

12 November 2020

Dear CEOs, CFOs and Audit Committee Chairs

### **Summary of key developments for 2020/21 annual reports**

I am writing to you with the FRC's perspective on key matters that are relevant to the 2020/21 financial reporting season.

My letter highlights topics that the FRC expects to scrutinise over the coming year and sets out our expectations. It also features recommendations on reporting the impact of Covid-19, which will have a pervasive impact on corporate reporting.

I also draw your attention to our recent Annual Review of Corporate Reporting<sup>1</sup>, and other FRC publications listed at the end of this letter, which provide detailed findings and good practice guidance. In particular, this year's annual review is accompanied by a short Corporate Reporting Highlights document<sup>2</sup> which is designed for readers, like yourselves, who may find a high-level summary, supplementing the detailed report, helpful.

My letter is addressed to you as CEOs, CFOs and Audit Committee Chairs, but is likely to be helpful for all preparers, reviewers and auditors. Please encourage your reporting teams and relevant committees to consider the messages when they prepare and review your annual reports.

I would welcome any feedback that you may have in relation to this letter and relevant FRC publications.

### **2020 year-end reporting environment**

Your forthcoming annual reports will be published against the backdrop of economic uncertainties resulting from Covid-19. Companies are also dealing with commercial and operational change associated with the UK's exit from the European Union. Public health measures taken in response to Covid-19 seem likely to continue into the first quarter of 2021. Home working and travel restrictions are likely to bring challenges for finance teams and auditors. Against this background, we encourage companies to consider carefully whether they should lengthen their reporting timetables for 2021, making use of the extensions to reporting deadlines announced by the FCA, which remain in place.

### *Covid-19 and its impact on corporate reporting*

The Covid-19 pandemic presents businesses with the challenge of providing clear and transparent information that focusses on issues of most interest to users. We encourage companies to refer to the guidance that we first published alongside the joint statement issued by the FRC, FCA and PRA in March<sup>3</sup> and have subsequently updated<sup>4</sup>.

More detailed commentary can be found in the FRC's thematic review on the financial reporting effects of Covid-19<sup>5</sup> and two reports published by the Lab,<sup>6, 7</sup> issued in June and updated in October<sup>8, 9</sup>.

The Lab reports highlight the information that investors tell us they find most critical to understand the impact of Covid-19 on a company. Investors expect reports to explain clearly:

- currently available cash and other resources;
- key actions that management has taken and is planning to take;
- the longer-term impacts of Covid-19 on the business model and strategy; and
- the board's assessment of going concern and viability, as well as the methods, judgements and assumptions underlying the assessments.

Companies may also find it helpful to refer to the cash flow and liquidity thematic review that we will publish shortly, which provides guidance on the disclosure of liquidity risk, going concern and viability.

We expect preparers to consider the principles contained in IAS 1, 'Presentation of Financial Statements', and provide disclosures that allow users to understand the impact of events and conditions on a company's position and financial performance, even if those disclosures are not explicitly prescribed. Such disclosures should, where possible, clearly quantify the impact of Covid-19 on a company's performance, position, and prospects. Where judgements have been made involving significant estimation uncertainty, we expect to see increased disclosure of relevant sensitivities or ranges of possible outcomes to help users of the accounts understand the assumptions made and the extent of the changes that might be reasonably possible in the next twelve months. Examples of useful disclosures on judgements and estimates can be found in the Lab reports and the Covid-19 thematic review.

Narrative disclosures within the strategic report should quantify the historical effect of Covid-19. However, we strongly discourage the arbitrary splitting of items between Covid-19 and non-Covid-19 financial statement captions. Such allocations are likely to be highly subjective and, therefore, unreliable. Companies should also apply existing accounting policies for exceptional and other similar items consistently to Covid-19-related income and expenditure.

For the avoidance of doubt, we confirm that we expect all UK companies that use Alternative Performance Measures (APMs) to continue to apply the European Securities and Markets Authority (ESMA) Guidelines on APMs as they reflect best practice in the reporting of such measures, notwithstanding the UK's exit from the European Union.

In considering their future prospects, we expect companies to articulate clearly the impact of Covid-19 on their business models and strategies, and how the changes are compatible with future forecasting assumptions used in other areas of the financial statements (for example, going concern, viability, impairment testing and recognition of deferred tax assets). In particular, we expect any significant judgements made in determining whether or not there is a material uncertainty in relation to going concern to be disclosed and explained.

We also remind preparers that significant judgements made in deciding whether impairment indicators exist should be disclosed and explained. Disclosures should describe the approach

used to determine key impairment assumptions and explain any significant year-on-year changes, including any changes due to Covid-19.

#### *Impact of UK Exit from the European Union*

At the time of writing, the outcome of the ongoing UK-EU trade negotiations is uncertain. We strongly encourage companies to assess carefully the nature of information about the likely impacts of the UK's exit that would be most relevant to users.

We expect reports to explain company-specific risks and uncertainties, including the potential impacts on different parts of the business and any effects on the financial statements (including major sources of estimation uncertainty, amounts at risk and ranges of potential outcomes).

#### **Insights and observations from our monitoring work**

The topics that gave rise to the highest number of queries during our monitoring work (the 'top 10 issues') are set out in the Highlights document<sup>10</sup>, designed as a quick reference to help you avoid the deficiencies that we commonly identify in our reviews.

This year's top 10 issues include the disclosure of judgements and estimates, and impairment of non-financial assets, as referred to in the Covid-19 section of this letter.

We also draw particular attention to working capital finance arrangements, such as reverse factoring/ supplier financing, about which we continue to have concerns regarding the transparency of companies' disclosures. Where companies have such arrangements, we expect disclosures that enable users to understand their significance, the key terms, relevant accounting policies and their effect on the balance sheet, cash flows and debt covenants. Where companies do not use reverse factoring/ supplier financing but operate in sectors that frequently use such facilities, it would be helpful to explain this.

#### **Insights and observations from our thematic reviews**

##### *Climate change*

Users expect companies to provide full information about the future impact of climate change on the business and how the company's activities affect the environment. Our recent thematic review<sup>11</sup> incorporated findings from the FRC's Regulatory Standards and Supervision divisions, as well as views from investors.

We found that, although reports usually comply with Companies Act requirements for narrative reporting of environmental matters, including climate change, most are not meeting investor needs. Moreover, some financial statements did not mention climate change, even though narrative reporting implied that it might be having a significant impact on key financial statement assumptions.

We encourage companies to:

- Provide strategic reports that clearly describe their environmental policies, rather than simply naming or listing them.

- Explain any terminology such as ‘net zero’ or ‘Paris compliant’ and provide transparent explanations about which emissions are included in any emissions targets, how progress will be measured and reported, and what assurance will be sought.
- Give a balanced description of how climate policies and targets have been incorporated into business plans and their expected business impact, making appropriate use of key performance indicators, where relevant, and without disproportionate focus on ‘good news’ stories in parts of the business that are not material.
- Describe the impact of their businesses on the environment, including their supply chains.
- Provide required segmental and disaggregated revenue disclosures to enable users to understand the relative sizes of operations for which climate change presents substantially different risks and opportunities.
- Provide financial statements that, where relevant, explain the impact of climate related risks, policies and strategies on both measurement and disclosure including, in particular:
  - impairment of individual assets as well as cash generating units;
  - useful economic lives of assets;
  - expected amounts and timing of cash outflows for provisions and other liabilities;
  - fair values of assets and liabilities; and
  - disclosure of key accounting judgements, estimation uncertainties and related sensitivities.

#### *IFRS 15, ‘Revenue from Contracts with Customers’*

Our IFRS 15 thematic review<sup>12</sup> was the third such review since IFRS 15 became mandatory for UK companies. We will continue to challenge companies whose disclosures do not clearly explain how they have applied the standard to their specific circumstances.

We expect companies to:

- clearly describe their performance obligations, the timing of revenue recognition and any significant judgements made by management;
- identify the balances that they consider to be ‘contract balances’ and explain any significant movements;
- report revenue-related information consistently in the strategic report and in the financial statements (for example, consistent information about significant customer contracts and consistent disaggregation of revenue); and

- specify the types of variable consideration that exist within customer contracts and how each type of variable consideration is estimated and constrained.

### *IFRS 16, 'Leases'*

Our thematic review of the first year of application of IFRS 16<sup>13</sup> identified areas where companies could improve reporting, including providing the following:

- Entity-specific, rather than boilerplate, accounting policies for all material items.
- Sufficiently detailed explanations that enable users to understand significant judgements and their implications (for example in relation to lease term, or items not within the scope of the standard).
- Sufficient information to address both IFRS 16's disclosure principles and its detailed disclosure requirements.

We encourage companies to note the examples of better disclosures provided in our thematic review report when considering enhancements to their leasing disclosures.

### *Cash flow and liquidity*

We recently conducted a thematic review looking at how companies reported cash flows and liquidity risk. In advance of our detailed findings, which will be published shortly, we set out what we expect to see in forthcoming reports:

- Clear explanation of matters considered in assessing going concern, viability and liquidity (for example, the availability of cash, undrawn borrowing facilities and compliance with debt covenants).
- Disclosure of methods, assumptions and judgements made in assessing going concern and viability.
- Consistency in the amounts and descriptions of items in the cash flow statement, and other areas of the annual report, including: the strategic report, other primary statements, disclosures of changes in financing liabilities and other notes.
- Disclosure of accounting policies and judgements in relation to the cash flow statement, particularly for large, one-off transactions.

As with our routine monitoring work, our thematic review highlighted issues in relation to companies' cash flow statements. In view of the basic errors we continue to see in cash flow statements at a time when cash management and liquidity is key, we expect companies to perform more robust pre-issuance reviews of these statements. Such checks should carefully consider the list of our common queries provided in the forthcoming thematic review report and in CRR's Annual Review of Corporate Reporting.

## **Narrative reporting and corporate governance matters**

### *Section 172 statements and reporting on workforce engagement*

Based on a review of section 172 statements in the first year of implementation, many companies did not sufficiently explain how their directors discharged their section 172 duty, and in particular the responsibility to have regard to the consequences of decisions in the long term. A number of companies reported on the methods of engagement with stakeholders but did not reflect a two-way dialogue or explain how the feedback affected decision making. Others treated the statement as one of compliance instead of reflecting how they specifically met the requirements.

As highlighted in the reporting tips published recently by the FRC Lab<sup>14</sup>, we encourage companies to report on the following:

- The effectiveness and outcomes of their engagement.
- The oversight that boards have over delegated engagement.
- How feedback has been used within the decision-making process.
- Difficult decisions, rather than just focusing on positive engagement.
- How stakeholders are considered strategically and how such consideration is contributing to companies' long-term success.
- Implications of the decisions on both long-term success and on stakeholders themselves.

It was also apparent that some companies were unsure as to whether they are required to prepare a section 172 statement. We draw your attention to the clarifications that we issued earlier this year<sup>15</sup>.

Our Corporate Governance team will be publishing its review of reporting against the 2018 Code in November, and will include findings on section 172 statements, as well as reporting on workforce engagement. On the latter, we expect companies to improve their reporting of the following:

- How employee-related issues and concerns are elevated to the board.
- The basis on which views are promoted to board discussion.
- Direct actions arising from board discussions.
- How the company relays its decisions on feedback provided by its workforce activities.

The FRC Lab's report on workforce reporting, published in January 2020, provides practical guidance and examples of information that investors may find useful<sup>16</sup>.

### *Chair Tenure*

The 2018 Corporate Governance Code states that a Chair should not remain in post beyond nine years from the date of their first appointment to the board. Reviews suggest that some companies may not be planning adequately for the departure of the Chair or other directors. Some reports assert that succession planning is a key priority of the Nominations Committee or the board, whilst also reporting that the Chair or other directors have been required to stay in post while a successor is found. Those two statements are inconsistent. This example highlights that in many cases companies are not offering detailed and transparent explanations to offer real insight into governance.

Effective succession plans should anticipate departures and ensure that sufficient time is built into the recruitment process to enable a smooth transition without the need to extend the tenure of the Chair or other directors. We accept that there will be unplanned departures. However, the Code offers flexibility for companies to fully explain their unique position.

We also identified a number of reports, which stated that succession plans considered the importance of a diverse leadership team and pipeline. We expect such statements to also include details of proactive measures taken to identify individuals from diverse backgrounds, as well as any diversity targets included within succession plans.

### **Future developments**

#### *UK endorsement mechanism*

At the end of this year, legislation made under the European Union (Withdrawal) Act 2018 will bring into UK law International Accounting Standards already endorsed in the EU in order to provide continuity. These standards are defined as UK-adopted International Accounting Standards.

The UK Endorsement Board is being established, and the intention is that it will be delegated the power to endorse new or amended standards.

Legislation sets out which accounting standards UK companies applying EU-adopted IFRS should apply during the transition period to UK exit from the European Union:

- Entities with financial years beginning on or before 31 December 2020 but ending after that date, continue to apply EU-adopted International Accounting Standards.
- Entities with financial years beginning after 31 December 2020, apply UK-adopted International Accounting Standards.

Additional transitional provisions permit UK-adopted International Accounting Standards to be applied earlier in some circumstances.

#### *Selected developments in IFRS effective in 2020 and 2021*

As in previous years, companies will be expected to apply amendments to IFRSs that became applicable this year and disclose the expected impact of revisions that have been issued but are not yet applicable, if material. Although the reporting implications of the amendments may

not be as pervasive as the accounting standards adopted in 2018 and 2019, they do reflect standard setters' responses to complex and topical matters.

Interest Rate Benchmark Reform — Phase 1 (Amendments to IFRS 9, IAS 39 and IFRS 7) was issued in 2019 and effective for periods commencing on or after 1 January 2020, with early application permitted. The amendments provide relief that will avoid the unnecessary discontinuation of hedge accounting during the period of uncertainty as interest rate benchmarks are reformed.

Interest Rate Benchmark Reform — Phase 2 (Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16) was issued in August 2020 and effective for periods commencing on or after 1 January 2021, with early application permitted. Phase 2 addresses issues arising as interest rate benchmarks are replaced. It provides reliefs to minimise discontinuities in accounting and the unnecessary discontinuation of hedge accounting as agreements are modified to transition to alternative benchmark rates. At the time of writing, it is subject to endorsement by the European Union, which is anticipated before the end of the year. As part of the preparations for the end of the Brexit transition period, work is being undertaken to ensure the UK is ready to undertake adoption of the amendments if EU endorsement does not occur before the end of the year.

Covid-19-Related Rent Concessions (Amendment to IFRS 16) was endorsed by the EU in October 2020 for application, at the latest, as from 1 June 2020 for financial years starting on or after 1 January 2020. This allows for early adoption for periods starting between 1 January and 1 June 2020. We anticipate that companies with rent concessions meeting the criteria in the amendment will choose to take advantage of the practical expedient not to assess whether a rent concession is a lease modification. Additional disclosure requirements then apply, relating to the use of the expedient and the amount recognised in profit or loss reflecting the changes in lease payments.

Yours sincerely

Sir Jonathan Thompson  
Chief Executive Officer  
Financial Reporting Council

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<sup>1</sup> <http://www.frc.org.uk/document-library/corporate-reporting-review/2020/2020-annual-review-of-corporate-reporting>

<sup>2</sup> <http://www.frc.org.uk/document-library/corporate-reporting-review/2020/2020-annual-review-of-corporate-reporting-highligh>

<sup>3</sup> <https://www.frc.org.uk/about-the-frc/covid-19/covid19-joint-statement-26th-march-2020>

<sup>4</sup> [https://www.frc.org.uk/about-the-frc/covid-19/company-guidance-updated-20may-2020-\(covid-19\)](https://www.frc.org.uk/about-the-frc/covid-19/company-guidance-updated-20may-2020-(covid-19))

<sup>5</sup> <https://www.frc.org.uk/document-library/corporate-reporting-review/2020/crr-covid-19-thematic-review-july-2020>



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<sup>6</sup> <https://www.frc.org.uk/getattachment/ef564f3f-d37b-4469-aa30-cc36f0343708/COVID-19-Going-concern-risk-and-viabilityFinal.pdf>

<sup>7</sup> <https://www.frc.org.uk/document-library/financial-reporting-lab/2020/covid-19-resources,-action,-the-future-june-2020>

<sup>8</sup> <https://www.frc.org.uk/getattachment/1778c4a6-bb89-45f7-8de5-e4737545a98d/COVID-19-Going-concern,-risk-and-viability-a-look-forward.pdf>

<sup>9</sup> <https://www.frc.org.uk/getattachment/15565835-6fec-46ad-a059-86481971e9a2/COVID-19-Resources-actions-and-the-future-a-look-forward.pdf>

<sup>10</sup> <http://www.frc.org.uk/document-library/corporate-reporting-review/2020/2020-annual-review-of-corporate-reporting-highligh>

<sup>11</sup> <https://www.frc.org.uk/document-library/climate/frc-climate-thematic---summary>

<sup>12</sup> <https://www.frc.org.uk/document-library/corporate-reporting-review/2020/ifrs-15-review>

<sup>13</sup> <http://www.frc.org.uk/document-library/corporate-reporting-review/2020/ifrs16>

<sup>14</sup> <https://www.frc.org.uk/document-library/financial-reporting-lab/2020/tips-on-section-172>

<sup>15</sup> <https://www.frc.org.uk/document-library/accounting-and-reporting-policy/2020/financial-reporting/2020-update-to-guidance-on-the-strategic-report/amendments-to-guidance-on-the-strategic-report-app>

<sup>16</sup> <https://www.frc.org.uk/news/january-2020/investors-call-for-improved-workforce-reporting>