

15 December 2015

Dear Audit Committee Chairman

Summary of key developments for 2015 annual reports

I am writing ahead of the 2015 reporting season with the FRC's perspective on various matters relevant to your 2015 annual report and accounts. In general the quality of corporate reporting in the UK is of a high standard, however this letter highlights where companies might take steps to continue to improve their reporting.

Clear & Concise reporting

One of the aims of the annual report is to communicate relevant information to investors. This involves going beyond a purely compliance driven approach to reporting and ensuring that the annual report as a whole is a clear and concise communication of the company's story. This includes avoiding boilerplate disclosures and ensuring that the annual report only contains information that is material to investors.

As part of its Disclosure Initiative the International Accounting Standards Board has issued amendments to IAS 1 *Financial Statement Presentation* which note that the inclusion of immaterial information can obscure relevant information and highlight the need for preparers to apply professional judgement in determining what information to disclose in their financial statements. The amendments are effective for accounting periods beginning on or after 1 January 2016, although early application is permitted.

Boards need to assess materiality through the "right lens" and not use materiality assessments to conceal errors or achieve a particular presentation. Our Guidance on the Strategic Report indicates the considerations that should apply.

We have heard from investors that the Strategic Report is a key tool to communicate information about a company and they use it to draw conclusions as to the underlying company culture.

Risk reporting

Companies are required to consider materiality in reporting on their 'principal' risks as part of their Strategic Report. We and investors encourage companies to disclose how the risk specifically affects them and the steps they are taking in mitigation.

Investors certainly do not seek a long list of all possible risks, however, they have recently expressed surprise that risks relating to data protection in IT systems/ cyber risk and risks from climate change are not reported more often as principal risks.

For those companies that apply the UK Corporate Governance Code, the requirement for risk and internal control reporting and a viability statement became effective for financial years beginning on or after 1 October 2014.

The viability statement is forward looking. Although companies may choose the time period, it is expected that the period assessed will be significantly longer than 12 months. Crucially, the directors should explain their reasoning for the period chosen, taking into account the circumstances of the company, in order to avoid making 'boiler plate' statements.

Investors are paying increasing attention to extended audit committee and auditor reporting introduced in 2012. They look for consistency and clarity between these and the financial statements.

Disclosures

Effective disclosure remains a topical area and there is an ongoing drive for improvement.

Accounting policies and impact of new standards

It is important to explain critical judgements and accounting policy choices. Pension reporting, for example, where there is diversity of treatment, is a particular area of focus. We have also recently announced that we will be carrying out a thematic review of tax disclosures.

Last year, the International Accounting Standards Board published two major standards IFRS 15 *Revenue* and IFRS 9 *Financial Instruments*. The effective date for IFRS 15 has been deferred to 1 January 2018 and IFRS 9 has not yet been endorsed for use in the EU. Nonetheless companies should disclose the likely impact of both once they can be reasonably estimated.

Alternative Performance Measures

There is continued investor and regulator focus on how non- GAAP measures and alternative performance measures are used to report performance. It is important to be clear and consistent in their use, including explanations and reconciliations of how they relate to GAAP measures.

Dividends

Dividends disclosure is important to many investors. The Financial Reporting Lab's recent report *Disclosure of dividends – policy and practice* explores how to make dividend disclosures more relevant for investors. Good dividend disclosures answer the following questions:

- Why this policy?
- What does the policy mean in practice?
- What are the risks and constraints associated with this policy?
- What was done in practice to deliver under the policy?

All investors consider that the disclosure relating to dividend resources, i.e. cash and the amount of distributable profits can be useful, particularly where the ability of the company to pay dividends is, or might be, insufficient relative to the level of dividends indicated by the policy. We agree with this. However, some investors believe that the law always requires distributable profits to be disclosed in the financial statements. One investor organisation has written to company Chairmen on this point. The Department for Business, Innovation and Skills has confirmed to the FRC that the Companies Act 2006 does not require the separate disclosure of a figure for distributable profits.

Other criticisms about the legality of the UK accounting framework are also incorrect. As government and the FRC stated in 2013; the UK accounting framework is legal and the presentation of a true and fair view remains a fundamental requirement of financial reporting.

The UK GAAP Reduced Disclosure Framework

The new suite of UK Accounting Standards (UK GAAP) became effective for accounting periods beginning on or after 1 January 2015 and includes FRS 101 *Reduced Disclosure Framework*.

Groups that apply EU-adopted IFRS in their consolidated financial statements can choose to apply UK GAAP in the individual financial statements for the companies (i.e. parent and subsidiaries) within the group. Companies applying UK GAAP have a further choice between FRS 101 and FRS 102.

FRS 101 may be a cost-effective choice as it allows recognition and measurement consistent with EU-adopted IFRS, but with more reduced disclosures than EU-adopted IFRS would require.

In July 2015, we made limited amendments to FRS 101 that improve further the cost-effectiveness of this option, amongst other things these reduce disclosures on first-time adoption and provide greater flexibility in the formats of the primary statements.

Digital communication

The medium of communication for company information is important and in recent years, digital reporting has gained greater prominence. The FRC's Financial Reporting Lab report *Digital present* notes that investors identify the PDF as their preferred digital mechanism for receiving, and viewing the annual report. Around 70% of those using the PDF, review the document on-screen. Companies can optimise the PDF report by "thinking screen first"; simplifying the report structure, removing double page spreads and considering how images and columns of text are displayed.

Quarterly reporting

The FRC supported EU legislative changes removing the requirement to issue quarterly reports. Institutional investors have told us that they support the move away from quarterly reporting and asked us to encourage companies to focus reporting outside of the annual report and accounts cycle on providing information which is of import to the longer term prospects of the company.

FRC oversight

We are committed to improving our own effectiveness in raising the quality of reporting in the UK. During 2016 we plan to increase transparency of reporting our conclusions on individual companies; letting companies know when we have reviewed their report and accounts and have no substantive points to raise; and publicising the names of the companies whose reports have been subject to our corporate reporting review. We will consult on these proposals to the extent that they affect our operating procedures.

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 below.

Yours sincerely



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FRC publications and further information

Further information on the FRC's Clear & Concise initiative is available at <https://www.frc.org.uk/Our-Work/Headline-projects/Clear-Concise.aspx> including the forthcoming publication Clear & Concise: Developments in Narrative Reporting.

Guidance on the Strategic Report – 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>

Corporate Reporting Review Annual Report 2015 – including Clear & Concise case study (pages 15-17). <https://www.frc.org.uk/Our-Work/Publications/Corporate-Reporting-Review/Corporate-Reporting-Review-Annual-Report-2015.pdf>

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

Press Notice: Tax reporting thematic review <https://intranet.frc.org.uk/News-and-Notes/Latest-News/2015/December/Tax-reporting-thematic-review>

Financial Reporting Lab reports: *Disclosure of dividends – policy and practice*, *Accounting policies and integration of related financial information* and *Digital present* <https://frc.org.uk/lab/reports>

FRS 101 *Reduced Disclosure Framework* - [https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/FRS-101-Reduced-Disclosure-Framework-\(1\).pdf](https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/FRS-101-Reduced-Disclosure-Framework-(1).pdf)