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The Deloitte Academy
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Governance *in brief*

FRC issues advice on annual reports for 2020/21 reporting season

Headlines

- The FRC has issued its annual open letter covering its perspectives on key developments and areas of focus for 2020/21 annual reports. This year the letter is addressed to CEOs as well as to finance directors and audit committee chairs.
- The FRC highlights in the letter that a summary of its Annual Review of Corporate Reporting was published this year, aimed at directors, and that this summary should also be considered in preparing for the year end.
- As expected, the key focus area this year for the FRC relates to the general 2020 reporting environment and the impact on financial reporting of the uncertainties around COVID-19 and the impact of the UK's exit from the EU.
- Other areas highlighted for attention in forthcoming annual reports include:
  - climate change and the outputs of the thematic review published in November 2020;
  - reporting on revenue under IFRS 15, focusing on the specific circumstances of the company;
  - reporting on leases under IFRS 16;
  - reporting on cash flows and liquidity risk;
  - section 172 statements and reporting on workforce engagement; and
  - succession planning, diversity and the tenure of the chair.
- The FRC corporate governance team's report on their review of reporting under the 2018 UK Corporate Governance Code is expected shortly.

2020 year-end reporting environment

The first area covered by the FRC in its letter is a reminder of the economic uncertainty arising from the COVID-19 pandemic and the commercial and operational changes that will result from the UK's exit from the EU.

The FRC reminds preparers of the extension to FCA filing deadlines (for annual reports, from the usual 4 months to 6 months) which remain in place for companies listed on a UK regulated market for financial periods ending before April 2021.

COVID-19 and its impact on corporate reporting

The FRC encourages preparers to refer to its earlier materials and joint statements around reporting under COVID-19. Deloitte's Need to know: Accounting considerations relating to the coronavirus 2019 disease is updated regularly and provides a helpful analysis of accounting matters under IFRS and FRS 101.

Areas highlighted by the FRC from its previous materials include:

- the information that investors consider critical to understand the impact of COVID-19:
  - currently available cash and other resources;
  - key actions that management has taken and is planning to take;
  - longer-term impacts on business model and strategy; and
  - the board's assessment of going concern and viability and how they have reached that assessment.
- disclosure of relevant sensitivities or ranges of possible outcomes where judgements have been made involving significant estimation uncertainty;
- quantification of the effect of COVID-19, without arbitrarily splitting items in financial statements;
- in considering future prospects, clearly articulating the impact of COVID-19 on business model and strategies, and how the changes are compatible with forecasting assumptions used in the financial statements; and
- disclosure and explanation of any significant judgements in determining whether or not there is a material uncertainty in relation to going concern, or deciding whether impairment indicators exist.

Impact of UK exit from the European Union

The FRC strongly encourages companies to assess carefully what information about the likely impacts of the UK's exit would be most relevant to users, explaining:

- company-specific risks and uncertainties;
- the potential impacts on different parts of the business; and
- any effects on the financial statements (sources of estimation uncertainty, amounts at risk, ranges of potential outcomes).

Narrative reporting and corporate governance matters

Section 172 statements and reporting on workforce engagement

The FRC states that many directors did not explain sufficiently how they have discharged their s172 duty, in particular the matter regarding the likely consequences of decisions in the long term. It also highlights the importance of explaining whether there is a two-way dialogue with stakeholders, how the feedback received affects board decision-making and describing how each company has met the requirements in its specific circumstances.

It also highlights certain key findings of the Financial Reporting Lab's reporting tips, on which a Deloitte newflash is available.

In advance of the FRC's corporate governance team's report on implementation of the 2018 Code, expected later in November, the letter draws out certain matters where the FRC expects companies to improve workforce engagement reporting:

- how employee-related issues and concerns are elevated to the board;
- the basis on which views are promoted to board discussion and direct actions arising from those discussions; and
- how the company relays back to the workforce its decisions on feedback provided by its activities.

Chair tenure and related governance matters

Other areas where the FRC expects urgent attention:

- companies should offer detailed and transparent explanations of their unique position with regard to succession planning for the departure of the Chair or other directors, bearing in mind that effective succession planning should build sufficient time into the process for a smooth transition; and
- include details of proactive measures taken to identify individuals who are part of the pipeline to achieve a diverse leadership team.

Observations from thematic reviews

Climate change

The FRC published its thematic review on climate change on 10 November 2020. The FRC highlights that, although companies usually comply with Companies Act requirements, there remains a gap between company disclosures and investor needs.

Companies are encouraged to:

- In the front half:
  - clearly describe environmental policies and give a balanced description of how they have been incorporated into business plans and their expected business impact, with appropriate use of key performance indicators, where relevant;
  - explain terminology used such as "net zero" or "Paris compliant";
  - explain emissions targets, how progress will be measured and any assurance that will be sought;
  - provide disclosure enabling users to understand the relative size of operations for which climate change presents substantially different risks and opportunities; and
  - describe the impact of their businesses on the environment, including their supply chains.
- In the financial statements, explain the impact of climate-related risks, policies and strategies on measurement and disclosure, including:
  - impairment of individual assets and cash generating units;
  - useful economic lives of assets
  - expected timings and amounts of cash outflows for provisions and other liabilities;
  - fair values of assets and liabilities; and
  - disclosure of key accounting judgements, estimation uncertainties and related sensitivities.

Thematic reviews on IFRS 15 "Revenues from Contracts with Customers" and IFRS 16 "Leases"

The FRC outlines some key findings of these two thematic reviews to bear in mind when preparing year end financial statements:

- IFRS 15: clearly describe performance obligations, the timing of revenue recognition and any significant judgements; explain significant movements in "contract balances"; report revenue information consistently in the strategic report and the financial statements; explain types of variable consideration and how each is estimated and constrained.
- IFRS 16: ensure accounting policies for material items are entity-specific; include explanations that have sufficient detail to enable users to understand significant judgements (for instance, in relation to lease term, or items outwith the scope of IFRS 16); include sufficient detail on disclosure principles and detailed disclosure requirements.

Thematic review on cash flow and liquidity

The FRC's thematic review has been published, highlighting the following areas for attention:

- a clear explanation of matters considered in assessing going concern, viability and liquidity;
- disclosure of methods, assumptions and judgements made in assessing going concern and viability;
- improved information around compliance with covenants and covenant testing;
- consistency in amounts and descriptions of items in the cash flow statement with other areas in the annual report, including the strategic report, other primary statements, other notes such as disclosures of changes in financing liabilities; and
- disclosure of accounting policies and judgements on the cash flow statement, especially for large, one-off transactions.

Annual corporate reporting review

The FRC's letter encourages directors to read the summary of the FRC's annual corporate reporting review, published in October 2020. The table below summarises the key findings.

Area of focus	Description
Strategic Report	This year the FRC has highlighted the following points: • improving section 172 disclosures with describing *outcomes* of the process, linking identified stakeholders, relates risks and impact on business model; and finally providing examples of decisions; • considering the impact of climate change on the organisation; • comprehensiveness of the strategic report, for instance reflecting key changes in income statement, balance sheet and cash flows in financial reviews; • providing thoughtful and accurate references for non-financial information matters, making sure those resources actually meet the legislation requirement; and • describing not only positives, but also difficulties or downturns.
Statement of Cash Flows	The FRC continues to observe issues with the cash flow statement and strongly encourages companies to pay particular attention to the correct classification of cash flows, avoiding inappropriate netting of gross cash flows and the disclosure of non-cash changes in financing liabilities.

Judgements and Estimates	More companies tailored their disclosures on judgements and estimates. However companies should ensure that they: • explain critical judgements around the accounting for difficult, subjective or complex transactions; • explain key assumptions and illustrate the impact of reasonably possible changes on reported results; • quantify estimation uncertainties, for instance through sensitivity analyses or by disclosing the range of reasonably possible outcomes; • use cross-referencing accurately throughout the financial statements; • quantify the values given to key inputs and assumptions; and • provide an explanation of judgements and estimates with regard to matters where there is no specific guidance within IFRS.
Impairment of Assets	Companies are expected to consider carefully the requirements for disclosures, for instance, quantification of the value assigned to key inputs and assumptions impacting headroom; describing the impairment testing method; disclosure of impairment losses; specifying the nature of CGUs.
Revenue	All companies are expected to tailor their disclosures to provide sufficient qualitative and quantitative information to enable users to understand the nature, amount, timing and uncertainty of revenue and cash flows from contracts with customers. In particular they should consider: • disclosures about performance obligations, e.g. significant judgements made in determining whether a contract contains multi-element arrangements; performance obligations delivered over time; • accounting policies and disclosures around determining transaction price in business combinations (including the variable consideration constraint); • clarifying any contract modifications that have occurred during the period; and • setting out clearly whether the entity is acting as an agent or a principal.
Financial Instruments	Companies are reminded that supply chain financing arrangements, including reverse factoring transactions, are currently an area of focus for the FRC. In particular, companies are expected to disclose sufficient details on expected credit losses, such as methodology used to assess recoverability; factors in considering credit risk.
Alternative Performance Measures ("APMs")	All companies that report APMs should apply the Guidelines produced by ESMA. In particular, companies should: • explain the rationale and consistency of adjustments made; and • provide a reconciliation to the closest equivalent IFRS line item.
Provisions and Contingencies	In relation to provisions and contingencies, companies should ensure that they provide sufficient details in disclosures, for example, the timing of third-party claims and high-level information about legal provisions, and clarify the measurement method, such as the discount rates applied.
Fair Value Measurement	Companies are expected to provide a description of valuation techniques used, even when the valuation is performed by a third party.
Business Combinations	Companies should provide information about discount rates applied and commodity assumptions, methodology and assumptions applied to estimating fair value of deferred income.
EPS and unlawful distributions	Companies are expected to consider carefully the calculation of EPS and be mindful about rules of distributions.

For further information:

The FRC's year end letter to CEOs, CFOs and Audit Committee Chairs is available here.

The CRR Annual Review of Corporate Reporting, summary report and press release are here.

FRC Thematic Reviews:

Time to raise the bar on climate change reporting is available here.

Review of financial reporting effects of COVID-19 is here.

IFRS 15 "Revenue from Contracts with Customers" follow-up thematic review is here.

IFRS 16 "Leases": A thematic review of disclosures in the first year of application is here.

Thematic review: Cash flow and liquidity disclosures is here.

FRC Financial Reporting Lab:

Reporting in times of uncertainty – a look forward is here.

Tips on s172 is here and the Deloitte newsflash is here.

Deloitte's Need to know: Accounting considerations relating to the coronavirus 2019 disease

Deloitte's Annual Reporting Insights 2020.

Deloitte view

- We welcome publication of this advice for Audit Committee Chairs, CEOs and CFOs, as there is much to evaluate and consider this year when reporting, including the challenges of COVID-19 and Brexit.
- Whilst none of the areas raised in the letter are surprising, this advice provides a timely reminder for audit committee agendas for the period ahead. The letter is not only detailed, it also cross-refers to the summary report on the CRR's Annual Review of Corporate Reporting, where in prior periods messaging arising from that report have been built into the letter, indicating just how much there is to contemplate when preparing this year's annual report.
- CEOs, CFOs and Audit Committee Chairs should take note that the FRC has called out the timetable extensions permitted by UK regulators and encourages companies to consider their timetables for 2021 annual reports. Our experience is that complex accounting and financial reporting matters are taking more time than usual for preparers, meaning more time is required for meaningful challenge by the the auditor and the audit committee. In the interests of high quality financial reporting and high quality audit, we agree strongly with the FRC's call for pragmatic reporting timetables.

The Deloitte Academy

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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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