Governance *in brief*

FRC advice on annual reports for 2021/22 reporting season

Headlines

- In a busy period for the FRC, its annual observations on key developments and areas of focus for 2021/22 annual reports have just been issued. This year the format has changed and is a bulletin aimed at CEOs, CFOs and audit committee chairs. Issued in advance of pre-year-end audit committee meetings, the FRC observes that its bulletin is "likely to be helpful" for all preparers, reviewers and auditors.
- The FRC has also published its Annual Review of Corporate Reporting along with a summary for those who do not require the full detail.
- With COP 26 underway the FRC draws attention to the importance of TCFD disclosures, mandatory for the first time for December year end reporters, urging that disclosure should be integrated into the annual report and avoid boilerplate. The Financial Reporting Lab has also published a report on developing practice in TCFD reporting and the FRC has published research on climate scenario analysis.
- Other areas highlighted for attention in forthcoming annual reports include:
  - the impact on financial reporting of the uncertainties around the COVID-19 pandemic, including judgements and estimates, going concern and liquidity, impairment indicators and recoverability of deferred tax assets;
  - the recommendations arising from the FRC's thematic reviews covering interim reporting, viability and going concern, provisions, contingent liabilities and contingent assets, alternative performance measures (APMs) and streamlined energy and carbon reporting (SECR);
  - discussion of all material items in the financial statements in the strategic report, including balance sheet items and cash flows;

- classification and presentation of cash flows; and
- enhancing governance reporting, particularly on remuneration, workforce engagement and diversity, through the use of examples and outcomes.

- The FRC corporate governance team's report on their review of reporting under the UK Corporate Governance Code is expected during November 2021.

The suite of FRC publications

In October 2021 the FRC issued three linked publications setting out corporate reporting expectations and areas of focus for the 2021/22 reporting season:

- Bulletin: Key matters for 2021/22 reports and accounts (Bulletin) – this includes a summary of the most important findings identified in the various FRC reports, thematic reviews and Financial Reporting Lab reports published during 2021.
- The FRC's Annual Review of Corporate Reporting 2020/21 (Annual Review) – this is the detailed publication and includes detail on the FRC's corporate reporting monitoring activity and findings over the year, case studies and example disclosures.
- Annual Review of Corporate Reporting 2020/21: Corporate Reporting Highlights (Corporate Reporting Highlights) – a short summary covering the key findings from the Annual Review and the FRC's expectations for reporting over the year ahead.

The FRC's Bulletin includes only limited observations from the Annual Review of Corporate Reporting 2020/21 and should be read in combination with either the Annual Review itself or the Corporate Reporting Highlights, depending on the level of detail required.

This Governance *in brief* brings together the key areas covered in the Bulletin and draws in other material from the Annual Review of Corporate Reporting 2020/21 and recent FRC publications on climate change reporting to provide a summary of the areas of focus for your reviews of annual reports this reporting season. This briefing is in three main sections:

- 2021 year-end reporting environment
- Other findings from recent FRC reports
- Annual Review of Corporate Reporting "Top Ten" findings

2021 year-end reporting environment

The first area mentioned by the FRC in its Bulletin is the ongoing economic and operational effects of the COVID-19 pandemic, along with an observation that no decline in reporting quality has been noted as a result.

The FRC reminds readers of the reporting extensions to FCA filing deadlines (for annual reports, from the usual 4 months to 6 months) which remain available for companies listed on a UK regulated market.

There is also a reminder of three amendments to IFRS endorsed by the UK Endorsement Board which should be considered in the forthcoming reporting season: COVID-19 related rent concessions beyond 30 June 2021; Interest Rate Benchmark Reform – Phase 2; and Extension of the Temporary Exemption from Applying IFRS 9.

Reporting on climate change

The main area highlighted by the FRC for particular attention in this year end's reporting environment is the introduction of the FCA's Listing Rule on climate-related reporting for commercial premium listed companies, applicable to December 2021 year-end reporters. Companies are required to report in line with the TCFD recommendations on a "comply or explain" basis (although the FCA expects appropriate explanations to be rare). The FRC reminds other market participants that there are consultations ongoing to extend the net of companies required to make the TCFD climate disclosures.

The FRC observes that many large companies have already started to implement the TCFD recommendations.

Areas highlighted for attention by the FRC include:

- Companies should ensure the information is not an "add-on" containing boilerplate messages; and
- Reporting is improved where better integrated with the description of the company's strategy with effective cross-referencing.

The Annual Review also highlights considerable scope for improvement in disclosure on climate change and emphasises that the FRC's Corporate Reporting Review team has challenged and will continue to challenge companies' assessments of the effect of climate change on areas of the financial statements, including asset impairment.

Taskforce on Climate-related Financial Disclosures (TCFD): ahead of mandatory reporting

The Financial Reporting Lab published Ahead of mandatory reporting in late October 2021. This explores the pathway to mandatory TCFD disclosure and investor expectations, accompanied by multiple examples of disclosures that investors have found useful.

The Lab highlights the following key questions for companies to consider as they respond to each of the four TCFD disclosure pillars. The Appendix to its report includes more detailed questions that supplement each of these areas.

Governance and management	Business model and strategy
• What arrangements does the board have in place for assessing and considering climate-related issues? • What information helps the board understand the company's climate risk profile? • Does the board consider the company's climate-related reporting to be fair, balanced and understandable? • What arrangements does the Executive Committee, and divisional management, have in place for assessing and considering climate-related issues, and who has responsibility for them?	• What opportunities and risks concerning climate-related issues are most relevant to the company's business model and strategy? • What does the company look like in the future and how will it continue to generate value? • What strategy has been put in place to reach Net Zero or other targets, and what operational or capital expenditures are needed to address any necessary business model changes? • How are the risks and opportunities reflected in the financial statements?
Risk management	**Metrics and targets**
• What systems and processes are in place for identifying, assessing and managing climate-related risks? • How are the risks from climate change being monitored, including decisions around mitigation, transfer, acceptance and control? • How is the assessment of the company's viability over the longer term taking into account climate-related issues? • When undertaking scenario analysis, how did the company decide on which scenarios to use, and what assumptions have been made?	• What performance information is most relevant to monitoring and managing the impacts of climate-related issues (both on the company and of the company)?

In addition to disclosures that answer the questions above, the Lab also flags some specific issues raised by investors which were reflected in 2020's Climate Thematic Review:

- There is a lack of sufficient **detail and specificity on the impact of climate** on business model and strategy.
- Disclosures of risks and opportunities arising from climate change impacts on the business model are of mixed quality, with a **lack of substance on how strategy will be adapted**, or there is much more emphasis on opportunities than on risks. More information on prioritisation, likelihood and impact, and the timeframes over which risks and opportunities might crystallise is needed.
- **Reporting on scenarios** remains a key area of investor interest, but is an area of weaker disclosure. Some companies disclose climate change scenarios that may affect viability, but detail is scarce.

- Pledges and indicators related to Net Zero are often ill-defined and difficult to understand and compare; and have the potential to be misleading. **'Aims' and 'ambitions' should be clearly distinguished from policies which are actively being pursued** and included in business plans and budgets.
- There is a lack of explanation of performance against set targets and a **disproportionate focus on 'good news stories'** related to a small part of the business. Outcomes for the business as a whole should be reported.
- **Scope and basis of calculation of metrics is often unclear**.

The Lab explains that high quality reporting under the four pillars and eleven disclosures set out by the TCFD should address all of these investor challenges.

On the key topic of reflecting climate change in the financial statements, the Lab reminds companies that this is important to investors and in particular that companies should ensure consistency between the front and back half of the annual report, ensuring forward-looking assumptions and judgements used to prepare the financial statements are consistent with the narrative discussion of climate change.

It also pulls together a selection of other reminders based on other FRC publications:

- Put thought to more informative disclosures outlining the impact of the company on the environment, which tend to be less developed than disclosures on the challenge climate change poses to the company.
- SECR disclosures may not be the most appropriate metrics to meet the TCFD unless they are representative of the whole group's emissions.
- Companies should consider how to explain which disclosures are included in the annual report, compared to other standalone reports, to meet FCA requirements.
- On climate scenario analysis, companies should work to improve disclosure in the following areas:
  - linking disclosures of climate risk mitigation plans to discussions around climate scenarios;
  - being more explicit in climate scenarios in considering the impacts of climate change on the company's customers or suppliers; and
  - reflecting results of climate scenario analysis in the viability statement.

Climate scenario analysis: Current practice and disclosure trends

This FRC-commissioned research was conducted by the University of Manchester Alliance Business School based on interviews and reviews of disclosure. The main focus of the research is on the use of scenario analysis by companies and practical steps companies have taken to get started, together with challenges and good practice.

Although reporting is not the primary focus of the research, the report highlights a number of features of climate scenario analysis disclosure that are worth considering by companies when drafting their annual reports:

- there is a challenge to resolve the conflicting demands of explaining how the company is prepared for various futures whilst appearing stable and predictable, highlighting the need to explain the rationale behind climate scenario analysis not being a forecasting technique but a way of preparing for a complex and uncertain future;
- disclosures tend to be aligned and integrated with the TCFD recommendations, including illustration of where climate scenario analysis sits within the governance structure and scenarios underpinning the analysis. However, the research highlights that it is often unclear how companies determine what level of information to include in the annual report;
- there was little disclosure of rationale guiding the selection of particular scenarios, including why other scenarios had not been chosen, and little disclosure of the financial impacts; and
- very few disclosures explicitly linked climate-related KPIs and targets to the insights from climate scenario analysis and how the analysis impacts strategy and business planning.

In summary, there is much for companies to improve in climate reporting.

Other findings from recent FRC reports

Thematic reviews and Financial Reporting Lab reports

Annual report area	Findings to consider when reviewing the annual report
Viability and going concern (thematic review)	• Disclosure of inputs and assumptions used to support viability and going concern assessments often lacked sufficient qualitative and quantitative detail. • Where significant judgements have been applied they should be identified and explained. • Companies are encouraged to extend the period over which they assess viability and to provide longer-term information where possible.
Alternative performance measures (APMs) (thematic review)	• Adjustments mainly resulted in the exclusion of costs, resulting in more favourable adjusted results than IFRS results – companies should focus on IFRS measures having sufficient prominence and discussion. • Companies should avoid descriptions of APMs that imply they are more useful or reliable than their IFRS equivalents. • More granular information in explanations of APMs and adjusting items would be useful.
Stakeholders, decisions and s172 (Financial Reporting Lab report)	• Users want to understand how a company is progressing towards fulfilling its purpose and achieving long-term success; better information on both stakeholders and decisions can help with that understanding. • Section 172 statements can act as a helpful bridge between these two types of information. • The report includes a series of questions for companies and examples of reporting that investors find useful.
Risks and scenarios (Financial Reporting Lab report)	• Despite companies updating their internal processes regarding risks and scenarios, particularly since the start of the pandemic, there is not enough information in annual report disclosures that explains these processes and the changes to them. • The report includes the information on risks, uncertainties and opportunities that contributes to investors' understanding of a company's business model, longer-term strategy, resilience and viability and examples of reporting that investors find useful.
Provisions, contingent liabilities and contingent assets (thematic review)	• Consider improving reporting on the disclosure of quantitative information on the expected timing of future economic outflows, the key assumptions used to estimate those outflows, and the associated uncertainties. • Clarify the nature of the costs included in certain types of provision. • Disclose more specific accounting policies. • Provide more quantitative information about contingent liabilities.
Streamlined energy and carbon reporting (SECR) (thematic review)	• Disclosures need to be understandable and relevant, including explaining the methodologies used and the extent of any third-party assurance. • Good practice includes disclosure of Scope 3 emissions and information about emissions-reduction targets, 'net zero' strategies, or other emissions reduction commitments.

Review of corporate governance

In the Bulletin, the FRC highlights the work it has done in advance of legislation giving it powers over the full annual report. The FRC has been writing to companies about areas of corporate governance disclosure and believes that its activities have led to an improvement in reporting and it plans to continue.

The key observations raised by recent corporate governance focused reports are the importance of reporting on outcomes, rather than process, and the importance of reporting clearly any departures from Code provisions, supported by effective explanations.

The FRC also notes the research it commissioned into remuneration, workforce engagement and diversity and identifies a common theme that disclosures often lacked detail and appeared to be boilerplate. Again, the use of examples and outcomes is encouraged to improve reporting in these areas, particularly where there have been board level discussions, improvements implemented in governance or engagement with stakeholders on these matters.

The FRC's 2021 review of corporate governance reporting is expected in November.

Annual Review of Corporate Reporting "Top Ten" findings

The table below summarises the "Top Ten" key findings from the FRC's Annual Review of Corporate Reporting, published in October 2021. The Annual Review has been accompanied by the Corporate Reporting Highlights which covers some key findings and the FRC's expectations for reporting this year.

The CRR explains that routine monitoring of 2021/22 annual reports will focus on climate-related risks and disclosures and on judgements and estimation uncertainty in the face of the continuing impact of the pandemic.

Area of focus	Description
Judgements and estimates	Companies should ensure that they: • explain the specific accounting judgements made and their effects on the financial statements; • identify assets and liabilities at risk of material adjustment within the next financial year and the key assumptions underlying their measurement; and • provide information about the sensitivity of assumptions to changes, or ranges of possible outcomes.
Revenue	Companies are expected to provide accounting policies for all significant areas of revenue, which cover the timing of revenue recognition, the basis for recognising any revenue over time, and the methodology applied. They should also: • explain the nature of any variable consideration and how it is estimated; • explain any constraint to recognition of variable consideration and consider alignment to disclosures, particularly if those refer to a significant risk of a downward adjustment to revenue; • disclose significant judgements, for example, in relation to the allocation of the transaction price and the timing of satisfaction of performance obligations.
Statement of cash flows	The FRC continues to observe issues with cash flow statements, including those that should be captured through robust pre-issuance reviews. Those reviews should ensure: • consistency of reported cash flows with amounts reported elsewhere in the report and accounts; • classification of cash flows and cash and cash equivalents complies with the requirements of the standard; and • cash flows are not inappropriately netted.

Statement of cash flows	Other areas raised include: • disclosure of material non-cash transactions; • reconciliation of changes in financing liabilities; and • the presentation of the parent company cash flow statement.
Impairment of assets	Climate change and the continuing effects of the COVID-19 pandemic mean that impairment remains an area of focus. Impairment indicators should be followed up robustly and, where mentioned elsewhere in the annual report, it should be clear how they have been reflected in impairment reviews. Companies should also consider disclosure covering: • whether the key assumptions used in impairment reviews are consistent with past experience or external sources of information; • reasons for any significant changes in the assumptions; • whether reasonably possible changes could result in an impairment; and • information about impairment testing of investments in subsidiaries.
APMs	APMs should not receive more prominence than IFRS figures, for instance through management commentary that focuses on APMs. Companies should ensure: • they disclose the basis for classifying amounts as adjusting; • they include reconciliations of APMs to the most directly reconcilable line item presented in the financial statements; and • they bear in mind that adjustments should include gains as well as losses, where relevant. Also see the findings of the Thematic Review above.
Financial instruments	Companies should disclose the use of factoring or reverse factoring, where relevant. They should also disclose the approach and significant assumptions applied in the measurement of expected credit losses; and concentrations of risks and information about covenants, where material.
Strategic report and the Companies Act	Points highlighted for attention include: • the balance of the strategic report, covering both positive and negative aspects without bias; • highlighting and explaining linkages between information in the strategic report and elsewhere in the annual report and financial statements; and • a reminder, echoing previous years' reminders, that there are specific statutory requirements around distributions that include filing accounts for interim distributions in excess of previously reported retained earnings.
Provisions and contingencies	Describe the nature of each material provision or contingency, together with the timeframe over which it is expected to become certain and the basis used to determine the estimate of the outflow. Also see the findings of the Thematic Review above.

Area of focus	Description
Leases	Companies should disclose entity-specific accounting policies for material areas. Judgement areas around definition of a lease and length of lease should be explained. Companies should provide enough information in the notes to enable users to assess the effect of leases on financial position, performance and cash flows.
Income taxes	Companies should describe the nature of the evidence supporting the recognition of material deferred tax assets, together with any significant accounting judgements or sources of estimation uncertainty.

Deloitte view

- We welcome the timely publication of this bulletin aimed at Audit Committee Chairs, CEOs and CFOs, as there is much to evaluate and consider this year when reporting, including for the first time the challenge of mandatory TCFD disclosures for premium listed commercial companies.
- Whilst none of the areas raised are surprising, the advice provides a timely reminder for management and for audit committee agendas for the period ahead. The cross-references to thematic reviews, to Lab reports and to the Corporate Reporting Highlights accompanying the CRR's Annual Review of Corporate Reporting indicate just how much there is to contemplate when preparing this year's annual report.

For further information

Bulletin: Key matters for 2021/22 reports and accounts

The FRC's Annual Review of Corporate Reporting 2020/21

Annual Review of Corporate Reporting 2020/21: Corporate Reporting Highlights

FRC Lab report: TCFD: ahead of mandatory reporting

FRC-commissioned research: Climate scenario analysis: current practice and disclosure trends

Deloitte's Annual report insights 2021: Surveying FTSE reporting

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For further details about the Deloitte Academy, including referring colleagues for membership, please email enquiries@deloitteacademy.co.uk.

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