Accounting Technical Services

Hot Topic

FRC's Annual Review of Corporate Reporting 2019/20 – Key Highlights Checklist

November 2020

FRC's Annual Review of Corporate Reporting 2019/20 – Key Highlights

Introduction and overview of the FRC's key findings

Introduction

This Hot Topic sets out the key highlights identified by the Financial Reporting Council ("FRC") in their Annual Review of Corporate Reporting for 2019/20 by providing a checklist of the common areas where companies tend to be non-compliant, poor on quality, or omit from their financial statements.

The checklist therefore sets out the common areas that companies should ensure they include and improve within their financial statements, as well as those that they should look to avoid within their reporting.

Quality of corporate reporting

The table opposite sets out the top ten topic areas that arose most frequency when the FRC conducted its reviews of the 216 annual reports for 2019/20, along with the corresponding place for each topic area within the top ten for the previous two years.

The FRC's key findings were:

1. The overall quality of reporting by UK companies has remained consistent in recent years, and whilst the topics have remained similar, the specific nature of the issues has evolved.
2. Gradual improvements in the quality of reporting were identified in certain areas, however judgements and estimates continue to be the key topic area that present the most issues.
3. Companies should aim to meet the overall disclosure objectives of financial reporting, being "to provide financial information that is useful to a wide range of users in making economic decisions", as well as seeking to meet the detailed reporting requirements of specific IFRSs.
4. Companies should look to 'step back' to consider the overall picture presented by the annual report. This should promote:
   - consistency between different parts of the annual report and accounts;
   - coherent approaches to going concern, viability, impairment and other key areas of estimation assumptions; and
   - connections between different parts of the annual report, where clear linkage through signposting and cross-reference enhances users' understanding.

Topic	2019/20	2018/19	2017/18
Judgements and Estimates	1	1	1
Impairment of Assets	2	4	6=
Revenue	3	10	5
Financial Instruments	4	8=	-
Alternative Performance Measures	5	3	2
Strategic Report	6	2	3
Statement of Cash Flows	7=	5	9
Provisions and Contingencies	7=	7	10
Fair Value Measurement	9=	8=	-
Business Combinations	9=	-	-

Priorities for 2020/21

The FRC has stated that its focus for the forthcoming 2020/21 cycle will be on:

i. disclosures addressing risk, judgement and uncertainty in the face of the ongoing economic and social impact of Covid-19;

ii. the potential consequences of geopolitical tensions and the UK's exit from the European Union; and

iii. climate-related risks.

The Group should, therefore, communicate clearly and concisely its expectations of the possible impacts of these factors on the business and its operations, as well as consider the financial reporting implications of the specific circumstances, such as the impact on debtor recoverability, inventory provisioning, impairment testing and fair value measurement of pension scheme assets.

Impact of Covid-19

The FRC's Review was based on company annual reports for periods up to 31 October 2019, **therefore it did not cover the impact of Covid-19**. However, the FRC has set out its expectations for companies preparing their forthcoming annual reports – Refer to the separate Hot Topic: *Reporting on the impact of Covid-19 – Key disclosure expectations for 2020/21.*

FRC's Annual Review of Corporate Reporting 2019/20 – Key Highlights

Checklist of key points raised by the FRC

Topic	What to provide:		What to avoid:

1. Judgements and Estimates	**Critical judgements**	• Disclosures are tailored to the company's specific circumstances.
		• Disclosures should:
		  • explain the *specific* judgements made and the *effects* of those judgments;
		  • explain the judgments made in concluding that there are no material going concern uncertainties; and
		  • identify specific amounts at risk of material adjustment (rather than simply saying the amounts are at risk).
			• **Repetition of the standards:** Simply just repeating the requirements of the accounting standard when explain the judgment that has been made.
			
			• **Limited information:** *Only* giving a cross-reference to the relevant note to the financial statements (unless all the required information about the judgment or estimate is provided in the note).

	Sources of estimation uncertainty	• Disclosures should be *quantified* through sensitivity analyses or ranges of outcomes. • Values should be assigned to key inputs and assumptions. • Where cross-references to notes are given, ensure the required information is provided in the note.	
2. Impairment of Assets	***Companies are expected to focus on impairment in the light of the economic effects of Covid-19***		• **Boilerplate terminology:** Avoid the use of boilerplate information, such as about the basis/nature of CGUs and the basis for carrying out value in use testing (based on the requirements of the standard).

	Indicators of impairment	• Where there has been an indicator of impairment for investments, tangible or intangible assets, ensure the following is explained:
		  • the outcome of the judgement (i.e. whether the indicator resulted in an impairment or not);
		  • the basis for the assumptions made; and
		  • any sensitivities to changes in those assumptions.	

	Cash generating units ("CGUs")	• Disclosures should give specific information about:
		  • the basis on which CGUs are identified; and
		  • any changes year-on-year, such as the reason for changing the basis of the CGUs and methodology applied.	

	Future cash flow	• Disclosures should explain:
		  • the selection and quantification of assumptions when modelling future cash flows, and:
		  • the effects of sensitising those assumptions on any headroom in calculations.	

	Sensitivity analysis	• Values should be assigned to key assumptions and headroom.	
	Discount rate	• Explanations should be provided about how discount rates have been derived.	
	Impairment losses	• Disclosures should give information about the losses reocgnised in the year e.g. the recoverable amount of the impaired asset and the events and circumstances that led to the impairment.	

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3. Revenue from Contracts with Customers	**Revenue recognised over time**	• Disclosures should explain:
		  • the basis for selecting this accounting policy; and
		  • the basis for monitoring how performance obligations are satisfied over time.
			• **Insufficient explanations:** Where there have been significant and/or unusual transactions, sufficient information should be provided to explain the effect on the financial statements. Common unexplained areas include:
			  • Contract modifications;
			  • Contract assets and liabilities; and
			  • Acting as a principal vs agent

	Revenue recognised at a point in time	• Fuller explanations should be provided e.g. explaining why dispatch of goods coincides with the transfer of control.	
	Arrangement with multiple elements	• Disclosures should clearly explain any significant judgments made in identifying relevant performance obligations, whether one performance obligation or many.	
	Variable consideration	• Accounting policies should explain the nature of any variable consideration receivable and how it is estimated and constrained.	
4. Financial Instruments	**Other financial assets**	• Disclosures should be provided about the recoverability of other financial assets (e.g. parent company receivables from subsidiaries and 'other' financial assets) along with the methodology used to assess recoverability.	
	Estimation of ELC provisions and credit risk	• Disclosures should quantify weightings applied to forward-looking economic scenarios and quantify key variables. • Explanations should be given about the factors considered when determining whether there had been a significant increase in credit risk (i.e. quantitative and qualitative thresholds triggering a transfer form stage 1 to stage 2).	
	Liquidity risk	• Given the current economic circumstances, additional information will be expected in relation to: liquidity risk management, covenants, and the use of drawn and undrawn facilities.	

	Factoring and reverse factoring arrangements	• Disclosures should be provided about such arrangements, including:
		  • the effect on the balance sheet and cash flows;
		  • the accounting policies applied; and
		  • the effect on covenants.	

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5. Alternative Performance Measures ("APMs")	**Reconciliations to GAAP measures**	• Reconciliations should be given for all APMs, including ratios, with clear explanations of how reconciling items relate to the amounts in the financial statements.	• **Undue prominence:** Giving undue prominence to APMs e.g. by only giving meaningful commentary on non-GAAP measures, by presenting more APMs than IFRS measures, or by focussing discussions in key statements on APMs rather than IFRS measures. • **Unfair view:** Adjusting for costs that are part of normal operations.
	Adjustments made to APMs	• Adjustments made in calculating APMs from IFRS numbers should include gains, as well as losses, when relevant to the definition of the APMs.	
	Descriptions of APMs	• Labels or descriptions should not be similar to IFRS measures, as this may be misleading.	
	Rationale for APMs	• The rationale for presenting APMs should be explained i.e. why they provide useful information and how the APMs are used internally.	
	Definitions of APMs	• Definitions should be provided for *all* APMs.	

6. Strategic Reports	**Fair, balanced and comprehensive view**	• Consider the performance *and* position of the business by:
		  • including information about the balance sheet and cash flows, rather than solely the results for the period; and
		  • incorporating other significant matters, such as tax, debt covenants or debt facilities, where they are discussed elsewhere in the financial statements;
		• Give a balanced view that discusses both positive and negative matters i.e. a financial review that discusses an adjusted profit should also discuss the IFRS loss;
		• Compare year-on-year performance using a like-for-like basis, for example by stripping out the impact on a new standard adopted in the year.
			• **Omitting risks:** Omitting risks that appear to merit inclusion e.g. the impact of climate change, the impact of EU exit by the UK, the impact of Covid-19.

7. Cash Flow Statement	***The cash flow statement was the main source of restatements due to non-compliance.***		• **Presenting non-cash items:** Ensure non-cash amounts are excluded from the cash flows e.g. assets purchased under lease arrangements. • **Net basis reporting:** Ensure cash flows are presented on a gross basis e.g. new borrowings and repayments.
	Consistency of reporting	• Reporting in the cash flow statement must be consistent with information reported in the front-end of the annual report, e.g. the strategic report.	
	Add-backs and deductions	• In the reconciliation of profit to operating cash flows, expenses (debits) should be added back and income (credits) should be deducted.	
	Key areas of focus for compliance	Disclosures should include: • Dividends received from associates and joint ventures (classified as investing activities); • Net cash paid on acquisitions (classified as investing activities); • Cash flows from acquisitions of non-controlling interests (classified as financing activities); • Cash flows from derivatives (classified as operating activities where relating to operational hedges, or as investing activities where relating to net investment hedges).	

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Topic	What to provide:		What to avoid:
8. Provisions and Contingencies	**Recognition of provision**	• Sufficient information should be provided about the basis for recognition i.e. explaining the obligating event that has given rise to the provision.	• **Netting provisions covered by insurance:** Netting of provisions that are covered by insurance; the claim and related reimbursement asset must be reocgnised on a gross basis.
	Judgements	• Significant judgements should include those taken to recognise provisions, as well as *not* to recognise provisions e.g. a decision taken not to recognise an onerous lease provision.	
	Disclosures	• Sufficient information should be provided to explain the nature of provisions, related uncertainties and the potential timing of cash outflows.	
	Seriously prejudicial exemption	• Where full disclosure about a provision is not provided, information is *still* required to be disclosed about the general nature of the dispute and the reason why the information has not been disclosed due to the information being seriously prejudicial.	
9. Fair Value Measurement	**Valuation techniques**	• Disclosure should be provided of the choice of valuation technique where it clearly required judgement. • Disclosure should explain the methods, inputs and assumptions applied, even where an independent valuer had provided the valuation. • Where fair value estimation required company-specific adjustments t established valuation techniques, this should be disclosed in sufficient detail.	• **Being inconsistent:** Ensure inputs used in the fair value level 3 measurements are consistent with information provided elsewhere in the financial statements e.g. discount rates.
	Sensitivity analyses	• For recurring level 3 fair value measurements, disclosures should include: • A narrative description of the sensitivity of fair value measurements; and • A sensitivity analysis illustrating the effect of reasonably possible alternative assumptions. • For non financial assets measured at fair value (i.e. investment properties), a sensitivity analysis would be helpful to where the source of estimation uncertainty is deemed significant.	
	Level 3 measurements	• Unobservable inputs and assumptions should be quantified. • A reconciliation of opening and closing balances should be provided.	
	Other financial assets and financial liabilities	• Disclosure should explain: • What such 'other' amounts represented; and • How the fair values had been determined.	

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Topic	What to provide:		What to avoid:

10. Business Combinations	**Assets and liabilities recognised on acquisition**	• A clear explanation should be provided of how acquired assets and liabilities, and any contingent consideration are measured.
		• Disclosure should be provided that:
		  ◦ Explains the valuation of the assets acquired i.e. discount rates applied and commodity price assumptions; and
		  ◦ Explains the methodology and assumptions applied in estimating the fair value of deferred income on acquisitions.
			• **Insufficient explanations:** Where there have been significant and/or unusual elements to the acquisition, sufficient information should be provided to explain the effect on the financial statements. Common unexplained areas include:
			  ◦ Gains on bargain purchases;
			  ◦ Accounting policy for group reorganisations;
			  ◦ Asset acquisitions vs business combination accounting;
			  ◦ Deferred and/or contingent consideration and
			  ◦ Put and call options over non-controlling interests.

	Separate recognition of intangible assets	• *Key area of challenge by the FRC:* Ensure the financial statements recognise the appropriate separately identifiable intangible assets, such as brands or customer lists, that are appropriate for the acquired business.	

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