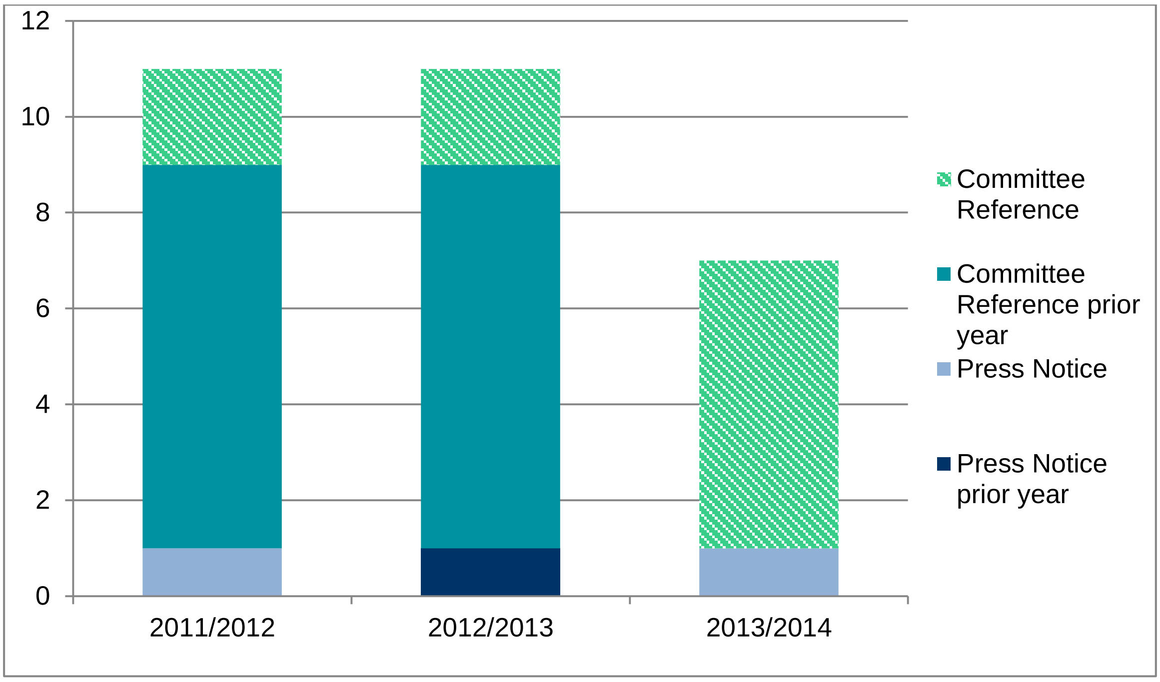
Since our last annual report, nine companies have, as requested, included Committee References in their report and accounts in which they made a change prompted by our intervention. We are aware that some companies voluntarily referred to our correspondence in their next report and accounts, usually in the Audit Committee Report, but not all gave us the opportunity to see and agree the proposed text in advance. We welcome this increase in transparency but it is important that we should have the opportunity to comment on draft wording that refers to our exchange. This reduces the risk that further public clarification of our involvement in a case will be required where we believe that investors may be misled

[9] https://www.frc.org.uk/Our-Work/Conduct/Corporate-Reporting-Review/FAQs.aspx

regarding the status or nature of our concern. We discourage companies from disclosing information regarding ongoing cases unless it relates to a case that has been partially closed and a Committee Reference is being given in relation to the matters which have been resolved.

Table C shows the number of FRC Press Notices and Committee References that have been published between 2011 and 2014. Appendix B contains a synopsis of the matters giving rise to the Press Notice and Committee References in the period since our last Report.

Table C: Press Notices and Committee References



Note: The above data analyses Committee References and Press Notices reported in CRR Annual Reports by reference to the year in which the review of the report and accounts commenced (and not when the Committee Reference or Press Notice was agreed or published).

When the number or significance of corrections required to a company's accounts is exceptional, the FRC may send to the senior partner or chairman of the company's audit firm a copy of its letter to the company closing a case. The FRC writes such letters sparingly and issued two letters in respect of 2013/14 reviews.

Exercising our powers

Our powers are described on our website[10]. During the year we wrote to one overseas company on two separate occasions formally advising that we would apply to court for provision of information and explanations that we had previously requested and which had not been provided. For the avoidance of doubt, all overseas companies listed in the UK are expected to comply with relevant reporting requirements and respond constructively when we have questions about their reports and accounts. Similarly, while we appreciate the

[10] https://www.frc.org.uk/Our-Work/Conduct/Corporate-Reporting-Review/FAQs

challenges faced by UK companies whose management is based overseas, we expect boards to be prompt in providing us with additional information and explanations as requested. In our discussions with the major accounting firms, we have emphasised the importance of complying with our regulatory requirements. We have indicated that it may benefit firms in their global network to take advice from those most familiar with the FRC's activities.

We used our power to require information from a company's auditors on one occasion during the year.

Coordination with other regulators

Our activities are not limited to reviewing company reports and accounts.

We share the detailed outcomes of our listed company enquiries with the Financial Conduct Authority (FCA). Other companies who operate under licence by the FCA are also referred to the authority where we have a concern about their corporate reporting.

We liaise with other regulators where we consider that matters that have come to our attention could be of significance to them in the discharge of their responsibilities. This year, we referred one AIM company to the London Stock Exchange.

We work closely with other European enforcers under the auspices of the European Securities and Markets Authority ('ESMA'). We meet regularly during the year with our European peers to discuss enforcement decisions and common reporting issues relevant to the coordination and consistency of IFRS reporting across the EEA.

We participated in three ESMA Working Groups during the year, which have all now reported:

- Accounting for business combinations;
- Comparability of banks' reports and accounts; and
- Guidelines on enforcement of financial information.

The last of these working groups met to discuss responses to a public consultation paper on draft enforcement guidelines that would apply to European enforcers. The guidelines have now been issued. They codify and expand previous standards issued by the Committee of European Securities Regulators, which preceded ESMA. We do not expect the guidelines to have a significant impact on the way in which we interact with companies. We do, however, anticipate some changes to our internal reporting processes in order for us to be able to comply with the new requirements.

3 Emerging Issues

This year we highlight issues prompted by recent changes to IFRS or legislation and regulations or where we have had an early indication that they will be particularly relevant in the near future:

Pensions

IAS 19, the revised pension accounting standard, changed the way in which companies are required to recognise and measure pension costs, including the means by which the financing element is to be calculated. It also introduced new requirements regarding how the risks around defined benefit plans should be disclosed. As the standard applies to periods beginning after 1 January 2013, we have seen only the first examples of those changes being implemented as part of our 2014/15 reviews. We have not yet identified any substantive issues with the revised accounting policies applied by companies.

Boards must now disclose information surrounding the governance of their pension plans and the applicable regulatory framework, such as the level of any minimum funding requirements. They are also required to disclose information about the plan's funding arrangements and maturity profile. To be appropriately informative to users, we expect these disclosures to include quantitative, as well as qualitative, information.

We have seen variable practice regarding companies' quantification of their minimum pension funding requirements. Given the prevalence of such arrangements in the UK, we would expect these disclosures to be given by many UK corporates. We will continue to monitor whether the information provided is adequate.

De facto control of subsidiaries

IFRS 10, the revised consolidation accounting standard, explicitly states that companies must consider whether they exert 'de facto control' over an entity and, if so, include it in the consolidated financial statements.

The concept of 'de facto control' reflects the situation where a parent company may be able to control a subsidiary through its voting rights although it does not hold a majority of the voting shares. This happens when there is a wide group of other shareholders that do not tend to vote together. This is often seen in public companies where there may be a large minority shareholder that, effectively, runs the company.

As the requirement is a substantive change from the previous standard, we encourage boards to consider this particular change carefully when applying the standard for the first time. We will consider how companies have applied IFRS 10 on its initial adoption.

Acquired intangibles

The UK's economic outlook is improving, as reflected in the increase in the level of merger and acquisition activity. This is a timely opportunity for companies considering acquisitions to revisit their approach to identifying and recognising intangible assets, such as brands or customer lists, acquired as part of a business combination. These must be recognised separately from goodwill and measured at fair value when they arise from contractual or legal rights or can be sold or otherwise disposed of separately. IFRS 13, which is applicable for periods beginning after 1 January 2013, provides additional requirements and guidance for estimating fair value.

We would expect most business combinations to result in the recognition of some separate intangible assets. Companies may need expert assistance in order to estimate the fair value of these assets. We plan to challenge companies that undertake business combinations that result in the recognition of material goodwill but few or no separate intangible assets.

Other legislation and regulation

Our statutory remit is to monitor compliance with the financial reporting requirements of the Companies Act 2006. Where we become aware that a company has not complied with other legislation or regulations that companies are required to comply with when preparing annual reports and accounts, we will draw that failure to the company's attention and seek confirmation that the relevant requirements will be complied with in the future.

For example, the Large and Medium-Sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 seek to address the disparity between the remuneration of senior executives and other employees of a company. Although the Regulations are not within our statutory remit, we will raise apparent non-compliance with companies when it is brought to our attention.

4 Common Areas of Challenge

We have identified 10 areas of corporate reporting that were commonly raised with companies during the year:

- Business reviews/ Strategic Reports;
- Pensions;
- Exceptional and other similar terms;
- Critical judgements;
- Clear & Concise (Cutting Clutter);
- Principal risks and uncertainties;
- Accounting policies (particularly revenue);
- Impairment;
- Taxation; and
- Cash flow statements.

Many of our questions were prompted by a lack of sufficient information for a reasonably informed reader to understand the relevant accounting policies or judgements.

Business reviews/ Strategic reports

Until it was replaced by the strategic report, the business review gave management the opportunity to provide shareholders with broader context and helpful analysis from which to better understand the reported results. From September 2013, the disclosure requirements of the business review have been subsumed within the strategic report, which also requires a description of the company's strategy and business model. Our concerns on business reviews that were previously provided as part of Directors' reports remain relevant to the reviews in the strategic report. Our letters to companies included questions on the business review where the narrative appeared inconsistent with what was reported in the accounts.

The business review had to be 'balanced and comprehensive'. We challenged companies if their business review focused only on 'good news' or if trend information was not sufficient to explain the effect of non-recurring items. We considered the balance between the discussion of IFRS and non-IFRS measures, particularly where this affected trend information. We asked questions of companies where their key performance indicators were not adequately explained, could not be recalculated or were apparently unbalanced.

The strategic report requirements apply to private companies, other than small companies as defined in the Companies Act, and smaller listed or AIM-quoted companies. There is no exemption for private equity portfolio companies and, as these companies include many groups that are significant to the UK economy, we would expect their strategic reports to include a business review with an appropriate level of detail. In our experience, unbalanced, incomplete, or inappropriately brief business reviews are a particular issue for smaller listed, AIM-quoted and private companies.

The strategic report of a listed company must now also include information on: greenhouse gas emissions, human rights and gender diversity. Where this information appears to have been omitted, we will write to companies drawing this to their attention.

Pensions

Pension accounting requires boards to make a number of critical judgements and estimates. For example, companies whose pension fund shows a surplus under IAS 19 have to consider whether the surplus represents a recognisable asset. We will continue to write to companies if their policies are unclear in this respect. We will also challenge companies when, from the information provided, we cannot determine whether a company should have recognised a liability for its minimum funding requirements. This matter was the subject of a company-specific Press Notice during the year.

In January, we issued a generic Press Notice regarding changes to pension schemes that were structured to achieve a particular accounting effect. We were pleased to note that a number of other companies changed their reporting in these areas, citing our Press Notice as the catalyst for change.

We will continue to consider such schemes when they are identified by our reviews.

Exceptional and other similar terms

In December 2013, the FRC issued a Press Notice seeking greater consistency in the treatment of 'exceptional items' in companies' income statements. We may refer to this Press Notice when writing to companies about matters of concern prompted by their identification, presentation or disclosure of exceptional, 'special' or 'specific' items in their reports and accounts. In particular, we will monitor carefully the use of additional columns or lines on the face of the income statement to identify items that could be inconsistent or misleading.

Areas of concern included:

- Lack of, or poorly described, accounting policies for exceptional or similar items;
- Inconsistent application period-on-period;
- Recurring and/ or immaterial items often reported as 'exceptional';
- Lack of symmetry between debits and credits, i.e. including 'bad' news but not the related or equivalent 'good' news as exceptional;
- Lack of comparative information.

Case Study: Exceptional items

Background

A number of house-builders made very large provisions against inventory during the financial crisis to reduce land to net realisable value. Many identified the charges as exceptional items, so excluding them from measures of adjusted earnings. The housing market subsequently recovered over a number of years leading to such provisions being reduced, either as part of the sale of impaired inventories or as a release of the provision, on the basis that the increase in the level of house prices meant that some of the provision was no longer required.

Companies' initial views

Companies provided diverse disclosures relating to the release of these inventory provisions. They believed that it was generally sufficient to disclose the release of the provisions in a footnote to the accounts. In very few cases the release was included in exceptional items or shown on the face of the income statement. There was also considerable variability in the disclosure of year end balances on the provisions and movements on the provision in the year.

FRC's view

It is essential that investors be able to understand and rely on the trends in the profitability of companies. Providing limited disclosure of the reversal of the provision and its impact on profitability is not sufficient to meet this aim. Accordingly, the FRC strove to ensure that companies made disclosures and adopted treatments which addressed the concerns set out in its Press Notice.

Companies' amended views

The companies agreed to improve the standard of disclosure as recommended by the FRC's Press Notice. Improvements obtained included:

Reinstatement of, and clarifications to, the accounting policy for exceptional items;

Disclosure of opening and closing balances and analysis of movements on inventory provisions;

Confirmation that material reversals would be treated as exceptional items or otherwise distinguished from recurring profit;

Confirmation that material amounts attributable to movements on inventory provisions would be separately identified and discussed in the business review; and

Disclosure of significant movements on the provision in the year.

FRC focus points

The FRC will challenge a company where it believes that investors have insufficient information to be able to understand the impact of exceptional items, or their reversal, on the company's financial statements and, in particular, on any adjusted earnings figures disclosed.

Critical judgements

Accounting policies need to be supplemented by a discussion of the key judgements made in their application to give users a full appreciation of the underlying issues. We raise questions with boards when either the precise nature of the judgment, or how it affects the financial statements, is insufficiently clear. We do not expect the disclosure of critical judgements to simply repeat or refer to the relevant accounting policy. We expect disclosures to differentiate between critical judgements and areas of estimation uncertainty and deal with both separately, even when they relate to the same item.

Our experience shows that investors have similar requirements of critical judgement disclosures.

We will also use information on how the judgements have been made, as disclosed in the Audit Committee report, and audited, as disclosed in the Audit Report, to assess the adequacy and quality of disclosure in the financial statements.

Clear & Concise (cutting clutter)

During the year we made a number of suggestions to companies about how they might cut clutter as a step towards producing clearer and more concise reports. We identified the following:

- Accounting policies for items where no material amounts are disclosed in the accounts. This is particularly relevant when the policy description is 'boiler-plate' and its relevance to the accounts is unclear. Examples include:

  - accounting policies for all categories of financial instruments for a company that had only cash and accounts receivable/ payable;
  - an accounting policy for goodwill in a company that had completely impaired its goodwill several years ago; and
  - an accounting policy for translating from functional to presentation currency when all the companies in the group had the same functional currency as the group's presentation currency and no translation was required.

- Income statement line items presented for amounts that were nil or clearly trivial;
- Repetition of disclosures that could have been given only once or, where required, could have been cross-referenced effectively; and
- Voluminous disclosure of the requirements of new accounting standards not yet applicable where these included changes that were clearly not relevant or material to the company's future reporting.

When writing to companies which had clearly undertaken a full-scale review of their report and accounts for extraneous material, we welcomed the initiative they had shown. Cutting clutter, however, requires the exercise of judgment. On occasion, where it was not clear how that judgement had been applied, we asked boards for further information about the basis on which they had concluded that certain items were not material, either quantitatively or qualitatively.

These questions, and similar, are included in our opening letters as part of our function of holding directors to account. We may ask a company how, for example, an accounting policy for recognising intangible assets complies with the relevant accounting standard. This should not be taken to mean that the existing policy should be replaced with recognition criteria copied directly from the standard.

Following correspondence with a company, it may transpire that the disclosures would not be material or relevant and our letters are clear that companies should not include such items in their accounts.

We expect companies to be robust if we challenge a matter that is eventually found to be immaterial. We would be disappointed to find that companies were adding immaterial disclosures to their accounts rather than explaining to us why they did not believe that they were required.

Principal risks and uncertainties

We continue to note improvements in the disclosure of companies' principal risks and uncertainties, following our earlier focus on this area of narrative reporting. We are pleased that an increasing number of companies now explain how they manage or mitigate the risks identified but we still identify companies that do not. We emphasise that the risks and uncertainties disclosed should be the companies' principal risks and uncertainties. We will continue to write to those companies who present a voluminous list of possible risks without emphasising those they believe are most important.

Accounting policies (particularly revenue)

Accounting policies are key to an understanding of the financial statements as a whole. We challenge companies that present 'boiler plate' descriptions, which are not tailored to the facts and circumstances of their businesses.

During the year, we queried a lack of description of accounting policies for apparently material items, including policies for unusual items; for example, deferred income on onerous contracts or success and incentive fees. We also challenged a lack of appropriate granularity, for example, where revenue policies were not given for significant business streams in enough detail for a user to understand clearly the point at which the 'risks and rewards' of ownership were transferred.

In July 2014, the FRC's Financial Reporting Lab issued a report on 'Accounting policies and integration of related financial information'[11]. It confirms that investors support our advice for boards when drafting accounting policies for inclusion in their accounts, which is to:

- Describe the policies that are significant given the nature or complexity of the business;
- Explain how the policies are applied to that specific business and transactions;
- Exclude references to immaterial policies which can obscure key information; and
- Avoid boiler-plate text such as extracts from standards or model accounts.

Impairment

Asset impairment calculations and disclosures have featured in the common areas of challenge section of our annual report for several years. Our focus has been to question whether, given the facts and circumstances, an impairment loss should have been charged in the period. We continued to challenge companies when we identified potential areas of concern from poor quality disclosures and apparent inconsistencies when compared with the remainder of the annual report and accounts. Our findings suggest that there has been continuing improvement in companies' disclosures, but it is disappointing that we often raised questions in the following areas:

- The description of key assumptions. We challenged companies which disclosed discount and growth rates, but not the key assumptions in the cash flow forecasts to which they were applied;
- The approach taken to determining the values assigned to each key assumption;
- Why a single discount rate had been applied to CGUs with apparently different risk profiles;
- Unclear or generic sensitivity disclosures; and
- The heroic nature of assumptions supporting a significant short term turn-around in a loss-making business.

Taxation

We identified a number of issues relating to tax accounting during the year, including:

- Deferred tax not recognised on acquired intangibles in a business combination; and
- Lack of disclosure of the basis for the company believing a deferred tax asset was recoverable.

We raised queries regarding the reconciliation of the tax charge to the accounting profit multiplied by the effective tax rate, including:

- Lack of description of how the applicable tax rate was calculated; and

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[11] https://frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/Accounting-policies-and-integration-of-related-fin.pdf

- Unclear reconciling items or items, such as timing differences, that we would not have expected to appear in a reconciliation of the total tax charge.

Case Study: Taxation

Background

A company made an accounting loss in the current and previous years. It recognised a net deferred tax asset relating to those losses. It did not disclose why it thought that there would be sufficient future taxable profits available to recover the deferred tax amount despite its recent history of losses.

Company's initial view

The company believed that the tax asset was recoverable based on management's forecast of future profitability. It noted that there had been one-off charges in the current and previous years that were not expected to recur in the future and that the forecasts showed it was probable that the business would be profitable for several years to come.

FRC's view

When there is a recent history of losses there is strong evidence that future taxable profits are not available to recover the net deferred tax asset. There should be convincing other evidence available that future taxable profits will be available before a company recognises such an asset.

In this case, management was able to demonstrate that it had performed a detailed exercise to show that it was probable that future taxable profits would be available. It had not, however, disclosed this material information in the accounts or explained that this was one of the key accounting judgements that the directors had considered during the year.

Company's amended view

The company agreed to improve the disclosures surrounding the recognition of the deferred tax asset. The Directors agreed to state that this was a critical accounting judgement and explain the nature of the convincing other evidence that supported the judgement.

FRC focus points

The FRC will challenge management's judgement on an accounting issue when there is insufficient information in the accounts to support its conclusion.

Companies are required to disclose the critical accounting judgements they make each year, such as whether or not there is convincing other evidence supporting recognition of a deferred tax asset for losses.

Cash flow statements

Cash flow statements are one of the primary sources of financial information. Investors have told us that they value accurate cash flow information because it helps them assess the company's ability to convert its profits into cash.

We were pleased to note a continuing decline in the number of questions raised in respect of cash flow statements this year. However, we still identified a number of companies that either:

- Misclassified cash flows, for example, by presenting non-recurring cash flows outside operating cash flows, despite operating being the appropriate classification;
- Inappropriately netted items, such as loan draw-downs and repayments; or
- Reported non-cash movements, such as the conversion of convertible debt, as cash flows.

Detailed technical observations

A more detailed technical presentation, summarising the resolution of certain issues that arose from reviews undertaken in the past year, is available on our website. We expect this presentation to be particularly relevant to those involved in the detailed preparation and review of financial statements

Appendix A: Members of the Financial Reporting Review Panel

The Conduct Committee draws on members of the Financial Reporting Review Panel when establishing a Review Group.

Chairman

Richard Fleck CBE	Former Chairman, Conduct Committee; Director, FRC; and consultant, Herbert Smith Freehills LLP

Deputy Chairs

Joanna Osborne	Formerly Partner, KPMG, specialising in financial reporting
Ian Wright	Formerly Director Corporate Reporting, FRC

Members

Daniel Abrams	Chief Financial Officer, Volex plc
David Cairns[12]	IFRS Consultant and Visiting professor, University of Edinburgh Business School
James Coyle	Group Financial Controller, Lloyds Banking Group
Jimmy Daboo	Partner, KPMG. Vice Chairman of KPMG's Global Energy and Natural Resources Practice
Graeme Dacomb	Partner, Ernst & Young LLP
Mary Dolson	Member of PricewaterhouseCoopers Accounting Consulting Services IFRS Central Team, located in London
Stephen Edlmann	Consultant, Ashurst LLP
Margaret Ewing[13]	Non-Executive Director and member of the Audit and Remuneration Committees, Standard Chartered plc and external member of the John Lewis Partnership Audit and Risk Committee
Eric Hutchinson	Chief Executive, Spirent Communications plc
Vanessa Knapp, OBE	Former Partner, Freshfields Bruckhaus Deringer LLP
Iain Lowson	Head of Risk and Quality, BDO LLP

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[12] Retired February 2014

[13] Resigned March 2014

David Mabb QC	Member of Erskine Chambers
Andrew McIntyre	Partner, Ernst & Young LLP
Richard Meddings	Former Group Finance Director, Standard Chartered plc
Chris Moulder	Director of General Insurance, Prudential Regulation Authority
Brendan Nelson	Non-Executive Director and Audit Committee Chairman, Royal Bank of Scotland plc and BP plc
John Nicholas	Non-Executive Director and Audit Committee Chairman, Rotork plc, Hunting Plc and Mondi Group. Non-Executive Director of Diploma PLC
Andrew Palmer	Non-Executive Director and Audit Committee Chairman, Direct Line Group and Royal London Group. Formerly Group Finance Director, Legal and General Group
Richard Pinckard	Partner, KPMG
Richard Piper	Partner at Restoration Partners Limited and Chairman and NED of a number of main listed and AIM businesses
Alan Trotter	Chief Financial Officer, Alliance Trust PLC, a FTSE 250 company. Member, Technical Committee of the Association of Investment Companies, the Hundred Group of Finance Directors and the FCA Practitioner Panel
Colin Walklin[14]	Chief Operating Officer, Standard Life Investments
Richard Wilson	Partner, Ernst & Young LLP
John Worby	Non-Executive Director, Cranswick plc and Smiths News Group PLC

[14] Retired May 2014

Appendix B: FRC Press Notices and Committee References

Unless otherwise stated, the Press Notices and Committee References referred to below related to accounts reviewed in the 2013/14 FRC year. Where a Press Notice or Committee Reference related to a review commenced in an earlier reporting period, the year that was under review is indicated on the schedule; this year four references related to reviews commenced prior to 2013/14. This table excludes companies who disclosed that correspondence with the FRC was closed with no adjustments required. The identification in this Appendix of companies who published Committee References is with the agreement of the companies concerned.

Company	Listing	Issues	Publicity
WH Smith Plc	FTSE 250	Recognition of liability for pension minimum funding requirement	Press Notice
Anglo-Eastern Plantations Plc 31/12/2010	FTSE Small Cap	Fair value of biological assets restated to reflect current, rather than historical, cash flow data, in relation to notional rent	Press Notice and Reference
Anglo Pacific Group PLC	FTSE 250	Restatement of a mineral royalty arising from land ownership, from property, plant and equipment to investment property, and impairment of equity investments (References in annual and interim accounts)	Two references
Eland Oil & Gas Plc	AIM	Restatement of cash flow statement to account correctly for a non-cash item	Reference
Pendragon PLC 31/12/2011	FTSE Small Cap	Accounting for a pension funding arrangement involving a Scottish Limited Partnership	Reference
Rolls-Royce Group plc 31/12/2010	FTSE 100	Accounting for entry fees received from key suppliers	Reference

Company	Listing	Issues	Publicity
GKN plc 31/12/2011	FTSE 100	Accounting for a pension funding arrangement involving a Scottish Limited Partnership	Reference
The Co-Operative Bank plc	Listed debt	Capital management and fair value disclosures and capitalisation of software development costs	Reference
The Royal Bank of Scotland Group plc	FTSE 100	Discussions relating to the consolidation of a subsidiary company on the basis of de facto control. No changes were made to prior period amounts. The matter was not pursued by the Committee given the amounts involved.	Reference
Kazakhmys plc	FTSE 250	Improvement to environmental disclosures	Reference

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