FRC's Corporate Reporting Review

The Financial Reporting Council ("FRC") has published the results of its annual review of corporate reporting. Beliz McKenzie from Travers Smith LLP outlines the key issues and problems identified by the FRC in this year's reports, and the areas on which companies need to focus over the next year.

Introduction

Every year the Conduct Committee of the FRC conducts a review of the reports and accounts of a sample of public and large private companies to determine whether they comply with relevant reporting requirements. On 14 October 2014, the FRC published its 2014 Corporate Reporting Review Annual Report ("the Report") setting out its findings for the year ended 31 March 2014.

The Report is accompanied by a more detailed technical presentation of the FRC's findings, also available on the FRC's website (www.frc.org.uk).

The FRC's approach

Once it has reviewed a set of accounts, the FRC considers whether any potential matters identified are significant enough to require additional explanation or information from the company concerned. This year, it followed up on 37% of the 271 reports reviewed, which represents a slight increase from last year.

Virtually all of the FRC's correspondence results in companies agreeing to make a change to their next report and accounts. The nature of the change depends on the type, number and significance of the issues raised and ranges from replacing generic language with more tailored wording in an accounting policy, to amending figures or correcting other more significant data. The FRC receives undertakings from companies to make the changes and follows up where the promises are not delivered.

The FRC's engagement with companies is evidenced by references in companies' financial statements to the intervention of the FRC's Conduct Committee – a "Committee Reference". This is required when the FRC believes a company should publicly disclose the fact that the changes it is making to its reporting were promoted by the FRC's review.

The FRC also issues Press Notices, which are either generic or company-specific, when it feels that the changes being made are material to the accounts as a whole, represent an emerging trend or set a precedent. The Report includes statistics on the Press Notices and Committee References published since 2011 and summarises the matters giving rise to the Notices/References since the FRC's last report.

The FRC's findings

One of the FRC's key messages is that, as was the case last year, large public companies, particularly FTSE 350 companies, have maintained a good level of corporate reporting. The FRC notes that it tends to raise fewer questions on straightforward issues in relation to FTSE 350 companies than for smaller companies. However, there is a higher number of poorer quality accounts produced by smaller listed and AIM companies.

The FRC has found that smaller companies often struggle to account for "complicated transactions", such as innovative capital products or derivatives. It also notes the fact that its prioritisation of the accounts of FTSE 350 companies has meant that it tends to write to smaller companies later in the reporting season, which leaves less time to resolve any issues prior to publication of the next report and accounts.

The FRC has decided that simply reviewing more accounts and asking questions of the boards of smaller listed and AIM companies is not proving sufficient and so is now looking at ways of improving the quality of financial reporting by such companies.

The FRC began a three-year project in April this year and is currently gathering evidence of the causes of the challenges and exploring ways in which the problems may be resolved. In the second phase of the project the FRC will consider ways of encouraging companies to make improvements and come up with supporting actions.

At the end of the three years, the FRC will assess whether the project has achieved any improvement in the quality of reporting.

Areas of challenge

The Report identifies ten areas of corporate reporting that were commonly raised with companies during the year, and uses case studies to illustrate some of the issues. These broadly fall into two categories: technical accounting issues and qualitative corporate reporting issues.

Technical accounting issues

- **Pensions** – The FRC reminds companies of its generic Press Notice regarding changes to pension schemes that were structured to achieve a particular accounting effect and confirms that it will continue to consider such schemes when they are identified by its reviews.
- **Exceptional and other similar items** – The FRC seeks greater consistency in the treatment of "exceptional items" in companies' income statements and clearer accounting policies for exceptional items.
- **Critical judgements** – The FRC raised questions when either the precise nature of the judgement, or how it affected the company's financial statements, was unclear, for example when the disclosure of critical judgements simply repeated or referred to the relevant accounting policy. The FRC states that it will look at information on how the judgements have been made and audited, as disclosed in the audit committee report and audit report, when assessing the adequacy and

quality of disclosure in the financial statements.

◆ **Impairment** – This has featured on the "common area of challenges" list for the past few years. Although improvements have been made in disclosures, the FRC continues to raise questions in this area.

◆ **Taxation** – The Report identifies a number of issues around tax accounting, and it is clear that the FRC will scrutinise tax disclosures in great detail. Companies should therefore take care in preparing these.

◆ **Cash flow statements** – Although there has been a notable reduction in the number of questions raised, the FRC notes a few issues which still need to be addressed.

Qualitative aspects of corporate reporting

◆ **Business reviews/strategic reports** – The Report covers the transitional period for reporting and the FRC therefore looked at both business reviews and strategic reports, which have replaced business reviews for financial years beginning on or after 30 September 2013. Criticisms included inadequate explanations of key performance indicators; inappropriate focus on "good news"; and omission of significant explanations on the grounds that they had been previously published in the company's interims.

Companies should remember the FRC's guidance on the strategic report which was published earlier this year and which gives advice to companies preparing a strategic report so that it both meets legal requirements and addresses the needs of shareholders. The FRC says that it will write to companies where information required on greenhouse gas emissions, human rights and gender diversity – required for quoted companies – has been omitted.

◆ **Accounting policies** – The FRC criticises "boilerplate" descriptions which are not tailored to the company's business.

◆ **Principal risks and uncertainties** – There are continued improvements in disclosure. However, the FRC stresses that it will continue to follow up on instances where companies present a long list of possible risks without emphasising the most important ones.

◆ **"Clear and concise" (cutting clutter)** – The FRC is encouraging boards to dispense with immaterial matters in their reports and include only material or relevant disclosures. The FRC acknowledges that "cutting clutter" requires the exercise of judgement. Where it was unclear in the reports how judgement had been applied, the FRC has asked boards for further information about the basis of their conclusions. Companies should note that the Financial Reporting Lab's report "Towards clear and concise reporting" provides further guidance on the practical steps which companies can take to make reports clearer and more concise.

The FRC's recommendations

Emerging issues

The FRC highlights the following four "emerging issues" prompted by recent changes to IFRS (which is about to undergo some of its most significant changes since it became mandatory for UK listed companies) or legislation:

◆ **Pensions** – The revised pension accounting standard (IAS 19) has changed the way in which companies are required to recognise and measure pension costs and there are now disclosure requirements, for example in relation to minimum pension funding requirements. The FRC notes that it has seen only the first examples of the changes being implemented in this reporting cycle, and says that it will continue to monitor the adequacy of the information disclosed.

◆ **De facto control of subsidiaries** – the revised consolidation accounting standard (IFRS 10) states that companies must consider whether they exert "de facto control" over an entity (for example a large minority shareholder that effectively runs a public company) and, if so, include it in their consolidated financial statements. The FRC advises companies to carefully consider this change.

◆ **Acquired intangibles** – against a backdrop of increased M&A activity, the FRC states that companies considering acquisitions should take the opportunity to review their approach to intangible assets, such as brands or customer lists which are acquired as part of a business combination – these must be recognised separately from goodwill. The FRC will challenge companies which make acquisitions resulting in the recognition of material goodwill but few or no separate intangible assets. Companies should therefore have a robust process in place for the identification and recognition of such assets.

◆ **Other regulation** – The FRC states that, although the Large and Medium-Sized Companies and Group (Accounts and Report) (Amendment) Regulations 2013 (SI 2013/1981) – which brought in the changes relating to directors' remuneration reports – are not within its statutory remit, it will raise with companies apparent non-compliance with the rules when it is brought to the FRC's attention.

Practical guidance

This year's Report also includes guidance on how to respond effectively to a letter from the Conduct Committee and includes good practices which, if followed, should help to resolve matters earlier.

For example, the FRC suggests that companies should:

◆ respond to all questions raised;

◆ explain fully the board's judgements;

◆ engage fully and at an early stage with auditors;

◆ involve both the board and the audit committee; and

◆ show a willingness to consider alternative viewpoints expressed by the FRC.

It remains to be seen what impact the FRC's advice and initiatives will have going forward, especially on the reporting of smaller listed and AIM companies.

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The Financial Reporting Council recently published a two-page document summarising key areas from the Financial Reporting Lab's reports which companies may wish to consider in the next reporting cycle. In 2015 the Financial Reporting Lab intends to publish reports looking at corporate reporting in a digital world and on disclosure of dividend policy and capacity, as well as case studies supporting companies' efforts on clear and concise reporting.