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GAAP: Beyond the detail

Need to know
FRC publishes the *Corporate Reporting Review Annual Report 2014*

In a nutshell

The Financial Reporting Council ("FRC") has published its Corporate Reporting Review ("CRR") Annual Report 2014 ("the CRR report"). The CRR report highlights the main issues identified by the FRC's Conduct Committee ("the Committee') during the year ended 31 March 2014, illustrating these with case studies showing the concerns raised and how they were resolved. The CRR report is accompanied by a slide deck with detailed technical findings that further expand on the areas of challenge identified by the Committee.

The common areas of challenge in the report and the deck can be broadly split between **technical accounting issues** (such as correctly classifying cash flows or recognising liabilities in respect of pension schemes) and **qualitative issues** (such as the balance of information in the Strategic Report, or inclusion of immaterial information). Additionally, **emerging issues** prompted by recent changes to IFRSs or legislation and regulations which are likely to pose future challenges for preparers are identified.

The CRR report also includes information on the Committee's **operating procedures**, including suggestions on how companies might best respond to queries it raises on their annual report.

This need to know publication gives a combined overview of the issues raised in both the CRR report and its accompanying slide deck.

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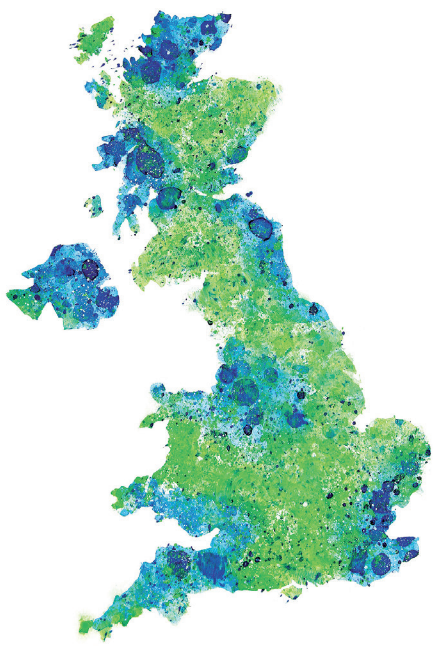
Overview of the report

Every year the Committee reviews the reports and financial statements of a sample of public and large private companies to determine whether they comply with the Companies Act 2006 and other reporting requirements. This activity was previously undertaken by the Committee's predecessor body, the Financial Reporting Review Panel. Where it appears that those requirements have not been complied with, the Committee investigates the position and determines the action to be taken to address any non-compliance. The activities of the Committee during the year form a large part of the CRR report.

The main message of the 2014 report is that there has been a good level of corporate reporting by large public companies, particularly those in the FTSE 350, but that a higher number of poorer quality annual reports are produced by smaller listed and AIM quoted companies. To address this, the FRC launched a three year project in April 2014 to drive a step change in the overall quality of reporting by smaller companies.



The report largely focusses on issues identified by the Committee in its reviews of annual reports, but it also includes information on recent developments, a summary of the FRC's CRR activities and advice on how the companies should respond effectively to communication from the Committee.

The CRR report is accompanied by a slide deck with detailed technical findings that expand on the areas of challenge identified by the Committee.

Technical accounting challenges

The report identifies a number of technical accounting issues that were commonly raised with companies during the year. The following areas were identified as the most significant issues.

- Concerns raised around **pension accounting** included the assessment of whether a surplus calculated in accordance with IAS 19 represents a recognisable asset and, conversely, whether a minimum funding requirement exists that necessitates the recognition of an additional liability under IFRIC 14. This matter was the subject of a company-specific Press Notice in October 2013, when the FRC concluded that a schedule of contributions prepared under section 227 of the Pensions Act 2004 between a company and its pension scheme trustee constitutes such a minimum funding requirement.

- Also in relation to **pensions,** a generic *Press Notice* was issued in January 2014, with the FRC warning Boards about arrangements, typically involving the use of Scottish Limited Partnerships, that purport to turn pension obligations into equity instruments. The FRC will continue to monitor such schemes when they are identified and has warned that it will "open an inquiry into the financial reporting of any company in which material pension liabilities are reclassified from debt to equity".

- Inconsistency in the treatment of **exceptional and other similar items** in companies' income statements was another area of focus. The main causes of concern included:

  – lack of or poorly described accounting policies;

  – inconsistent application period-on-period;

  – recurring or immaterial items reported as 'exceptional';

  – lack of symmetry between 'bad' news and 'good' news;

  – lack of comparative information.

  The report includes a case study on exceptional items which helps to illustrate the type of concerns raised and how they were resolved.

Case Study

The case study notes that a number of house-builders identified large provisions against inventory during the financial crisis as **exceptional items**. As the housing market recovered, the provisions were released or reduced through the sale of properties. Only in a very few cases was the release included in exceptional items or shown on the face of income statement. In most cases companies only included disclosures (with varying amounts of detail) relating to the release of these provisions in a note to the financial statements.

Following the Committee's intervention, **amendments made** included clarification of the accounting policy for exceptional items, treatment of the reversal of these provisions as an exceptional item or otherwise distinguishing it from recurring profit and improved disclosure of movements on inventory provisions.

The FRC will continue to **challenge** companies where insufficient information is provided on the impact of exceptional items, or their reversal, on the financial statements.

The use of adjusted performance measures, such as profit before exceptional items, is also an area of focus for global securities regulators, with both the European Securities and Markets Authority (ESMA) and the International Organisation of Securities Commissions (IOSCO) currently developing guidelines around their use in corporate reporting.

- Questions were raised around **critical judgements** when either the precise nature of the judgement, or how it affected the financial statements, was unclear. An example of this is where the disclosure of critical judgements simply repeats or refers to the relevant accounting policy, rather than explaining the judgement in its application. It is also expected that disclosures will differentiate between critical judgements and areas of estimation uncertainty and deal with both separately, even when they relate to the same item. When assessing the adequacy and quality of the disclosures required by IAS 1, the FRC will use information from the Audit Committee report on how judgements have been made, and from the Audit Report on how they have been audited.

- For several years the CRR report has featured asset **impairment** calculations and disclosures as a common area of challenge. Although there has been continuing improvement in companies' disclosures, questions continue to be raised in the following areas:

  – the description of key assumptions – where companies disclosed discount and growth rates, but not the key assumptions to which they were applied;

  – the way the values assigned to each key assumption are determined;

  – instances of a single discount rate applied to multiple CGUs with different risk profiles;

  – unclear or generic sensitivity disclosures; and

  – unrealistic assumptions (described in the CRR report as "heroic") regarding a short term turn-around in a loss-making business.

- The review has identified a number of issues around **tax accounting**, in particular in relation to insufficient disclosure around recoverability of deferred tax assets, lack of description of how the applicable tax rate was calculated and failure to recognise deferred tax on intangibles acquired in business combinations. The technical findings accompanying the CRR report provide more detail on the queries raised in this area, including:

  – unexpected items such as adjustments to share-based payments included in the reconciliation of profit to total tax;

  – tax relating to items recognised directly in equity being mistakenly classified in other comprehensive income rather than in equity; and

  – apparent discrepancies between explanations in the tax reconciliation and the business review on items such as prior year items and non-taxable income.

  These observations show the detail in which tax disclosures can be scrutinised and, therefore, the care that should be taken in their preparation.

  A case study helps to illustrate the issues raised around tax accounting and how they were resolved, including the FRC's focus points.

Case Study

The case study discusses a **scenario** where a company made accounting losses in the current and previous years and recognised net deferred tax assets relating to those losses. However, it failed to adequately disclose how, given its recent history of losses, there would be sufficient future taxable profits available to recover these assets. Although it transpired that management had performed a detailed assessment of future probable taxable profits, they did not disclose this information in the financial statements or include it as a key accounting judgement.

Following the Committee's intervention, **amendments made** included improvement to the disclosure on recognition of deferred taxes and inclusion of 'recoverability of deferred tax assets' as a key accounting judgement, with extended explanation of the nature of the supporting evidence.

The FRC will continue to **challenge** judgements on critical accounting issues, such as whether or not there is convincing evidence supporting recognition of a deferred tax asset for losses.

- There has been a noticeable reduction in the number of issues raised in respect of **cash flow statements**, however companies continue to misclassify cash flows (for example, classifying pension cash flows as financing), net items (such as loan drawdowns and repayments) inappropriately and report non-cash movements (including conversions of convertible debt) as cash flows. A range of minor mistakes was also noted, deemed by the Committee to be indicative of a lack of care. Since cash flow statements are one of the primary sources of financial information and the FRC continues to receive feedback that they are of significant value to investors, it will continue to monitor this area in the future.

As well as providing detail on the issues above, the slide deck of **detailed technical findings** highlights other areas in which the Committee has identified issues:

- property, plant and equipment – grouping of dissimilar assets into a single class, disclosures on the assumptions used in revaluing assets and the treatment of sales of assets previously held for rental

- intangible assets – the justification for long amortisation periods and for capitalisation of either all or no development costs

- capital management – failures to identify what is managed as capital and inconsistencies in the qualitative and quantitative disclosures on identified capital

- provisions, contingent liabilities and contingent assets – poor disclosure of movements in provisions, justification for cash outflows being deemed 'remote', aggregation of accruals and provisions or of different provisions into a significant class of 'other' and, specifically the amount recognised for **PPI mis-selling**

- presentation of financial statements – non-disclosure of proposed dividends, aggregation of dissimilar items such as accruals and deferred income and prepayments and accrued income and reclassifications and restatements made without the provision of a quantified explanation

Industry issues were also noted in respect of **resource companies**, specifically around the disclosure of key policies on recognition and impairment of exploration and evaluation assets, the use of undefined industry specific terms and a lack of clarity on the reserves used as a basis for impairment and depreciation calculations.

Emerging issues

The CRR report highlights a number of issues prompted by recent changes to IFRSs or legislation and regulations or where there has been an early indication of particular relevance in the near future.

- IAS 19, the revised standard addressing **pension accounting**, became effective for periods beginning on or after 1 January 2013 and as a result the Committee has only reviewed a few examples of reports which implement its changes. Although no substantive issues have been identified yet, IAS 19 changes the way in which pension costs are recognised and measured, including changes to the calculation of the financing element. It also introduces new disclosure requirements for the risks around defined benefit plans. The FRC expects companies to include quantitative, as well as qualitative, information on the governance of their pension plans and the applicable regulatory framework (e.g. the level of any **minimum funding requirements**), funding arrangements and maturity profiles in their revised disclosures.

- The guidance on **de facto control of subsidiaries**, introduced by IFRS 10, is a substantive change to the consolidation accounting standards and companies are encouraged to consider its impact carefully on initial adoption of the standard. 'De facto control' arises where a parent company may be able to control a subsidiary through its voting rights although it does not hold a majority of the voting shares. The CRR report notes that this is often seen in public companies where there may be a wide group of shareholders that do not tend to vote together and a large minority shareholder that, effectively, runs the company. The FRC will also consider the application of IFRS 10 more widely.

- When applying IFRS 3 to **business combinations**, companies should ensure that they have a robust process for the identification and recognition of **intangible assets**, such as brands or customer lists. These are required to be recognised separately from goodwill and measured at fair value (as defined by IFRS 13) when they arise from contractual or legal rights or can be sold or otherwise disposed of separately from the business. The FRC expects that with the UK's economic outlook improving, more companies will be entering into merger and acquisition activity and should be aware that they will be challenged where a business combination results in material goodwill but few or no separate intangible assets.

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- **Compliance** with the financial reporting requirements of the Companies Act 2006 will continue to be monitored, as well as compliance with **other relevant legislation and regulations**, such as legislation on remuneration disparity within a company. Although these are not within the statutory remit of the FRC's Conduct Committee, failure to comply will be drawn to the company's attention and confirmation sought that the relevant requirements will be complied with in the future.

- Companies are encouraged to report the likely effect of the changes to be introduced in 2017 by IFRS 15, **'Revenue from Contracts with Customers'**, as soon as this is, or should be reasonably estimable.

In response to requests, this year the CRR report includes guidance on how to respond effectively to a letter from the Committee.

Deloitte view
The accounting challenges and emerging issues discussed above provide a valuable list of technical challenges identified by the FRC and of areas likely to continue to be monitored by the Committee when reviewing future annual reports. It should be noted, however, that it is not intended to be exhaustive. As illustrated by the range of issues included in its detailed technical findings, the Conduct Committee can, and will, raise queries on any aspect of financial reporting.

Common qualitative areas of challenge

The following qualitative areas of corporate reporting also have been highlighted in the CRR report.

- Issues were raised around **Business reviews and Strategic reports**, including inadequate explanations of key performance indicators and inappropriate focus on 'good news'. For companies looking for guidance in this area, in June 2014 the FRC published *Guidance on the Strategic Report*, a comprehensive publication designed to help companies prepare a strategic report that meets both the requirements of the law and the needs of shareholders. As well as the FRC's guidance, we have also published our own *Strategic Report – A practical guide.*

- **Clear & Concise reporting (Cutting Clutter)** continues to be an area of focus for the FRC, with suggestions having been made that companies could dispense with, amongst other things, irrelevant or immaterial accounting policy disclosures and detailed discussion of new accounting standards unlikely to have an effect. The CRR report also notes that when writing to companies which had undertaken an exercise of eliminating extraneous material then, as part of its function of holding directors to account, the Committee has asked for future information on the basis for concluding that certain items were quantitatively or qualitatively material. However, the Committee expects companies to be robust in responding to such challenges rather than simply adding disclosures that the directors consider immaterial back to the financial statements. For companies looking to improve their reporting in this area, guidance is provided in the FRC's Financial Reporting Lab report *Towards Clear & Concise Reporting* published in August 2014.

- Although the report notes improvement in the disclosure of companies' **principal risks and uncertainties**, the Committee will continue to write to companies which present a voluminous list of possible risks without emphasising those they believe are most important.

- Concerns were raised around **accounting policies** which are 'boiler-plate' and not tailored to the facts and circumstances of the businesses, particularly with reference to revenue. A discussion of investor views on this issue can be found in the Financial Reporting Lab report *Accounting policies and integration of related financial information* published in July 2014.

Effective responses to the Committee's letters

In response to requests, this year the CRR report includes guidance on how to respond effectively to a letter from the Committee. It includes a number of good practices which, if followed, should help to resolve matters earlier. The main suggestions are:

- respond to all questions raised, explaining fully the board's judgements and how they comply with the requirements of IFRSs, and raising the Committee's understanding of the issue to that of the company;

- involve both the Board and the Audit Committee, as well as engaging in full and early with auditors, and clarify in the correspondence that these parties have been involved; and

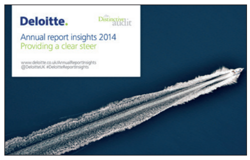
- show a willingness to consider alternative viewpoints expressed by the FRC.

Changes to the Conduct Committee's operating procedures

As well as publishing the CRR report, the FRC has recently amended the Conduct Committee's operating procedures. One of the main changes relates to way the Committee deals with non-compliance with the reporting requirements, whereby in future the CRR report will automatically include the names of companies that have published Committee References (references to the intervention of the Conduct Committee) in their financial statements rather than this inclusion being dependent on the relevant company agreeing to it.

Deloitte View

There is a significant degree of commonality between the issues identified by the FRC and those identified in our recent publication *Annual report insights 2014 – Providing a clear steer.* In particular, the supporting publication *A clear steer for your annual report* provides a wealth of ideas for improving the content of your annual report and the annual report preparation process, which will be of interest to those responsible for the preparation and review of the annual report.



Find these documents at:
www.deloitte.co.uk/annualreportinsights

Further information

The **Corporate Reporting Review annual report 2014** can be accessed on the FRC website, as well as the supporting slide deck of **technical findings**.

Information on previous pronouncements from the FRC and the Conduct Committee, as well as other UK accounting, reporting and corporate governance new and publications, can be found at **www.ukaccountingplus.co.uk.**

Contacts

If you would like further information on the FRC's findings, please contact your local Deloitte partner or:

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