



Financial Reporting Council

# **ANNUAL REVIEW OF CORPORATE GOVERNANCE AND REPORTING 2017/2018**

**OCTOBER 2018**

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The FRC's mission is to promote transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

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# 1 EXECUTIVE SUMMARY

The landscape for corporate governance and reporting is changing and stakeholder expectations are evolving. Companies are coming under increasing scrutiny from investors and other stakeholders, not only over how they perform financially, but also how they contribute to society and minimise their impact on the environment.

Major corporate failures such as Carillion, perceptions of excessive CEO remuneration and a lack of transparency or objectivity, particularly on key judgements, estimation uncertainty and underlying performance, undermine trust. Better governance, supported by increased transparency and meaningful reporting, can make a difference to public perceptions, although it will not prevent every business failure. The 2018 Edelman Trust Barometer indicates that, over the last year, trust in business has not improved, either amongst the informed public or amongst the general public. Accordingly, there is much still to be done.

Against this backdrop, the FRC has made substantive revisions to the UK Corporate Governance Code (“the Code”) and the Guidance on the Strategic Report, discussed in more detail later. The changes are designed to bring about a shift in focus and improve openness and transparency, the hallmarks of good governance and reporting. Companies can respond to the challenges facing them by developing a more collaborative and participative approach to doing business, through real engagement with stakeholders on the broader impacts of their activities.

## Corporate Reporting: Areas for Improvement

This report provides our review of corporate reporting in the UK based on evidence and broad outreach from our activities. Our findings were informed primarily by the FRC’s own monitoring work on cases opened in the year to 31 March 2018. In addition, it draws upon the results of our recent thematic reviews.

We reviewed aspects of 220 reports and accounts in the year; predominantly December 2016 year ends. Disclosure of judgements and estimates and alternative performance measures (“APMs”) were our most common areas of concern, arising in a large proportion of the 46% of companies we wrote to seeking further explanation. These two areas were highlighted in the previous year as providing the greatest opportunities for improvement and which we selected for thematic review in 2017. Our reports, published in November last year, identify what ‘good’ looks like and provide a benchmark against which we are now reviewing subsequent disclosures with the expectation that we will see an improvement in quality.

## Financial statements

Our findings this year, as last, indicate that while there are points of strength in corporate reporting, there is clearly room for improvement in some areas. We were disappointed that the reporting of the significant judgements and estimates

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companies made in the preparation of their accounts was, again, a major area for improvement.

These disclosures are the lens through which investors can evaluate a company's financial position and results and gain an appreciation of the quality of management's judgements. We continued to see instances of poor disclosure of the sensitivity of assets and liabilities to the assumptions and estimates on which they were based. Clear disclosure is needed here to help investors understand the effect and timing of any possible changes to management's estimates.

We were also disappointed to see a rise in basic errors and non-compliance in a few areas of reporting, including misclassification of cash flows in the primary statement, where the accounting standards set out a clear requirement or direction which appeared to have been overlooked. A number of these points were readily evident and, in our view, should have been identified by a robust pre-publication review process.

While boards and audit committees focus on material matters affecting the company's performance and the reporting of significant events and transactions, they must also put effective procedures in place to ensure that the basic rules and requirements embedded in reporting standards, and which investors are entitled to assume have been complied with, are observed. This is particularly the case in times of change and uncertainty whether due to new accounting standards or the possible impact of the UK leaving the European Union ("EU").

We are pleased, however, that companies generally react well to our conclusions and recommendations, even when these go beyond what is strictly required by reporting standards to meet user needs. This demonstrates that, broadly, most companies want to 'do the right thing' by their investors.

A number of new accounting standards have come into effect in 2018 with more to follow in 2019. These pose significant challenges to companies and could divert resources from other areas of reporting. Companies have implemented IFRS 9 and IFRS 15 from the beginning of the year and are planning for the implementation of IFRS 16 from 1 January 2019. In addition, subject to endorsement, IFRS 17 *Insurance Contracts* is due to replace IFRS 4 from 1 January 2021.

We will focus on how companies are implementing the new endorsed standards over the coming 2-3 years and will be paying close attention to the impact on the quality of reporting. Our preliminary findings in respect of thematic reviews of IFRSs 15 and 9 are included in section three. We will report in full on our findings in November 2018.

### Strategic Reports

Strategic reports provide an opportunity for boards to present a single, coherent narrative explaining and complementing the company's financial statements. Information from a variety of sources, including via social media, can affect investors' assessments and the prospects of a company. The availability to investors and other stakeholders of this wide, but not necessarily reliable, knowledge base makes it all the more important for boards to ensure that their formal reporting is fair, balanced and comprehensive.

Companies should pay particular attention to ensuring that:

- the report includes a fair review of the company's business that is balanced and comprehensive; and
- APMs are clearly presented, reconciled to International Financial Reporting Standard ("IFRS") numbers and explained as required by the European Securities and Markets Authority's ("ESMA's") Guidelines,<sup>1</sup> which, in our view, represent best practice for all companies.

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<sup>1</sup> The European Securities and Markets Authority's Guidelines on Alternative Performance Measures

## Corporate Governance and Stewardship

This year, for the first time, this report also includes information on compliance with, and the quality of reporting against, the Code. The FRC's current monitoring of annual reports does not include corporate governance statements, as the FRC does not have powers to challenge and secure changes to these parts of the annual report. Our assessment of corporate governance is, therefore, based largely on evidence gathered through research conducted by external parties.

Reported compliance with the Code remains high, with 95% of the FTSE 350 reporting compliance with all but one or two of its 54 Provisions. Declared full compliance has risen from 66% to 72% this year. High levels of compliance are not necessarily an indication of high standards of governance. They can be a signal of an excessive focus on formulaic compliance with the Provisions leading companies to overlook reporting on how they have applied the Principles in the Code in a manner that shareholders can evaluate, as required by the Listing Rules.

At the same time, companies remain reluctant fully to explain non-compliance with the Provisions. Full explanations are essential to the effective operation of the 'comply or explain' model on which the Code is based. Poor explanations are therefore unacceptable. Explanations are also a positive opportunity to communicate how a company's alternative approach maintains a high standard of governance practice. Explanations must be thoughtful and provide a clear rationale for the action the company is taking. We expect investors to do more to challenge companies and to hold them to account when explanations are inadequate.

Too few companies are taking the opportunity to provide more information about board evaluations. This information is useful for investors and we would like to see more examples of companies disclosing more detail about the nature of their evaluations, their findings and any follow-up actions.

Detailed reporting on directors' remuneration is a requirement of company law and falls outside the corporate governance statement. The quality of remuneration committee reporting has remained static in 2017/18. In particular, the standard of reporting on the relationship between directors' remuneration and employee pay, and the successful achievement of company strategy, is poor. The revised Code, which the FRC issued in July 2018 ("the 2018 Code"), includes new Principles and Provisions designed to improve practice and reporting in these areas.

The 2018 Code, which comes into effect on 1 January 2019, places emphasis on the value of good corporate governance to the long-term sustainable success of the company. It signals a move away from tick-box compliance with the Provisions, towards companies explaining how they have applied the Principles.

We will also be consulting on a revised UK Stewardship Code. The objective is to bring about a step change in the quality and quantity of the stewardship activities of investors and others by engaging the different parts of the investment chain, including asset owners and proxy advisors, and raising market expectations of signatories to the Stewardship Code.

## Risk Reporting and Viability Statements

The introduction of viability statements in the 2014 Code has brought a greater focus on risk management at board and senior management level, enabling many companies to make more informed decisions about their risk appetite. However, viability statements are yet to deliver all the external benefits expected when they were introduced and many companies' viability statements are not sufficiently illuminating. Although some companies have enhanced their disclosure this year, many are still not explaining the processes that they have undertaken to prepare their statement, including the stress and scenario testing they have carried out, which is disappointing.

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The 2018 Code... places emphasis on the value of good corporate governance to the long-term sustainable success of the company.

The FRC's Financial Reporting Lab ("the Lab") report concluded that viability statements could be enhanced to show more clearly how companies have assessed their prospects and viability. It recommended that directors adopt a two-stage process in developing their assessment of viability, firstly describing the long-term prospects of the company, and then selecting a (potentially) shorter time-period to make the statement on whether they have a reasonable expectation of the company's viability. We expect companies to select a viability period that reflects the nature of its business and to be specific in explaining why the period selected is appropriate.

Adopting the recommendations in the Lab's report will help companies to address many investors' concerns that the time periods being selected are too short and we are pleased to see that companies are beginning to do this, including applying the two-stage process and more detailed disclosure of stress and scenario testing. In due course, this will help companies to fulfil Provision one of the 2018 Code. This Provision asks boards to describe *"how opportunities and risks to the future success of the business have been considered and addressed, the sustainability of the company's business model and how its governance contributes to the delivery of its strategy"*.

## Non-Financial Reporting

The spotlight continues to fall on the impact companies' activities have on their stakeholders, with society demanding greater accountability from company directors, their advisors and regulators. The FRC has responded to rising expectations of companies to explain how directors have fulfilled their duties under section 172 of the Companies Act 2006 by:

- updating its Guidance on the Strategic Report, including guidance on the new section 172 (1) statements; and

- revising the Code, including a provision which asks boards to describe in the annual report how the interests of key stakeholders and the matters set out in section 172 have been considered in board discussions and decision-making.<sup>2</sup>

We continue to believe that companies can be more transparent, for example by explaining how they engage with their stakeholders to understand and have regard to their interests or how they allocate capital resources for different purposes such as paying dividends and tax, and funding workforce pay and capital investment.

The FRC's Guidance on the Strategic Report was revised in August 2018 to reflect changes to UK law that implemented the EU Non-Financial Reporting Directive and to highlight and strengthen the link between section 172 and the purpose of the strategic report.

The Government has introduced secondary legislation to require all companies of significant size to make a statement ("a section 172 (1) statement") which describes how the directors have had regard to the matters set out in section 172 when performing their duty to promote the success of the company.

We are also seeing increasing demands for better reporting, often outside the annual report and accounts, on gender pay gaps, payment practices and climate-related disclosures. These developments are closely connected to changing stakeholder and societal expectations. These are now a major part of the reporting landscape and will be an important consideration for our work on the future of corporate reporting.

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<sup>2</sup> Provision 5 of the 2018 Code

## 2 INTRODUCTION

The FRC's mission is to promote transparency and integrity in business. The FRC's activities contribute to an overall regulatory framework, designed to create conditions that will lead to sound decision-making by companies, effective capital markets, confident investors and enhanced trust in business. Promoting high quality corporate governance and reporting and encouraging trustworthy information and behaviour are central to achieving these aims.

A commitment to clear and transparent presentation of relevant and material information, and engagement with key stakeholders, can make a significant difference to how companies are perceived and help build trust.

Improving confidence in corporate governance and reporting is a key objective for the FRC. In addition to setting and maintaining the Code and the Guidance on the Strategic Report, the FRC contributes to a robust framework for corporate reporting in the UK in other ways. In particular, it:

- monitors companies' compliance with the Companies Act 2006 and applicable accounting standards;
- influences the development of IFRS;
- sets UK accounting standards; and
- supports clear and concise reporting and the development of good reporting practice throughout its activities, but particularly through the activities of the Lab.

### Purpose of the Report

This report sets out the findings of our reviews of certain aspects of corporate reporting in the UK, primarily based on our monitoring work on cases opened in the year to 31 March 2018 and thematic reviews conducted more recently. The FRC does not have powers to support effective monitoring of corporate governance statements or remuneration reports and does not conduct its own reviews in this area.

For the first time, this report also includes information on the level of compliance with the Provisions of the Code as well as the quality of explanations and reporting provided by companies in their governance statements and committee reports, based largely on evidence gathered and analysed by third parties.

The broad range of outreach and evidence gathering undertaken by the FRC provides detailed insights into the practical application of the corporate reporting framework which help inform our monitoring, standard-setting and other activities.

The report aims to help companies to improve the quality of their reporting so the key audiences for the report are preparers and auditors. It also aims to provide insight into the quality of company governance and should therefore also be of interest to investors.

The report aims to help companies to improve the quality of their reporting...



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## Structure of the Report

The report is structured around our overall review of corporate reporting and in particular the two key elements of the report and accounts, the financial statements and the strategic report, which fall within the remit of our reviews (section 3). The appendices provide more information on our monitoring and enforcement activities and procedures.

Section 4 discusses other aspects of narrative reporting as well as providing information on compliance with, and reporting against, the Code.

A separate section (section 5) provides information on the development of reporting by those companies using UK GAAP. And section 6 provides our views on future developments.



# 3 ANNUAL REVIEW OF CORPORATE REPORTING

## The FRC's Monitoring Programme

Events like the failure of Carillion call into question the effectiveness of the overall regulatory regime. Our monitoring work does not examine the quality of the management or governance of a company or provide real-time insight into a company's prospects. Nor does the FRC have powers to intervene directly in the affairs of companies or to monitor effectively corporate governance statements. Our monitoring work does, however, provide some insight into the companies we review. The FRC must ensure that it is risk-focussed and transparent (whilst maintaining confidentiality), focusing more of its monitoring efforts on higher risk companies and acting in a timely manner. We have taken steps to provide more transparency over the outcome of our monitoring work to help bolster investor insight, and have recently begun to publish, periodically, a list of those companies subject to our monitoring work.

The FRC's monitoring of corporate reporting is led by the Corporate Reporting Review ("CRR") team, which acts in accordance with the Conduct Committee's Operating Procedures. The Conduct Committee has delegated powers to monitor compliance with the law, and to seek correction of defective reports and accounts through the court, where appropriate voluntary correction is not secured through engagement with the company. To date, no such action has proved necessary as companies have, following discussion, amended or improved their reports and accounts in a

manner that is consistent with the FRC's views without the need for a court ruling.

The CRR's review of corporate reports is essentially a desk-top review. This means that its reviews are based solely on company reports and accounts and do not benefit from detailed knowledge of companies' businesses or the underlying transactions entered into during any period.

They are, however, conducted by FRC staff who have an understanding of the relevant legal and accounting framework. We write to companies asking for further information or explanation where it is not clear whether, and if so how, a company has complied with the relevant reporting requirements in such a clear manner as to enable investors to understand the transaction which they have entered into or the judgements they have made in their reporting.

FRC monitoring includes reviews of reports and accounts that look at all areas within FRC scope. The focus here is first on determining any potential areas of non-compliance which are then pursued with the company to FRC satisfaction. The review also incorporates reference to more minor matters where there is room for improvement and enhancement of the general quality of the company's report.

Our exchanges with companies, while generally achieving the FRC's desired outcome, can take time to resolve. In today's world of real time reporting and immediate access to business news, there is a question whether the current regulatory regime needs to adapt

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to better meet the needs of relevant stakeholders. Sir John Kingman was appointed in the spring of 2018 to conduct an independent review of the FRC, with a particular focus on issues related to its monitoring and enforcement activities, including the timeliness of regulatory action.

## Thematic Reviews

The FRC's commitment to stimulating continuous improvement in corporate reporting is demonstrated through its thematic reviews. These tend to focus on areas of emerging risk or areas where there is most need of a step change in quality to meet the reasonable expectations of investors.

The selection of topics for FRC thematic reviews usually takes as its starting point our findings from the previous year's full reviews. We also take account of concerns expressed by investors and others through various FRC committees and outreach, of where they believe reporting to be poor and not meeting their expectations. Added impetus is given if the topics feature in headline news and attract interest and attention from the public more generally.

In the year to 31 March 2018, the FRC reviewed aspects of 220 sets of reports and accounts. Of these, 121 full scope reviews were conducted, chosen from the full range of entities in scope. We also performed thematic reviews on specific aspects of 58 companies' reports and accounts who were pre-informed that their reports would be subject to thematic review.

In November 2017, we publicly reported on our findings in three thematic reports - [Judgements and Estimates](#), [Alternative Performance Measures](#), and [Pension Disclosures](#). The remaining company reviews were selected for lighter touch thematic reviews on the UK's EU exit and disclosures required by IAS 8 in respect of incoming standards IFRS 9 and

IFRS 15. The findings from these lighter touch thematic reviews were reported in the FRC's Annual Review of Corporate Reporting 2016/17.

This year, however, our principal thematic review, 'Smaller Listed and AIM Company Reporting', was the result of an earlier commitment made following an FRC project in 2015. We undertook to conduct a further review of smaller company reporting in three years' time to determine whether there had been any improvement in the general quality of reporting.

Other thematic reviews were prompted primarily by several new accounting standards coming into effect in 2018 and 2019 and which follow an extended period of stability in terms of financial reporting requirements. IFRSs 15 and 9, effective for years starting on or after 1 January 2018, are standards known to have presented significant challenge and change to a wide range of companies. By focussing our reviews on June 2018 interims, we have monitored the quality of implementation with a view to setting out our expectations in respect of December 2018 reports and accounts and beyond. This marks the beginning of our dialogue with companies as the new standards are embedded.

The topics for this year's thematic reviews then are:

- (1) targeted aspects of smaller listed and AIM quoted company reports and accounts;
- (2) the effect of the new International Financial Reporting Standards (IFRSs) on revenue and financial instruments in companies' 2018 interim accounts;
- (3) the expected effect of the new IFRS for lease accounting; and
- (4) the effects of the UK leaving the EU on companies' reporting in their strategic reports and associated disclosures.

In the year to 31 March 2018, the FRC reviewed aspects of 220 sets of reports and accounts.

## CLEAR AND CONCISE

The FRC's clear and concise philosophy, which runs through all our activities, aims to encourage good communication in corporate reporting by:

- ensuring that information in the annual report is relevant to investors;
- encouraging greater emphasis on the application of materiality; and
- considering other digital channels for reporting information.

The FRC does not expect companies to include information that is immaterial or irrelevant. Equally, the FRC does not encourage companies to cut short their disclosures simply to reduce the number of pages in their report and accounts or over-simplify a transaction or judgement that readers must be able to acknowledge as complex. The FRC expects companies to say what they have to say in order to meet a quality reporting standard, but to say it as concisely as they can, using cross-referencing and sign-posting where helpful.

Our summary findings are outlined below. The detailed findings from (i) and (ii) above will be published in November in time to influence December 2018 reporters. Our findings in respect of the UK leaving the EU and IFRS 16 are included below.

### Quality of Corporate Reporting

Last year, we reported that the standard of corporate reporting in the UK, primarily by the largest listed companies, was generally good. However, we were concerned that there were still weaknesses in the reporting of the key judgements and estimates that management make when concluding their appropriate accounting treatments and in their presentations of a fair and balanced review of their performance for the year. We warned companies to expect to be challenged where their disclosures fall short of our expectations.

We were disappointed this year that, in the reports and accounts reviewed, primarily December 2016 year ends, we continued to raise a substantive number of questions in this area. We were particularly concerned by instances of poor disclosure of the sensitivity of management's assumptions about the future, which are required to better inform investors of the potential for change in a company's assets and liabilities in the next twelve months.

The extent of the challenge and the effort required to persuade some companies of the need for improvement fell short of expectations.

In a principles-based reporting framework like IFRS, there are relatively few 'bright lines' or rules that have to be applied irrespective of a company's specific facts and circumstances. We were disappointed by the increase in required FRC references in the year to 15 (2016/17:3) reflecting, in part, a number of more basic errors we found where the relevant standards require adherence to a rule or direction which appears to have been overlooked. The references were, in the main, attributable to companies outside the FTSE 350. These were cases of clear breach of accounting requirements or errors in the way in which some items had been calculated, for example, misclassification of cash flows in the primary statement, in particular, but also errors in the calculation of earnings per share.

In a number of instances, points were evident from our desk-top review of the financial statements and, we believe, should have been detected through company or auditor review procedures prior to publication.

Although not a matter that resulted in an FRC reference, the fact that we continue to see some companies not complying with the legal filing requirement to support dividend payments indicates a possible weakness in the broader control environment and, possibly, the role of the company secretary.

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In a number of instances, points were evident from our desk-top review...

Applying the principles of reporting standards as well as ensuring compliance with their detailed requirements can help to close the expectation and performance gaps between what the standards require, what stakeholders are increasingly asking for and what companies actually report. A tendency by some to rely on overly optimistic judgements in the presentation of their results, or failure to explain the degree of uncertainty attaching to a material item, undermines credibility and trust, and this is particularly the case in periods of change and uncertainty.

To help boards meet the required quality standard, we published the outcome of our thematic reviews in advance of the December 2017 year end, highlighting what 'good' looks like in respect of key judgements and estimate reporting, APMs and pension disclosures. We expect to see improvement in these areas when we come to review December 2017 reports and accounts which we will report on in a year's time.

The apparent failure by some to maintain a robust control environment is a matter for concern. We acknowledge the challenge posed by current uncertainty around the impact of the UK leaving the EU. We also understand that the attention of boards and audit committees is focussed on material matters affecting the performance and position of their companies and the appropriate accounting for significant events and transactions, particularly with new accounting standards to contend with. However, neither they nor their auditors can afford to overlook the basics. Effective procedures must be in place to ensure that specific rules and requirements embedded in reporting standards are observed and which investors are entitled to assume have been complied with.

## Review Outcomes

We reviewed aspects of a total of 220 annual and interim reports and accounts as part of our 2017/18 monitoring activities and wrote to 101 companies with substantive questions to address. Of those receiving a request for additional information or explanation, the most common topics are detailed on page 13.

Virtually all of our queries led to some degree of change or improvement in the companies' reporting. Cases were closed on the basis that the companies undertook to make the required and agreed changes in their next accounts. All such undertakings are checked when the next accounts are published to ensure that CRR views and expectations have been appropriately reflected. Where it appears that an undertaking has not been followed through as expected, we re-open the case and ask the company to explain its failure to follow through. This year, we re-opened 3 cases for this reason.

More detail about our monitoring activities during 2017/18 can be found in Appendix B.

## Publication of CRR Interaction

Until recently, the outcomes of CRR reviews have been confidential unless we issued a Press Notice or asked the company to make specific reference to our intervention in their next report and accounts. A 'required reference', explained in more detail below, brought some of CRR review work into the public domain but, generally, only to those who read those subsequent reports. One outcome of the FRC's independent effectiveness review in 2015 was the acknowledgement that investors had a keen interest in knowing which accounts had been reviewed and their outcomes.

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Virtually all of our queries led to some degree of change or improvement in the companies' reporting.

In response, the FRC's *Guidance on Audit Committees*, revised in April 2016, introduced an expectation that companies complying with the Code would explain the nature and extent of interaction (if any) with the FRC in their subsequent report and accounts. The disclosure, to be meaningful, should include details of the questions raised, and any corrections or improvements made to the company's reporting as a result of our enquiry as well as the inherent limitations of our review. The expectation applied to relevant reports and accounts for reporting years commencing on or after June 2016.

From the disclosures we have seen to date, we are pleased to see that most companies in receipt of a substantive enquiry have referred to CRR intervention in their subsequent audit committee report. However, there has been significant variation as to whether the reference provided a fair and balanced summary of the nature of the exchange. Some companies' disclosures provided insufficient detail for a reader to understand the outcomes of the interaction with the FRC or the limitations of the FRC's review. We may write to companies where we believe the reference to our correspondence is not sufficiently comprehensive and balanced.

In a further response to the demand for greater transparency of our work, we have this year begun publicly identifying the reports we have reviewed once the company has published its next report and accounts. Our disclosure names the companies, identifies the reports reviewed and separately highlights those who were in receipt of substantive challenge. We are considering the need for more direct disclosure by the FRC, particularly in light of some of the bland and uninformative disclosures we have seen in the relevant audit committee reports.

While we encourage all companies to be transparent about their interactions with us, including those not subject to the Code, where matters are particularly significant we sometimes specifically ask companies to reference our interaction

with them in language that we agree with them, termed a 'required reference'. This is where we believe that the nature of the correction or amendment merits additional publicity and where other companies can benefit from being aware of a CRR decision. Required references and press notices are only sought in respect of more significant findings.

### Press Notices

We generally only issue a press notice where there is a significant material change such as to a primary statement, or the content of the strategic report. One press notice was issued this year in relation to Mitie Group plc ("Mitie") (2016/17: one; 2015/16: none).

The main issue we raised with Mitie concerned its impairment testing of the goodwill allocated to the Healthcare cash generating unit in its 2016 accounts. In its 2017 annual report and accounts, Mitie recorded a prior year adjustment to goodwill of £26.0 million and explained that there was a material disclosure deficiency in its 2016 annual report and accounts relating to a failure to disclose certain of the significant judgements that it had made in its impairment testing.

### References

As explained above, in instances where the outcome is less significant but a degree of publicity is still appropriate, we ask companies to refer to our intervention in their next published accounts in language agreed with us. This year fifteen companies (2016/17: three; 2015/16: two) were required to refer to the corrective action taken.

The fifteen required references this year are outlined below.

### Cash flow statements

We know from our 2015 'Smaller listed and AIM Quoted company' project that investors consider reported operating cash flows to be an important indicator of a company's current, and potential future, performance and is relied upon in their analyses. It is, therefore, important for cash flows to be accurately presented

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One press notice was issued this year in relation to Mitie Group plc ("Mitie") (2016/17: one; 2015/16: none).

as 'operating', 'investing' or 'financing' in accordance with the requirements of the standard, IAS 7. We were disappointed that this year seven companies were required to refer to the correction of errors in their cash flow statement, the majority of which had had the effect of increasing operating cash flow. Where the companies have published their corrections, they are named below.

- restructuring cash outflow incorrectly classified as investing activities rather than operating activities (The Restaurant Group plc);
- acquisition-related income statement expense incorrectly classified as investing activities rather than operating activities (Vectura Group plc and another);
- cash flows relating to joint venture funding incorrectly classified as financing rather than investing activities (Great Portland Estates plc);
- non-cash movement relating to the unwind of a discount incorrectly included in the cash flow statement (ULS Technology plc);
- interest on loans reclassified and cash flows incorrectly netted (not yet published); and
- borrowings under invoice financing facility incorrectly classified as cash and cash equivalents (not yet published).

#### Earnings per share

Two companies should have restated their comparative earnings per share to reflect changes to the share structure that took place in the current year (Accrol Group Holdings plc and Harworth Group plc).

#### Impairment

Mitchells & Butlers plc restated its parent company accounts to correct an error in the impairment calculations relating to investments and intercompany receivables.

#### Consolidation

Following detailed discussions with the company, including with a Review Group,<sup>3</sup> RAK Petroleum plc agreed to consolidate an investee company over which it had de facto control.

#### Correction of error

Kier plc corrected the reporting of a profit on the sale of a subsidiary which had incorrectly been disclosed as continuing, rather than discontinued, operations. This error flowed through to the cash flow statement where the classification also had to be corrected. The net proceeds of sale were deleted from continuing operations and properly shown as investing activities.

Blancco Technology Group plc also acknowledged FRC intervention in relation to its prior year adjustment relating to the value of goodwill, acquired intangibles and provisions.

Revolution Bars Group plc should have corrected a material prior period error by retrospective restatement rather than including the correction in the income statement for the year in which the error was discovered.

Another company commenced hedge accounting part way through a hedge arrangement when the necessary conditions were not met and the necessary disclosures had not been given. The company agreed to restate the comparative figures.



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<sup>3</sup> See Appendix B

## Key findings

Key findings from this year's monitoring activity relating to financial statements and the strategic report are detailed separately below. Table A ranks the topics where substantive queries were most frequently raised with companies following review. As noted elsewhere, it is disappointing that for the third year running, we raised more questions on judgements and estimates than any other issue.

**Table A:** Most commonly raised issues

Topic	Ranking		
	2017/ 2018	2016/ 2017	2015/ 2016
Judgements & Estimates	1	1	1
Alternative Performance Measures (APMs)	2	5	-
Strategic Report	3	2	3
Income Taxes	4	-	-
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## Financial Statements

This section sets out how we expect companies to address our findings arising from the five issues most commonly raised with companies as identified in table A. It includes the more significant findings from our reviews, together with an outline of the findings from this year's thematic reviews.

A high-level summary of our observations, with illustrative examples, *Technical Findings 2017/18*, is available on the FRC website. We have this year refreshed the presentation to have a more accessible focus on how companies might avoid future challenge on the most commonly raised matters.

## Judgements and estimates

Disclosure of key judgements and estimates is critical to a principles-based reporting framework if investors are to understand the basis on which management has applied the requirements of the standards to its reporting. They are the lens through which readers can appreciate and evaluate a company's financial position and results and their sensitivities to changes in any underlying assumptions.

Clarity of disclosure is therefore important. Our thematic report identified the key areas of challenge that were consistent with our full scope reviews of 2016 reports and accounts and on which we are reporting now. We had a key focus on ensuring that, in view of the different disclosure requirements, companies properly distinguished their key judgements from their estimates. Reporting estimates as judgements means that users of the accounts are not given the sensitivity disclosures required to help them understand why there is an underlying uncertainty and the degree to which it is subject to change ahead.

... it is disappointing that for the third year running, we raised more questions on judgements and estimates than any other issue.

Reporting estimates as judgements means that users of the accounts are not given the sensitivity disclosures required to help them understand why there is an underlying uncertainty...



## Judgements

We challenged companies whose disclosure of significant judgements did not explain the specific judgements made or the basis for their conclusion. We also identified companies who incorrectly disclosed that judgements had been made in circumstances where the accounting was straightforward and no judgements had been required to be made at all. We expect companies to focus on the judgements they took which, had they concluded differently, would have had a significant impact on their reports and accounts.

In other instances, it appeared from disclosures elsewhere in the annual report, such as in the audit committee report, that significant judgements had been made but that the required disclosures under IAS 1 had not been given. Examples included whether a company is acting as principal or agent, the classification of investment properties and the nature of pension arrangements.

## Estimation uncertainty

Our thematic report expressed disappointment about the quality of a number of disclosures relating to estimation uncertainty and which were replicated in our full scope reviews. Our report indicated where, and how, those disclosures could be improved.

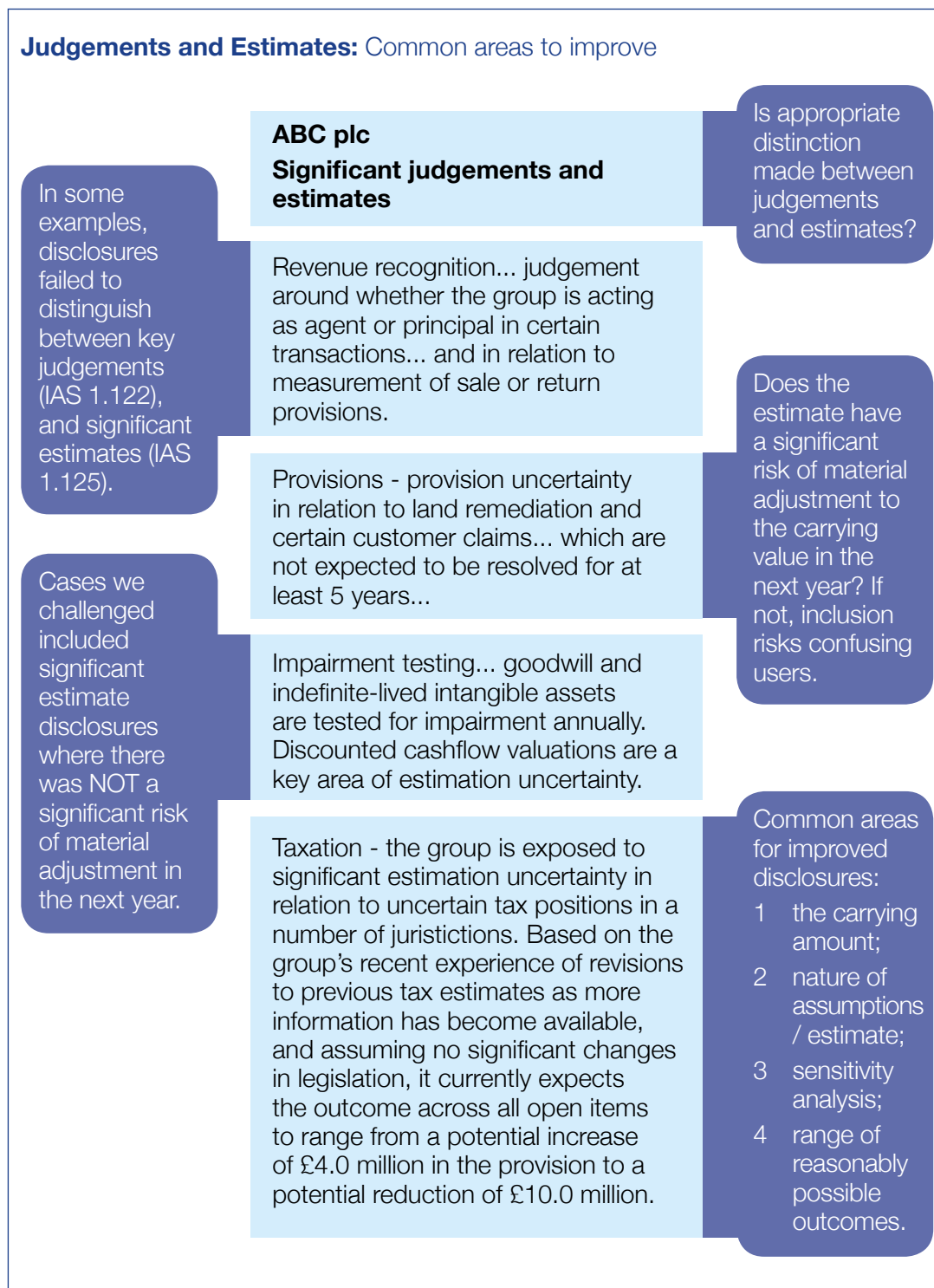
The key point is that management should disclose sufficient information to enable investors to understand material sources of estimation uncertainty. IAS 1 helpfully includes a number of examples of the types of disclosure that might be relevant and which we expect to see, to the extent necessary to support investor understanding. For example, if there is no disclosure of the sensitivity of carrying amounts to the assumptions and estimates underlying their calculation, we then expect to see the range of reasonably possible outcomes within the next year in respect of the carrying amounts of the relevant assets and liabilities.

Some companies voluntarily provide additional disclosures of estimation uncertainty such as details of longer-term risks that are not expected to have any impact in the next year, or even several years beyond. We understand why some companies may want to highlight the longer-term risks that may, in due course, impact assets and liabilities. However, investors do need to be able to properly assess the effect and timing of any possible changes to estimates. Boards should, therefore, distinguish these disclosures from those required by the standard and explain why they are being presented at this stage.

We expect companies to focus on the judgements they took which, had they concluded differently, would have had a significant impact on their reports and accounts.



The case study shown below illustrates what we expect to see by way of informative disclosures.



## Income taxes

Our reviews commonly raise questions on the accounting for income taxes and the related disclosures. This year there were relatively more issues identified in comparison with previous years. Our challenges principally related to the reconciliation of the effective tax rate and the basis for the recognition of deferred tax assets for losses.

### Effective tax rate

The effective tax rate reconciliation should enable users of the accounts to understand both (i) the relationship between the tax expense and the accounting profit and (ii) the significant factors that could affect that relationship in the future.

We frequently raised questions of companies where significant reconciling items were not explained. The better disclosures that we saw clearly described each significant reconciling item and its effect on the effective tax rate.

### Tax losses

We challenged companies where the basis for recognising a deferred tax asset for losses was not adequately explained, particularly where the company was loss-making.

### Share-based payments

We also questioned companies where it was unclear whether tax relating to share-based payments had been appropriately allocated between equity and the income statement.

## Revenue

We challenged companies where the accounting policies did not provide a clear explanation of how revenue is recognised for each significant revenue stream.

This year, we again commonly questioned companies where revenue from services appeared significant but the accounting policy disclosures did not explain the methods used to recognise revenue from service contracts or how for example, related bid and mobilisation costs and variations were accounted for.

We frequently raised questions of companies where it was not clear how the company had assessed whether it acts as a principal or agent in transactions with customers.

We expect these issues to continue to be relevant to an assessment of compliance in accordance with IFRS 15, as below.

## Thematic Reviews

### IFRS 15 Revenue from Contracts with Customers

IFRS 15 *Revenue from Contracts with Customers* became mandatory for annual periods beginning on, or after, 1 January 2018. We performed a thematic review this year on the disclosures of the impact of the new standard included within the June 2018 interim reports of a sample of companies. We selected companies in industries which are known to be heavily impacted by the new requirements. The purpose of the thematic was to identify any weaknesses in interim disclosures, with a view to providing useful guidance for all companies when considering the completeness of their IFRS 15 disclosures in their year-end accounts, the requirements for which are more extensive than for interim reports.

The thematic review will also help us inform the selection of annual accounts for our review for the next year, identifying those companies with weaker disclosures and also those industries where a sufficient understanding of the impact of the new requirements may be less apparent, or which could benefit from clearer explanation.

While we identified a number of good examples of transitional disclosures, there were also a number of common weaknesses identified.

- Companies had a tendency to focus on explaining their new accounting policy without clearly explaining how this new policy was different to their previous accounting policy. It is clear explanation *of the change*

We frequently raised questions of companies where significant reconciling items were not explained.

We challenged companies where the accounting policies did not provide a clear explanation of how revenue is recognised for each significant revenue stream.

that is important. In addition, these explanations of changes in accounting policies could be improved by providing more detail and more company-specific information.

- Some companies provided a clear breakdown of the impact of the new standard by category of adjustment. It is disappointing that some did not provide the level of detail we expected.
- The identification of performance obligations is a key step in determining when revenue is recognised under IFRS 15. However, most disclosures about performance obligations were either absent or generic. Where a company sells goods or services which comprise numerous performance obligations we expect disclosures to explain what these obligations are and when they are satisfied.
- There were very few disclosures about the key judgements that management made in complying with the new standard, the requirements for which we note are over and above the regular IAS 1 requirements in this area.
- Disclosures about the impact on balance sheet line items, and on accounting for costs, were minimal.
- Companies that adopt the modified retrospective approach to transition to the new standard will be disclosing revenue in the current period under IFRS 15 and revenue in the prior period under the previous standard. To the extent that the front end of the report and accounts discusses trends or other aspects of revenue, these companies will need to take particular care identifying and explaining the lack of comparability year on year.

## IFRS 9 *Financial Instruments*

IFRS 9 *Financial Instruments* also became effective from 1 January 2018. Our thematic review focussed on the quality of the disclosures explaining the effect of adopting the new standard in a sample of June 2018 interim accounts.

Our sample was skewed towards the banking industry, which has been heavily impacted by the standard's new impairment requirements that require earlier recognition of losses. However, we also included insurers and a number of non-financial services entities as part of the review.

The principal findings of the review to date are set out below.

### Financial services companies

- There were some good explanations of the impact of adoption of IFRS 9, particularly from the larger banks, and most institutions provided an analysis of the impact on balance sheet line items affected by IFRS 9.
- There was a marked difference in the level and quality of disclosure in respect of impairment models between the larger and smaller banks; for example, some smaller banks did not explain or quantify the impact on impairment provisions of staging, forward looking information or scenario analysis.
- Most banks early adopted the option to present changes in own credit risk through OCI in respect of financial liabilities designated at FVTPL.
- There were very few disclosures about the key judgements made by management in complying with the standard.
- Accounting policies were generally boiler-plate and there was very little explanation of how these have changed following the adoption of IFRS 9 in place of IAS 39.
- Drivers of the designation of assets and liabilities at fair value could be better explained.

There were some good explanations of the impact of adoption of IFRS 9, particularly from the larger banks

Accounting policies were generally boiler-plate

## Non-financial services companies

- IFRS 9 did not have a material effect on the results of the non-financial services companies we reviewed. However, most provided a high-level qualitative description of the key changes introduced by IFRS 9.
- Only one non-financial services company clarified that the simplified approach for impairment had been adopted.
- Owing to a new test; solely payments of principal and interest, (SPPI), embedded derivatives are no longer separated from the host contract (where the host is within the scope of IFRS 9). Consequently, the entire contract is classified as fair value through profit or loss (FVTPL). We identified one company that had incorrectly reclassified contracts containing contingent pricing arrangements in their entirety as FVTPL.
- Unlike the banking companies, all the non-financial sector companies have adopted the new hedging requirements of IFRS 9. All disclosed that this did not affect existing hedges and some noted IFRS 9 might offer greater flexibility in hedges going forward.
- We identified one company that incorrectly continued to use IAS 39 terminology (available for sale) to describe equity instruments.
- We did not identify any past modifications of financial liabilities carried at amortised cost which would result in a restatement of comparatives.

We encourage preparers, and their advisers, to take note of these preliminary findings and look to the additional material in our thematic reports, once published, to inform their future reporting under the two new standards.

## Smaller listed and AIM quoted company reports and accounts

Our press release of November 2017 announced that we would follow-up the discussion paper, *'Improving the Quality of Reporting by Smaller Listed and AIM Quoted Companies'*, issued in 2015, with a thematic review.<sup>4</sup> The paper identified a range of factors which might have contributed to our previous findings that the quality of reporting by such companies was generally not as good as their larger peers and made a number of proposals. We have followed this up this year by undertaking a thematic review targeting five aspects of smaller listed and AIM-quoted companies' reports and accounts:

- i. APMs and their Strategic Reports;
- ii. accounting policies, including critical judgements and estimates;
- iii. pension disclosures;
- iv. tax disclosures; and
- v. cash flow statements.

The first four topics include aspects of reporting that were subject to recent thematic reviews focusing on larger companies. The accuracy of cash flow statements is an area which smaller company investors told us they focussed on more often. We notified 40 companies (comprising 22 listed companies outside the FTSE 350 and 18 AIM quoted companies), of the two areas of corporate reporting, selected from the five above, that we would review in their next report and accounts.

The thematic review findings will be issued in November 2018. We were encouraged to see that, like their larger peers, most of the companies in our sample responded to advance notification of our review by making some improvements to their reporting. We identified some examples of good quality disclosures that will be included in our report, particularly around APMs. Some companies were prompted to enhance their strategic report to provide commentary on significant matters such as tax, pensions and cash flows.

We were encouraged to see that, like their larger peers, most of the companies in our sample responded to advance notification of our review by making some improvements to their reporting.

<sup>4</sup> <https://www.frc.org.uk/getattachment/fdc1afd6-6838-4e40-a167-513d21dcbbc2/Smaller-listed-and-AIM-quoted-company-reporting-thematic-review.pdf>

However, there is clearly still scope for further improvement. The required FRC references discussed earlier, relate mainly to companies outside the FTSE 350. This confirms our previous findings that more basic compliance errors tend to occur more frequently in smaller companies. We identified some areas for disclosure improvement in almost all of the companies in our sample, with similar themes arising as in our routine reviews. Strategic reports lacking comprehensive information remain an issue. This is of particular importance to investors in smaller companies, who may have fewer alternative sources of information.

While our rotational reviews focus on the FTSE 350, as this is the area of the market with the biggest effect on investor confidence, we will continue to routinely monitor a number of smaller listed and AIM quoted companies.

### The expected effect of the new IFRS for lease accounting

IFRS 16 *Leases* becomes mandatory for annual periods beginning on, or after, 1 January 2019. We conducted a light touch thematic review of the disclosures relating to the introduction of the standard in a sample of companies' interim reports and accounts with a view to setting out our expectations in respect of December 2018 disclosures.

The standard introduces a new model for lease accounting, resulting in more leases being recognised in the primary statements and affecting related performance metrics. The standard will have a particularly significant effect on companies with extensive lease portfolios. Our sample was skewed towards these companies and the quality of their reporting under IAS 8 which requires disclosure of known or reasonably estimable information about the impact of a new reporting standard.

- The review showed that most companies still appear to have a fair amount of work to do in order to provide meaningful information in their 2018 year-end report and accounts.

- Most companies provided a boiler-plate description of the general effect of IFRS 16 and not in a way that helped readers understand the specific impact on the company.
- Many companies appeared not to have decided on their transition method which we would have expected to have been resolved by this stage
- Many companies referred to the accounting choices under the standard – for example, the recognition exemption available for low value assets and short-term leases – but did not say which they intended applying.

We were pleased to see examples of disclosure that:

- provided qualitative and full quantitative information – for example, the net impact of the standard on both income statement and balance sheet;
- identified the specific lease portfolios most significantly impacted;
- explained the specific judgements and policy changes prompted by the new model; and
- provided detail about the structure of their implementation projects, supported by areas of focus and expected time-lines.

One company helpfully disclosed revised APMs, highlighting the expected impact of the standard on their key performance metrics.

We expect companies to significantly improve the quality of their disclosures at the year end by providing company specific detail about the impact of the standard. This should include qualitative and quantitative information, clarification of the exemptions they intend applying and the policy choices that they have made.

Strategic reports lacking comprehensive information remains an issue.

We expect companies to significantly improve the quality of their disclosures at the year end by providing company specific detail about the impact of the standard.

## Other issues

### Supplier financing arrangements

Concerns have been raised about the transparency of arrangements where, in order to enable smaller companies to be paid more promptly, a company's suppliers are paid by a financial provider, such as a bank, on its behalf.

We expect both the strategic report and the disclosures of financial instruments to describe the nature and amount of any material supplier financing arrangements and the impact on the company's liquidity.

We challenged companies where it was unclear whether the creditor and subsequent cash paid to the financial provider had been appropriately classified in the balance sheet and statement of cash flows, respectively.

Our press release on complex supplier arrangements, issued in December 2014, remains relevant to the reporting of supplier financing.<sup>5</sup>

## Strategic Reports

This section sets out our assessment in relation to strategic reports based on our:

- monitoring work; and
- Lab studies.

We challenged companies where it was unclear whether the creditor and subsequent cash paid to the financial provider had been appropriately classified in the balance sheet and statement of cash flows, respectively.



<sup>5</sup> <https://www.frc.org.uk/news/december-2014/frc-urges-clarity-in-the-reporting-of-complex-supp>

## CRR findings on strategic reports

This year our challenges to companies in this area were principally on: (i) the description and disclosures relating to: APMs and (ii) whether the strategic report was sufficiently balanced and comprehensive.

### APMs

Our thematic review conducted last year and which we published in November 2017 set out the key outcomes and our expectations.<sup>6</sup>

Although partly prompted by ESMA's Guidelines on Alternative Performance Measures, which apply to listed companies, we encourage all companies to comply with the Guidelines which we see as codifying best practice.<sup>7</sup>

The most commonly raised challenges were in respect of the following:

- undue prominence given to APMs, such as alternative measures of profit, over the equivalent IFRS measures;
- unclear, cursory or boiler-plate explanations, or a simple statement that adjusted measures are superior to the equivalent IFRS measures;
- items excluded from 'underlying' profit when their inclusion would appear to be warranted as part of normal trading;
- unclear reconciliations to relevant IFRS numbers – including ratios such as return on capital and cash conversion;
- inappropriate labelling of 'recurring' items as 'non-recurring';
- costs of multi-year restructuring programmes that are charged in successive years without reporting on overall progress; and
- adjustments that appear inconsistent with the stated accounting policy.

### Effects of the UK decision to leave the EU

This is the third year we have monitored how companies are reporting the impact of leaving the EU on their business. Reporting at this time last year, we expected companies to be able to provide increasingly specific descriptions of the impact of the decision in their next report and accounts. In view of the continuing uncertainty about the nature of the UK's exit and the arrangements, if any, that are to be put in place across the full range of trade and tax relationships, the development of focussed disclosures has been patchy.

Companies who failed to refer to the decision in their 2017 strategic reports, either as a principal risk or elsewhere in their discussion of performance and outlook, were those internationally diversified companies with no significant operations in the UK or with no specific exposure. Nearly one third of the companies in our tracked sample who reported the impact of the 'leave' decision as a principal risk last year no longer did so in their 2017 reports. Reasons for this varied. Some had concluded that there was no noticeable impact on the likely demand for their goods and services. Others were further advanced in expanding or establishing offices or subsidiaries outside the UK to focus on European trade and associated implications, for example, the passporting rights of banks.

Some companies had firmed up on their initial view that the decision would have an impact on their business, for example, due to material and labour costs or the availability of skilled workers in the building industry. We also noted specific reference to the impact of potential higher tariffs on imported goods and the consequences of increased customs declarations.

Nearly one third of the companies in our tracked sample who reported the impact of the 'leave' decision as a principal risk last year no longer did so in their 2017 reports.

<sup>6</sup> <https://www.frc.org.uk/getattachment/ff987c01-416f-4635-8dba-fcda5530f4b5/091117-APMs-CRR-thematic-review.pdf>

<sup>7</sup> The ESMA Guidelines apply to regulated information and prospectuses of listed companies with the exception of APMs disclosed in the financial statements.



Other companies, for whom there was no obvious specific impact, continued to refer to the continuing uncertainty in the markets generally and in fairly bland terms. Despite the general level of uncertainty for most, we have not seen any indication from companies that the final outcome will have an impact on their status as a going concern.

The most informative disclosures made by those who are significantly impacted. These explained the reasons for any change in their risk assessment and identified a range of mitigating options. The better reporters also identified those responsible for developing their strategic response to the challenge. A few companies appear to have considered a range of possible scenarios attaching to the current position. It was encouraging that these companies then reflected the outcomes of their stress testing in their viability reporting.

### Business reviews

We frequently challenge companies where the strategic report is insufficiently balanced and comprehensive to meet the Companies Act requirements or where the disclosures of principal risks and uncertainties are missing or are incomplete.<sup>8</sup>

These requirements also apply to private companies, other than small companies as defined in the Companies Act, and smaller listed or AIM quoted companies. As in previous years many, but not all, of the questions we raised relate to these types of company. For example:

- the strategic report of one AIM quoted company contained no analysis of the group's financial performance or position; and
- a large private company had to be reminded of the requirement to include information about the principal risks and uncertainties facing the company.

### Materiality

We also challenged companies whose strategic report did not include a discussion of all material aspects of the company's reported performance such as significant foreign exchange movements or a material reduction in the cash generated in the period.

### Key performance indicators (KPIs)

Where necessary for an understanding of a company's performance, the law requires management to use KPIs in their review of the business. We expect management to identify and report on the most relevant metrics they use to monitor their performance, clearly explaining their purpose and the basis on which they have been calculated.

The case study opposite illustrates our approach to monitoring key performance indicators.

### Dividends and distributable reserves

In last year's report we drew attention to potential breaches of the Companies Act requirements for the payment of dividends in circumstances where the latest annual accounts cannot support the planned distribution, i.e. at the time of their preparation there were insufficient distributable profits but where distributable profits have been generated subsequently. For a public company, the Companies Act then requires Interim Accounts for the individual company to be filed prior to the payment of the dividend.

We continue to regularly come across companies which do not appear to have considered these requirements, or which, having identified the issue themselves, are considering with their professional advisors how best to resolve matters.

We frequently challenge companies where the strategic report is insufficiently balanced and comprehensive

We continue to regularly come across companies which do not appear to have considered these requirements

<sup>8</sup> Companies Act 2006, paragraph 414C 2 and 3

# Case Study

## Alternative performance measures

### Background

Many fund managers discuss the investment performance of their funds in their strategic reports and, in some cases, investment performance is also presented as a key performance indicator. The reason for discussing investment performance is that it is an important aspect of the business model. Funds that outperform their benchmarks will attract investors, leading to an increase in the assets under management and higher fee income. Funds that underperform will lose investors, resulting in a negative impact on the business. There are, broadly speaking, two ways of calculating investment performance: gross of fees and net of fees. A question was put to the FRC whether we should require all investment performance metrics to be calculated on a consistent and net of fees basis.

### FRC's approach

We reviewed the accounts of a number of fund managers and found that some calculated investment performance on a gross of fees basis while others used a net of fees basis. However, we also found examples of fund managers that presented investment performance and did not state the basis of calculation. We wrote to those fund managers that did not state the basis of calculation, asking them to confirm the basis of calculation and explain why they had chosen that basis. We also discussed this issue with the FCA, which confirmed that the Conduct of Business Sourcebook, which regulates the presentation of investment performance and requires the effect of fees to be disclosed, does not apply to the annual report and accounts.

### The fund managers' response

The fund managers we approached all agreed to disclose the basis of calculation in future years. With respect to the choice of the basis of calculation, a gross of fees presentation is usually used for funds managed on behalf of institutional investors, while a net of fees presentation tends to be favoured for funds managed on behalf of retail investors. This is a convention consistent with global industry standards. A relevant factor in deciding which basis to use is the fund's benchmark or comparator. Where the comparator is, for example, an index, a gross of fees performance will provide a suitable like-for-like comparison because costs are not taken into account in calculating the index return. Furthermore, there are certain practical difficulties involved in calculating investment performance on a net of fees basis, for example, the variation of fee structures across different funds and the possibility of investors incurring costs in addition to the fund manager's fees.

### FRC focus points

The choice of metric and how it is calculated requires judgement to be exercised by the preparer, although this will also be informed by industry practice. We will challenge companies when they do not clearly explain their choice of metrics. It is important that users of the accounts understand the basis of calculation, which we believe will facilitate a dialogue between preparers and users.

We will challenge companies when they do not clearly explain their choice of metrics.

## INSIGHTS FROM THE LAB

### Dividends

The availability of dividend resources within companies and their strategy regarding the payment of dividends continue to be areas of interest to investors and others. The Lab's review of this area showed that while many companies had made efforts to provide more information about dividend policy and resource, wider adoption of disclosure recommendations made in the Lab's report, [Disclosure of dividends - policy and practice](#), would be welcome.

Recent legislative developments with regards to section 172 highlight the need for directors to consider wider stakeholder groups in key decisions and for companies to report on directors' decisions. Often the setting of policy for dividends and choices around the payment of a dividend would be significant capital allocation events for a company (and ones in which investors and others are keenly interested). Our work in this area suggests that reporting on the interaction between the requirement to have regard to wider stakeholders and dividend policy and payment is not yet common practice and as such we would expect this to be an area where reporting develops.

... reporting on the interaction between the requirement to have regard to wider stakeholders and dividend policy and payment is not yet common practice...

## INSIGHTS FROM THE LAB

### Reporting on Performance

Investors continue to highlight the importance of performance metrics disclosed by companies in their assessment of the valuation and performance of a company as well as the credibility of management. This is an area that has also been subject to increasing regulatory focus, including requirements in the non-financial reporting directive, the ESMA 'Guidelines on Alternative Performance Measures' and the FRC's thematic reviews of compliance with these guidelines. There have also been increasing calls from investors and other stakeholders for the reporting of wider metrics, beyond the traditional focus on financial measures, as they seek to identify other drivers of long-term value.

With this context in mind, the Lab initiated a project to gather investor views on how disclosure of [performance metrics](#), including GAAP, non-GAAP and wider metrics had developed. Based on a wide-ranging set of investor interviews the Lab developed a set of five principles




to help companies develop their metrics. Investors seek performance metrics that are:

- aligned to strategy;
- transparent;
- in context;
- reliable; and
- consistent

To help companies apply these principles the Lab developed supporting questions for companies and boards to ask themselves when assessing their presentation of performance metrics.

Investors highlighted some good examples of reporting on performance metrics, but are calling for improvement in a range of areas. Investors stressed how important the reporting of performance metrics in a range of areas is for their assessment of management credibility, and applying the principles highlighted in our report is a way for management to ensure that their disclosures are meeting investor needs.

Investors highlighted some good examples of reporting on performance metrics, but are calling for improvement...

Performance metrics – an investor perspective		
 GAAP  Non-GAAP  Wider metrics		
Principles	Investors seek disclosure...	Company management and their boards should ask...
<b>Aligned to strategy</b>	<ul style="list-style-type: none"> <li>Of metrics that provide insight into the company's business model, strategy and competitive advantage and measure its success</li> <li>Of metrics that demonstrate how the company creates long-term value</li> <li>Of the metrics used internally to make business decisions and to manage, monitor and incentivise the achievement of the business strategy</li> </ul>	<ul style="list-style-type: none"> <li>Do our metrics clearly link to our company's strategy and value drivers? Have we addressed all relevant financial and wider metrics</li> <li>Are we reporting the metrics that are being monitored and managed internally?</li> <li>Is there a clear link between the metrics that drive our business model and strategy, and our remuneration policy?</li> </ul>
<b>Transparent</b>	<ul style="list-style-type: none"> <li>That provides transparency on how metrics are calculated and defined to help investors make their own assessments, with clear reconciliations from GAAP to non-GAAP metrics</li> <li>That gives a clear explanation of why metrics have been used and, in the case of non-GAAP metrics, why management think these are a more faithful representation of the value that has been generated by the company's business model than the GAAP metrics</li> </ul>	<ul style="list-style-type: none"> <li>Is it clear to investors why we use these metrics and what performance they are trying to represent?</li> <li>Are we transparent about the way in which our metrics are calculated and defined?</li> <li>Where we report non-GAAP metrics, do we explain why and how they more appropriately represent our business model and strategy? Where we make adjustments to exclude items do we also exclude related gains? Do we explain why we have made specific adjustments, at least at a material level?</li> </ul>
<b>In context</b>	<ul style="list-style-type: none"> <li>That shows how a company has performed, with explanations where this is different from what it was trying to achieve, either good or bad</li> <li>That explains the company's position, for example, its balance sheet strength, liquidity and market position</li> <li>That gives an indication of the company's prospects within the context of the market and market changes. Longer term objectives are often preferable</li> </ul>	<ul style="list-style-type: none"> <li>Do we explain what performance we are expecting to achieve, what we actually achieved, and why?</li> <li>Do we explain what performance our metrics are trying to achieve in the future, and provide an understanding of our overall long-term objectives?</li> </ul>
<b>Reliable</b>	<ul style="list-style-type: none"> <li>That provides information to help investors gain confidence on the process of developing, monitoring and reporting reliable metrics, and whether there are appropriate controls in place</li> <li>That provides clarity over the level of scrutiny that metrics are subject to (including board, audit committee, internal and external assurance processes) and the boundary of the information</li> </ul>	<ul style="list-style-type: none"> <li>Do we provide an overview of how our metrics have been developed and monitored to allow investors to assess their reliability?</li> <li>Do we explain the level of scrutiny to which metrics are subject to allow an assessment of whether they are fair, balanced and understandable? Do we outline the audit committee's (or other executive or non-executive committee) oversight and whether they consider the appropriateness of specific metrics or adjustments in addition to the way in which the metrics are reported? Do we explain what additional scrutiny may be given to adjusted metrics used in remuneration?</li> <li>Is the boundary of each metric clear (for example, the timeframe, parts of business covered etc)?</li> </ul>
<b>Consistent</b>	<ul style="list-style-type: none"> <li>Of metrics that are calculated consistently year-on-year and also presented consistently across reporting formats (annual report, investor presentation, sustainability reports, press releases etc)</li> <li>That provides a track record, preferably over five years</li> <li>That provides enough detail to allow effective comparisons of similar companies, either at a business model or sector level</li> </ul>	<ul style="list-style-type: none"> <li>Are our metrics consistent year-on-year? If our metrics have changed, do we provide a clear explanation as to why the change has been made and why the new metric is better? Do we provide comparatives for a number of years?</li> <li>Are our metrics calculated consistently every year? If they are not, do we provide an explanation for any change, and an outline of the impact of the change?</li> <li>Are the same metrics reported consistently across the investor presentation, preliminary announcement, annual report, press releases and other documents?</li> <li>Is a track record of our performance provided, preferably over five years?</li> <li>Are our metrics consistent with an industry standard or our close competitors? If not, do we explain why our metrics are more appropriate?</li> </ul>

# 4 Developments in Corporate Governance and Non-Financial Reporting

## Strategic and Governance Reports

The agenda on non-financial and wider corporate reporting is expanding at a rapid pace, with major developments in 2018. Some wider reporting matters are now embedded in the Code and others are addressed through other mechanisms or voluntary frameworks.

## New Reporting Requirements

A recent report from PwC monitoring the first year of reporting against the new requirements of the Non-Financial Reporting Regulations highlights that there is scope for improvement in reporting non-financial information by companies.<sup>9</sup> Areas of focus include explaining policies and due diligence processes while avoiding boiler-plate, and reporting on the positive and negative impacts of a company's activities on key stakeholders. In July 2018, the government published The Companies (Miscellaneous Reporting) Regulations. These introduce new reporting requirements for the strategic and directors' reports which require directors to explain how they have had regard to a number of broader matters in performing their duty under section 172 of the Companies Act 2006 to promote the success of the company. This duty includes considering the long-term in decision making, the interests of broader stakeholders and the wider impacts of a company's activity.

The new requirements are effective for financial years beginning on or after 1 January 2019 and apply to large companies.

The Companies (Miscellaneous Reporting) Regulations also introduce a requirement for large private companies to include a statement of their corporate governance arrangements in the directors' report. The legislative requirement is supported by the Wates Corporate Governance Principles for Large Private Companies, which are discussed in more detail in section 6.

Additionally, these Regulations include a requirement for disclosure of pay ratio information in the directors' remuneration report which applies to companies with more than 250 employees.

## Guidance on the Strategic Report

The FRC published its revised Guidance on the Strategic Report in July 2018. The updated Guidance reflects recent developments in non-financial reporting and aims to strengthen the link between the purpose of the strategic report and the duty of each director under section 172. The Guidance on the Strategic Report incorporates recent legislative changes and complements developments in the 2018 Code.

The enhanced Guidance on the Strategic Report encourages companies to consider the broader matters that impact company performance over the longer term. This includes providing relevant non-financial information and explaining how regard was had to the interests of wider stakeholders and other matters such as the environment. However, the primary audience of the strategic report, as set out in legislation, remains the shareholders.

The new requirements are effective for financial years beginning on or after 1 January 2019...

<sup>9</sup> Responding to the new non-financial reporting regulations is available at <https://www.pwc.co.uk/audit-assurance/4/e/assets/pdf/responding-to-non-financial-reporting-regulations.pdf>

The revised Guidance on the Strategic Report places greater emphasis on how a company generates and preserves value over the longer term and encourages companies to consider the sources of value that are not recognised on the balance sheet as part of its business model reporting.

### Stakeholder Reporting

Long-term success depends on securing the trust of key stakeholders. The emphasis placed on section 172 of the Companies Act via the Companies (Miscellaneous Reporting) Regulations as well as in the 2018 Code has raised the degree of attention being paid to this issue by companies in their reporting. Consequently, stakeholder engagement was one of the biggest reporting themes in 2017 annual reports.

Analysis of a sample of the latest annual reports of FTSE 350 companies found a clear increase in companies making specific mention of their responsibilities under section 172, although far fewer companies set out how they have fulfilled these responsibilities.<sup>10</sup>

Almost all companies in the FTSE 100 (95%) now provide some level of discussion on engagement with some of their stakeholders. This is encouraging, although detailed discussion is much less common.<sup>11</sup> 86% of FTSE 350 companies surveyed in 2018 identified some stakeholder groups in addition to shareholders, with employees and customers the most commonly mentioned groups. All groups were, however, mentioned more often than in 2017.<sup>12</sup>

The quality of company reporting on stakeholder issues varies considerably and is clearly in a state of evolution. Companies appear to be responding to demands for more information about their approach to engagement. With the coming into force of the 2018 Code and revised Guidance on the Strategic Report, we expect companies increasingly to add colour and insight about who their key stakeholders are, how they engage with them, what their expectations are and the effect the engagement has on strategy and decision-making.

### Culture Reporting

Culture is another area of increasing focus for company reporting and we expect this to continue, particularly with the addition of a board responsibility for monitoring culture in the 2018 Code.

In 2015, when the FRC announced its study on corporate culture and the role of boards, 48% of FTSE 100 companies defined the values of their organisation, 35% defined their purpose and 14% discussed their corporate culture in their annual reports.<sup>13</sup>

In 2017 these numbers were significantly higher, as set out in figure one.

Furthermore, over half of companies are going further and discussing how values are embedded, thus giving more meaningful insight into how committed the company is to driving its culture.

However, only a quarter of companies are taking the extra step of linking purpose and culture to strategy and value creation. Nevertheless, it is encouraging that companies are starting to make these links, particularly as this is a key focus for both the Guidance on the Strategic Report and the 2018 Code. We therefore expect to see rising levels of sophistication in reporting over the next few years, and an increase in the number of companies setting out a purpose that goes beyond profit and encompasses a broader set of objectives.

Figure one:<sup>14</sup> Culture Insights

#### In 2017:

- 74% of FTSE 100 companies outlined their values
- 66% of the FTSE 100 defined their purpose
- 71% evidenced how the board has oversight of culture

#### and:

- 57% provide information on how values are being embedded

#### but only:

- 26% went further and linked purpose to strategy
- 26% discuss culture in relation to value creation.

Long-term success depends on securing the trust of key stakeholders.

Almost all companies in the FTSE 100 (95%) now provide some level of discussion on engagement with some of their stakeholders.

...only a quarter of companies are taking the extra step of linking purpose and culture to strategy and value creation.

<sup>10</sup> Deloitte LLP, Annual Report Insights 2018

<sup>11</sup> Black Sun, Less Perfection More Authenticity, 2018

<sup>12</sup> EY, Annual reporting in 2017/18

<sup>13</sup> Black Sun, Corporate Culture, A Thought Piece on Reporting, Feb 2016

<sup>14</sup> Black Sun Less Perfection More Authenticity, 2018

## Diversity Reporting

Since 2013, companies have been required to include in their strategic reports:<sup>15</sup>

*a breakdown showing at the end of the financial year:*

*(i) the number of persons of each sex who were directors of the company;*

*(ii) the number of persons of each sex who were senior managers of the company (other than persons falling within sub-paragraph (i)); and*

*(iii) the number of persons of each sex who were employees of the company.*

In their annual reports published in the year to 1 March 2018,<sup>16</sup> a smaller proportion of FTSE 350 companies used infographics to present this information than in earlier years. The absence of infographics has the effect of making the information less accessible and stark differences in gender representation at different levels tend to stand out less. Several companies gave the information as percentages, missed out one of the three categories or just gave the proportions of women, therefore only partially complying with the legal requirement. These findings are consistent with the FRC's experience through its monitoring of strategic reports.

In the FTSE 100, 55 companies were fully compliant, reporting the information as specified in section 414C of the Companies Act. A further 30 companies were partially compliant. In the FTSE 250, 142 companies (56.8%) were fully compliant and a further 24 companies (9.6%) were partially compliant. This level of compliance is somewhat surprising and rather disappointing given that this disclosure is a legal requirement. Where as part of our monitoring activity, we find that disclosure is not provided as required, the matter is brought to a company's attention.

FTSE 350 companies used a wide range of different interpretations of 'senior managers' as part of this disclosure, making comparisons between companies and across sectors difficult. A number explained how they had interpreted

the definition in section 414C of the Companies Act and therefore who was included in the number. Others provided no narrative explanation of the numbers at all. A few used a definition consistent with the Hampton-Alexander recommendation that senior managers should comprise the most senior level of management below the board plus their direct reports.<sup>17</sup>

Due to these inconsistencies in how companies interpret 'senior managers', the 2018 Code has introduced a new reporting requirement based on the Hampton-Alexander recommendations. With effect from 2020 companies will report the gender balance in the top level of management below board level (often referred to as the executive committee) and their direct reports. The aim is to bring more consistency and comparability to the reporting to increase transparency and facilitate benchmarking.

The focus for driving diversity at the top of the UK's largest companies, has now shifted to the pipeline for succession to executive management roles. The FRC's recent report, *Board Diversity Reporting*, published in September 2018, found that 67% of FTSE 100 companies and 89% of FTSE 250 companies did not report any initiatives for increasing gender diversity at senior management levels. We expect more focus on the pipeline by nomination committees under the 2018 Code.

## Financial Reporting Lab

In the last two years, the Lab has focussed much of its work on different aspects of the strategic report. It issued a report on *Business model reporting* in October 2016, followed by a report on *Risk and viability reporting* in November 2017. Earlier this year it published a report on *Performance metrics*. All these reports provide details of reporting that investors are seeking and practical examples of how companies are delivering this. But practice does not stand still. To consider how reporting has changed, the Lab has relooked at the reporting of business model, risk and viability. Highlights are covered below and on pages 40 and 41.

The absence of infographics has the effect of making the information less accessible and stark differences in gender representation at different levels tend to stand out less.

<sup>15</sup> Section 414C, Companies Act 2006

<sup>16</sup> Data and analysis provided by Professor Ruth Sealy, University of Exeter Business School

<sup>17</sup> FTSE Women Leaders: Improving the gender balance in FTSE Leadership, November 2017

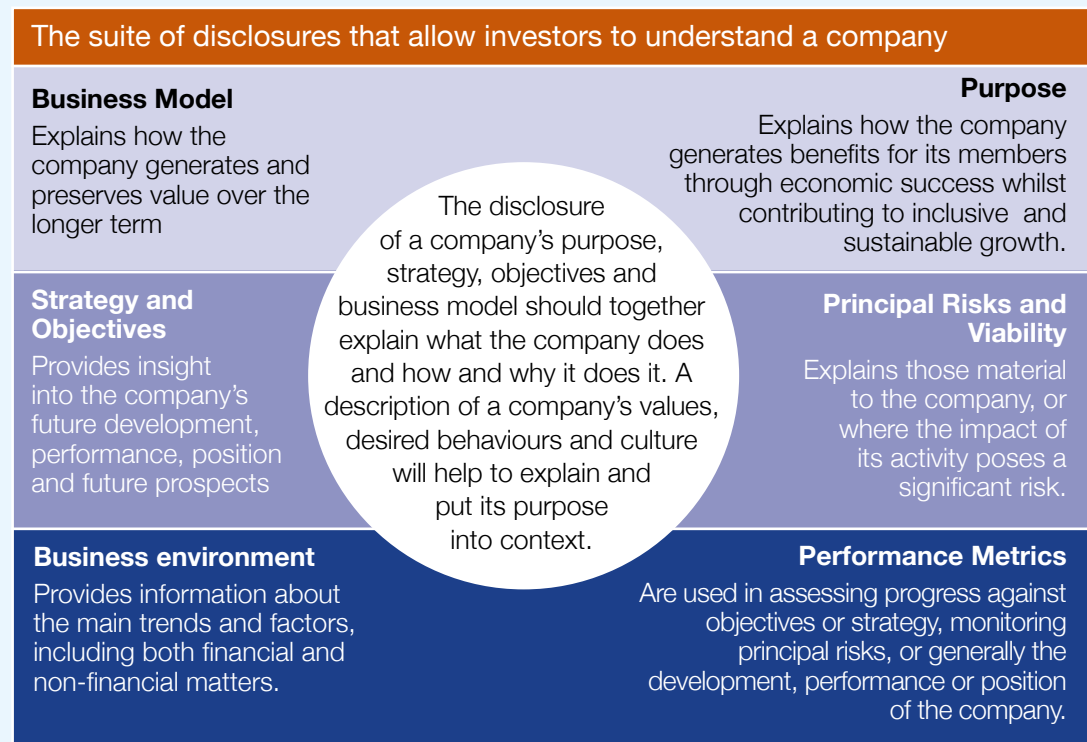
## INSIGHTS FROM THE LAB

### Business model reporting

The Lab's 2016 [Business model reporting](#) project showed that business model disclosures were a key starting point for investors when trying to understand how a company makes money and why that is sustainable over the longer term.

While the Lab's original report highlighted certain attributes and types of information that investors and other users of the annual report wanted from a business model, the Lab's [implementation study](#) revealed a subtler message. Investors do not expect all information to reside within the business

model disclosure itself, and appreciate the need for flexibility for companies to structure their communications in a way that best meets their stakeholders' needs. Therefore, clear disclosure that builds understanding, either directly or through cross-referencing and linkage across a suite of disclosure (see diagram), will provide investors with the information that they want. However, linkage and cross-referencing are useful only where they add value and meaning, and where they contribute to a coherent report and further understanding of the company's disclosure, rather than for the sake of having superficial linkage.



The Lab noted a trend for the business model to be presented in an 'inputs, business activities, outputs/outcomes' format. The Lab noted that this approach can often be a good way of making a complex business easy to understand, particularly where it is attempting to communicate to a wide range of shareholders. It does, however, run the risk (if done poorly) of over-simplifying, leading to basic questions about what the business does, how the company actually makes money and how the business model is likely to evolve, all of which investors want to understand from the disclosure.



## Wider corporate reporting initiatives

The strategic report provides the overall framework for reporting non-financial information and the FRC encourages companies to disclose this information when it is material.

### Climate-related disclosures

There are several other frameworks addressing specific aspects of non-financial reporting including initiatives relating to disclosures of climate risk, most notably the Task Force for Climate Related Disclosures' recommendations. These provide companies with a framework for considering the governance and reporting of climate-related matters.

Investors and other stakeholders are increasingly seeking information from companies regarding their response to climate risk. The Lab is carrying out a project to consider how companies might respond to investor demands for such information. Using the investor-identified attributes of good reporting in previous Lab reports (in particular explanations of business models, stress testing and scenario analysis used in the

preparation of risk and viability reporting, and the reporting of wider metrics), the project seeks to identify how climate and workforce disclosures can be reported most effectively.

### Gender pay gap

2018 is the first year in which companies with more than 250 employees have been required to publish their gender pay gap. This disclosure is provided outside of the annual report and accounts but provides information that may be relevant for issues that are covered in the annual report. These regulations have been powerful in stimulating discussions within companies, and some other organisations that have voluntarily adopted them. It is encouraging that companies are considering how they close their gap.

### EU and International Developments

Narrative and wider corporate reporting is gaining traction in the EU and at an international level. The EU has an increasing focus on sustainable finance and as part of this will be considering improvements to corporate reporting over the next few years.

Investors and other stakeholders are increasingly seeking information from companies regarding their response to climate risk.

These regulations have been powerful in stimulating discussions within companies...



## UK Corporate Governance Code

Over the years, the Code has been revised and expanded to take account of the increasing demands on the UK's corporate governance framework. The principle of collective responsibility within a unitary board has been a success and – alongside the stewardship activities of investors – played a vital role in delivering high standards of governance and encouraging long-term investment. Nevertheless, the debate about the nature and extent of the framework has intensified as a result of the 2008 financial crisis and high-profile examples of inadequate governance and poor conduct, which have led to poor outcomes for a wide range of stakeholders.

In July 2018, the FRC published a revised Code and supporting Guidance on Board Effectiveness, which puts the relationships between companies, shareholders and stakeholders at the heart of long-term success. The 2018 Code places emphasis on businesses building trust by forging strong relationships with key stakeholders. It calls for companies to establish a corporate culture that is aligned with the company purpose and business strategy, and which promotes integrity and values diversity. Key changes are described below.

- Workforce and stakeholders: new Principles and Provisions to drive increased board engagement with the workforce and improved reporting by boards on how they have considered the interests of stakeholders when performing their duty under section 172 of the Companies Act 2006.
- Culture: a responsibility for boards to create a framework which will drive a culture which aligns company values with strategy and to monitor culture on an ongoing basis.

- Succession planning and diversity: renewed emphasis on achieving the right mix of skills and experience on the board to foster overall competence, constructive challenge and on promoting diversity through regular board refreshment and effective succession planning.
- Remuneration: new Principles and Provisions linking remuneration to long-term company success. The remuneration committee must take into account workforce remuneration and related policies when setting director remuneration. Discretion should be exercised to override formulaic remuneration outcomes that do not reflect underlying performance.

The changes in structure and content to the 2018 Code are designed to improve the quality of practice and reporting. The 2018 Code is applicable for accounting periods beginning 1 January 2019. Companies will be reporting against it from 2020 onwards and the FRC expects to see clear, meaningful reporting on how the Principles have been applied, in a manner that shareholders and others can evaluate.

In relation to the 2018 Code, the FRC is undertaking a programme of embedding aimed at both raising awareness of the changes in the 2018 Code and encouraging better reporting and practice. The FRC is also considering the nature and scope of the additional monitoring it is planning to undertake once companies begin to report against the 2018 Code from 2020 onwards. This is discussed in more detail in section six.

The 2018 Code places emphasis on businesses building trust by forging strong relationships with key stakeholders.

...the FRC expects to see clear, meaningful reporting on how the Principles have been applied, in a manner that shareholders and others can evaluate.

## Assessment of Compliance with the Code

Reporting on the Code is a requirement of the Listing Rules. Premium-listed companies must make a statement explaining:

- how the company has applied the Principles of the Code in a manner that would enable shareholders to evaluate how they have been applied;
- whether the company has complied with the relevant Provisions in the Code; and
- where it has not complied, provide an explanation for non-compliance.

We set out below our assessment of the degree to which listed companies comply with the Code and the quality of reporting against it.

## Overall compliance rates

Grant Thornton's annual review of FTSE 350 companies found that reported compliance with Code Provisions has risen to a new high with 72% declaring full compliance, up from 66% in 2017. This drive toward compliance came from the FTSE 250 with 71% reporting full compliance, a significant increase on 61% in 2017. Compliance with all but one or two Code Provisions remains at 95 per cent.<sup>18</sup>

This information can be further broken down. Table B shows that, in respect of board and committee composition, although compliance rates across smaller companies remain on par with those of larger companies, there clearly is a need for more independent non-executive directors in smaller companies, especially to fulfil remuneration committee roles.<sup>19</sup>

... compliance with Code Provisions has risen to a new high with 72% declaring full compliance...

**Table B:** Compliance with selected Provisions of the Code

Code Provision	FTSE 350 companies		Smaller companies	
	2018	2017	2018	2017
A.2.1 – Separate chairman and CEO	99%	99%	99%	98%
B.1.2 – Met minimum provisions for number of independent NEDs	97%	96%	90%	90%
B.2.1 – Met minimum provisions for nomination committee composition	99%	98%	97%	97%
C.3.1 – Met minimum provisions for audit committee composition	98%	97%	93%	93%
D.2.1 – Met minimum provisions for remuneration committee composition	97%	95%	87%	85%

Source: Minerva Analytics (date range 1 September 2017 to 31 July 2018)

Note: The 2016 Code has different requirements for FTSE 350 and smaller companies regarding the minimum number of independent directors and minimum requirements for board and committee composition.

<sup>18</sup> Corporate Governance Review 2018; Grant Thornton; October 2018

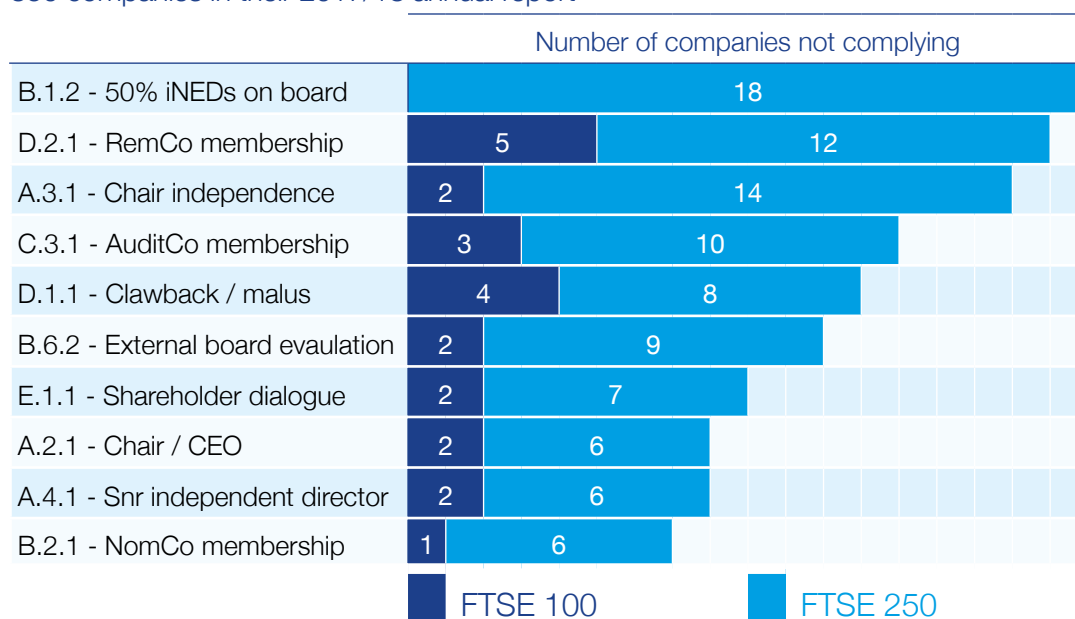
<sup>19</sup> Minerva Analytics looked at 335 FTSE 350 companies, 278 from the Small Cap and 25 from the Fledgling Index.

Table C highlights which Provisions were least complied with by the FTSE 350 companies as at 31 July 2018. Overall, 85 companies, of which 24 were from the FTSE 100, made some declaration of non-compliance. In total, there were 172 instances of declared non-compliance over 37 Code Provisions. As in previous years, Code Provision B.1.2 has the lowest levels of compliance, albeit there

has been a drop from the 2017 figure of 29 companies to 18 this year, none of which were FTSE 100 companies. It is not, therefore, surprising that the Provisions relating to membership requirements of the committees of the board are also in the top ten. We analyse below how well companies explained their non-compliance.

As in previous years, Code Provision B.1.2 has the lowest levels of compliance...

**Table C:** Most frequent areas of non-compliance with the Code as reported by FTSE 350 companies in their 2017/18 annual report



An explanation should set out the background to the departure from the Provision, provide a clear rationale for the action being taken, and describe any mitigating activities.

Source: Extract from Practical Law What's Market database. Data as at 31 July 2018.

### Explanations

Companies are expected to explain areas of non-compliance with Code Provisions. FRC guidance on 'comply or explain' provides a benchmark for companies when writing explanations and for shareholders when assessing them. An explanation should set out the background to the departure from the Provision, provide a clear rationale for the action being taken, and describe any mitigating activities.

Companies remain reluctant to explain non-compliance with Code Provisions. Monitoring of the quality of explanations found companies are still not providing sufficient detail to allow shareholders

(and other interested parties) to understand a company's decision to depart from a Provision.

We have reviewed in detail:

- Provision A.3.1 – where the chairman is not independent on appointment or they were previously the company's chief executive;
- Provision B.1.2 – where there is less than 50% of independent non-executive directors on the board; and
- Provision B.6.2 – no external board evaluation was carried out.

Better practice explanations include company specific context and historical background, and information on what mitigating actions have been taken to address any additional risk. It is important the company explains how its alternative approach is consistent with the spirit of the Provision it is departing from and whether it is time limited. Ideally, explanations should be sufficiently clear to be convincing and understandable to all shareholders, without the need to contact the company.

#### Explanations where the chair did not, on appointment, meet the independence criteria set out in the Code or where the chief executive goes on to be chair (A.3.1)

There were 16 FTSE 350 companies that reported non-compliance with this Provision. The majority related to the chair not being considered independent on appointment. However, there were also instances reported of a chief executive who had gone on to become chair. Neither situation is considered best practice by the Code. Nearly half the explanations provided essentially repeated the Code Provision, known as boiler-plate reporting, and gave no information as to why this arrangement was considered acceptable by the company. A more informative approach was taken by four of the companies, all in the FTSE 250. These companies provided details on why non-compliance had occurred and, in particular, included commentary on mitigating actions. Examples of these included strengthening the role of the deputy chair and/or senior independent director and ensuring that major shareholders were kept informed on the board changes.

#### Explanations where fewer than 50% of non-executive directors on the board are independent (B.1.2)

All 18 companies who did not comply with this Provision came from the FTSE 250, including three who were newly listed. Ten have since returned to full compliance with this Provision.

The overall quality of explanations here was better but there were some very poor examples from those who have continued to not comply with this Provision for many years. The most common reason given for non-compliance was where the loss of a director threw out the balance of the board. This points to a need for better succession planning so that the time taken to replace the director in question can be kept to a minimum.

Better-quality explanations included more information on mitigation that was put in place. One company explained that to ensure enough independent oversight of related party transactions, a committee comprising solely of independent directors had been established to review such transactions and decide whether a transaction could be submitted to the board for approval.

#### Explanations where no external board evaluation was conducted (B.6.2)

The Code requires boards to conduct an annual evaluation of its performance. FTSE 350 companies are expected to ensure that, once every three years, this evaluation is externally facilitated. There were 11 companies, including two from the FTSE 100, who did not carry out an external board evaluation in the 2017/18 reporting period even though they were due to do so under the Code. Most commented on the need to delay due to significant board changes – normally of the chair and/or senior independent director. The better explanations indicated that the board was proactively seeking to engage an external evaluator for the following year and gave details to demonstrate that it had, nevertheless, carried out a robust and extensive internal board evaluation.

The 2018 Code aims to promote higher quality external board evaluations. It emphasises the importance of the evaluator's direct contact with the board and individual directors. The nomination committee will be expected to provide more detail about how a company's

Better-quality explanations included more information on mitigation that was put in place.

The 2018 Code aims to promote higher quality external board evaluations.

evaluation was conducted, what action was taken as a result and how the board engaged with any external evaluator. The Guidance on Board Effectiveness provides suggestions for getting the most benefit from an externally facilitated board evaluation. Analysis on current practice in respect of board evaluations is provided later in this section.

### Significant Minority Voting

Code Provision E.2.2 requires companies to explain, when publishing meeting results, how they intend to engage with shareholders when a significant percentage of them have voted against a resolution. The purpose is to encourage companies to detail the process they will undertake to assess the concerns of shareholders, as well as setting out how they intend to respond to those concerns. Reporting on these two aspects may occur at different times.

Table D shows the voting results for the FTSE 350 AGMs held from 1 November 2017 to 31 August 2018 that had significant shareholder opposition. For our assessment we have used the figure of 20% as defined by the Investment Association in its Public Register of significant minority voting. In comparison to 2017, there has been a 20% increase in the number of resolutions with a significant minority voting against the recommendation of the board.

Of the 144 resolutions with 20 per cent or more votes against, there were 10 that did not pass, of which 6 were remuneration resolutions. These companies published commentary in their AGM results, but only a few provided more extensive disclosures. These included significant details on the background to the vote and the rationale for the original decision, along with how the company intended to address shareholder concerns.

Of the 144 resolutions with 20 per cent or more votes against, there were 10 that did not pass...

**Table D:** Significant Minority Voting at FTSE 350 AGMs

Resolution Type	Resolutions with 20%+ votes against		Number Defeated	
	2018	2017	2018	2017
Audit & Reporting	1	4	1	–
Director Elections	56	25	1	–
Issue of Shares & Pre-emption Rights	23	26	–	1
Remuneration – Policy	22	28	3	2
Remuneration – Report	32	30	3	3
Shareholder Rights	8	5	2	1
Political Activity	2	2	–	–
<b>TOTALS</b>	<b>144</b>	<b>120</b>	<b>10</b>	<b>7</b>

Source: Investment Association's Public Register (FTSE 350 data 1 Nov. 2017 to 31 Aug. 2018)

Of the remaining 134 resolutions which passed despite opposition, there were 28 resolutions where the company did not make any statement about how they intended to engage with shareholders following the vote, as shown in Table E. This lack of disclosure is surprising given the Public Register has been in place since December 2017. The 2018 Code, once it comes into effect, will require a further update 6 months after the vote. The Investment Association has already begun writing to companies at the 6 month mark to request an update for inclusion in the Public Register. We expect, therefore, to see a significant change during 2019's AGM season.

Data from the Public Register also indicates that there were 56 companies who appear on the list both in 2017 and 2018. Of these, 9 were on the list for the same broad issue (e.g. remuneration), and 32 were listed for the exact same resolution. This raises the concern that engagement does not appear to be working as well as it should. We will be looking to see what impact the changes in the 2018 Code have in this area.

... there were 28 resolutions where the company did not make any statement about how they intended to engage with shareholders...

**Table E:** Significant Minority Voting at FTSE 350 AGMs - information noted in AGM results

Resolution Type	Resolutions with 20%+ votes against		Info in AGM results?	
	2018	2017	Yes	No
Audit & Reporting	1	4	1	0
Director Elections	56	25	40	16
Issue of Shares & Pre-emption Rights	23	26	21	2
Remuneration – Policy	22	28	17	5
Remuneration – Report	32	30	27	5
Shareholder Rights	8	5	8	0
Political Activity	2	2	2	0
<b>TOTALS</b>	<b>144</b>	<b>120</b>	<b>116</b>	<b>28</b>

Source: Investment Association's Public Register (FTSE 350 data 1 Nov. 2017 to 31 Aug. 2018)

## Board Evaluations

There is evidence to suggest that board evaluations differ in both quality and cost.<sup>20</sup> In 2017/18 just five FTSE 350 companies (2%) did not comment on their board evaluation, thereby not complying with B.6.1 of the Code. Across the FTSE 350, exactly two thirds reported having an internal evaluation and one third had an external evaluation during the year on which they were reporting, as shown in table F.

All the companies who reported having an external evaluation (35% of FTSE 100 and 32% of FTSE 250) named their evaluator. Some companies also demonstrated ongoing relationships with their evaluators during the intervening years where an internal evaluation was undertaken. This explains why the percentage of named evaluators in table F is higher than the number of external evaluations.

**Table F: FTSE 100 & FTSE 250 Use of Board Evaluators**

	Reported Internal Evaluation	Reported External Evaluation	Named Evaluators
FTSE 100	62%	35%	47%
FTSE 250	167 (66.8%)	80 (32.0%)	105 (42.0%)

Some boards commented on the methodology used for the evaluation, i.e. questionnaire-based or more in-depth (for example, including interviews with all the directors, interviews with key stakeholders, observation of board and committee meetings, etc.). In the FTSE 100, 79 commented on methodology, with 45 of these (57%) stating a more in-depth evaluation was conducted. In the FTSE 250, there was a small majority preference for the use of questionnaires, as shown in table G.

The methodology used will have implications for the quality of the evaluation and the value of the results to the board. Questionnaire-based evaluation could suggest a more compliance mindset, while chairs who opt for an in-depth evaluation may be more committed to getting the most from the evaluation.<sup>21</sup>

**Table G: FTSE 350 Type of Board Evaluation Conducted**

	Questionnaires	More In-depth
FTSE 100	34	45
FTSE 250	99	94

The Code Provision asking companies to report on how performance evaluation has been conducted is broad and offers considerable scope to provide information on the evaluation itself, the outcomes and follow-up actions. Currently, too few companies are using the opportunity to provide more detail about board evaluations. 51% of FTSE 100 companies referred to actions taken since their last evaluation and 45% stated what those actions were. In the FTSE 250 the proportions were similar, with 56% mentioning actions and 42% being specific about what the actions were. We consider that this information will be of interest to investors and we would like to see more examples of companies providing additional information voluntarily.

## Remuneration Reporting

Reporting requirements in this area are set out in legislation. The FRC does not have powers to support effective monitoring of remuneration reports and does not conduct its own reviews. However, the remuneration committee's responsibilities fall within the scope of the Code and the remuneration report falls within the scope of the Code requirement to prepare annual reports that are fair, balanced and understandable.<sup>22</sup>

There is evidence to suggest that board evaluations differ in both quality and cost.

Currently, too few companies are using the opportunity to provide more detail about board evaluations.

<sup>20</sup> Based on analysis conducted by Professor Ruth Sealy, University of Exeter Business School, of FTSE 350 annual reports published in the year to 1 March 2018

<sup>21</sup> Sealy, Tilbury & Vinnicombe, 2018, "Leading diversity in the boardroom: Board evaluation project 2017", Working paper, University of Exeter Business School

<sup>22</sup> Provision C.1.1



The communication principles set out in the FRC's Guidance on the Strategic Report can equally be applied to remuneration reports.

The FRC relies on reviews of remuneration reports undertaken by external parties to shape its view of their quality. These reviews suggest that, overall, there has been no real change in the quality of remuneration reporting this year. We hope that the changes to the remuneration section of the 2018 Code will lead to more meaningful and insightful reporting in due course.

Remuneration reports should be clear and provide transparent disclosure, without including unnecessary or boiler-plate information which adds to the length of annual reports without giving the reader greater insight. Remuneration reports have come in for criticism for being too long and complex. In 2018, the average length of remuneration reports fell slightly. The average length in the FTSE 350 was 20 pages and around 70% of companies have a report which is less than 25 pages long including Policy and less than 16 pages excluding Policy.<sup>23</sup> A slight fall is perhaps not surprising as only a minority of companies are submitting a new Policy to shareholders this year.

Investors continue to call for reporting that explains the rationale behind remuneration structures and policies and makes clear linkages to strategy and key performance indicators. Better discussion of the link between strategy and remuneration has the potential to improve users' understanding of how directors are incentivised to deliver the strategy by clearly articulating the links between KPIs, long-term objectives and performance-related pay-outs.

In annual reports for company year-ends between 1 April 2017 and 31 March 2018, approximately 10% of the FTSE 350 included a table or diagram showing how incentives and performance metrics detailed in the remuneration report are consistent with the corporate strategy,

while just over 60% included limited narrative and there was no discussion in around 30% of remuneration reports.<sup>24</sup> These numbers show no improvement on last year and suggest that companies have a long way to go to properly link executive remuneration with strategy.

We expect remuneration committees to be on top of the wider context of workforce pay against which decisions on executive pay are made. In 2017/18, only 5% of FTSE 350 companies gave a meaningful explanation of how they engage with employees over executive remuneration and only 6% explained how they take account of workforce pay.<sup>25</sup>

The 2018 Code, effective from 1 January 2019, gives remuneration committees an expanded remit to review pay and incentives across the workforce and to engage with the workforce. Companies will be required to explain to their workforce how executive pay aligns with wider company pay policy. Although there is already a legislative requirement to explain how the approach to executive pay differs from that for other employees, few companies do this well. In 2017/18, only 14% of FTSE 350 companies were able to demonstrate a consistent approach across the company.<sup>26</sup>

Pay ratios will provide a useful reference point for remuneration committees, as will gender pay gap data, and help inform remuneration committee choices. However, only 7% of FTSE 350 companies voluntarily reported a CEO to employee pay ratio.<sup>27</sup> This is probably due in part to uncertainties over the methodology to be required in the impending legislation mandating pay ratio disclosures, that has since been published.

The 2018 Code aims to increase accountability and to encourage greater focus on the links between executive remuneration and strategy, and on what is proportionate and just in the wider context of workforce remuneration.

Investors continue to call for reporting that explains the rationale behind remuneration structures and policies

The 2018 Code... gives remuneration committees an expanded remit to review pay and incentives across the workforce...

<sup>23, 24, 25, 26</sup> Pricewaterhouse-Coopers LLP

<sup>27</sup> EY, Annual reporting in 2017/18

The 2018 Code also introduces, for the first time, a specific reporting Provision for remuneration committees.<sup>28</sup> We expect to see an increase in discussion of how remuneration committees have exercised discretion over executive pay outcomes and of how the broader workforce experience and features such as simplicity, transparency and risk mitigation have been addressed in designing remuneration policies. The FRC will be looking at how remuneration committees report against this Provision once it comes into force.

### Risk Reporting and Viability Statements

The introduction of viability statements in the 2014 Code has brought a greater focus on risk management at board and senior management level, enabling many companies to make more informed decisions about their risk appetite. However, viability statements are yet to deliver all the external benefits expected when they were introduced. Although some companies have enhanced their disclosure this year, many are still not explaining the processes that they have undertaken to prepare their statement, including the stress and scenario testing they have carried out, which is disappointing.

There has been no significant change in viability periods selected by FTSE 350 companies in 2017/18, as the table H below shows.<sup>29</sup>

**Table H: FTSE 350 Viability Periods**

Period selected (years)	2017-18	2016-17
3	73%	73%
4	3%	3%
5	20%	21%
6-10	4%	3%

There is, however, evidence that companies' explanations for the time period selected have improved, with far fewer companies citing the strategic planning cycle, and instead being more specific and referring to factors such as contract lengths, lease terms, finance and credit facilities and R&D pipelines.<sup>30</sup>

There has been some improvement in the proportion of companies indicating which specific risks were considered in making their viability statement. In reports issued for financial-years ending 30 September 2017 to 31 March 2018, 50% of companies indicated specific risks in 2018, compared to 34% in 2017.<sup>31</sup>

We have previously indicated that boards should undertake an assessment of a company's prospects and the resilience of the business model over a longer time period. However, only 13% of companies provided a distinct discussion in these areas.<sup>32</sup>

The 2018 Guidance on Board Effectiveness, which supports companies in applying the 2018 Code, contains updated guidance on how companies might approach their viability statements.

The Lab's report, (overleaf), sets out how companies can provide a longer-term focus. Adopting its recommendations will help companies to address many investors' concerns that the time periods being selected are too short. Applying the two-stage process and more detailed disclosure of stress and scenario testing will, in due course, help companies to fulfil Provision one of the 2018 which asks boards to consider the risks to future success and the sustainability of the business model and to report on these.

..., viability statements are yet to deliver all the external benefits expected when they were introduced.

<sup>28</sup> Provision 41

<sup>29</sup> Pricewaterhouse-Coopers LLP

<sup>30</sup> EY, Annual reporting in 2017/18

<sup>31, 32</sup> Deloitte LLP, Annual Report Insights 2018

# INSIGHTS FROM THE LAB

## Risk Reporting and Viability Statements

The Lab's report, [Risk and viability reporting](#), sets out how companies could provide useful disclosures in this area of reporting. Investors that participated in the Lab project were unanimous that understanding those principal risks faced by a company is important both before making an investment and during the holding of that investment. Disclosure

of principal risks also enables them to improve their understanding of how the board identifies and manages risk to protect the sustainability of the company. All investors are looking for principal risk reporting that is specific to the company, avoiding boilerplate disclosure and jargon. The report set out the attributes of risk reporting that are most important to investors as illustrated below.

... expectations of investors and companies' practice have not stayed still.

What entity-specific information is important to investors about risk?						
Information that helps investors to understand risk				Information that helps investors to understand how the company is managing risk		
Presentation of risks as gross or net of controls	Likelihood and impact	Priority	How important is it?	How does it link to the company's story?	Link to the rest of annual report	Risk appetite
	Categorisation		What type of risk is it?	What is the company doing about it?	Mitigating actions	Responsible person
	Movement during year		How is it changing			

But expectations of investors and companies' practice have not stayed still. To see how practice has changed the Lab has undertaken an [implementation study](#). The Lab's review of risk reporting has seen a number of companies taking up recommendations from the original report and therefore companies are now providing investors with more useful information. However, there continues to be a lack of detail in certain areas which is heightened by overall changes in the risk environment. In this context disclosures around the UK exiting the EU are a focus for investors.

Regarding the viability statement, the Lab's original report recommended that companies should explain the long-term prospects of the company more clearly, before considering the viability assessment.

... companies should explain the long-term prospects of the company more clearly, before considering the viability assessment.

**Assessment of Prospects**

**Taking into account**

- Current position
- Assessment of risks
- Business model

**Assessment of Viability**

**Taking into account**

- Stress and sensitivity analysis
- Link to principal risks
- Qualifications and assumptions
- Reasonable expectations

The Lab's implementation study found that there are some promising developments with companies separating the viability statement into an assessment of prospects, then an assessment of viability. Where this two-stage approach works best is where each element is supported with enough detail and linkage to the rest of the report to allow investors insight into management's process. However, because of the lack of consistency in application, many investors (and other users) do not view viability statements as a key element of disclosure. Continued focus is needed on the quality of disclosure if the viability statement is to be more helpful to investors.



# 5 UK GAAP

New UK GAAP, including FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, became mandatory for all companies, other than those eligible for small company exemptions, for accounting periods beginning in 2015. Small companies, including those eligible for the micro-entities' regime, were required to first apply new UK GAAP for accounting periods beginning in 2016.

## Implementation of FRS 102

### CRR findings

CRR's substantive enquiries of companies included a number of approaches to those applying FRS 102. The more minor items raised for further clarification and improvement were broad, ranging, for example, from the lack of explanatory detail supporting tax reconciliations, to the clarity of assumptions underpinning the fair value of investment properties and the benefits of disaggregating accruals from deferred income, when material. The types of questions raised were consistent with those put to smaller companies generally.

Significantly, however, virtually all our substantive enquiries relating to FRS 102 compliance, featured a request for additional information to help our understanding of the companies' revenue recognition policies. The specific focus of our questions was similar to those raised under IAS 18, for example, the methods used to determine the amount of revenue recognised, particularly in respect of the rendering of services, and the need to disclose any key judgements made in applying the policies.

The requirement for a note disclosing information about judgements and estimation uncertainty was a new addition to 'old' UK GAAP. Preparers may still be bedding in their thinking about what

they need to say. While there are clearly fewer disclosure requirements under FRS 102, there still has to be sufficient information to enable the user of the accounts to understand material policies, their application and the assumptions management makes about the future.

### ICAEW findings

In a recent report, the Institute of Chartered Accountants in England and Wales ("ICAEW"), noted their findings in respect of the continuing implementation of FRS 102, drawn from a combination of desk top reviews of financial statements and monitoring reviews of audits.<sup>33</sup>

While in the majority of cases no significant issues were identified, it is disappointing that they continued to identify similar issues in some financial statements as in the previous year, particularly as these were highlighted in the Annual Review of Corporate Reporting 2016/2017. The most significant issues showed a failure to respond to new accounting requirements, such as the differing presentation of gains and losses on the revaluation of investment property compared to revaluations on property, plant and equipment or the recognition of deferred tax on such revaluations, or a failure to provide clear disclosure and explanations. In a small number of cases financial statements were still being prepared under old UK GAAP when it had been replaced in 2015.

In a small number of cases financial statements were still being prepared under old UK GAAP when it had been replaced in 2015.

<sup>33</sup> "Audit Monitoring 2018": <https://www.icaew.com/-/media/corporate/files/technical/audit-and-assurance/working-in-the-regulated-area-of-audit/audit-monitoring-2018.ashx>

An over-reliance on accounting software was noted as a contributing factor in some cases. Preparers and auditors must ensure they keep up to date with developments in accounting standards to be able to critically review the output of such software.

## Recent and future developments

### Developments in UK GAAP

In December 2017, we issued Amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland – Triennial review 2017 – Incremental improvements and clarifications which concluded the first periodic review of FRS 102*. Building on the stakeholder outreach and feedback received, the amendments focussed on incremental improvements and clarifications, and resulted in simplifications, improved cost-effectiveness and made FRS 102 easier to use.

The most notable changes relate to:

- the measurement of loans to a company from one of its directors or a member of their close family;
- the measurement of investment property rented to another group company;
- the extent to which intangible assets should be recognised separately in a business combination;
- the distinction between basic and other financial instruments;
- the definition of a financial institution for disclosure purposes; and
- relief from recognising tax payable when a gift aid payment to a charitable parent is probable.

The amendments are effective for accounting periods beginning on or after 1 January 2019, with early application permitted provided all the amendments are applied together (with limited exceptions). Entities will need to determine which of the amendments will affect them and decide whether to apply them early. As the amendments include simplifications this might be an option many entities consider.

Fully revised editions of all UK and Ireland accounting standards were issued in March 2018. The FRC is now considering whether any further supporting material would be useful to preparers of financial statements.

Except where the process for the UK's exit from the EU may result in changes to company law that have a consequential impact on UK and Irish accounting standards, such as cross-referencing, no changes to those standards are under consideration currently. In relation to recent major changes in IFRS, the FRC is waiting for IFRS implementation experience before proposing any changes to FRS 102 (or FRS 103 *Insurance Contracts*). However, if necessary, amendments might arise to address emerging issues between periodic reviews.

Fully revised editions of all UK and Ireland accounting standards were issued in March 2018.

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# 6 FUTURE DEVELOPMENTS

The landscape for corporate governance and reporting is being shaped by changes in several areas. Changes to the underlying framework of legislation, standards and guidance, alongside the changing demands of stakeholders and developments in technology will have a significant effect on how companies operate and report over the coming years. This section outlines developments that will very soon be making an impact and future developments whose effects are less certain but have the potential to be highly significant in the medium-term.

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## Implications of the UK's Exit from the EU for the UK's Accounting Framework

The current accounting framework in the UK is based on European law, as follows:

- (a) The IAS Regulation:
- (i) requires that IFRS as adopted in the EU are applied in the group financial statements of UK companies listed on regulated markets in the EU; and
  - (ii) permits IFRS to be applied in the individual financial statements of all companies and the group financial statements of companies that are not listed.

The UK has reflected both these options in the Companies Act 2006.

- (b) The requirements of the Accounting Directive are reflected in the Companies Act 2006 requirements for the preparation of financial statements and are applicable to all other UK companies that have not used the option to apply IFRS as adopted in the EU.

When the UK exits the EU, many legislative requirements will need to be replicated in UK law to ensure continuity and legal certainty. These will include the text of EU-adopted IFRS which are applied in the UK by listed companies under existing law, AIM companies under market rules and voluntarily by some other companies.



A process for the assessment and endorsement of new and revised IFRS in the UK will be required. The precise form of this process is being developed by Government in consultation with regulators, partner bodies and industry stakeholders. It will also be subject to parliamentary scrutiny.

The FRC is working in partnership with the Department for Business, Energy and Industrial Strategy (“BEIS”) to create a UK IFRS endorsement board which will be responsible for assessing new and revised IFRS for consistency with certain prescribed criteria. It is expected that the FRC will provide oversight of the governance of the endorsement board and its compliance with due process.

## Developments in Financial Reporting Standards

### New IFRSs and their adoption in Europe

Under the IAS Regulation, new or revised IFRSs are subject to a process of assessment and endorsement before being added to the suite of standards applicable in Europe, i.e. EU-adopted IFRS. While the UK remains in the EU, we continue to be an active participant in this process. We remain a member organisation of the European Financial Reporting Advisory Group (“EFRAG”), which advises the European Commission on its endorsement decisions, with representation on its General Assembly, Board and Technical Experts Group. While the form of our future relationship with EFRAG will, in part, be determined by the outcome of the negotiated settlement on the UK’s withdrawal from the EU, the FRC will continue to collaborate with EFRAG and European standard setters to achieve our shared goal of high-quality international accounting standards.

IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers* are effective for the first time in 2018. The implementation of these standards, far-reaching in parts, has been challenging, as evidenced by our review of relevant disclosures in 2018 interim reports.

We hope that our thematic reports will help preparers improve the quality of their future disclosures required by the new standards.

In March 2018, a narrow scope amendment to IFRS 9 was endorsed. The amendment changes IFRS 9 for particular financial assets that would otherwise have contractual cash flows that are solely payments of principal and interest but do not meet the condition only as a result of a negative prepayment feature, i.e. a feature that could result in the borrower making a reasonable compensation payment to the lender on early settlement. The effect of the amendment is to make such financial instruments eligible for measurement at amortised cost or at fair value through other comprehensive income, subject to the usual business model assessment. While this amendment is effective for years commencing on or after 1 January 2019 it can be early adopted, permitting application on first time adoption of IFRS 9 in a company’s annual financial statements.

IFRS 16 was endorsed towards the end of 2017 for application in Europe. It is effective for annual periods beginning on or after 1 January 2019 but can be early adopted by those companies wishing to coincide its implementation with that of IFRS 15, which is effective from 1 January 2018.

### IFRS 17 *Insurance Contracts*

IFRS 17 *Insurance Contracts* was issued by the IASB in May 2017. It is effective for annual periods beginning on or after 1 January 2021. It replaces IFRS 4—an interim standard that permits companies to use national GAAP for the measurement of the insurance contracts they issue. IFRS 17 aims to introduce consistent principles for accounting for insurance contracts, enabling users to compare companies, contracts and industries within and across jurisdictions. The standard is expected to have a significant impact on accounting by insurance companies globally.

The FRC is working in partnership with the Department for Business, Energy and Industrial Strategy (“BEIS”) to create a UK IFRS endorsement board...

..the FRC will continue to collaborate with EFRAG and European standard setters to achieve our shared goal of high-quality international accounting standards.



Given its potential impact, it is being subjected to a particularly thorough assessment process by EFRAG, with a number of insurers participating in a comprehensive case study aimed at providing practical insight into the operation of the standard. We are discussing the application of the standard with UK constituents. In September 2018, EFRAG wrote to the IASB identifying six areas of the standard that they considered merit further consideration by the IASB which has been monitoring findings from stakeholders' implementation experiences. The European endorsement process is likely to be delayed as the IASB considers points raised by EFRAG and other constituents.

### Future Work of the IASB

In 2017, the IASB issued a discussion paper on principles of disclosure in the financial statements. In response to feedback received the IASB has decided to:

- i. develop guidance to help improve the way the IASB drafts disclosure requirements in IFRS and perform a targeted standards-level review of disclosure requirements; and
- ii. develop guidance and examples for inclusion in its Practice Statement, *Making Materiality Judgements*, to help entities apply materiality judgements to accounting policy disclosure.

The standards-level review will initially focus on IAS 19 *Employee Benefits* and IFRS 13 *Fair Value Measurement*. Insights gained from applying its disclosure guidance to these standards will be used to further refine the guidance as the projects develop. We welcome these developments as the clarity and relevance of disclosures is central to fair, balanced and understandable financial statements.

Looking further ahead, the IASB will be updating its non-mandatory Practice Statement on Management Commentary. It plans to issue a consultation document in 2020.

### Smaller Listed and AIM Company Reporting

In its 2016 update to *The Quality of Reporting by Smaller Listed and AIM Quoted Companies*, the FRC signalled its intention to develop a practice aid for audit committees in this market segment, on assessing the quality of the finance process and function. We are collaborating with the ICAEW to develop practical guidance with the intention of issuing a joint publication in spring 2019.

### Other European Developments in Corporate Reporting

In March 2018, the European Commission issued its Action Plan: Financing Sustainable Growth, which included proposals for corporate reporting. These include:

- revisions to its guidelines on non-financial information, which accompany the Non-Financial Reporting Directive that was transposed into UK law in 2017. It is intended that this will provide guidance on, amongst other things, climate-related information taking into account the Financial Stability Board's Task Force for Climate-related Financial Disclosures;
- the establishment of a Corporate Reporting Lab, similar to the UK Lab but with a focus on narrative reporting, initially in respect of the environment and climate change; and
- requesting EFRAG, where appropriate, to assess the impact of new or revised IFRSs on sustainable investments.

Following the Action Plan, the European Commission has requested that EFRAG explore potential alternative measurement bases for equity instruments to the fair value measurement required by IFRS 9. It has also issued a questionnaire as part of a "fitness check", reviewing the entire framework for public reporting by companies in Europe.

In September 2018, EFRAG wrote to the IASB identifying six areas of the standard that they considered merit further consideration by the IASB...

The fitness check evaluates certain aspects of the IAS Regulation, including the criteria for assessing new and revised IFRSs and whether the Commission should more freely be able to make changes to IFRS as issued by the IASB.

Given the on-going negotiations between the UK and the EU, the extent to which these developments will have an impact on UK companies remains uncertain. However, we believe the issues raised are of potentially critical importance to the future of corporate reporting so continue to engage in the debates.

### European Single Electronic Format

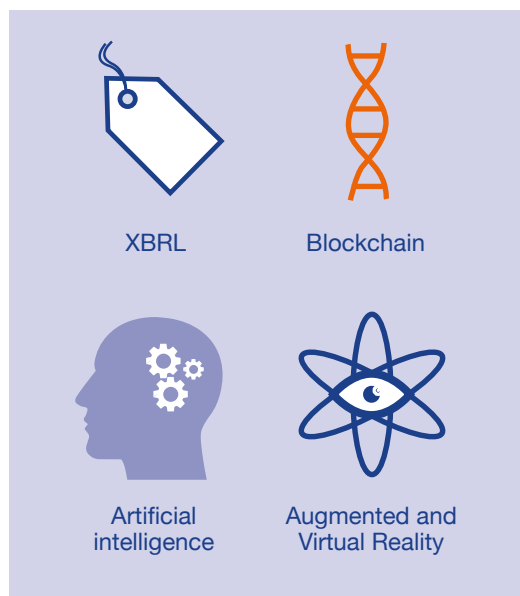
The finalisation of the proposals on the European Single Electronic Format is underway in the European Parliament. The regulation, which is expected to be adopted into EU law early in 2019, will require all listed companies across the EU to produce their annual report, principally as an xHTML document, with tags in XBRL, covering the primary statements and other specific elements of disclosure. The regulation is expected to lead to a significant change in the way that annual reports are produced and consumed by the public and is likely to require some additional governance processes for both companies and auditors. The fact that the regulation is not yet finalised, as well as interaction with the UK's departure from the EU means that the overall impact on UK companies is as yet unclear. However, the FRC continues to follow and engage in the process alongside those other agencies that ultimately have jurisdiction in this area.

### Corporate Reporting and Technology Driven Change

In the *Annual Review of Corporate Reporting 2016/17*, the Lab reported on how digital technology is significantly changing how corporate data is collected, accessed, and analysed. During the last year, if anything, the expectations about the potential of

digital corporate reporting are growing, with new mediums proliferating and a continual demand for data and information from various stakeholders. The information eco-system about a company (but not controlled by it) is ever growing and investors are making increasing use of this data, ranging from crowd sourced employee rating applications to monitoring website traffic. However, it is not clear that company reporting is responding well to these challenges, with only shallow pockets of innovation visible.

New regulation such as the European Single Electronic Format and innovative technologies such as Artificial Intelligence (AI), Blockchain and Augmented Reality (AR) are going to provide further (and sometimes competing) pressures to the relevance of the annual report as a communications document.



Against this backdrop of unprecedented change, the Lab is calling for preparers, regulators and investors to work together to understand the impacts of technology driven change and consider how best to take the opportunities that they offer. The FRC, through the Lab, is investigating the impacts of technology on corporate reporting. In the last year, it has issued reports on [XBRL](#) (structured data) and [blockchain](#) (structured trust) and is now considering AI and AR.

The regulation, which is expected to be adopted into EU law early in 2019, will require all listed companies across the EU to produce their annual report, principally as an xHTML document, with tags in XBRL covering the primary statements and other specific elements of disclosure.

... the Lab is calling for preparers, regulators and investors to work together to understand the impacts of technology driven change and consider how best to take the opportunities that they offer.

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## The Future of Corporate Reporting

Recent developments in narrative reporting are raising some fundamental questions relating to the purpose of the annual report, its effectiveness in meeting this purpose and company accountability to a wider group of stakeholders. Reporting will need to evolve in response to these developments.

As part of its 2018-2021 strategy, the FRC will be starting a major project on the 'Future of Corporate Reporting'. One of the aims of the project is to stimulate debate on what corporate reporting should look like in future. The project will be broad in scope and explore a number of themes including examining the types of information that investors find useful and reporting for a wider group of stakeholders. In addition, technology provides opportunities for considering different ways in which information can be disseminated.

The FRC recognises that the assurance model may also need to evolve in response these changes, and this project takes account of our work on the future of audit.

The FRC is aiming to publish a thought leadership paper on the Future of Corporate Reporting during quarter four of 2019 as a basis for discussion.

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## Stewardship Code

Investors and proxy advisors must also play their part in driving the quality of governance and reporting, engaging extensively, assessing explanations carefully and avoiding a tick-box approach. Following an initial consultation on the Stewardship Code earlier this year, the FRC will issue a revised Stewardship Code for consultation in late 2018 or early 2019.

The UK investment market has undergone significant change since the last iteration of the Stewardship Code in 2012. Listed equity no longer dominates the investment portfolio of

many investors and there is significant increased investment in other asset classes, such as fixed income and infrastructure. There is also a growing recognition of the importance of responsible investment, and how the careful integration of environmental, social and governance issues cannot only deliver improved financial returns, but contribute to a more sustainable financial system.

A revised Stewardship Code will seek to address the stewardship responsibilities of all key actors under a set of high-level principles, with differing guidance for asset owners, asset managers, proxy advisors and investment consultants. Importantly, it will aim to recognise that stewardship is not limited to the engagement between asset managers and companies to improve corporate performance – but that it also encompasses the responsible management of assets across the entire investment eco-system, improving long-term financial return for asset managers, asset owners, and the ultimate beneficiaries.

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## Corporate Governance in Large Private Companies

Throughout the UK, large private companies contribute to productivity, generate employment, and provide vital goods and services. Their economic and social significance can be as great as publicly-listed companies. In 2018, the Government legislated to require all companies with more than 2,000 employees and/or a turnover of more than £200 million, and a balance sheet of more than £2 billion, to provide a corporate governance statement disclosing their corporate governance arrangements in their directors' report and on their website, including whether they follow any corporate governance code.<sup>34</sup>

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...the FRC will be starting a major project on the 'Future of Corporate Reporting'.

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...the careful integration of environmental, social and governance issues can not only deliver improved financial returns but contribute to a more sustainable financial system.

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<sup>34</sup> The Companies (Miscellaneous Reporting) Regulations 2018.

A voluntary set of corporate governance principles for large private companies to assist companies in meeting this new requirement, the Wates Corporate Governance Principles for Large Private Companies (“the Wates Principles”), will be finalised in December 2018 to align with the introduction of the Government’s new reporting requirement, which will apply to company reporting for financial years starting on or after 1 January 2019.

The FRC will continue to work with other members of the Wates coalition group to promote the Wates Principles as an effective framework for large private companies to follow to raise corporate governance standards, improve transparency and meet regulatory requirements.

### FRC Powers

#### Monitoring of corporate governance statements

Reporting of governance matters is of increasing interest to investors and other stakeholders. The scope of our current monitoring of annual reports does not include corporate governance statements, nor does the FRC have power to require companies to make changes to these parts of the annual report. In the absence of such powers, we are considering how we can undertake such monitoring activity on a voluntary basis. The role of investors must not be undermined, but we believe they would benefit from regulatory support. The intention would be for this monitoring to support the stewardship activities of investors.

#### Enforcement powers against individual directors

Our enforcement action currently takes place under two separate procedures. Auditors are pursued under the Audit Enforcement Procedure (“the AEP”). This procedure does not apply to non-auditors such as accountants working as directors of companies. Such individuals are investigated under the Accountancy Scheme (“the Scheme”), a contractual arrangement with the professional accountancy bodies.

The AEP requires us to establish that there has been a breach of relevant requirements. The Scheme test is a much higher test of misconduct which is defined as an act or omission which falls significantly short of the standards reasonably to be expected. Past tribunals have said conduct must cross the threshold of real seriousness. This different threshold creates an unlevel playing field between accountants in business and in audit. Furthermore, the voluntary nature of the Scheme means that the professional bodies can withdraw from it at any point. We believe that there could be merit in replacing the Scheme with a new regime, with the same current scope, and tests that are aligned with and similar to those in the AEP.

Appendix C provides an overview of concluded cases against Member directors in the past year.

The FRC will continue to work with other members of the Wates coalition group to promote the Wates Principles as an effective framework for large private companies

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# **APPENDIX A: FRC YEAR-END ADVICE LETTER TO AUDIT COMMITTEE CHAIRS AND FINANCE DIRECTORS**

# APPENDIX A



24 October 2018

Dear Audit Committee Chairs and Finance Directors

## Summary of key developments for 2018/19 annual reports

I am writing ahead of the 2018/19 reporting season with the FRC's perspective on key matters that are relevant to the preparation of your forthcoming annual reports and accounts. This letter focuses on our expectations for reporting on the new accounting standards effective this year, our findings in respect of our monitoring work, and topical areas of reporting, including the effect of Britain exiting the EU.

You will no doubt be aware that, during 2018, the FRC updated its Guidance on the Strategic Report and published a new Corporate Governance Code ("the Code").<sup>1</sup> The Code is effective for accounting periods starting on or after 1 January 2019, concurrent with the new reporting requirement to include a section 172(1) statement in the strategic report. Further detail on these matters and the expected impact on the 2019/20 reporting season can be found in the FRC's Annual Review of Corporate Governance and Reporting.

## New Accounting standards

Two new international accounting standards, IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from contracts with customers*, are effective for December 2018 year ends. IFRS 16 *Leases* is effective for periods beginning on or after 1 January 2019.

We have undertaken thematic reviews looking at the adoption of IFRS 9 and IFRS 15 in June 2018 interim accounts. In advance of our detailed findings to be published shortly, I set out what we expect to see by way of year end disclosures that explain the impact of the new standards.

### IFRS 15 *Revenue from contracts with customers*

We encourage companies to invest sufficient time during their year-end preparation to ensure that:

- explanations of the impact of transition are comprehensive and linked to other relevant information in the annual report and accounts;
- changes to revenue policies are clearly described and explained, reflecting company specific information – as are any associated management judgements;
- performance obligations, a new concept introduced by IFRS 15, are identified and explained, with a focus on how they have been determined and the timing of delivery to the customer; and
- the impact of the standard on the balance sheet is also addressed, including accounting policies for contract assets and liabilities.

### IFRS 9 *Financial Instruments*

#### *Banks*

IFRS 9 has the most significant and far-reaching impact on reporting by banks. Our thematic report will have particular focus on how they have implemented the new requirements.

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### *Non-banking companies*

IFRS 9 may not have a material effect on the results of non-banking companies, in which case, many of the transition disclosures may not be required. However, we do expect companies to:

- have updated their hedging documentation and assessed the effectiveness of existing hedges on application of the new requirements;
- explain and, where possible, quantify material differences between IAS 39 and IFRS 9, including key assumptions adopted on implementation;
- remember that the scope of the impairment requirements has been extended to include, for example, IFRS 15 contract assets, lease receivables and will also apply to loans to subsidiaries and other undertakings in individual parent company accounts;
- take particular care when considering the application of the standard to embedded derivatives and the different treatment required where the host contract is a financial asset compared to where it is a financial liability;
- reconsider the accounting for previous debt modifications, such as refinancing, that did not result in derecognition;
- reflect the additional disclosure requirements of IFRS 7; and
- if relevant, explain why the impact is not material, particularly where significant financial instruments are recognised in the accounts.

### **IFRS 16 Leases**

We also conducted a light touch review of how companies reported on the impact of IFRS 16 in their June 2018 interim reports.

As the standard is mandatory for periods beginning on or after 1 January 2019, companies should be in a position to provide specific disclosure in their December 2018 reports and accounts explaining the impact of the new requirements on their business. We expect companies to:

- provide meaningful information about the application of the standard with a focus on their specific facts and circumstances;
- disclose qualitative and quantitative information, identifying any lease portfolios that are significantly impacted by the new requirements;
- explain the specific judgements and policy changes prompted by the new model and provided detail about the structure of their implementation projects; and
- identify the exemptions that companies intend to apply.

### **Findings of our monitoring work**

#### **Critical judgements and estimates**

Our monitoring work continues to have a focus on the critical judgements and estimates that management make when preparing their reports and accounts and which can provide valuable information to investors both about future expectations of assets and liabilities but also the quality of management's judgements. While we have seen some better disclosures in this area in recent years, there is still significant scope for further improvement and we will continue to press companies for more informative disclosures. Our thematic report,<sup>2</sup> published in November 2017, remains relevant to this area of reporting. We expect

- a clear distinction to be made between judgements and estimates as different disclosure requirements apply;
- clear disclosure of the sensitivity of carrying amounts to the assumptions and estimates underlying a measurement calculation, or, if more meaningful, disclosure of the range of reasonably possible outcomes within the next year in respect of the carrying amounts of the relevant assets and liabilities; and
- identification of any voluntary additional disclosures provided in respect of estimation uncertainty, for example, where the impact of any possible material change in estimate is not anticipated to have effect until a period outside the twelve-month window required by the standard.

## Control environment

This year, we identified an increase in the number of basic errors in the reports and accounts we reviewed. In times of change and uncertainty - whether due to new accounting standards or broader economic events like the UK exiting the EU - management's attention will rightly be focused on ensuring that there is quality disclosure around the key judgements and estimates they make in determining material matters in their reports and accounts. However, management also need to have effective procedures in place to ensure compliance with the basic reporting requirements of IFRS, which investors take as a given in audited reports and accounts.

These need to be sufficiently robust to ensure that reporting remains free of basic errors which can detract both from the integrity of the company's report and accounts and trust in management.

## Topical areas of reporting

### Britain exiting the EU

This year, we saw companies take a variety of approaches to reporting on the risks associated with Brexit. The nature and depth of disclosure depended, in part, on the potential impact on the business and the mitigating actions the company had been able to put in place. Although many companies may now be well advanced in developing their strategy in response to Brexit and an analysis of its potential impact, we still face significant uncertainties and unknowns in respect of the final deal that may be struck. This situation poses particular challenges for Boards as they prepare for their December 2018 report and accounts, many of which will be published shortly ahead of the March deadline.

We encourage companies to provide disclosure which distinguishes between the specific and direct challenges to their business model and operations from the broader economic uncertainties which may still attach to the UK's position when they report. Where there are particular threats, for example the possible effect of changes in import/export taxes or delays to their supply chain, we expect these to be clearly identified and for management to describe any actions they are taking, or have taken, to manage the potential impact. In some circumstances this may mean recognising or remeasuring certain items in the balance sheet.

The broad uncertainties that may still attach to Brexit when companies report will require disclosure of sufficient information to help users understand the degree of sensitivity of assets and liabilities to changes in management's assumptions. We expect that many companies will want to consider a wider range of reasonably possible outcomes when performing sensitivity analysis on their cash flow projections and which should be disclosed and explained. Not all companies will require extensive disclosure, but where sensitivity or scenario testing indicates significant issues, relevant information and explanation should be reflected in the appropriate parts of the annual report and accounts, for example in the impairment disclosures. It will be for companies to decide whether Brexit uncertainties impact their statements on viability and even their ability to continue as a going concern.

The situation may well change between the balance sheet date and the date of signing the accounts. We remind companies to ensure that they incorporate a comprehensive post balance sheet events review in their year-end reporting plan, in order to identify both adjusting and non-adjusting events and to make the necessary disclosures required by IAS 10. 'Events after the Reporting Period'.

### Complex supplier arrangements

Transparency of complex supplier arrangements and related financing arrangements remains an important issue. Where financing arrangements are in place, often enabling smaller suppliers to be paid in timely fashion, we expect the strategic report and the disclosures of financial instruments to describe the nature and amount of any material funding arrangement and the impact that it has on the company's liquidity. Our press notice on complex supplier arrangements, issued in December 2014, remains relevant to this area of reporting<sup>3</sup>.

Further information on accounting issues relating specifically to the construction and support services sectors can be found in the FRC's press notice 'Accounting and reporting framework for the construction and business support services sectors' issued in January 2018.<sup>4</sup>



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## Risk and viability reporting

Risk and viability reporting remains an area of focus for investors. Viability reporting should be based on a robust assessment of the principal risks that would threaten the business model, future performance, solvency or liquidity of the company. We encourage boards to apply a two-stage process to the viability statement: firstly, assessing the future prospects of the company; and secondly, stating whether directors have a reasonable expectation that the company will be able to continue to operate and meet its liabilities as they fall due (potentially over a shorter period), drawing attention to any qualification or assumptions as necessary. Examples of how this has been applied by companies are included in the Financial Reporting Lab's implementation study issued in October 2018.<sup>5</sup>

I also take this opportunity to remind companies of the changes made to IAS 7 Statement of Cash Flows, which now requires disclosure of information that enables users to evaluate changes in liabilities arising from financing activities.<sup>6</sup>

## Strategic report

Strategic reports provide an opportunity for the board to present a single, coherent narrative explaining and complementing the information in its financial statements. Those adopting IFRS 15's modified retrospective method of implementation face a particular challenge as comparatives for the prior period may not be consistent. We expect any such inconsistency to be identified and explained. The spotlight continues to fall on the impact that companies' activities have on their stakeholders. A commitment to clear and transparent presentation of relevant and material information and engagement with key stakeholders can make a significant difference to how companies are perceived.

Strategic reports remain an area that we regularly challenge in our monitoring work. We expect companies to ensure that their reports include a fair review of the company's business that is a balanced and comprehensive analysis of both performance and position, and to pay particular attention to the following areas.

## Alternative Performance Measures ('APMs')

We expect all companies who report alternative performance measures to apply the Guidelines produced by ESMA which, in our view codify best practice in this area of reporting.<sup>7</sup>

We expect to see:

- definitions for all APMs used;
- good explanations for their use;
- reconciliations to IFRS amounts appearing in the financial statements;
- no greater prominence for APMs than measures directly stemming from the financial statements; and
- explanations for changes in APMs to be provided, which may include how they are defined or calculated.

Companies are also encouraged to read CRR's 2017 thematic report and an interim report by the Lab, Reporting on Performance Metrics, which highlighted that investors seek performance metrics that are aligned to strategy, transparent, in context, reliable and consistent.<sup>8,9</sup> A final report which will contain examples of how this can be achieved in practice is due to be published soon.

## Non-financial information statement

In July we issued our guidance on the strategic report,<sup>10</sup> incorporating the non-financial disclosure requirements which became effective in the 2017/18 reporting season.

The new requirements in sections 414CA and 414CB of the Companies Act 2006 were effective for the first time in the 2017/18 reporting season. Companies that are subject to the new requirements (traded companies, banking, and insurance companies with more than 500 employees) are required to include a non-financial information statement in their strategic report. The statement should include information (or references to where that information is disclosed in the strategic report) relating to environmental matters, employees, social matters, respect for human rights and anti-corruption and anti-bribery matters.

For companies within the scope of the new requirements, we expect disclosure to focus on the impact of its activities in respect of these matters, the policies it has in place, any due diligence processes introduced through which it assesses and tracks their effectiveness and the related outcomes.

### Looking forward

On 24 September, FRC Chair Sir Win Bischoff wrote to company chairs, senior investors and proxy advisors setting out our expectations in terms of achieving high standards of governance practice and reporting. This is a substantial evolution of the Code and the FRC strongly encourages companies to start considering these issues now. Both the new Code and the requirement to include a section 172(1) report in the strategic report have effect from 1 January 2019.

Yours sincerely



**Paul George**

**Executive Director Corporate Governance and Reporting**

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<sup>1</sup> <https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf>

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<sup>2</sup> <https://www.frc.org.uk/getattachment/651205c1-6521-49b4-9590-9cba1d899a53/Judgements-and-Estimates-thematic-review-2017.pdf>

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<sup>3</sup> <https://www.frc.org.uk/news/december-2014/frc-urges-clarity-in-the-reporting-of-complex-supp>

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<sup>4</sup> <https://www.frc.org.uk/getattachment/6d16d67d-3b41-477c-b618-a979dbc70a79/Accounting-and-reporting-framework-for-the-construction-and-business-support-services-sectors.pdf>

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<sup>5</sup> <https://www.frc.org.uk/getattachment/43c07348-e175-45c4-a6e0-49f7ecabdf36/Business-Models-Lab-Implementation-Study-2018.pdf>

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<sup>6</sup> [http://archive.ifrs.org/Current-Projects/IASB-Projects/Debt-disclosures/Documents/Disclosure-Initiative\\_Amendments-to-IAS-7.pdf](http://archive.ifrs.org/Current-Projects/IASB-Projects/Debt-disclosures/Documents/Disclosure-Initiative_Amendments-to-IAS-7.pdf)

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<sup>7</sup> <https://www.esma.europa.eu/sites/default/files/library/2015/10/2015-esma-1415en.pdf>

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<sup>8</sup> <https://www.frc.org.uk/getattachment/ff987c01-416f-4635-8dba-fda5530f4b5/091117-APMs-CRR-thematic-review.pdf>

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<sup>9</sup> [https://www.frc.org.uk/getattachment/e94631d1-69c1-4349-8ce5-780d4eca455f/LAB\\_Reporting-of-performance-metrics\\_June-2018.PDF](https://www.frc.org.uk/getattachment/e94631d1-69c1-4349-8ce5-780d4eca455f/LAB_Reporting-of-performance-metrics_June-2018.PDF)

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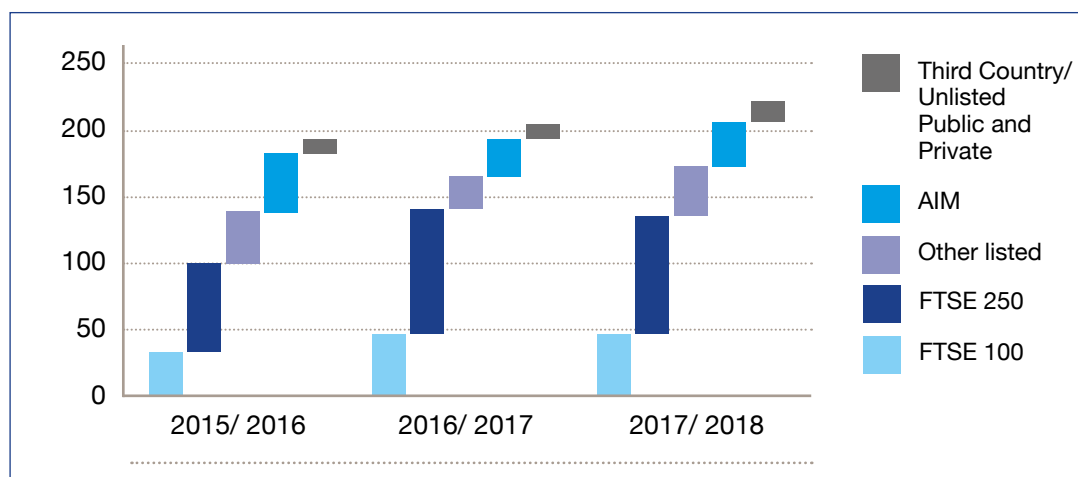
<sup>10</sup> <https://www.frc.org.uk/getattachment/fb05dd7b-c76c-424e-9daf-4293c9fa2d6a/Guidance-on-the-Strategic-Report-31-7-18.pdf>

# APPENDIX B: FRC MONITORING ACTIVITIES

# APPENDIX B

This section provides an overview of the FRC’s monitoring activities during 2017/18, which informs our views on the quality of corporate reporting in the UK. In 2017/18 we reviewed aspects of 220 sets of accounts (2016/17: 203; 2015/16: 192).

**Table B:** Reviews by Market



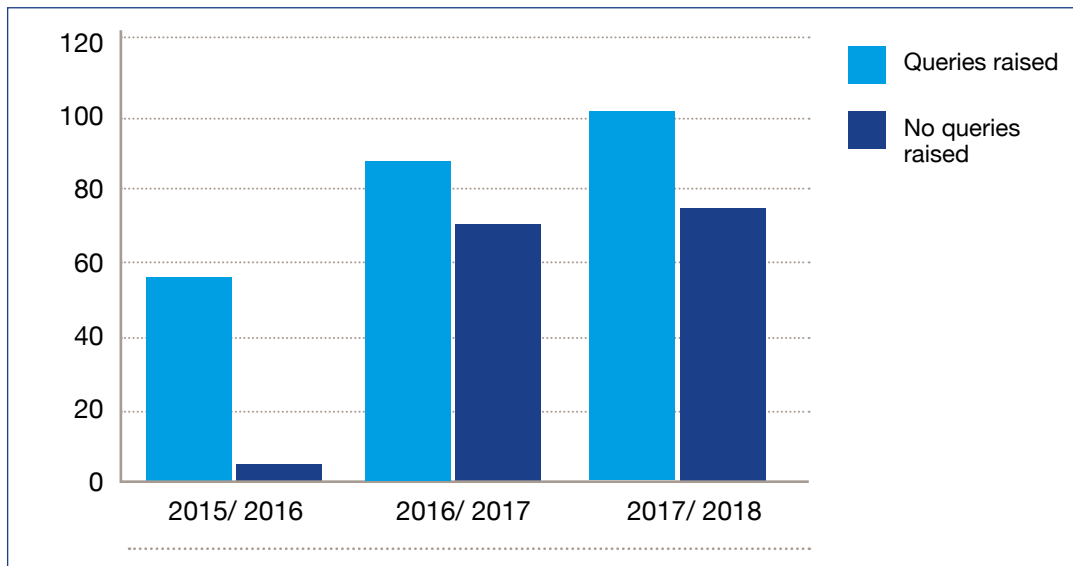
As the UK’s Competent Authority for the monitoring of financial information, we are currently required to select company reports for review consistent with Guidelines produced by ESMA. In practice, this is a combination of a rotational approach to FTSE 350 companies, selection from FRC-wide priority sectors, random selection and in response to complaints and referrals from other regulators.

We aim to review the report and accounts of FTSE 350 companies in full at least once every five years and supplement this in the intervening period by including them in the scope of at least one thematic review.

We target the completion of reviews in time for agreed improvements to be reflected in the companies’ next reports and accounts, ensuring that better quality information is in the public domain at an early opportunity. In 2017/18 85% of cases (2016/17: 83%; 2015/16: 69%) were completed before the next set of reports and accounts were due for publication. 92% of 2017/18 reviews were completed by the date of this publication (98%: 2016/17; 95%: 2015/16).

We aim to review the report and accounts of FTSE 350 companies in full at least once every five years...

**Table C:** Approaches to Companies



We write to companies when we have substantive questions to ask which are generally relevant to measurement or valuation issues and on which we require a considered response. We also write where we only identify less significant matters and where no substantive response is required.

Letters to companies emphasise that we do not expect them to include information in their published reports that is immaterial or irrelevant and letters should not be read as a suggestion that they do so. A question about the materiality of disclosures no longer provided is not an implied suggestion that they be reinstated. Directors are expected to have sufficient confidence in their own decisions to justify them.

### Queries Raised with Companies

Where we identify substantive issues with a company's annual report and accounts we raise these directly with the company to seek a resolution to our concerns.

We wrote to 101 companies raising substantive queries on which a response was sought (2016/17: 89; 2015/16: 56), which is 46% (2016/17: 44%; 2015/16: 29%) of the reports reviewed.

Historically, up until 2016, we tended to write letters raising substantive queries on approximately 30% to 40% of reports

reviewed. The slight increase in the rate of our substantive letters this year and last is not, in our view, indicative of a deterioration in the underlying quality of the reports and accounts reviewed but reflective of our changed approach.

### No Queries Raised with Companies

We also write letters to companies where we do not identify substantive queries. Where appropriate the letter includes an appendix of less significant matters where the company may not have complied with the relevant legal, accounting or reporting requirements or where there is opportunity for enhancing the general quality of the company's reporting.

### Pre-informing Companies of Thematic Reviews

When performing our thematic reviews, we may write to a sample of companies prior to their year-end informing them that we will review the disclosures subject to the thematic review in their next published reports. We select companies in accordance with our usual selection methodology, where we believe the thematic review topics will be particularly relevant. This provides those companies with an opportunity to focus on the matters highlighted in advance of publication, thereby prompting targeted improvements without regulatory intervention.

Letters to companies emphasise that we do not expect them to include information in their published reports that is immaterial or irrelevant

We wrote to 101 companies raising substantive queries...

## Review Groups

Our operating procedures provide for a Review Group of FRRP members to be set up where an enquiry by peers into a company's report and accounts is likely to be better placed to progress a review – whether because of the complexity of the issue involved or because it has not been possible to reach a common understanding of the issue with the company.

The Review Group of FRRP members set up in 2015/16 was closed during the year. This followed the announcement by RAK Petroleum Plc that, in consultation with the FRC, it had decided that DNO, an investee company, should be consolidated in the Group's annual report for the year ended 31 December 2017. No other Review Groups were established this year.

## Response Times

Companies are asked to respond to our initial letters within 28 days, so that potential matters are addressed promptly. Reasonable requests for extensions are granted. The average response time to all letters is now 31 days (2016/17: 30 days; 2015/16: 33 days).

Where possible, we respond to companies' letters within 28 days. However, the response time increases on more complex cases. The average for 2017/18 was 31 days (2016/17: 30 days; 2015/16: 29 days).

## Complaints and Referrals

A substantial amount of time is often absorbed considering well informed complaints and referrals from other regulators.

Eleven complaints were received in 2017/18 (2016/17: 20; 2015/16: 9) of which two were referred by a fellow regulator (2016/17: 4; 2015/16: 1).

We welcome complaints that are well-informed and provide additional insight that may not be observable from a review of the accounts. Further information on how we address complaints and referrals is available on our website.<sup>35</sup>

## Feedback

For 2017/18, we will follow up closed reviews by asking for feedback on the process from the companies approached. We will focus on the efficiency and effectiveness of the review process and the clarity of communications with a view to identifying ways to further improve our way of working.

## Company Responses to our Letters

We are often asked how companies should respond when they receive a letter from us requesting additional information and explanations.

In our experience the good practices which tend to result in earlier closure of the matters under review include:

- responses that address all the questions raised;
- not just answering the question asked in our first letter, which is based on the accounts, but raising our understanding of the issue to that of the company;
- responses that explain fully the board's judgements and how they comply with the requirements of IFRS;
- board and, where applicable, Audit Committee involvement;
- full and early engagement with auditors;
- correspondence that clarifies that these parties have been involved; and
- a willingness to consider alternative viewpoints expressed by the FRC.

We welcome complaints that are well-informed and provide additional insight that may not be observable from a review of the accounts.

Eleven complaints were received in 2017/18...

<sup>35</sup> <https://frc.org.uk/Our-Work/Corporate-Governance-Reporting/Corporate-Reporting-Corporate-Reporting-Review/FAQs.aspx>

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## Working with Other Regulators

### Working with Audit Regulators

Our CRR and Audit Quality Review (AQR) teams collaborate when they are able to assist each other's reviews. CRR advises AQR if it has concerns around the quality of the audit work performed. Where AQR reviews an audit and identifies potential issues with a set of accounts, CRR will then consider whether to open correspondence with the company.

### ESMA

Pending agreement on the terms of the withdrawal agreement, we continue to be an active participant in the European Enforcers' Coordination Sessions ('EECS'), the committee established by ESMA for European National Enforcers to deliver its mandate in strengthening European Supervisory convergence. We contribute to discussions on significant emerging issues and enforcement decisions that affect the broader European Market. ESMA publishes a selection of these decisions twice a year.

Each year, ESMA issues European Common Enforcement priorities, which it identifies after consultation with the National Competent Authorities. We reflect these in its reviews and report the results to ESMA. For reviews undertaken in 2017/18 the priorities were:

- presentation of financial performance;
- financial instruments: distinction between equity instruments and financial liabilities; and
- disclosures of the impact of the new standards on IFRS financial statements.

Our work did not identify any new concerns about these topics.

We actively participate in working

groups set up by ESMA to consider particular aspects of financial reporting. It is currently a member of the working groups on the application of IAS 12, narrative reporting and accounting by financial institutions.

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### Other UK Regulators

Regular meetings are held between FRC and the Financial Conduct Authority ("FCA") to share the outcome of our work on regulated companies and discuss ongoing matters of joint interest. Where the work relates to interim reporting or the reports of non-UK companies, our findings are passed to the FCA under the Companies (Audit, Investigations and Community Enterprise) Act 2004 for further consideration. The FCA may refer corporate reporting matters to the FRC when it is best suited to investigate further.

We also liaise with the Prudential Regulation Authority on matters of mutual interest regarding financial institutions and may share information, for example on complaints that affect both corporate and prudential reporting.

Our CRR and Audit Quality Review (AQR) teams collaborate when they are able to assist each other's reviews.

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# **APPENDIX C: OVERVIEW OF CONCLUDED CASES AGAINST MEMBER DIRECTORS**



# APPENDIX C

The FRC operates a disciplinary scheme for accountancy professionals. This helps to deter accountants from acting in a way that undermines confidence in financial reporting or corporate governance in the UK. Investigations under the Scheme are commonly conducted alongside investigations relating to the audit of financial statements, which are considered separately under the AEP.

The investigations involve detailed and rigorous legal and evidential analysis by lawyers and forensic accountants prior to enforcement proceedings being commenced. Such analysis involves the review of a wide range of material

relevant to the preparation of the financial statements and associated conduct.

In some cases, investigations involve working alongside other regulators (such as the FCA, the Serious Fraud Office, the Pensions Regulator and the Insolvency Service) who are often conducting their own investigations.

Since 1 October 2017, we have concluded investigations into five individuals. In two cases, misconduct was admitted. The remaining three cases were heard before a disciplinary tribunal. These are set out in the table below:

Since 1 October 2017, we have concluded investigations into five individuals.

Company	Member	Date announced	Outcome	Date	Sanction
Tech Data	Kevin Silverwood	May 14	Settled	Oct-17	Exclusion: 5 years <sup>36</sup> Fine: £50,000 <sup>37</sup>
AssetCo	John Shannon	Aug-14	Tribunal	Jan-18	Exclusion: 16 years Fine: £250,000
AssetCo	Raymond Flynn	Aug-14	Tribunal	Jan-18	Exclusion: 14 years Fine: £150,000
AssetCo	Matthew Boyle	Aug-14	Tribunal	Jan-18	Exclusion: 12 years Fine: £100,000
RSM Tenon	Russell McBurnie	Aug-12	Settled	May-18	Exclusion: 5 years Fine: £60,000 <sup>38</sup> Costs: £825,000
Nichols plc and the University of Salford	Eric Healey	Sep-14	Settled	Jul-18	Exclusion: 5 years Fine: £200,000 <sup>39</sup>

<sup>36</sup> Reduced to 4 years for mitigating factors

<sup>37</sup> Reduced to £11,250 taking into account Mr Silverwood's financial resources, adjusted for mitigating factors and discounted for settlement

<sup>38</sup> Discounted for settlement to £57,000

<sup>39</sup> Discounted for settlement to £150,000

## Summary of disciplinary cases concluded since 1 April 2017

### Tech Data Limited

Tech Data Limited was a trade-only distributor to the computer and mobile communications industry operating through a number of product divisions. Customers were exclusively dealers and value-added resellers in the UK and Ireland. Following the identification of significant accounting irregularities in March 2013 and a subsequent internal investigation of the company's accounting practices, the 2012 financial statements were restated. The directors' report in the financial statements for financial year 2013 stated:

*"The company has restated its financial statements to correct improper accounting. There were a number of instances where there was improper timing of recognition in the profit and loss account of certain vendor incentives, product discounts, price variances, promotions and other vendor credits. There were also errors related to accounting for accounts receivable, manual journal entries, cash cut-off, certain inventory transactions, improper recognition of foreign exchange gains and losses and certain other errors."*

Mr Silverwood, previously Financial Management Controller at Tech Data Limited, admitted six allegations that his conduct fell significantly short of the standards to be expected of a member of the ICAEW in relation to the preparation of the financial statements of Tech Data Limited for the financial years ended 31 January 2012 and 31 January 2013. Mr Silverwood breached the ICAEW's Fundamental Principle of Integrity, which required him to be straightforward and honest in all professional and business relationships and not knowingly associated with information that he knew to be false or misleading. Mr Silverwood resigned prior to the finalisation of the 2013 financial statements.

### AssetCo plc

AssetCo plc was an AIM quoted fire and rescue services business that provided fire engines to the London Fire Brigade. As a result of the Misconduct, AssetCo plc substantially restated its financial statements in 2011 (£146m reduction in assets and £25m reduction in profit). The share price fell 60p to 1.75p.

The FRC's Executive Counsel brought 27 allegations of Misconduct against Mr Shannon, Mr Flynn and Mr Boyle before the Tribunal. Findings of Misconduct were made in relation to all of them. Misconduct included dishonesty and breaching the Fundamental Principles of the ICAEW Code of Ethics, including Integrity, Objectivity and Competence. Misconduct related to dealing with company funds, the preparation of financial statements, and the recognition of fictitious assets and revenue. The tribunal also found that they had each misled the auditors, Grant Thornton UK LLP.

The sanctions awarded were substantial with periods of exclusion being the longest ordered to date.

Mr Silverwood, previously Financial Management Controller at Tech Data Limited, admitted six allegations that his conduct fell significantly short of the standards to be expected...

The FRC's Executive Counsel brought 27 allegations of Misconduct against Mr Shannon, Mr Flynn and Mr Boyle before the Tribunal. Findings of Misconduct were made in relation to all of them.

### RSM Tenon Group plc

RSM Tenon Group plc was an accounting firm which was listed on the London Stock Exchange in May 2010 with a market In October 2011 Mr McBurnie was replaced, shortly before the financial statements for 2011 were approved on 31 October 2011. Shortly afterwards a number of material accounting errors were uncovered. Restatements were subsequently made to the 2010 and 2011 financial statements.

Mr McBurnie admitted extensive Misconduct in relation to the preparation and approval of the financial statements of RSM Tenon Group plc for the year ended 30 June 2011. Mr McBurnie admitted nine allegations that his conduct fell significantly short of the standards reasonably to be expected of a member of the ICAEW.

Mr McBurnie breached two of the Fundamental Principles of the ICAEW Code of Ethics, including the Fundamental Principle of Integrity which required him to be straightforward and honest in all professional and business relationships, because he was reckless as to whether certain information within the financial statements was fairly and accurately stated.

Allegations related to multiple financial statement areas including the accrual of bonus payments, the assessment of the impairment of goodwill, and the preparation of the financial statements on a going concern basis.

### Nichols plc and University of Salford

The Misconduct related to Mr Healey, a former senior partner in Grant Thornton, who joined the audit committees of Nichols plc and the University of Salford, both audit clients of Grant Thornton, while he was also engaged by the firm to provide services under a consultancy agreement.

Mr Healey has admitted that his conduct was in certain respects reckless, that it fell significantly short of the standards reasonably to be expected of a Member of the ICAEW and that he failed to act in accordance with, inter alia, the ICAEW's Fundamental Principle of Objectivity.

Mr McBurnie admitted extensive Misconduct

Mr Healey has admitted that his conduct was in certain respects reckless...

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