Corporate Reporting Review

Technical Findings 2017/18

October 2018

Financial Reporting Council

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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 2018 and builds on the themes identified in the 'Annual Review of Corporate Governance and Reporting 2017/18' ('annual report').

Particular focus has been given to the top three areas identified by CRR's work, two of which, judgements and estimates, and the use of alternative performance measures, were the subject of thematic reviews published in 2017. These issues, together with the Strategic Report, represent approximately 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 & Estimates
2. Alternative Performance Measures (APMs)
3. Strategic Report
4. Income Taxes
5. Revenue
6= Business Combinations
6= Impairment of Assets
8= Pensions
8= Statement of Cash Flows
8= Provisions and Contingencies

Judgements and estimates

The FRC published its thematic review on judgements and estimates in November 2017, highlighting a number of examples of good practice and identifying areas for improvement.

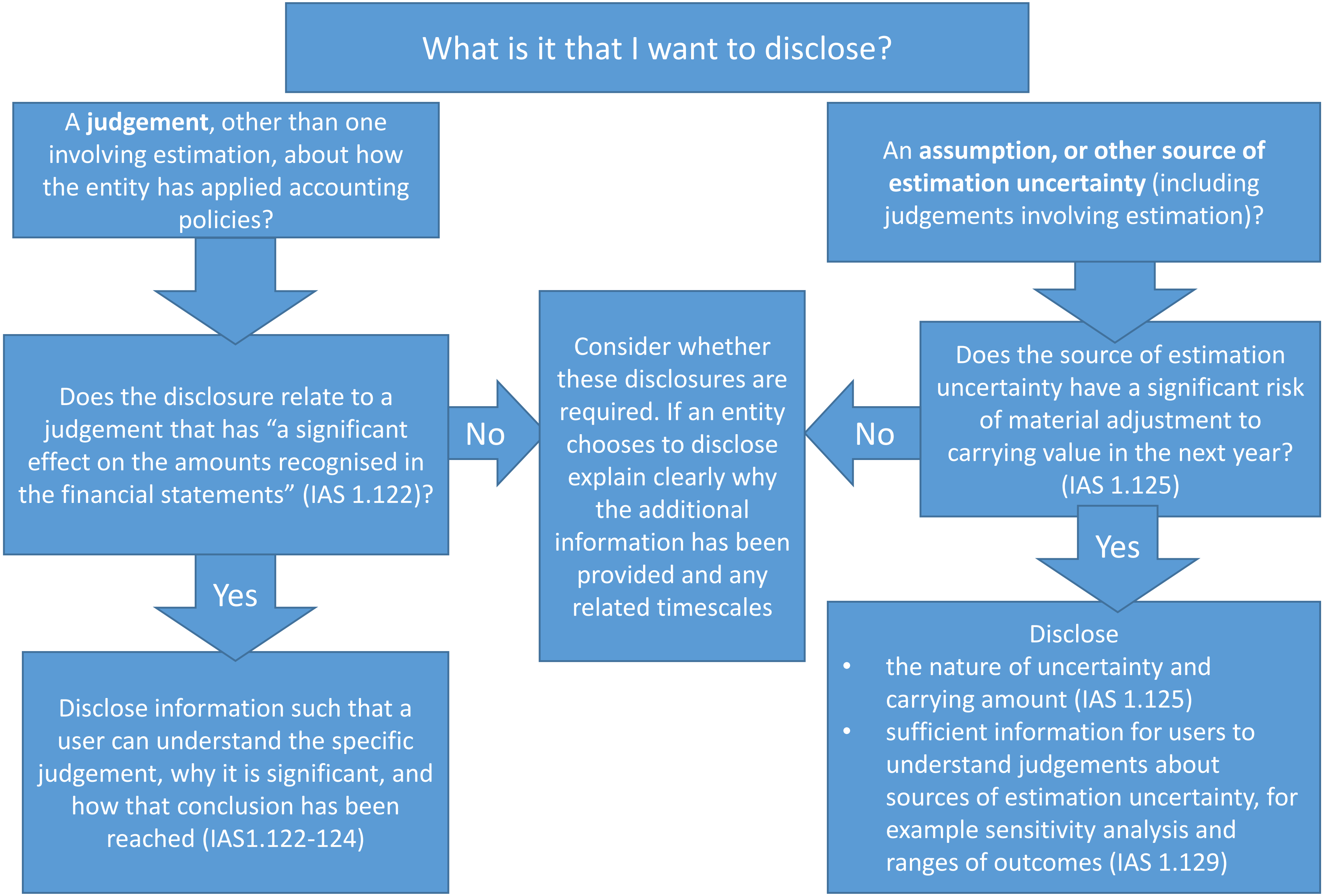
The aim of the judgements and estimates disclosure requirements of IAS 1 is to inform users of the most subjective judgements, and the significant sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying value of assets or liabilities in the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

The better examples we saw identify a small number of significant areas, and provide sufficiently granular information to understand the judgement, or the source of estimation uncertainty, and its effect on the accounts.

Disclosures relating to estimates specified by standards other than IAS 1, such as impairment disclosures (IAS 36), were generally of a higher standard than those where no such specific requirements apply. In some cases, in particular, estimates relating to uncertain tax positions, we challenged the absence of disclosures required by IAS 1 125-129.

We also questioned disclosures where preparers failed adequately to distinguish between judgements and estimates, or where their usefulness was limited by inclusion of estimates where there was no significant risk of material adjustment in the next year.

The following slides highlight the different disclosures required for judgements and estimates, illustrate our expectations of good disclosures using a “before and after” comparison of common issues, and identify common findings. We encourage all preparers to review the thematic review findings, which are consistent with our findings from our regular full scope reviews.
https://www.frc.org.uk/getattachment/42301e27-68d8-4676-be4c-0f5605d1b467/091117-Judgements-and-Estimates-CRR-thematic-review.pdf


What is it that I want to disclose?
A **judgement**, other than one involving estimation, about how the entity has applied accounting policies?
An **assumption, or other source of estimation uncertainty** (including judgements involving estimation)?
Does the disclosure relate to a judgement that has "a significant effect on the amounts recognised in the financial statements" (IAS 1.122)?
No
Consider whether these disclosures are required. If an entity chooses to disclose explain clearly why the additional information has been provided and any related timescales
No
Does the source of estimation uncertainty have a significant risk of material adjustment to carrying value in the next year? (IAS 1.125)
Yes
Disclose information such that a user can understand the specific judgement, why it is significant, and how that conclusion has been reached (IAS1.122-124)
Yes
Disclose
• the nature of uncertainty and carrying amount (IAS 1.125)
• sufficient information for users to understand judgements about sources of estimation uncertainty, for example sensitivity analysis and ranges of outcomes (IAS 1.129)

Example - Extracts from the Annual Report for the year ended 201X

No clear distinction is made between judgements and estimates in the following text

Significant judgements and estimates

Significant judgements, estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the year in which the estimate is revised and in any future years affected.

In applying the Group's accounting policies described above the Directors have identified that the following areas are the key judgements and estimates that have a significant impact on the amounts recognised in the financial statements.

Lease classification

The classification of leases as either operating or finance leases is a key area of judgement. Leases are treated as finance leases where they transfer substantially all the risks and rewards of ownership to the group.

Impairment of Goodwill

The Group determines whether goodwill is impaired at least on an annual basis. This requires an estimate of the value in use of the cash generating units to which the goodwill is allocated. To estimate the value in use, the Group estimates the expected future cash flows from the cash generating unit and discounts them to their present value at a determined discount rate, which is appropriate for the territory where the goodwill is allocated to.

Forecasting expected cash flows, and selecting an appropriate discount rate inherently requires estimation. A sensitivity analysis has been performed over the estimates (see Note A).

Note A. Goodwill (extract)

A reduction of 10% in the forecast cashflows for each CGU from year 2 to 5 or an increase in the discount rate applied to the cashflows of each CGU of 1 percentage point would not cause the carrying value to exceed its recoverable amount for any CGU. Therefore, management believe that no reasonably possible change in the key assumptions would result in an impairment charge.

This wording does not reflect the requirements of IAS 1 for sources of estimation uncertainty – a significant risk of material adjustment in the next financial year

If there is no reasonable possibility of an adjustment to carrying values, why are these considered to be key estimates?

Boilerplate language simply repeats wording in the standard, and does not explain the precise nature of the judgement

"Before": disclosures in the year reviewed

Example continued - Extracts from the Annual Report for the year ended 201X

Employee Post Retirement Benefit Obligations

The Group had two defined benefit pension plans, Scheme A and the Scheme B.

Scheme A was settled during the year through an insurance buy-out arrangement. The final present value of the obligation was calculated by independent actuaries as at the buy-out date, with input from management, in accordance with the Group's usual approach as outlined below. Further details of the buy-out can be found in Note C.

The obligations under these plans are recognised in the Balance Sheet and represent the present value of the obligations calculated by independent actuaries, with input from management. These actuarial valuations include assumptions such as discount rates, return on assets, salary progression and mortality rates. These assumptions vary from time to time according to prevailing economic and social conditions. It is considered that the assumptions used are the most appropriate but it is recognised that the resulting pension liability can be very sensitive to these assumptions. Details of the assumptions used are provided in Note C.

Going forward without Scheme A the estimation uncertainty regarding employee post retirement benefit obligations will be significantly reduced for the Group as Scheme B is less significant.

Tax

The Group operates, and is subject to tax, in numerous territories and jurisdictions. Judgement is required in determining the provisions in relation to tax as there are varying tax treatments which have to be applied to transactions across the jurisdictions. The treatments can be complex and cannot be finally determined until formal resolutions have been reached with the relevant tax authorities – these can take several years to conclude. Provisions are made based on management's interpretation of country specific tax laws and likely settlement outcomes based on the facts known at the Balance Sheet date. These judgements may impact the tax charge as well as the assets and liabilities.

Deferred taxes are recognised in respect of temporary differences between the tax treatment and treatment within the financial statements for assets and liabilities. Deferred tax assets are only recognised to the extent they are expected to be recovered. Recoverability is assessed on an ongoing basis. Deferred tax is calculated at the substantively enacted rate which is expected to apply in the period the asset or liability is expected to be realised.

Note C. Employee Benefits (extract)

No sensitivity analysis has been performed regarding Scheme A given there remains no liability on the Group's Balance Sheet at the 31 December 201X.

Why do these disclosures continue to be given if there is no continuing uncertainty?

Boilerplate language used does not specify the precise areas of estimation for the Group, or quantify the amounts at risk of material adjustment, or provide any sensitivity analysis

Recognised and unrecognised deferred tax assets are not material

"Before": disclosures in the year reviewed

Extracts from the Annual Report for the year ended 201Y

Significant judgements

In the course of preparing the financial statements, no judgements have been made in the process of applying the Group's accounting policies, other than those involving estimations, that have had a significant effect on the amounts recognised in the financial statements.

Estimates

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the year in which the estimate is revised and in any future years affected.

In applying the Group's accounting policies described above the Directors have identified that the following areas are the key estimates that have a significant risk of resulting in a material adjustment to the carrying value of assets and liabilities within the next financial year.

Impairment of Goodwill

The Group determines whether goodwill is impaired on at least an annual basis. This requires an estimate of the value in use of the CGUs to which the goodwill is allocated. To estimate the value in use, the Group estimates the expected future cash flows from the CGU and discounts them to their present value at a determined discount rate, which is appropriate for the territory where the goodwill is allocated to.

Forecasting expected cash flows and selecting an appropriate discount rate inherently requires estimation. A sensitivity analysis has been performed over the estimates (see Note A). The resulting calculation is sensitive to the assumptions in respect of future cash flows and the discount rate applied. The Directors consider that the assumptions made represent their best estimate of the future cash flows generated by the CGUs, and that the discount rate used is appropriate given the risks associated with the specific cash flows. Although based on the sensitivity analysis performed there is no impairment charge to goodwill, it is considered appropriate to disclose this as an area of significant estimation due to the size of the balance and the fact that it could change as a result of future events within the next three years.

Immaterial and irrelevant disclosures have been removed

A clear distinction is made between judgements and estimates.
Boilerplate text has been replaced with statement that there are no key judgements

Reason given for disclosures where there is no significant risk of material adjustment within the next twelve months

Information disclosed elsewhere does not need to be repeated—cross-referencing may be used

"After": disclosures in the following year

Extracts from the Annual Report for the year ended 201Y

Tax

In determining the income tax assets and liabilities recognised in the Consolidated Statement of Financial Position, the Group is required to estimate the outcome of multiple tax years remaining open to tax authority audit in each of the jurisdictions in which the Group has companies. The key judgement area for tax is the pricing of cross-border transactions between Group companies, in each of the jurisdictions in which the Group operates. In most countries transfer pricing law requires that taxable profits reflect arm's length pricing of intra-group transactions. Determining the arm's length price of a transaction and the likelihood of challenge by local tax authorities is inherently subjective. In making estimates for tax provisioning purposes management make use of in-house tax expertise, comparable third party studies prepared by professional advisors and any other information available. In the event of an audit the Group may liaise with the relevant taxation authorities to agree an outcome.

The tax liability provided for each tax year and jurisdiction is reassessed in each period to reflect our best estimate of the probable outcome in light of all the information available. A final position agreed with a tax authority or through expiry of a tax audit period could differ from the estimates made by us which would impact the current tax liability of £x (201X: £y) recognised in the Consolidated Statement of Financial Position.

Currently there are no significant ongoing tax audits. Should a tax audit commence this would give additional visibility over maximum potential exposures as the tax authorities' own position becomes clearer. Such developments would then further inform our best estimate in line with the approach above. Conversely should tax audit windows close without audits commencing this would enable tax provisions to be released. The amount of the current tax liability subject to significant uncertainty is £z, being the reduction in the liability if all filed returns are agreed without adjustment. Conversely the liability may increase due to the outcome of tax audits or changes in our assessment. Five years of tax returns remain open to audit across multiple jurisdictions. Due to the uncertainty associated with such tax items, it is possible that at a future date, on conclusion of open tax matters, the final outcome may vary significantly. Whilst a range of outcomes is reasonably possible, the extent of the range is additional liabilities of up to £x to a reduction in liabilities of up to £y.

Deferred taxes are recognised in respect of temporary differences between the tax treatment and treatment within the financial statements for assets and liabilities. Deferred tax assets are only recognised to the extent they are expected to be recovered. Recoverability is assessed on an ongoing basis. Deferred tax is calculated at the substantively enacted rate which is expected to apply in the period the asset or liability is expected to be realised. Although the deferred tax asset recognised may not be material, there is still estimation involved in those potential tax assets which remain unrecognised. The nature and amounts of unrecognised potential tax assets are disclosed in Note C and these are material for the Group. Although the Group does not believe that there is a significant risk of a material adjustment to deferred tax assets within the next financial year, there is a significant uncertainty existing at each year end and therefore the Group's overall tax position could change within the next 12 months.

Immaterial and irrelevant disclosures have been removed

Disclosures pinpoint the specific areas of uncertainty

Specific amount at risk of material adjustment has been quantified, and range of possible outcomes has now been provided

Reason given for disclosures where there is no significant risk of material adjustment within the next twelve months

"After": disclosures in the following year

Judgements and estimates: areas for preparers to think about

We encourage preparers to stand back, review 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 former sources of estimation uncertainty no longer present a material risk of adjustment in the next year, should these 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 made clear these are not the disclosures required by IAS 1.125.

In a number of the cases we challenged, the key areas of estimation uncertainty had been obscured by a number of disclosures where there was no risk of material adjustment. In some cases, impairment testing was disclosed as a key source of estimation uncertainty, yet other disclosures indicated no reasonably possible change in any key assumption would lead to an impairment.

Is presentation consistent with other information in the financial statements?

If other disclosures suggest risk in an area 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. Uncertain tax positions were one of the most common areas where we identified scope for improvement. 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.

Alternative Performance Measures (APMs)

The FRC published its thematic review on APMs in November 2017, highlighting examples of good practice, and identifying areas for improvement.

ESMA's Guidelines on Alternative Performance Measures were published in 2015, and apply to listed company reports published from July 2016. We encourage preparers, including those with an AIM listing, to consider these guidelines, which we believe codify best practice for all.

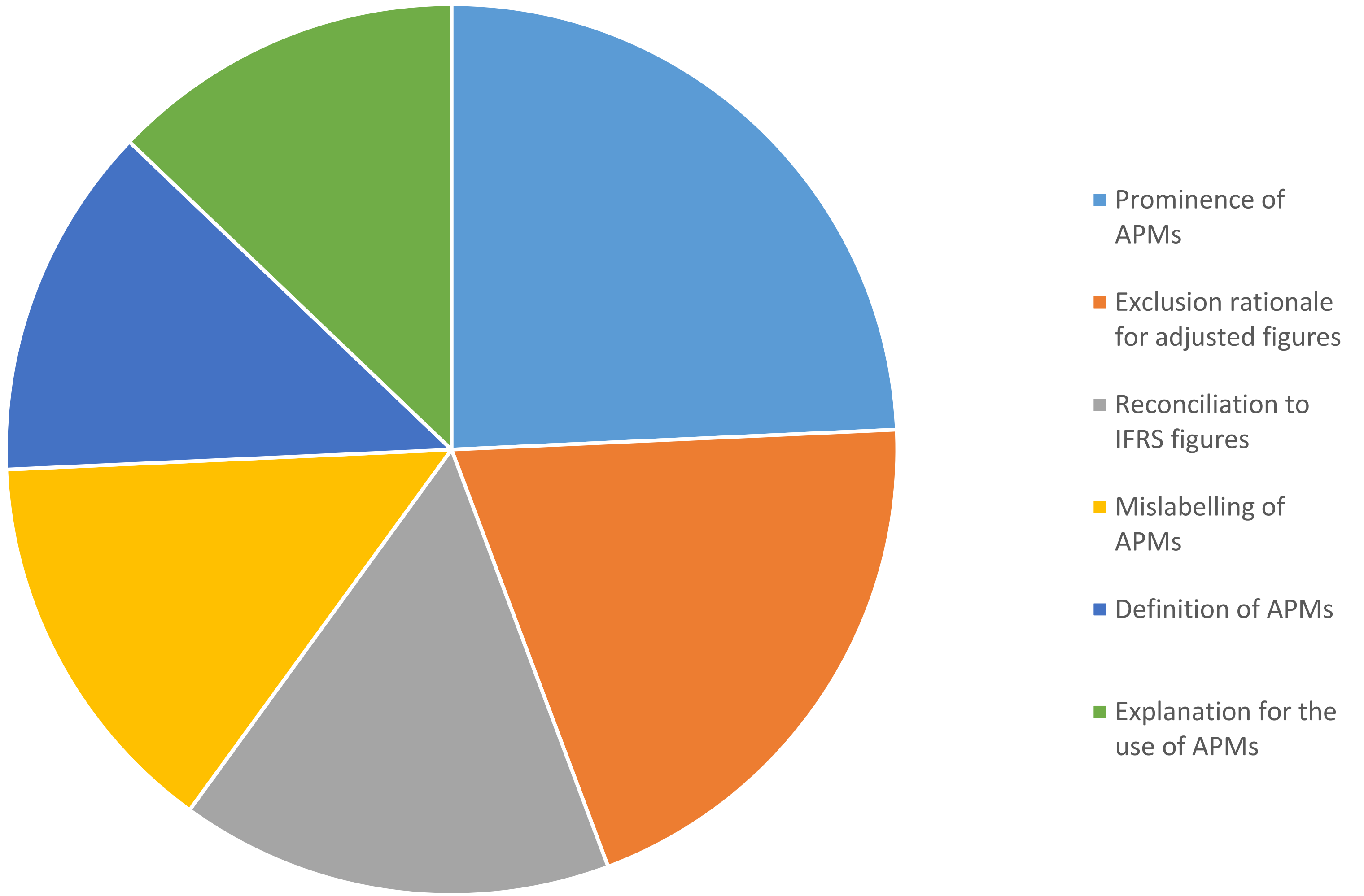
Practice continues to evolve. Our thematic review acknowledged the step change in quality of disclosures by companies in our 'pre-informed' review. However, we still had substantive questions for over half of the sample. We consistently raised questions in this area across our routine reviews.

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

The following slides highlight the issues around APMs that were most frequently identified and how we expect them to be addressed. We encourage all preparers to review the thematic review findings:

https://www.frc.org.uk/getattachment/ff987c01-416f-4635-8dba-fdda5530f4b5/091117-APMs-CRR-thematic-review.pdf

Which aspects of APM use were raised most often?



Prominence

The most common area we questioned was whether APMs were presented with undue 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
- APMs referred to as "most meaningful" or "true" measures of performance.

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 recognised in several consecutive periods but described as non-recurring

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

Our thematic review welcomed the trend of fewer companies excluding share based payment expense from adjusted profit. It also highlighted the importance of a clear explanation for the exclusion of intangible amortisation, where the intangible in question has contributed to profits in the period.

"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 not provided for ratios (eg ROCE), and growth-based APMs (e.g. organic/constant currency growth)

Are large adjustments to underlying profit highlighted for APM purposes, or to meet the requirements of IAS 1.97?*

"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)

* IAS 1 requires individually material items to be disclosed. These may differ from items identified as adjusting in calculating APMs.

Mislabelling of APMs

The better examples we saw clearly identified all APMs. We challenged the mislabelling of APMs. Misleading labelling, even where an appropriate reconciliation has been provided, can risk 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 <u>all</u> APMs. Examples that we challenged included:

- ROIC – return on invested capital
- Free cash flow
- Like-for-like growth

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

Strategic reports: fair, balanced and comprehensive

We asked questions about preparers' compliance with s414C of the Companies Act.

Some of these questions stemmed from our challenge of APMs, and, in particular, focus upon the adequacy of commentary on IFRS performance relative to APM narrative.

In general, at the larger end of the market companies' explanations of performance in the period were generally good. On occasion, we raised questions around the discussion of "one-off" or "unusual" items and the adequacy of narrative relating to balance sheet and cash flow items. At the smaller end of the market, we continued to identify scope for better use of the strategic report to enhance the explanations or disclosures already provided within the financial statements.

Some examples of specific questions are set out below.

The FRC published its updated guidance on the strategic report in July 2018.

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

Strategic report:

CA 2006 s414C *(2) The strategic report must contain*

(a) A fair review of the company's business, and

(b) A description of the principal risks and uncertainties facing the company

(3) The review required is a balanced and comprehensive analysis of

(a) The development and performance of the company's business during the financial year, and

(b) The position of the company's business at the end of that year

We raised an increased number of substantive queries in relation to strategic reports in 2017. The main area we questioned was the absence of adequate commentary within the report.

Typical examples were:

- decreases in profit (for example where the narrative concentrated on an increase in adjusted profit)
- increase in working capital
- impact of foreign exchange movements in year
- recognition of deferred tax assets against a backdrop of making losses
- loss on disposal of business
- change in KPIs
- business combinations
- Significant balance sheet amounts or movements

Other areas of questioning included PRU disclosures (e.g., no PRU disclosures at all, or not referencing litigation risks, when clearly significant)

Income taxes

Areas we questioned included:

- the adequacy of disclosure about the recognition of deferred tax assets in relation to losses, in particular in the context of continued loss making
- 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)), for example:
  - large one-off reconciling items not explained
  - incorrect explanations/descriptions in tax rate reconciliations
- insufficient granularity of disclosure of temporary differences (IAS 12.81(g))
- errors in accounting for the tax effect of share based payments (where in accordance with IAS 12.68C, tax deductions in excess of the relevant share based payment remuneration expense should be reflected in equity, rather than profit or loss).

Revenue recognition

We encourage reporters to objectively review revenue recognition policies, and ask themselves whether they convey how the company generates revenue and how it is recognised.

The adequacy of revenue recognition policy disclosures will be subject to increased scrutiny by users with the introduction of IFRS 15 in 2018. CRR will have an increased focus in this area over the coming 12 months, including publishing a thematic review on transition disclosures. The points highlighted below will continue to be relevant on adoption of IFRS 15.

Areas we questioned included:

- how deferred revenue arose when this was not clear from accounting policy note;
- agent vs principal, where it was not clear why a particular treatment had been arrived at;
- references to long term contracts without any apparent revenue recognition policy for such contracts;
- absence of detail as to how the stage of completion was assessed on long term contracts; and
- inconsistency between the strategic report and financial statements – for example, where the strategic report provided narrative on (immaterial) revenue streams for which no accounting policy was given.

Business combinations

The majority of our questions related to deferred or contingent consideration, in particular:

- initial measurement, or subsequent remeasurement, of contingent consideration, and adequacy of disclosures relating to deferred and contingent consideration; and
- whether contingent payments were linked to future employment and should have been accounted for as post combination employment expense rather than as consideration. We will continue to raise this as an issue if it is unclear whether a company has considered IFRS 3 B.55(a).

Impairment

The main reason for us asking for additional information was the apparent omission of disclosures required by IAS 36 paragraph 134.

Areas we questioned included:

- lack of clarity over whether or not changes in key assumptions were reasonably possible;
- 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 for what period, explanation for why certain growth rates were used, and lack of explanation for significant changes in growth and discount rates (IAS 36.134(d)); and
- the identification of CGUs (IAS 36.68) and amounts of goodwill allocated to them.

Pensions

Defined benefit pensions were the subject of one of our thematic reviews during the period.

Areas we questioned included:

- diversity in accounting for one industry pension scheme by several different scheme members;
- inadequate disclosures relating to pension scheme assets and associated judgements;
- failure to include disclosures required by IAS 19 – for example, future funding commitments; and
- lack of disclosure or explanation of substantive changes – including significant changes in assumptions, or expected plan contributions

Cash flow statements

We required seven companies to refer to discussions with the FRC in the context of correction of cash flow statement errors.

Areas we questioned included:
- classification of cash flows; for example, restructuring and acquisition cash flows incorrectly classified as investing rather than operating cash flow;
- non cash movements incorrectly included in the cash flow statement;
- incorrect netting of cash flows, such as borrowing and repayments; and
- borrowings under invoice financing facility incorrectly classified as cash & cash equivalents for the purposes of the cash flow statement.

Early indications are that some preparers of financial statements for years ending 31 December 2017 have omitted disclosures required by IAS 7 (paragraphs 44A-44E).

Provisions and contingent liabilities

Areas that we questioned included:
- the incorrect use of the same discount rate for onerous contract provisions and asset impairment testing;
- netting of litigation provisions and corresponding insurance claim assets; and
- failure to separately present remediation provisions related to land.

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