10 October 2016

Dear Audit Committee Chairs and Finance Directors

Summary of key developments for 2016 annual reports

I am writing ahead of the 2016 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.

Strategic report

Investors call for annual reports to be more user-friendly and information to be communicated more clearly. Companies should consider whether the information in the strategic report is presented in a clear and concise manner. They should not, however, overlook the legal requirement to provide a fair review of the business that is balanced and comprehensive. A strategic report is comprehensive if it complies with the law and explains all material matters in sufficient detail to be useful and understandable. Such explanations, if focussed only on those material matters, can still be clear and concise. In particular, we note room for improvement in the strategic reports of many smaller companies, including the need to consider whether they have adequately discussed their financial position and cash flows as well as their company's performance.

Business model reporting

Whilst many companies had been presenting disclosures on their business model for a number of years, with this becoming a requirement of the strategic report the FRC's Financial Reporting Lab has this year worked with companies and investors to explore improvements to existing practice. Our Lab report, due to be published in October, will confirm the importance of disclosure to investors and suggest practical ways that companies might consider meeting investor needs. The biggest areas for improvement are the clarity of the explanation of how the company makes money and what differentiates it from its peers.

Alternative performance measures (APMs)

There is increasing regulatory focus on the use of APMs (or 'non-GAAP' measures). APMs are often used in strategic reports, to supplement information prepared in accordance with IFRS or UK GAAP. It is important that their use does not replace or obscure IFRS or UK GAAP information. In June 2015, the European Securities and Markets Authority (ESMA) published 'Guidelines on Alternative Performance Measures'. The guidelines apply to all regulated information, which includes annual reports (but excludes the financial statements), published on or after 3 July 2016. The guidelines codify best practice in this area. Companies should consider whether they need to make changes in response to the guidelines. We issued FAQs on this topic in May 2016 and in November will publish a thematic study on the use of APMs in interim reports issued since the guidelines became effective.

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Risk reporting and viability statements

We encourage companies to consider a broad range of factors when determining the principal risks and uncertainties facing the business, for example cyber security and climate change.

Amendments to 'The UK Corporate Governance Code' (the Code) in 2014 introduced reporting of a longer-term view of a company's prospects in a viability statement. Companies should consider how solvency, liquidity or other principal risks affect the long-term viability of the business. Our initial assessment of statements suggests that there is little variation in disclosures between business sectors. We encourage companies to provide clear disclosure of why the period of assessment selected is appropriate for the particular circumstances of the company, what qualifications and assumptions were made, and how the underlying analysis was performed.

UK referendum result

In light of the referendum vote in favour of the UK leaving the EU, companies will need to consider the consequential risks and uncertainties in the political and economic environment and the impacts of those risks and uncertainties on their business. Not all businesses will be affected to the same extent. Boards must determine what disclosures, if any, are required to meet the needs of investors and comply with regulatory requirements.

We highlighted matters that Boards should consider in relation to the potential impact of the referendum result in our press release of 12 July, 'Reminders for half-yearly and annual financial reports following the EU referendum'.

We subsequently conducted a targeted thematic review of interim reports. Uncertainty remains the key reference point, with most companies considering it too early to provide any more specific commentary on the impact of the referendum result. As the economic and political effects are developed and become more certain in the medium and longer term, we expect Boards to provide increasingly company specific disclosures with quantification of the effects.

Financial statement disclosures

Tax

The FRC's thematic study of tax reporting identifies areas for improved disclosure. Although we saw some improvements in companies' explanations of their effective tax rates, there remains scope for greater visibility of the factors affecting the rates and their sustainability. Companies should articulate better how they account for material tax uncertainties by explaining the bases for recognition and measurement and we expect more companies to disclose the amount of their tax provisions than do so presently. Disclosures of estimates and judgements may be particularly relevant in this context. The FRC's report will be published in October 2016.

Companies' tax arrangements are an area of increasing public focus, which can give rise to significant risk. Companies need to respond to increasing stakeholder scrutiny of their tax strategies, including where they pay tax, and to consider carefully whether they are sustainable and any material risks to which this gives rise are clearly described in the report and accounts.

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Dividends

Last year the FRC's Financial Reporting Lab produced a report on best practice in dividend disclosures. The report suggests a scaled approach to disclosure of available cash and distributable profits. We have already noted examples of improved disclosure, and expect to see more over the coming reporting period. We consider that there is room for further improvement in linking more detailed disclosure of how dividend policies operate in practice to how those policies may be impacted by the risks and capital management decisions facing the company.

The Local Authorities Pension Fund Forum (LAPFF) recently wrote to a number of listed companies urging companies to disregard the position taken by the FRC in response to their previous letter of November 2015. Our position remains that we encourage good disclosure and companies paying close attention to their investors' views whilst noting that the Companies Act 2006 does not require the separate disclosure of a figure for distributable profits or, specifically, multiple figures for distributable profits. The Act is a matter for the Department for Business, Energy and Industrial Strategy. Its public statements are consistent with the FRC's.

Low interest rates

Companies should consider the impact of low interest rates on the amounts reported in their financial statements. In particular, careful consideration should be given to the valuation of long term assets and liabilities, for example the effects of adjusted discount rates on pension scheme liabilities and suppressed returns on pension scheme assets. Companies may need to provide sensitivity analysis to highlight the potential impacts.

Critical judgements and estimates

Disclosures of critical judgements should explain clearly the specific judgements the Board has made and their effect on the financial statements. In some cases, the quality of explanation of the particular sources of estimation uncertainty that are likely to have a material effect on the following year's results could be improved. Companies should consider whether quantitative disclosures, such as sensitivities or ranges of outcomes, are required so that users of the accounts can fully understand the potential effect of estimates.

Accounting policies

There continues to be room for improvement in the disclosure of accounting policies, particularly in relation to revenue recognition. Investors benefit from specific, granular policy information and there should be a clear link between the sources of income described in the business model and revenue recognition policies. We expect companies to explain exactly when revenue from complex long-term contracts is measured.

Developments in IFRS

The International Accounting Standards Board has published three major standards that will become effective in the next few years: IFRS 15 *Revenue from Contracts with Customers* (effective for periods beginning 1 January 2018), IFRS 9 *Financial Instruments* (effective 1 January 2018), and IFRS 16 *Leases* (effective 1 January 2019). Given that comparative periods for IFRS 15 and IFRS 9 will be commencing from 1 January 2017, we expect that most companies that apply IFRS will have made substantial progress in their implementation of these standards. Companies should provide information on this progress and disclose the likely impacts of each of the new standards once they can be reasonably estimated.

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The IASB also recently added requirements to IAS 7 *Statement of Cash Flows* for disclosure explaining changes in a company's financing obligations over the period (effective 1 January 2017). This initative can be traced back to a series of reports from the FRC's Financial Reporting Lab that highlighted investor calls for improvements to debt and cash flow disclosures, including net debt reconciliations. While many UK companies provide such reconciliations, investors continue to have an interest in good quality reconciliations that clearly identify cash and non-cash drivers of changes.

Developments in UK GAAP

There are choices available to companies in relation to the accounting standards that can be applied in the individual financial statements of entities within a group, including for example, FRS 101 *Reduced Disclosure Framework* and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. Unless the changes to the standards that were made during 2015 were applied early, there will be some, limited, changes to take into account for the current year. In particular, there is greater flexibility over the format of the primary statements. In addition, FRS 101 has been subject to an annual review so that it remains effective as IFRS changes. Amendments to FRS 101 that were issued in July 2016 gave exemptions from many of the disclosure requirements of IFRS 15.

In order to take advantage of the reduced disclosure options in FRS 101 and FRS 102 an entity must first notify its shareholders in writing. However, in FRED 65 *Draft amendments to FRS 101 - Notification of shareholders* we are currently consulting on removing this requirement, reducing administrative burdens. Subject to the results of the consultation, we expect to finalise these amendments in December 2016 and they will be effective for accounting periods beginning on or after 1 January 2016.

Remuneration reporting

Investors would like more clarity and brevity in remuneration reporting. In August 2016, the GC100 and Investor Group published a revised version of its 'Directors' Remuneration Reporting Guidance'. The revisions include additional guidance in relation to explaining the link between remuneration and strategy, justifying non-disclose of performance measures or targets on the basis of commercial sensitivity, disclosure of remuneration policy, and clarification of items to be included in the single total figure of remuneration.

Audit Committee reporting

Investors would like to see more informative reporting about the specific actions taken by Audit Committees. The Code looks to Audit Committees to disclose the significant issues that they have considered, including:

- issues in relation to the financial statements and how these were addressed, having regard to matters communicated to the Committee by the auditors;
- the nature and extent of interaction (if any) with the FRC's Corporate Reporting Review team; and
- where a company's audit has been reviewed by the FRC's Audit Quality Review team, the Committee should discuss the findings with their auditors and consider whether any of those findings are significant and, if so, make disclosures about the findings and the actions they and the auditors plan to take. This discussion should not include disclosure of the audit quality category.

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In 2015, the FRC issued its 'Audit Quality Practice Aid for Audit Committees' to assist Audit Committees in evaluating and reporting on audit quality in their assessment of the effectiveness of the external audit process. The practice aid draws on feedback from Audit Committee members and investors, and sets out practical suggestions on how Audit Committees might tailor their evaluation and reporting in the context of the company's business model and strategy, the business risks it faces, and the perception of the reasonable expectations of the company's investors and other stakeholders.

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 2015/16.

Yours sincerely

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Publications and further information

Annual Review of Corporate Reporting 2015/16 (to be published shortly)

FRC: Further information on the FRC's Clear & Concise initiative is available at https://www.frc.org.uk/Our-Work/Headline-projects/Clear-Concise.aspx.

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

FRC: Guidance on the Strategic Report (June 2014) – including principles for good communication, placement of information and materiality. https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Strategic-Report.pdf.

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: ESMA Guidelines on Alternative Performance Measures – Frequently Asked Questions (May 2016). https://frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/FAQs-ESMA-Guidelines-on-Alternative-Performance-M.pdf.

FRC: Guidance on Risk Management, Internal Control and Related Financial and Business Reporting – including implementation of the Code requirements for a viability statement (September 2014). https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Risk-Management,-Internal-Control-and.pdf.

FRC: Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks – for companies that do not apply the Code (April 2016). https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Going-Concern-Basis-of-Accounting.pdf.

FRC: Reminders for half-yearly and annual financial reports following the EU referendum (July 2016). https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2016/July/Reminders-for-half-yearly-and-annual-financial-rep.aspx

GC100 and Investor Group: Directors' Remuneration Reporting Guidance (August 2016). http://uk.practicallaw.com/cs/Satellite?blobcol=urldata&blobheader=application%2Fpdf&blobkey=id&blobtable=MungoBlobs&blobwhere=1248125282835&ssbinary=true.

FRC: Guidance on Audit Committees (April 2016). https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Audit-Committees-(2).pdf.

FRC: Audit Quality Practice Aid for Audit Committees (May 2015). https://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Audit-Quality-Practice-Aid-for-Audit-Committee-(1).pdf.

GCHQ: Guidance for companies in relation to cyber-security is available from the National Cyber Security Centre (October 2016). https://www.ncsc.gov.uk.

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