Financial Reporting Council

24 October 2018

Dear Audit Committee Chairs and Finance Directors

Summary of key developments for 2018/19 annual reports

I am writing ahead of the 2018/19 reporting season with the FRC's perspective on key matters that are relevant to the preparation of your forthcoming annual reports and accounts. This letter focuses on our expectations for reporting on the new accounting standards effective this year, our findings in respect of our monitoring work, and topical areas of reporting, including the effect of Britain exiting the EU.

You will no doubt be aware that, during 2018, the FRC updated its Guidance on the Strategic Report and published a new Corporate Governance Code ("the Code").[1] The Code is effective for accounting periods starting on or after 1 January 2019, concurrent with the new reporting requirement to include a section 172(1) statement in the strategic report. Further detail on these matters and the expected impact on the 2019/20 reporting season can be found in the FRC's Annual Review of Corporate Governance and Reporting.

New Accounting standards

Two new international accounting standards, IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from contracts with customers*, are effective for December 2018 year ends. IFRS 16 *Leases* is effective for periods beginning on or after 1 January 2019.

We have undertaken thematic reviews looking at the adoption of IFRS 9 and IFRS 15 in June 2018 interim accounts. In advance of our detailed findings to be published shortly, I set out what we expect to see by way of year end disclosures that explain the impact of the new standards.

IFRS 15 *Revenue from contracts with customers*

We encourage companies to invest sufficient time during their year-end preparation to ensure that:

- explanations of the impact of transition are comprehensive and linked to other relevant information in the annual report and accounts;
- changes to revenue policies are clearly described and explained, reflecting company specific information – as are any associated management judgements;
- performance obligations, a new concept introduced by IFRS 15, are identified and explained, with a focus on how they have been determined and the timing of delivery to the customer; and
- the impact of the standard on the balance sheet is also addressed, including accounting policies for contract assets and liabilities.

8th Floor, 125 London Wall, London EC2Y 5AS Tel: +44 (0)20 7492 2300 Fax: +44 (0)20 7492 2301 www.frc.org.uk

IFRS 9 *Financial Instruments*

Banks

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

Non-banking companies

IFRS 9 may not have a material effect on the results of non-banking companies, in which case, many of the transition disclosures may not be required. However, we do expect companies to:

- have updated their hedging documentation and assessed the effectiveness of existing hedges on application of the new requirements;
- explain and, where possible, quantify material differences between IAS 39 and IFRS 9, including key assumptions adopted on implementation;
- remember that the scope of the impairment requirements has been extended to include, for example, IFRS 15 contract assets, lease receivables and will also apply to loans to subsidiaries and other undertakings in individual parent company accounts;
- take particular care when considering the application of the standard to embedded derivatives and the different treatment required where the host contract is a financial asset compared to where it is a financial liability;
- reconsider the accounting for previous debt modifications, such as refinancing, that did not result in derecognition;
- reflect the additional disclosure requirements of IFRS 7; and
- if relevant, explain why the impact is not material, particularly where significant financial instruments are recognised in the accounts.

IFRS 16 *Leases*

We also conducted a light touch review of how companies reported on the impact of IFRS 16 in their June 2018 interim reports.

As the standard is mandatory for periods beginning on or after 1 January 2019, companies should be in a position to provide specific disclosure in their December 2018 reports and accounts explaining the impact of the new requirements on their business. We expect companies to:

- provide meaningful information about the application of the standard with a focus on their specific facts and circumstances;
- disclose qualitative and quantitative information, identifying any lease portfolios that are significantly impacted by the new requirements;
- explain the specific judgements and policy changes prompted by the new model and provided detail about the structure of their implementation projects; and
- identify the exemptions that companies intend to apply.

8th Floor, 125 London Wall, London EC2Y 5AS Tel: +44 (0)20 7492 2300 Fax: +44 (0)20 7492 2301 www.frc.org.uk

Findings of our monitoring work

Critical judgements and estimates

Our monitoring work continues to have a focus on the critical judgements and estimates that management make when preparing their reports and accounts and which can provide valuable information to investors both about future expectations of assets and liabilities but also the quality of management's judgements. While we have seen some better disclosures in this area in recent years, there is still significant scope for further improvement and we will continue to press companies for more informative disclosures. Our thematic report,[2] published in November 2017, remains relevant to this area of reporting. We expect

- a clear distinction to be made between judgements and estimates as different disclosure requirements apply;
- clear disclosure of the sensitivity of carrying amounts to the assumptions and estimates underlying a measurement calculation, or, if more meaningful, disclosure of the range of reasonably possible outcomes within the next year in respect of the carrying amounts of the relevant assets and liabilities; and
- identification of any voluntary additional disclosures provided in respect of estimation uncertainty, for example, where the impact of any possible material change in estimate is not anticipated to have effect until a period outside the twelve-month window required by the standard.

Control environment

This year, we identified an increase in the number of basic errors in the reports and accounts we reviewed. In times of change and uncertainty - whether due to new accounting standards or broader economic events like the UK exiting the EU - management's attention will rightly be focused on ensuring that there is quality disclosure around the key judgements and estimates they make in determining material matters in their reports and accounts. However, management also need to have effective procedures in place to ensure compliance with the basic reporting requirements of IFRS, which investors take as a given in audited reports and accounts.

These need to be sufficiently robust to ensure that reporting remains free of basic errors which can detract both from the integrity of the company's report and accounts and trust in management.

Topical areas of reporting

Britain exiting the EU

This year, we saw companies take a variety of approaches to reporting on the risks associated with Brexit. The nature and depth of disclosure depended, in part, on the potential impact on the business and the mitigating actions the company had been able to put in place. Although many companies may now be well advanced in developing their strategy in response to Brexit and an analysis of its potential impact, we still face significant uncertainties and unknowns in respect of the final deal that may be struck. This situation poses particular challenges for Boards as they prepare for their December 2018 report and accounts, many of which will be published shortly ahead of the March deadline.

8th Floor, 125 London Wall, London EC2Y 5AS Tel: +44 (0)20 7492 2300 Fax: +44 (0)20 7492 2301 www.frc.org.uk

We encourage companies to provide disclosure which distinguishes between the specific and direct challenges to their business model and operations from the broader economic uncertainties which may still attach to the UK's position when they report. Where there are particular threats, for example the possible effect of changes in import/export taxes or delays to their supply chain, we expect these to be clearly identified and for management to describe any actions they are taking, or have taken, to manage the potential impact. In some circumstances this may mean recognising or remeasuring certain items in the balance sheet.

The broad uncertainties that may still attach to Brexit when companies report will require disclosure of sufficient information to help users understand the degree of sensitivity of assets and liabilities to changes in management's assumptions. We expect that many companies will want to consider a wider range of reasonably possible outcomes when performing sensitivity analysis on their cash flow projections and which should be disclosed and explained. Not all companies will require extensive disclosure, but where sensitivity or scenario testing indicates significant issues, relevant information and explanation should be reflected in the appropriate parts of the annual report and accounts, for example in the impairment disclosures. It will be for companies to decide whether Brexit uncertainties impact their statements on viability and even their ability to continue as a going concern.

The situation may well change between the balance sheet date and the date of signing the accounts. We remind companies to ensure that they incorporate a comprehensive post balance sheet events review in their year-end reporting plan, in order to identify both adjusting and non-adjusting events and to make the necessary disclosures required by IAS 10. 'Events after the Reporting Period'.

Complex supplier arrangements

Transparency of complex supplier arrangements and related financing arrangements remains an important issue. Where financing arrangements are in place, often enabling smaller suppliers to be paid in timely fashion, we expect the strategic report and the disclosures of financial instruments to describe the nature and amount of any material funding arrangement and the impact that it has on the company's liquidity. Our press notice on complex supplier arrangements, issued in December 2014, remains relevant to this area of reporting[3].

Further information on accounting issues relating specifically to the construction and support services sectors can be found in the FRC's press notice 'Accounting and reporting framework for the construction and business support services sectors' issued in January 2018.[4]

Risk and viability reporting

Risk and viability reporting remains an area of focus for investors. Viability reporting should be based on a robust assessment of the principal risks that would threaten the business model, future performance, solvency or liquidity of the company. We encourage boards to apply a two-stage process to the viability statement: firstly, assessing the future prospects of the company; and secondly, stating whether directors have a reasonable expectation that the company will be able to continue to operate and meet its liabilities as they fall due (potentially over a shorter period), drawing attention to any qualification or assumptions as necessary. Examples of how this has been applied by companies are included in the Financial Reporting Lab's implementation study issued in October 2018.[5]

8th Floor, 125 London Wall, London EC2Y 5AS Tel: +44 (0)20 7492 2300 Fax: +44 (0)20 7492 2301 www.frc.org.uk

I also take this opportunity to remind companies of the changes made to IAS 7 *Statement of Cash Flows*, which now requires disclosure of information that enables users to evaluate changes in liabilities arising from financing activities.[6]

Strategic report

Strategic reports provide an opportunity for the board to present a single, coherent narrative explaining and complementing the information in its financial statements. Those adopting IFRS 15's modified retrospective method of implementation face a particular challenge as comparatives for the prior period may not be consistent. We expect any such inconsistency to be identified and explained. The spotlight continues to fall on the impact that companies' activities have on their stakeholders. A commitment to clear and transparent presentation of relevant and material information and engagement with key stakeholders can make a significant difference to how companies are perceived.

Strategic reports remain an area that we regularly challenge in our monitoring work. We expect companies to ensure that their reports include a fair review of the company's business that is a balanced and comprehensive analysis of both performance and position, and to pay particular attention to the following areas.

Alternative Performance Measures ('APMs')

We expect all companies who report alternative performance measures to apply the Guidelines produced by ESMA which, in our view codify best practice in this area of reporting.[7]

We expect to see:

- definitions for all APMs used;
- good explanations for their use;
- reconciliations to IFRS amounts appearing in the financial statements;
- no greater prominence for APMs than measures directly stemming from the financial statements; and
- explanations for changes in APMs to be provided, which may include how they are defined or calculated.

Companies are also encouraged to read CRR's 2017 thematic report and an interim report by the Lab, *Reporting on Performance Metrics*, which highlighted that investors seek performance metrics that are aligned to strategy, transparent, in context, reliable and consistent.[8] [9] A final report which will contain examples of how this can be achieved in practice is due to be published soon.

Non-financial information statement

In July we issued our guidance on the strategic report,[10] incorporating the non-financial disclosure requirements which became effective in the 2017/18 reporting season.

The new requirements in sections 414CA and 414CB of the Companies Act 2006 were effective for the first time in the 2017/18 reporting season. Companies that are subject to the new requirements (traded companies, banking, and insurance companies with more than 500 employees) are required to include a non-financial information statement in their strategic report. The statement should include information (or references to where that information is disclosed in the strategic report) relating to environmental matters, employees, social matters, respect for human rights and anti-corruption and anti-bribery matters.

8th Floor, 125 London Wall, London EC2Y 5AS Tel: +44 (0)20 7492 2300 Fax: +44 (0)20 7492 2301 www.frc.org.uk

For companies within the scope of the new requirements, we expect disclosure to focus on the impact of its activities in respect of these matters, the policies it has in place, any due diligence processes introduced through which it assesses and tracks their effectiveness and the related outcomes.

Looking forward

On 24 September, FRC Chair Sir Win Bischoff wrote to company chairs, senior investors and proxy advisors setting out our expectations in terms of achieving high standards of governance practice and reporting. This is a substantial evolution of the Code and the FRC strongly encourages companies to start considering these issues now. Both the new Code and the requirement to include a section 172(1) report in the strategic report have effect from 1 January 2019.

Yours sincerely

Paul George
Executive Director Corporate Governance and Reporting
Email: P.George@frc.org.uk

[1] https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf

[2] https://www.frc.org.uk/getattachment/651205c1-6521-49b4-9590-9cba1d899a53/Judgements-and-Estimates-thematic-review-2017.pdf

[3] https://www.frc.org.uk/news/december-2014/frc-urges-clarity-in-the-reporting-of-complex-supp

[4] https://www.frc.org.uk/getattachment/6d16d67d-3b41-477c-b618-a979dbc70a79/Accounting-and-reporting-framework-for-the-construction-and-business-support-services-sectors.pdf

[5] https://www.frc.org.uk/getattachment/43c07348-e175-45c4-a6e0-49f7ecabdf36/Business-Models-Lab-Implementation-Study-2018.pdf

[6] http://archive.ifrs.org/Current-Projects/IASB-Projects/Debt-disclosures/Documents/Disclosure-Initiative_Amendments-to-IAS-7.pdf

[7] https://www.esma.europa.eu/sites/default/files/library/2015/10/2015-esma-1415en.pdf

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

[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/fb05dd7b-c76c-424e-9daf-4293c9fa2d6a/Guidance-on-the-Strategic-Report-31-7-18.pdf