

30 October 2019

Dear Audit Committee Chairs and Finance Directors

Summary of key developments for 2019/20 annual reports

I am writing to you with the FRC's perspective on key matters that are relevant to the 2019/20 financial reporting season.

This letter features recommendations following our routine monitoring work, recent thematic reviews and topical areas of focus. This year, we place particular emphasis on recent changes to reporting requirements designed to address broader matters of increasing concern to investors and other stakeholders which will require consideration by you and your Boards when preparing your next report and accounts.

Strategic report

We have previously highlighted the strategic report as giving Boards an opportunity of providing users with a holistic narrative explaining and supplementing key information in their financial statements.

Recent developments in the content requirement of the report also serve to highlight the potential for quality communication with shareholders and other stakeholders on a range of environmental, social and governance related issues.

Non-financial information statement

The statutory requirement for a non-financial information statement from relevant companies¹ met a mixed response in terms of providing the required content and its manner of presentation. The statement should be separately identifiable but can cross-refer to where the required disclosures are provided within the strategic report. These include clear description of the company's policies, any due diligence processes implemented in pursuance of those policies and their outcomes in respect of environmental, social, anti-corruption and anti-bribery matters, employees and respect for human rights.

Section 172 report

For periods commencing after 1 January 2019, Boards are required to include a further statement within their strategic report, describing how they have had regard to a number of factors when working to promote the success of their business; broadly, these include the likely consequences of any decision in the longer term, the interests of employees and the need to foster business relationships, the impact of the company's activities on the environment, the desirability of high standards of business conduct and the need to act fairly as between members of the company².

The duty is not new; but the reporting requirement is. The Government has published a set of FAQs on what might be included in the report.

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We encourage Boards to disclose:

- the issues, factors and stakeholders that they consider relevant in complying with s172(1) and the basis on which they came to that view including, for example, consideration of reporting on payment to suppliers in line with the BEIS response to their call for evidence 'Creating a Responsible Payment Culture';³
- the main methods they have used to engage with stakeholders and to understand the issues to which they must have regard; and
- information about the effect of that regard on the company's decisions and strategies during the financial year.

Environmental disclosures, including reporting on climate risk

In July, the Government published its Green Finance Strategy⁴ which sets the direction for climate change regulation and action. Large asset owners and listed companies are expected to report in accordance with the requirements of the Task Force on Climate-Related Financial Disclosures (TCFD) by 2022. The FRC is an active member of a regulatory group established to consider how that expectation might be implemented.

Alongside the Green Finance Strategy, the FRC published a statement⁵ which set out what it expects companies to report on in relation to climate change. Neither the requirements of the non-financial information statement nor the section 172 report specifically require companies to disclose the impact of climate change on their operations. However, consistent with the UK Corporate Governance Code's focus on emerging risks, and after considering the likely consequences, companies should, where relevant, report on the effects of climate change on their business (both direct and indirect). Such reporting should cover how the Board has taken account of the resilience of the company's business model and its risks, uncertainties and viability in the immediate and longer term in light of climate change. It should also consider the impact on the financial statements, in particular in relation to asset valuation and impairment testing assumptions.

The Financial Reporting Lab's recent report on Climate Change⁶ sets out the questions Boards should ask themselves when considering the adequacy of their reporting in relation to TCFD. To be clear, we expect companies to disclose risks that extend beyond the period covered in their viability statement.

2019 year-end reporting environment

In times of uncertainty, whether created by political events, general economic conditions or operational challenges, investors look for greater transparency in corporate reports to inform their decision-making. We expect companies to consider carefully the detail provided in those areas of their reports which are exposed to heightened levels of risk; for example, descriptions of how they have approached going concern considerations, the impact of Brexit and all areas of material estimation uncertainty.

A specific issue affecting this season's year end reporting are the published amendments to IFRS 9 and IAS 39, reflecting the global reforms of interest rate benchmarks, such as LIBOR, the futures of which post 2021 are not clear in a number of cases. In terms of their reporting,

Boards must make their own judgement whether the level of uncertainty is so high that the conditions for hedge accounting are not met.

We encourage all companies that are parties to contracts referencing LIBOR, or any other rate subject to the reforms, to start planning now for the transition to new rates. This should include early consideration of the need to re-negotiate relevant contracts and agreements.

Findings of our monitoring work

Critical judgements and estimates

More companies this year made a clear distinction between the critical judgements they make in preparing their accounts from those that involve the making of estimates and which lead to different disclosure requirements. However, some provided insufficient disclosures to explain this area of their reporting where a particular judgement had significant impact on their reporting; for example, whether a specific investment was a joint venture or a subsidiary requiring consolidation. We will continue to have a key focus on the adequacy of disclosures supporting transparent reporting of estimation uncertainties. An understanding of their sensitivity to changing assumptions is of critical value to investors, giving them clearer insight into the possible future changes in balance sheet values and which can inform their investment decisions.

Reporting of cash

As recently reported by the Lab, the availability of cash,⁷ its generation and the uses to which it is put, is a critical input to investors' decision making. Investors may look beyond the cash flow statement for contextual disclosures satisfying their information needs, but they are entitled to rely on the cash flow statement as a compliant core.

This year saw a further rise in the number of questions put to companies about their cash flow statements and related disclosures. We continue to see basic errors, many of which were misclassification of cash flows which were evident from the face of the financial statements and which could have been identified through robust pre-issuance review. We expect companies to follow the detailed requirements of IAS 7 to assist investors' comparability between companies. Where a genuine material judgement has been made on presentation, we expect that judgement to be disclosed and explained.

We continue to have particular concerns about the level of disclosure around supplier financing arrangements as featured in the Lab report. We will ask companies direct questions on whether and, if so, the extent to which, they enter into this type of arrangement where their usage is common place in their industry and there is no reference to the matter in their report or accounts.

Alternative performance measures ('APMs')

We were pleased to note some improvement in the quality of APM disclosures this year and encourage companies to continue to enhance this aspect of their reporting. We will continue to challenge disclosure where there is apparent failure to comply with ESMA's Guidelines⁸ and which, in our view, codify best practice reporting. Any apparent reluctance to identify and highlight the audited IFRS numbers from which APMs are derived is a cause for concern.

We expect compliance by all companies who choose to disclose such metrics when explaining and highlighting various aspects of their historic performance. The Lab report 'Performance metrics - Principles and Practice' sets out user expectations in this area.⁹

Thematic reviews

It is against a background of economic uncertainty that we paid particular attention this year to the impairment of non-financial assets, including a focused review of the impairment of goodwill in accordance with IAS 36.¹⁰ We expect Boards to:

- clearly identify and quantify the key assumptions used in the cash flow projections (including comparatives), not just the discount and long term growth rates;
- explain the process by which the Board determined those key assumptions; and
- describe the changes in key assumptions that management thinks reasonably possible and the impact of these changes if they would reduce headroom to nil or give rise to a potential material adjustment to its carrying value.

Turning to parent company investments, where the carrying value of a parent company's investment in subsidiaries exceeds the group's market capitalisation – generally considered to be an indication of impairment – we will ask whether an impairment review has been carried out, and, if so, for further details if there is inadequate disclosure in the accounts.

Accounting standards

Two new international accounting standards, IFRS 9 'Financial Instruments' and IFRS 15 'Revenue from Contracts with Customers', were effective for December 2018 year ends.

We followed up our 2018 thematic reviews on these standards by looking at their adoption in a sample of December 2018 reports, publishing our findings on the FRC website.¹¹¹²

Broadly, we thought that companies had dealt well with the implementation with some clear evidence of early messaging having had some effect on the quality of disclosures. As the standards continue to be embedded, we encourage you to focus on greater clarity and transparency in those areas where there is opportunity for improvement. We invite you to benchmark the quality of your draft disclosures by asking yourselves the following questions;

IFRS 15 Revenue from Contracts with Customers

- Do your accounting policies identify the specific nature of your performance obligations and explain the point at which they are satisfied?
- Does your policy description clearly set out when revenue is recognised in respect of all material revenue streams?
- Have you focused your disclosure on the specific judgements you have made which have a significant impact on the amount or timing of revenue recognition?
- Have you quantified estimation uncertainties relating to revenue and, where helpful, provided sensitivities or ranges of outcomes?

- Have you explained significant movements in contract assets and liabilities?

IFRS 9 Financial Instruments

IFRS 9 had the most significant and far-reaching impact on reporting by banks. Our thematic report had particular focus on how they have implemented the new requirements.

We expect banks to address the following questions:

- Do you adequately explain the triggers for any significant increase in credit risk and default?
- When considering forward looking information, do you quantify the most significant economic assumptions?

We expect non-banking companies to address the following questions:

- Does the description of your business model adequately explain and support the hold to collect model?
- Have you removed all old IAS 39 terminology from your disclosures?
- Do your accounts reflect the fact that the scope of the impairment requirements includes, for example, IFRS 15 contract assets, lease receivables and also applies to loans to subsidiaries and other undertakings in your individual parent company accounts?
- If relevant, do you explain why the impact of IFRS 9 is not material, particularly where significant financial instruments are recognised in the accounts.

IFRS 16 Leases

IFRS 16 is effective for periods beginning on or after 1 January 2019. We recently conducted a thematic review looking at how companies reported on their adoption of the new standard in their June 2019 interim accounts. In advance of our detailed findings which will be published shortly, I set out what we expect to see by way of disclosures in the forthcoming accounts, drawing on the results of our work.

- Clear explanation of the key judgements made in response to the new reporting requirements;
- Effective communication of the impact on profit and loss, addressing any lack of comparability with the prior year;
- Clear identification of practical expedients used on transition and accounting policy choices; and
- Well explained reconciliation, where necessary, of operating lease commitments under IAS 17, 'Leases', the previous standard and lease liabilities under IFRS 16.

Corporate governance reporting

This year we undertook an assessment of both early adoption of the new UK Corporate Governance Code and reporting on the 2016 Code. We will publish our findings and our expectations for reporting in 2020 later this year.

Yours sincerely

Sir Jonathan Thompson
Chief Executive Officer
Financial Reporting Council

¹ Section 414CA requires a traded, banking or insurance company with more than 500 employees (a public interest entity or 'PIE') or a parent with more than 500 employees in a group headed by that company to include a non-financial information statement as part of its strategic report.

² https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/755002/The_Companies_Miscellaneous_Reporting_Regulations_2018_QA_-_Publication_Version_2_1_.pdf

³ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/814819/prompt-payment-cfe-govt-response.pdf

⁴ <https://www.gov.uk/government/publications/green-finance-strategy>

⁵ <https://www.frc.org.uk/news/july-2019/frc-statement-on-the-government%E2%80%99s-green-finance-st>

⁶ <https://www.frc.org.uk/getattachment/85121f9f-15ab-4606-98a0-7d0d3e3df282/Climate-Change-v8.pdf>

⁷ <https://www.frc.org.uk/getattachment/0689ba0c-2a23-4850-b0b9-8bec52938cce/Disclosures-on-the-sources-and-uses-of-cash-Final.pdf>

⁸ <https://www.esma.europa.eu/press-news/esma-publishes-final-guidelines-alternative-performance-measures>

⁹ https://www.frc.org.uk/getattachment/e94631d1-69c1-4349-8ce5-780d4eca455f/LAB_Reporting-of-performance-metrics_June-2018.PDF

¹⁰ <https://www.frc.org.uk/getattachment/4daee650-59fe-43b0-904c-ba9abfb12245/CRR-Thematic-Review-Impairment-of-Non-financial-Assets-final.pdf>

¹¹ <https://www.frc.org.uk/getattachment/4998f20e-30e1-47a8-a9e7-f15654fa0e03/IFRS-9-thematic-final.pdf>

¹² <https://www.frc.org.uk/getattachment/498aa4b3-85b2-4d4c-8f5a-3d0d28db9237/IFRS-15-thematic-PDF.pdf>