THE 100 GROUP

A collective voice for the development of UK-based business

THE HUNDRED GROUP
OF FINANCE DIRECTORS

Looking ahead

What you need to know Winter 2018

December 2018

The 100 Group briefing

Dear members of The 100 Group,

Welcome to the first edition of The 100 Group briefing for the financial year 2019. As we approach the end of the calendar year, the 'big announcements' are winding down, but there have still been a number of guidance documents and reviews published which you may wish to familiarise yourself with for the New Year.

The statutory audit market continues to hold focus. There are two ongoing reviews; the CMA review of the audit sector and its resilience; and the Kingman review of the FRC as regulator. We've summarised the intended outcomes of each review, along with the latest developments in the assurance section.

Elsewhere, the FRC published its Annual review of corporate reporting, this year also covering corporate governance matters. Whilst there are no surprises, the tone of the review was more negative than previous years. Group members may wish to refer to the areas highlighted and take another look at their own reporting.

And finally with Brexit approaching, we've included a piece on what Group members may wish to think about when preparing their next financial statements – The FRC has recently increased their attention on this area, so we'd advise Group members to think carefully.

We've set out in the Executive summary the other topics included in this edition. I hope you find the briefing useful – please do let me know what you'd like to see more of and how we can improve the publication, and have a pleasant holiday season.

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Looking ahead

The 100 Group briefing, *Looking ahead*, is a quarterly briefing commissioned by the 100 Group of Finance Directors. Its aim is to brief the Group on key developments in the capital markets and proposed changes in regulation and standards that might require response, lobbying, or which are important for general awareness.

For further information, please contact *Gilly Lord.*

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Key: M – Monitor R – Respond/React L – Lobby

Reporting

Brexit-specific reporting considerations

With the UK's departure from the EU approaching, what should companies consider for their next financial statements? PwC's Olaf Pusch takes a look.

As the UK's exit from the European Union approaches, businesses need to consider how the eventual withdrawal and possible trade agreement could impact their organisations. Some of the impacts might be financial in nature, such as additional import duties on goods shipped to the UK from the EU. Others might be administrative in nature, even though they would come at a cost too; examples include dealing with possible labour shortages, port/border delays that might interrupt production, additional data collection and customs declarations to be completed as well as adherence to a different set of regulations.

It is true that any impact from duties and customs will be reflected in the accounts only once they arise, next year or at some point in the future depending on the details of the withdrawal and any trade agreement that is eventually struck. But there are a lot of reporting considerations to be evaluated now.

Companies will need to conclude whether, for them, Brexit constitutes a principal risk. The Companies Act requires companies to report on these as part of their strategic reporting.

Recently the FRC has sharpened its focus on this topic, making it very clear in the recent annual review of corporate governance and reporting, as well as in a letter to Audit Committees Chairs and Finance Directors, that it expects companies to provide increasingly specific descriptions of the Brexit impact. To date, we have seen a wide spectrum of how companies are disclosing this risk: Some are providing a lot of detailed information about specific impact areas, others take a wider approach describing broader economic and political uncertainty. Some companies disclose the Brexit risk as a separate principal risk, others describe it as a factor within another broader category of risks, for example within financial, regulatory, economic, or market-related risks.

But there are companies that are internationally highly diversified with no significant UK operations or no specific exposure. For these types of companies there could be no such principal risk. Also there are some companies that initially reported Brexit as a principal risk but might no longer believe this to be the case. Management should justify this in their accounts and explain their reasons why a previously identified risk no longer exists.

For those companies that are impacted, the better reporters distinguish between specific and direct challenges the company faces and link the risks to their business model and operations, as opposed to those reporting vaguely by stating broad economic uncertainties. Management should report their responses to each identified risk as well as strategic plans to combat or mitigate the Brexit impact they identified. Some companies have also considered a range of Brexit scenarios and included this as part of their stress testing for the viability statement.

To date we have not seen a company where the impact was so significant that the going concern assumption was challenged, but it is something management will need to monitor as political negotiations continue.

Reporting (cont'd)

One of the immediate impacts after the referendum was the devaluation of sterling. This already resulted in financial impacts, for example when translating foreign subsidiaries and asset valuations. There might be an impact on other measurement areas too, in some cases perhaps not just yet, but companies need to monitor this. For example, impairment indicators might arise or restructuring provisions might be needed. Also, counterparties might be negatively affected such that receivables might need to be impaired – an important consideration given IFRS 9's new expected loss model for provisioning for doubtful debts. As with all assumptions and estimates, if there is a significant risk that there could be material changes to assets and liabilities within the next year, some sort of sensitivity disclosures are required.

Finally, companies need to be mindful when declaring dividends. Apart from statutory duties, directors have fiduciary duties to take future losses into account to ensure the company remains in a position to pay its debts as they fall due.

Group members should carefully consider what they disclose, and what impact Brexit might have – as discussed, the FRC are paying special attention to this topic, attention which will undoubtedly heighten the nearer we get.

FRC review findings on IFRS 9 and IFRS 15 interim disclosures

The Financial Reporting Council (FRC) has published its review findings on the first interim reports prepared under the new standards – and there's a real sense of disappointment. PwC's Dasa Brynjolffssen and Helen Stokes look at how companies still have work to do.

After what may feel like a lifetime, the dust is now settling for the vast majority of companies who have now completed their transition to the new revenue and financial instrument standards (IFRSs 9 and 15). There was a lot of discussion and hard work involved...finally time to relax? Maybe not just yet...

The FRC has recently published its review findings on the first interim reports prepared under the new standards. These, by definition, are the reports in which the impact of transition was explained. Some of these findings will not come as any great surprise, for example the fact that impact varied greatly from industry to industry, and that the majority of reporters took many of the transition exemptions and practical expedients available to make their lives easier.

What was surprising, however, was the general tone of these reports around the quality of disclosure made so far. Overall there was a real sense of disappointment from the FRC, who identified significant scope for improvement in disclosure. So it would seem that we are not quite over the finishing line yet, and there is more work to be done before annual reporting comes around in terms of having that last big push to critically review what's been done so far.

Starting with those who assessed the impact of transition to IFRS 9 and/or IFRS 15 as immaterial; Whilst you may have been lucky enough to avoid the rafts of disclosure that those reporters with material impacts are currently wading through, there is still a need to consider if your disclosures go far enough to explain why the impact was immaterial, including disclosure of where significant judgements had been made to come to this conclusion.

Reporting (cont'd)

For those companies where the impact is material, there is even more to think about.

Boards should carefully consider whether their disclosure of accounting policy is robust enough. Firstly we would encourage you to really ask yourself whether your accounting policies are sufficiently company specific. Have you ensured you have avoided boilerplate language or wording lifted directly from the standards with no linkage to the company? Next, have you drawn comparisons of your new policies to those applied previously? And, critically, have you presented sufficient discussion around judgements and estimates being applied in your accounting policies? The list goes on, but the message is consistent... due care and attention is needed to ensure that your accounting policies really give the whole picture and clearly explain the changes upon transition and their impact.

Then thinking about your disclosures for the transition adjustments themselves, have you provided meaningful explanations of the transition adjustments and clearly explained how the adjustments link back to the changes in accounting policies? If you have disaggregated your transition adjustments into impact categories, have you described them and provided explanations for how this has been done? Have you considered and explained fully the adjustments to all areas of the financial statements (for example the creation of contract assets and impact on balance sheet for IFRS 15).

In conclusion, if you think your work is done on IFRS 15 and IFRS 9 transition, you may be missing a trick. Boards will be aware that they need to plan for providing the more detailed disclosures required by the new standards at the year end, and that this will likely involve collating new information compared to previous years. Importantly however, that is not all that they need to think about.

Given the FRC's comments, boards would be advised to critically assess whether disclosures already made in interim reports, or planned to be made at year end, meet the disclosure objectives of providing clear explanations of the changes in policies, the impact of those changes and the associated judgments made.

FRC's Annual Review of corporate reporting 2017/18

In the first week of November, the FRC released this year's annual review of corporate governance and reporting. PwC's Mark O'Sullivan takes a look at reporting areas highlighted.

Many of the themes included in this year's annual review are familiar, with a particular focus on the disclosure of judgements and estimates, the impact of new accounting standards and the quality of strategic reports.

While there are relatively few surprises in this year's report, the tone is perhaps a little more negative than in previous years. In an open letter sent earlier in October to Audit Committee Chairs and Finance Directors, the FRC noted 'an increase in the number of basic errors'. In a year of significant change and uncertainty – whether due to the impact of new accounting standards or broader economic events – the FRC is challenging boards and audit committees to have 'effective procedures in place to ensure that specific rules and requirements embedded in reporting standards are observed …'.

Reporting (cont'd)

Areas highlighted

The FRC explores a number of areas that frequently arise from reviews of annual reports performed by its Corporate Reporting Review team ('CRR'). Areas particularly emphasised in both this year's review and the open letter are laid out below.

Disclosure of judgements and estimates

This is the CRR's most frequent area of challenge. In particular, the CRR will challenge companies where there is no disclosure of sensitivity or a range of possible outcomes in cases of estimation uncertainty (especially tax). However, the FRC does acknowledge that the timing of last year's thematic review of judgements and estimates disclosure might have meant that some companies with December year ends were not able to reflect properly on the findings. Expectations are much higher this year.

Adoption of IFRS 9 and IFRS 15, and disclosure of the likely impact of adopting IFRS 16

As discussed earlier, given the FRC's comments boards would be advised to critically review the disclosures they have already made or intend to make around transition and challenge themselves as to whether they have truly met the disclosure objectives.

Supplier arrangements, including disclosure of the use of supplier financing arrangements

The FRC focused on complex supplier arrangements some years ago, but the matter remains relevant, especially where a company makes use of supplier financing arrangements.

Where financing arrangements are in place, often enabling smaller suppliers to be paid in timely fashion, the FRC expects 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.

Use and explanation of alternative performance measures

While there are some indications that the FRC considers practice to be improving, the CRR will still often challenge the quality of explanations of why items are considered to be 'non-recurring'. It expects all companies who report alternative performance measures to apply the Guidelines produced by ESMA, and also encourages companies to read the CRR's 2017 thematic report and a report by the Lab, *Reporting on Performance Metrics*.

Reporting (cont'd)

Strategic report matters

The FRC is focused on balance, comprehensiveness and clarity (especially where adopting IFRS 15's modified retrospective approach), risk and viability, and compliance with the new non-financial information requirements. 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.

Brexit reporting

Not surprisingly, the focus on Brexit reporting has increased – earlier we covered the FRC's increased attention on this area. Companies are encouraged to distinguish between 'the specific and direct challenges to their business model and operations [and] the broader economic uncertainties'. Specific implications might include 'recognising or remeasuring certain items in the balance sheet'.

The FRC's findings and focus areas are primarily aimed at listed companies, so we'd advise Group members to keep them in mind when approaching the upcoming reporting season.

FRC launches project looking at Future of Corporate Reporting

The FRC has launched a major project to challenge existing thinking about corporate reporting. PwC's Mark O'Sullivan has more.

In recent years there's been growing debate about the purpose of the annual report. Despite efforts to encourage companies to report in a 'clear and concise manner', reports continue to grow in size, leading some to question their usefulness and whether they meet the information needs of stakeholders. With reporting requirements continuing to rise, the FRC's project aims to seek a balance between the needs of users and the costs and practicalities of providing this information.

As part of the project, the FRC will:

- review current financial and non-financial reporting practices;
- consider how companies should better meet the information needs of shareholders and other stakeholders;
- examine the different types of corporate communication produced by companies; and
- look at the fundamental purpose of corporate reporting and the annual report.

The deadline to participate has now closed, but the FRC expects this project will result in a series of calls for changes to regulation and reporting practice. Group members should keep an eye out for a paper summarising the outcomes of the project, to be published in the second half of 2019. If this topic is of interest, PwC has recently published a paper covering similar ground.

Corporate governance

Corporate governance aspects of the FRC's Annual Review

As part of the FRC's Annual Review, a number of aspects of governance and non-financial reporting were highlighted for boards to think about. PwC's John Patterson explains.

A number of major developments in governance and non-financial reporting will come into effect for periods beginning on or after 1 January 2019. The FRC's commentary on governance issues in its Annual review does not systematically distinguish between these new requirements and those that are already in force, which is consistent with our expectation that we will see more reporting on matters such as stakeholder engagement and corporate culture in 2018 reports.

Current aspects the FRC highlights for boards to consider include the following.

Explanations under comply or explain – The quality of these explanations is a perennial issue. The FRC focuses on three specific Code provisions this year, namely: where the chairman was not independent on appointment or was previously the chief executive; where there are fewer than 50% independent non-executive directors on the board; and where no external board evaluation was carried out.

Reporting on significant dissent – Despite the additional publicity arising from the Investment Association's public register of instances of significant dissent in AGM voting, a substantial number of companies are not yet responding as the Code requires.

Diversity disclosures – A substantial number of companies are not fully compliant with the Companies Act reporting requirements on gender. The FRC also issued a separate report in September, which states that only 15% of FTSE 100 companies comply in full with the Code provision on diversity reporting.

Remuneration reporting – The FRC notes 'no real change in the quality of remuneration reporting this year', including in areas such as the link between incentives and metrics and strategy. The FRC hopes that the introduction of a specific provision on remuneration reporting in the 2018 Code will help to address this.

It's clear that the FRC is looking for the issues they have raised to be taken into account in the current reporting season. Given the number of announcements this year covering both governance and the stakeholder agenda, Group members would be wise to engage and review their own reporting.

Corporate governance (cont'd)

GC100 releases Guidance on Directors' duties on Section 172

GC100, the association of general counsel and company secretaries of FTSE 100 companies, has released a document aimed at providing guidance on the Section 172 duty, stakeholder considerations and putting them in a practical context. PwC's John Patterson looks at what's covered.

As has been widely discussed in connection with the governance reform debate, Section 172 of the Companies Act imposes a general duty on company directors to act in the way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its shareholders as a whole. This duty is owed to the company itself, but Section 172 also requires directors, in making their decisions and choices and in setting policies and strategy, to have regard to a non-exhaustive list of factors, including the interests of employees and how the actions and behaviours of the company affect customers, suppliers, the community and the environment, as well as the company's reputation.

Section 172 applies across a director's role, ranging from setting their company's strategy and defining its culture to agreeing governance structures, settling business plans and budgets, setting policies and procedures and making business decisions.

The GC100 Guidance aims to provide practical help to directors on their performance of the Section 172 duty by:

- setting out practical steps directors can take to discharge their duties;
- summarising the key legal background to and aspects of the Section 172 duty; and
- including an example scenario of how directors in a specific business situation could discharge their duties.

Group members may find the GC100's Guidance useful when thinking about how they will demonstrate that the board has done the right thing in relation to the directors' Section 172 duties. If there is an overarching theme to the guidance it is that the concepts underlying Section 172 need to be embedded in day-to-day governance and decision-making throughout an organisation, rather than being a legal technicality considered only by the board.

Investor engagement

WBCSD and PwC launch report on enhancing the credibility of non-financial information

The World Business Council for Sustainable Development (WBCSD), together with PwC, have released a new report looking at what investors need in order to make decisions using non-financial information. PwC's Hilary Eastman looks at the outcomes reported.

The goal of the research was to understand which aspects of non-financial information (defined in the report as information outside the financial statements, including alternative performance measures and other key performance indicators, as well as environmental, social and governance metrics) are most useful in investment decision making, how investors and analysts use this information and what can be done to improve their confidence in the information reported. PwC and WBCSD held investor roundtables in 8 cities in May – July 2018, supplemented with individual interviews.

When asked whether they use non-financial information, the answer amongst interviewees was almost unanimous: non-financial information is used for investment decision-making because it:

- helps give context to financial information;
- helps investors to understand corporate governance;
- identifies risks and opportunities; and
- provides insight into the long-term sustainability of the business.

Non-financial information helps provide context to the investor for a better understanding of the financial information and the overall performance of the business. For some, it goes further and supports baseline decisions for investment because it provides information about the quality of the business and its long-term viability, complementing the valuation model.

The report highlights that while investors have an appetite for using non-financial information to make capital allocation decisions, they have difficulty in assessing how much they can rely on the information. Despite its usefulness, investors say it's not always clear how much they can trust non-financial information. Because of this, many emphasised that external assurance is worth the cost – but only when the information being assured is relevant to decision-making.

The report is designed to inform the work of standard setters and regulators to improve the relevance and reliability of non-financial information. Group members may wish to review the set of actions the report sets out that companies can take to build the credibility of non-financial information.

Assurance

CMA review of the audit sector; Kingman review of the FRC; and 'Project Flora'

There are currently two reviews underway into the audit sector – The CMA Market Study into the statutory audit market and the Kingman review of the FRC. In addition, 'Project Flora', a review launched by the Audit Quality Forum into the future of the audit, is expected to begin in the New Year. PwC's Jayne Kerr looks at the objectives of each review.

This is clearly a fluid area, subject to evolution and change as the reviews are completed. In fact, just recently, in a further development, Rachel Reeves MP, Chair of the Business, Energy and Industrial Strategy (BEIS) Select Committee, announced a further review in the form of a parliamentary inquiry to be launched in the New Year, which will look at the recommendations arising from the CMA and Kingman reviews with the aim of ensuring they are acted upon.

A summary of the objectives of each review is provided below.

CMA Market Study

This Market Study is considering whether the statutory audit market is working as well as it should. The study is focused on three sets of issues:

- **Choice and switching** – The CMA recognises that changes put in place by the Competition Commission after its review five years ago have strengthened competition between the four largest firms, but has raised concerns over choice, especially among auditors chosen by the largest listed companies.
- **Resilience** – The CMA has examined whether long-term competition is threatened by the biggest firms perhaps being 'too big to fail'.
- **Incentives** – The CMA has followed up concerns on whether audit committees, rather than an independent appointment body, selecting a company's auditor might result in 'a lack of incentive to produce challenging performance reviews'.

The scope of the study has been the whole of the statutory audit market, including listed companies, other public interest entities (PIEs) and private companies. This is much wider than the previous investigation performed by the Competition Commission, which focussed on the provision of audits to FTSE 350 companies.

The study has explored a number of potential interventions that may be considered by the CMA, including:

- market share caps, which could involve limits on the proportion of the audit market any one firm has;
- the introduction of shared or joint audits;
- further restrictions on providing non-audit services to audit clients and/or the introduction of audit-only firms; and
- the introduction of an independent body to appoint auditors.

The deadline for submission of responses to the invitation to comment (ITC) on the study was October 31 and the CMA has said it will report back by the end of the year, which aligns with the publication of the Kingman review into the Financial Reporting Council (see below).

Assurance (cont'd)

The Kingman review

In 2018 the government launched an independent review of the Financial Reporting Council (FRC). The review is being led by Sir John Kingman, Chairman of Legal and General Group PLC, who has extensive private and public sector experience, supported by an advisory board. The root and branch review, due for completion by the end of 2018, is assessing the FRC's governance, impact and powers, to help ensure it is fit for the future.

The review aims to make the FRC the best in class for corporate governance and transparency, while helping it fulfil its role of safeguarding the UK's leading business environment. It has explored a range of themes including the FRC's:

- role and purpose;
- effectiveness and its powers;
- potential role in preventing corporate failure;
- legal status and relationship with the government; and
- governance and leadership.

The call for evidence closed in August 2018. It is estimated that the review will report on its recommendations by the end of the year.

Project Flora

Project Flora is a review into the existing model for auditing and whether is fit for purpose. It is being backed by the Audit Quality Forum, the FRC and the ICAEW, and has the support of BEIS. It is expected to launch in the New Year.

In our responses to the CMA and Kingman, we made it clear that we believe confidence in company audits is critical to the functioning of the economy and that we recognise that the quality and purpose of audit and the role of the regulator has been placed in the spotlight by recent company failures. We support both reviews, but also believe that addressing the 'expectation gap' between the role of the statutory audit under current regulations and what many stakeholders, and the wider public, believe is, or should be, the function of the audit must also be addressed and so also welcome the Project Flora review of the future of the audit.

Assurance (cont'd)

IAASB releases ISA 540 (Revised)

In October, the IAASB released a revised version of ISA 540, the standard for auditing accounting estimates and related disclosures. PwC's Jamie Shannon looks at the revisions.

The International Auditing and Assurance Standards Board (IAASB) decided to revise ISA 540, Auditing Accounting Estimates and Related Disclosures, to respond to changes in financial reporting standards and the increasingly complex business environment. Entities, in particular banks, insurers and other financial services firms, have seen significant change in their accounting practices as they move to new accounting standards that have changed the way they deal with loan provisions and insurance contracts, which has increased the importance and visibility of accounting estimates and disclosures for users of financial statements.

The revision reflects this rapidly evolving business environment where management judgement and forward-looking information are becoming more prevalent. The changes address challenges in auditing increasingly complex accounting estimates as well as reinforcing the importance of the auditor adopting a sceptical mindset in support of a more robust approach to identifying, assessing and responding to risks of material misstatement of the financial statements relating to accounting estimates and related disclosures.

This revised standard is the first to be completed as part of the IAASB's broader program 'Addressing the Fundamental Elements of an Audit' and is an important part of the IAASB's efforts to improve audit quality globally. Some of the significant revisions include the following:

- Obtaining a more detailed understanding of management's process for making accounting estimates and related disclosures.
- An enhanced risk assessment that requires auditors to consider complexity, subjectivity and other inherent risk factors in addition to estimation uncertainty. This will drive auditors to think more deeply about the risks inherent to accounting estimates.
- A closer link between the enhanced risk assessment and the methods, data and assumptions used by management in making accounting estimates, including the use of complex models.
- Specific focus on the relevance and reliability of information obtained from sources outside of the entity.
- Specific material to show how the standard is scalable to all types of accounting estimates.
- Emphasis on the importance of applying appropriate professional scepticism when auditing accounting estimates to foster a more independent and challenging mindset in auditors.

ISA 540 (Revised) becomes effective for financial statement audits for periods beginning on or after 15 December 2019. Group members are encouraged to engage with their auditors – it's critical all parties in the financial reporting supply chain collaborate in the implementation of a standard with such far-reaching effects on the audit of financial statements.

Assurance (cont'd)

PwC launches Future of Audit roundtables

With the UK audit profession currently under review, PwC has launched an initiative to gather stakeholder views through a series of roundtables and an online discussion on the Future of Audit. PwC's Hilary Eastman outlines the rationale and plans.

The auditing profession is current under great scrutiny. It's become a subject of much debate and commentary in the public arena, with questions asked on matters of quality, independence and choice.

To help explore these issues in more detail Kevin Ellis, PwC Chairman and Senior Partner, announced an initiative looking at the Future of Audit. In this announcement, he states that the sector is at a watershed moment, the profession's critics have raised valid concerns and there's an urgent need to explore how audit needs to evolve for the future.

Whilst audits perform a critical role in underpinning confidence in financial reporting and are valued by many stakeholders, it's evident that the audit has not kept pace with society's expectations, and there's a need to explore how it must evolve for the future. To help frame this debate, the following questions are being asked:

- Who should the audit be for? Just equity shareholders? Or should a wider range of stakeholders be able to rely on our work?
- What should the audit cover? Today, our audit opinions cover historical financial performance – but is assurance needed over future viability, operational risks, or non-financial performance?
- Should the focus continue to be on a binary "true and fair view"? Or instead on a more subjective account of significant business and financial risks?
- Does one size of statutory audit fit all organisations? Should our largest listed companies, with the greatest public interest, face a greater degree of scrutiny than a smaller, owner-managed business?
- How will technology enhance the future of the audit? Would automated assurance over real-time data free up human auditors to concentrate more on exercising judgement over a refined set of information?

A series of roundtable discussions will be taking place across the UK, starting in Birmingham on 14 December. Other events are planned for Manchester, Belfast, Edinburgh and London during January and February. The themes and views that emerge from these dialogues will be made available in a white paper. PwC are also accepting views via their UK website, with responses published on a public portal.

Should you wish to take part in this debate, you can submit your responses to the questions above here or send an email to futureofaudit@pwc.com to express your interest in attending a roundtable event.

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