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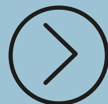
# Closing out 2017



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Deloitte resources


In Closing Out 2017, we discuss the principal issues arising in respect of 31 December 2017 annual reports, being primarily:

- Areas of regulatory focus identified in the Financial Reporting Council's (FRC's) *Annual Review of Corporate Reporting 2016/2017* ('the FRC annual review'), its accompanying slide deck of Corporate Reporting Review Technical Findings and year-end advice letter to audit committee chairs and finance directors.
- The European Securities and Markets Authority's (ESMA's) common enforcement priorities.
- The new requirements arising from enactment of the EU Non-Financial Reporting (NFR) Directive into UK law.
- The FRC's thematic reviews of practice on the use of Alternative Performance Measures and on disclosures on pension obligations and the judgements and estimates applied in financial reporting.
- Issues arising from the current economic environment and developments in reporting standards.

As in previous years, the FRC annual review provides an assessment of UK corporate reporting based on reviews of listed, AIM quoted and large private companies by the FRC's Corporate Reporting Review team whilst the year-end advice letter highlights issues relevant to the upcoming reporting season. There is a high level of consistency in the issues covered by these two publications.

As well as financial reporting issues, we also cover other aspects of reporting, including the increasing focus on disclosure of climate risk and of dividend policy.

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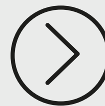



# The UK regulatory environment

The FRC annual review draws primarily on the FRC Conduct Committee's reviews of the annual and interim reports of listed, AIM quoted and large private companies, which are designed to ensure compliance with legal and regulatory reporting requirements. The accompanying slide deck provides additional detail on specific issues raised in reviews of companies' annual reports. The FRC also writes to the finance directors and audit committee chairs of listed companies to highlight changes in reporting requirements and to share its perspective on areas of corporate reporting that could be improved.

The Committee directs its resources primarily towards the reports of the UK's largest listed companies as the quality of those reports is of the greatest importance to investor confidence. If its reviews identify potential substantive issues, a dialogue with the company is instigated to resolve the issues and agree any action needed to improve the company's reporting. Companies are also written to when their reports have been reviewed but no substantive queries have arisen – either with an appendix of less significant matters for the company to consider or simply to inform them that a review has been performed but no points have been raised.

The FRC has also continued its programme of thematic reviews (this year covering the disclosure of significant accounting judgements and estimation uncertainty, pension disclosures and the use of Alternative Performance Measures (APMs)). Companies selected for such a review are informed prior to the relevant year-end, providing them with an opportunity to focus on the matter at hand.

The FRC annual review states that whilst the standard of UK corporate reporting, particularly amongst larger public companies, remains generally good, there is room for improvement. In particular, the need for clarity and completeness in areas such as key judgements and estimates and the linkage between financial statements, KPIs and APMs is noted together with, more generally, the need to provide a fair and balanced assessment of a company's performance and future prospects that covers both positives and negatives.

## 2018/19 Thematic Reviews

The FRC has recently announced the topics to be addressed by its thematic reviews in 2018/19 as:

- Targeted aspects of smaller listed and AIM quoted company reporting.
- The effect of IFRS 15 on revenue and IFRS 9 on financial instruments on 2018 interim reporting.
- The expected effect of IFRS 16 on leasing.
- The effect of 'Brexit' on reported principal risks and uncertainties.

The smaller listed and AIM companies thematic review is part of the FRC's initiative to improve the quality of financial reporting amongst this group, which it has long viewed as lagging behind that of their larger listed cousins. The 40 companies selected for this thematic review will be made aware of both this fact and which aspects of financial reporting will be reviewed prior to their year-ends.

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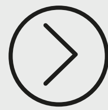



## The effect of 'Brexit' on the UK accounting framework

The FRC annual review highlights the fact that, whilst the UK remains in the EU, UK reporting remains subject to the EU legislative framework. This means that:

- application of IFRSs 'as endorsed for use in the European Union' remains a legal requirement, meaning that new or revised standards cannot be adopted before EU-endorsement; and
- the FRC remains a competent authority of an EU member state, tasked with monitoring and supervising compliance with ESMA's common enforcement priorities, which therefore remain relevant for UK company reporting.

In the longer term, the possible effect of Brexit on financial reporting requirements is less clear. In its annual review, the FRC states that it is providing input to government on a post-Brexit framework for accounting in the UK together with its current view that this framework should:

- continue to be based on IFRS;
- have a UK process for endorsement, with the FRC as the endorsing body; and
- depart from standards issued by the IASB only subject to strict and agreed criteria.

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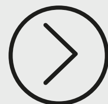



# Topical issues – reporting on the year to 31 December 2017

FRC Focus Area

## 'Brexit' and 2017 annual reports

As might be expected given its economic significance and range of possible effects on business, the FRC notes in its Annual Review of Corporate Reporting that in most 2016 annual and 2017 interim reports companies included reference to 'Brexit' either as part of their discussion of risk or in commenting on their performance, but also that there was a consistent theme of it still being too early to measure the longer term effects on their businesses.

It is important, however, that as the landscape develops companies continue to refine their analysis of the potential impacts and, as they do so, continue to provide more detailed and more company-specific discussion of these impacts in their corporate reporting. Such a discussion could be included in a company's narrative reporting as part of, inter alia, the discussion of a company's business model, principal risks and uncertainties or the longer-term viability statement. Equally important is to include the effects of 'Brexit' that a company might already be experiencing (for example, higher costs of foreign currency as swaps taken out before the referendum expire) in discussions of performance in 2017.

Within the financial statements themselves, such uncertainties could be relevant to disclosure of sources of estimation uncertainty and to the parameters of 'reasonably possible' changes used in sensitivity analyses of fair value measurements, market risks on recognised financial assets and liabilities and impairment reviews.

ESMA's common enforcement priorities also make reference to discussion of 'Brexit', making the specific comment that recognition and measurement of deferred tax assets could be an area in which major sources of risks and uncertainties will need to be disclosed. Whilst there could be uncertainty over the generation of future taxable profits to utilise tax losses, this assessment should be made on the basis of currently enacted tax law and as noted in a Deloitte Need to know the triggering of 'Article 50' did not constitute substantive enactment of any changes to existing tax law.

As with other economic events, changes in tax law should be accounted for when they occur rather than being anticipated based on an expectation of possible future change. Tax accounting is, however, unusual in that a change in tax law provides a simultaneous 'trigger point' for all affected companies. Other accounting that may occur, directly or indirectly, as a result of 'Brexit' such as recognition of restructuring provisions or classification of assets as held-for-sale are likely to result from events or decisions particular to an individual company.

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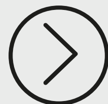



FRC Focus Area

## Reporting financial performance and the use of Alternative Performance Measures

The use of 'non-GAAP' or 'Alternative Performance' measures is an area of increasing regulatory focus, with the FRC taking a specific interest in compliance with ESMA's Guidelines on Alternative Performance Measures as clarified by a series of Questions and Answers published in 2017.

The FRC reviews the use of APMs in light of the overarching requirement in law for a company's strategic report to be fair, balanced and comprehensive. As well as being contrary to the ESMA Guidelines, giving undue prominence to an adjusted profit figure over the equivalent IFRS figure can call into question whether this requirements has been met.

The Deloitte publication 'Alternative performance measures: A practical guide' provides additional guidance on the use of APMs, setting out what is considered best practice and providing real-life examples of how entities present such measures.

The FRC annual review notes a generally good level of compliance with the ESMA Guidelines in areas such as defining APMs and explaining their use and reconciliations of APMs to equivalent IFRS figures, but also identifies room for improvement on:

- The use of terms such as 'non-recurring' and 'one-off' to describe adjusting items such as restructuring and impairment charges, stating that for larger companies there will be few occasions when such a charge does not arise more than once over a number of years. The FRC recommends that, in general, such terms be removed from definitions of APMs.
- Reconciliations of ratios such as return on capital and cash conversion to IFRS figures. The ESMA Questions and Answers confirm that this is required.
- Giving at least equal prominence to IFRS measures. The FRC noted that chairman or chief executive's statements were particularly likely to give undue prominence to APMs, but giving due prominence to IFRS measures in highlights pages (including in pictorial analyses such as graphs of year-on-year profit growth) is very important as is an early discussion of IFRS results in, for example, a financial review.

The ESMA Questions and Answers make clear that 'adjusted' profit figures used in the financial statements themselves (for example, as part of segment information) as well as in narrative reporting remain within the scope of its guidelines on APMs.

In using such measures, it should be noted that:

- a measure labelled as 'operating profit' should not exclude items such as inventory write-downs that would be generally understood as forming part of the entity's operations;
- gains and losses should not be offset unless permitted by IFRSs;
- the approach to identifying 'exceptional' or 'adjusting' items should be even handed (with gains excluded as readily as losses), consistent from year to year and clearly disclosed (including an explanation of why it is believed necessary to adjust for certain items); and
- a clear accounting policy for the identification of such items should be provided.

The tax and cash flow effects of any 'exceptional' items should also be clearly presented.

The use of Alternative Performance Measures was the subject of a thematic review by the FRC in 2017. The report resulting from that review covers many of the issues above and also provides examples of good practice.

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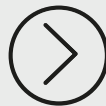
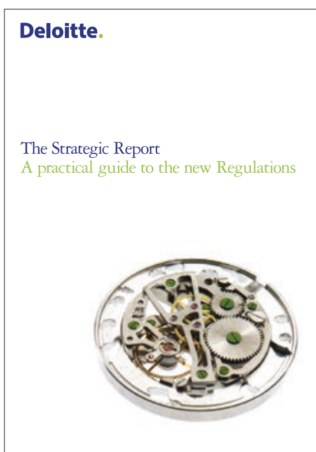




FRC Focus Area




For companies looking for guidance in this area, UK Accounting Plus provides a number of resources on the strategic report and narrative reporting more generally.

## The strategic report

In addition to its specific focus on APMs, the FRC highlighted issues arising in respect of other aspects of the strategic report.

### Business review and business model reporting

In terms of the business review, the FRC highlighted cases in which it challenged the comprehensiveness of the discussion provided, including when there was limited discussion about major revenue sources or product lines or of variations in levels of profitability. Such omissions can also give rise to challenges over the balance of a strategic report if it appears that discussion of successful parts of the business is prioritised over less well performing segments.

The comprehensiveness of a review of financial position was also challenged when it excluded, for example, movements in working capital and cash flows.

Central to a discussion of business performance are a company's Key Performance Indicators (KPIs). The FRC questioned companies when the basis for calculation of KPIs or the reasons for changing them was unclear.

In terms of the description of a company's business model, the FRC annual review highlights the need for linkage and consistency with other information in the annual report, something that can be achieved more naturally if the key drivers of the business are clearly articulated. On a similar theme, the year-end advice letter to audit committee chairs and finance directors recommends an explanation of how a company's KPIs interact with the remuneration paid to its directors.

### Risk and viability reporting

UK listed companies are required by Companies' Act 2006 to provide:

- a description of the principal risks and uncertainties facing the company or group;
- the main trends and factors likely to affect the future development, performance and position of the company or group's business; and
- a description of the company or group's strategy and its business model.

In addition the UK Corporate Governance Code now requires a longer term viability statement covering:

- how the directors have assessed the prospects of the company;
- over what period they have done so; and
- why they consider that period to be appropriate.

The viability statement should also state whether the directors have a reasonable expectation that the company will be able to meet its obligations as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary.

In respect of Principal Risks and Uncertainties (PRUs), the FRC highlighted concerns over cases where:

- The description was unclear or insufficiently detailed.
- It was unclear how the identification of PRUs had been performed, citing the example of an energy company with no PRU related to climate change.
- A number of risks were discussed in the strategic report, with no clarity over which were deemed to be 'principal'.

The viability statement is a newer element of corporate reporting, with the FRC noting that to date most companies have identified a period of three years over which to consider viability, reflecting a company's medium-term business plan.

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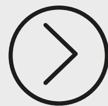



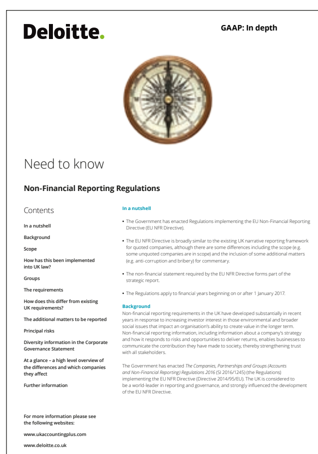

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GAAP: In depth

Need to know

**Non-Financial Reporting Regulations**

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In a nutshell
Background
Scope
How has this been implemented into UK law?
Groups
The requirements
How does this differ from existing UK requirements?
The additional matters to be reported
Principal risks
Diversity information in the Corporate Governance Statement
At a glance – a high level overview of the differences and which companies they affect
Further information

For more information please see the following websites:

www.ukaccountingplus.com

www.deloitte.co.uk

**In a nutshell**

- The Government has enacted Regulations implementing the EU Non-Financial Reporting Directive (EU NFR Directive).
- The EU NFR Directive is broadly similar to the existing UK narrative reporting framework for quoted companies, although there are some differences including the scope (e.g. some unquoted companies are in scope) and the inclusion of some additional matters (e.g. anti-corruption and bribery) for commentary.
- The non-financial statement required by the EU NFR Directive forms part of the strategic report.
- The Regulations apply to financial years beginning on or after 1 January 2017.

**Background**

Non-financial reporting requirements in the UK have developed substantially in recent years in response to increasing investor interest in those environmental and broader social issues that impact an organisation's ability to create value in the longer term. Non-financial reporting information, including information about a company's strategy and how it responds to risks and opportunities to deliver returns, enables businesses to communicate the contribution they have made to society, thereby strengthening trust with all stakeholders.

The Government has enacted *The Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016* (SI 2016/1245) (the Regulations) implementing the EU NFR Directive (Directive 2014/95/EU). The UK is considered to be a world-leader in reporting and governance, and strongly influenced the development of the EU NFR Directive.

A Deloitte 'Need to know' publication provides more detail on the effects of the Directive on UK corporate reporting, covering

- The changes relevant to large (in this context, meaning with more than 500 employees), listed companies on the reporting of non-financial risks, diversity issues and anti-corruption and bribery matters.
- The extension of non-financial reporting requirements to unlisted entities that are nevertheless deemed public-interest entities (PIEs) for the purposes of the Directives, this include banks, credit unions and insurers.

The FRC annual review notes that other factors such as the nature of the business and investment periods are also relevant to this consideration and recommends a two stage approach to developing viability statements:

- consider and report on the prospects of the company, taking into account its current position and principal risks; then
- state whether they have a reasonable expectation that the company will be able to continue in operation an meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary.

The FRC's Financial Reporting Lab has published a report on risk and viability reporting, providing guidance on and better practice examples of both disclosure of principal risks and uncertainties and discussion of companies' longer-term viability.

## The EU Non-Financial Reporting Directive

The requirements of the EU Non-Financial Reporting (NFR) Directive have been enacted into UK law and are effective for periods beginning on or after 1 January 2017.

The effect of these new requirements will be felt most keenly by unlisted entities falling within the definition of a public interest entity (PIE) for the purposes of the Directive which have more than 500 employees. These entities will now have to provide information on, for example, environmental and human rights issues which has previously only been required of listed companies.

There will, however, also be an impact on listed companies who will now have to provide information on anti-corruption and bribery matters together with more extensive information on environmental, human rights and diversity matters (including due diligence processes adopted in implementing policies in these areas). Discussion of the business model should also now include information on the relationships, resources and other dependencies that are a source of value and necessary for the success of the business.

The FRC has published a factsheet on the impact of the NFR Directive in the UK and Frequently Asked Questions on how best to apply them in the context of a Strategic Report. The European Commission has also published guidelines on application of the Directive more generally.

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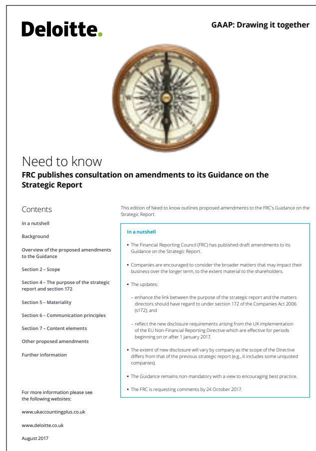
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GAAP: Drawing it together

Need to know

**FRC publishes consultation on amendments to its Guidance on the Strategic Report**

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Background
Overview of the proposed amendments to the Guidance
Section 2 – Scope
Section 4 – The purpose of the strategic report and section 172
Section 5 – Materiality
Section 6 – Communication principles
Section 7 – Content elements
Other proposed amendments
Further information

This edition of Need to know outlines proposed amendments to the FRC's Guidance on the Strategic Report.

**In a nutshell**

- The Financial Reporting Council (FRC) has published draft amendments to its Guidance on the Strategic Report.
- Companies are encouraged to consider the broader matters that may impact their business over the longer term, to the extent material to the shareholders.
- The updates:
  - enhance the link between the purpose of the strategic report and the matters directors should have regard to under section 172 of the Companies Act 2006 (s172); and
  - reflect the new disclosure requirements arising from the UK implementation of the EU Non-Financial Reporting Directive which are effective for periods beginning on or after 1 January 2017.
- The extent of new disclosure will vary by company as the scope of the Directive differs from that of the previous strategic report (e.g., it includes some unquoted companies).
- The Guidance remains non-mandatory with a view to encouraging best practice.
- The FRC is requesting comments by 24 October 2017.

For more information please see the following websites:

www.ukaccountingplus.co.uk

www.deloitte.co.uk

August 2017

A Deloitte 'Need to know' publication provides more detail on the proposed changes to the FRC's Guidance on the Strategic Report.

# Section 172 of Companies Act 2006 and proposed revisions to FRC Guidance on the Strategic Report

The requirements of Section 172 of Companies Act 2006 for a director to promote the success of the company and, in so doing, to consider a wider set of stakeholders including employees, the community and the environment have recently become an area of much greater focus.

In its annual review, the FRC highlights two specific areas that have moved into the spotlight:

- The importance of engagement with employees, customers, suppliers and other stakeholders. The FRC states that companies could be more transparent about these relationships by explaining their strategies for engaging with, and distributing value to, those various stakeholders.
- Communication of how a company generates and preserves value. The FRC sees information about sources of value including those not captured in the financial statements as crucial to investment decisions and, therefore, transparency over the key sources of value, how that value is managed and how value is likely to be generated in the future as a necessary part of corporate reporting.

The FRC has proposed amendments to its Guidance on the Strategic Report which aim, inter alia, to strengthen the link between the Strategic Report and the requirements of Section 172 by stating that the Strategic Report should "include information relating to sources of value that have not been recognised in the financial statements and how those sources of value are managed, sustained and developed, for example a highly trained workforce, intellectual property or internally generated intangible assets, as these are relevant to an understanding of the entity's development, performance, position or impact of its activity."

Although the revised Guidance is not expected to be finalised until 2018, the draft amendments provide a useful guide to the developing expectations in this area.

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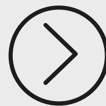




FRC Focus Area

## Accounting policies, judgements and estimates

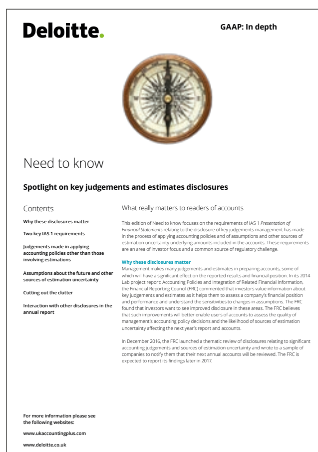
A primary source of information enabling investors to understand the items in the financial statements is a clear description of the accounting policies applied in producing those numbers. IAS 1 *Presentation of Financial Statements* requires this to be supplemented by a discussion of:

- the most significant judgements made in applying those policies (apart from those involving estimation); and
- the major sources of estimation uncertainty (including assumptions made about the future) that have a significant risk of resulting in a material adjustment to the carrying amount of assets and liabilities in the next financial year.

An effective description of accounting policies should include clear, entity-specific discussion of the policies applied to material transactions and balances, covering ongoing elements of the business (for example, revenue and cost recognition policies for each revenue stream) as well as one-off transactions such as significant business combinations and, perhaps as importantly, should *exclude* irrelevant repetition of the requirements of accounting standards in respect of items that are not material to the entity.

Specifically in respect of accounting for revenue transactions, this remains important as a means of explaining how a company's income is generated but takes on an additional significance in the run up to application of IFRS 15 as a basis for explanation of how these policies may change on adoption of the new Standard (for example, in respect of the principal-agent analysis or the basis for 'unbundling' elements of a contract).

> The FRC's year-end advice letter to audit committee chairs and finance directors includes a specific request for transparency on the accounting policy applied by providers of 'teaser rates' of interest on credit card or mortgage debt.



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GAAP: In depth

Need to know

**Spotlight on key judgements and estimates disclosures**

Contents

- Why these disclosures matter
- Two key IAS 1 requirements
- Judgements made in applying accounting policies other than those involving estimations
- Assumptions about the future and other sources of estimation uncertainty
- Cutting out the clutter
- Interaction with other disclosures in the annual report

What really matters to readers of accounts

This edition of Need to know focuses on the requirements of IAS 1 *Presentation of Financial Statements* relating to the disclosure of key judgements management has made in the process of applying accounting policies and of assumptions and other sources of estimation uncertainty underlying amounts included in the accounts. These requirements are an area of investor focus and a common source of regulatory challenge.

**Why these disclosures matter**

Management makes many judgements and estimates in preparing accounts, some of which will have a significant effect on the reported results and financial position. In its 2014 Lab project report: Accounting Policies and Integration of Related Financial Information, the Financial Reporting Council (FRC) commented that investors value information about key judgements and estimates as it helps them to assess a company's financial position and performance and understand the sensitivities to changes in assumptions. The FRC found that investors want to see improved disclosure in these areas. The FRC believes that such improvements will better enable users of accounts to assess the quality of management's accounting policy decisions and the likelihood of sources of estimation uncertainty affecting the next year's report and accounts.

In December 2016, the FRC launched a thematic review of disclosures relating to significant accounting judgements and sources of estimation uncertainty and wrote to a sample of companies to notify them that their next annual accounts will be reviewed. The FRC is expected to report its findings later in 2017.

For more information please see the following websites:

www.ukaccountingplus.com

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A Deloitte 'Need to know' publication provides more detail on the disclosure of significant judgements and sources of estimation uncertainty.

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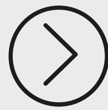



The requirements for disclosure of critical judgements and of estimation uncertainty are separate and address distinct issues. In broad terms, a critical **judgement** is applied in *characterising* a transaction or item (for example, whether a debt restructuring is a modification or an extinguishment or which party was the acquirer in a business combination) whilst **estimation** uncertainty is concerned with the *value* of, for example, a provision for an uncertain tax position or the net realisable value of inventory. Both in preparing and presenting useful disclosures, it is helpful to distinguish clearly between the two.

It is also important to bear in mind that IAS 1 refers to the judgements that have had “the most significant effect” and to “major sources” of estimation uncertainty. A comprehensive discussion of a small number of issues that genuinely demanded management scrutiny in the current year is of more value than a superficial reference to many items which may have been relatively unproblematic. In respect of estimation uncertainties, it should also be noted that this disclosure requirement refers specifically to a risk of material adjustment **within the next financial year**. Information about longer term uncertainties might be useful as additional disclosure, but does not form part of this IAS 1 requirement and should be kept separate from the IAS 1 disclosures.

Finally in respect of estimation uncertainties, the quantitative elements of the disclosures should not be overlooked, including the carrying amounts of the assets and liabilities in question, the sensitivity of balances to changes in estimates and, if an uncertainty is expected to be resolved within the next year, the range of possible outcomes.

Disclosure of significant accounting judgements and estimation uncertainty was the subject of a thematic review by the FRC in 2017. The report resulting from that review covers many of the issues above and also provides examples of good practice.

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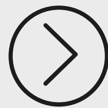



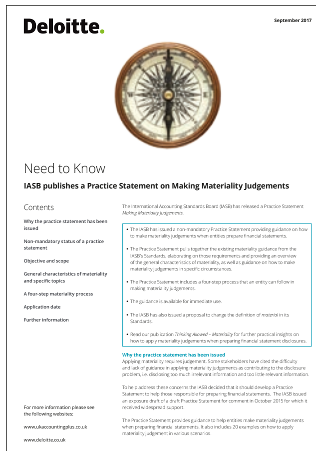

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September 2017

Need to Know

**IASB publishes a Practice Statement on Making Materiality Judgements**

Contents

- Why the practice statement has been issued
- Non-mandatory status of a practice statement
- Objective and scope
- General characteristics of materiality and specific topics
- A four-step materiality process
- Application date
- Further information

The International Accounting Standards Board (IASB) has released a Practice Statement *Making Materiality Judgements*.

- The IASB has issued a non-mandatory Practice Statement providing guidance on how to make materiality judgements when entities prepare financial statements.
- The Practice Statement pulls together the existing materiality guidance from the IASB's Standards, elaborating on those requirements and providing an overview of the general characteristics of materiality, as well as guidance on how to make materiality judgements in specific circumstances.
- The Practice Statement includes a four-step process that an entity can follow in making materiality judgements.
- The guidance is available for immediate use.
- The IASB has also issued a proposal to change the definition of *material* in its Standards.
- Read our publication *Thinking Allowed – Materiality* for further practical insights on how to apply materiality judgements when preparing financial statement disclosures.

**Why the practice statement has been issued**

Applying materiality requires judgement. Some stakeholders have cited the difficulty and lack of guidance in applying materiality judgements as contributing to the disclosure problem, i.e. disclosing too much irrelevant information and too little relevant information.

To help address these concerns the IASB decided that it should develop a Practice Statement to help those responsible for preparing financial statements. The IASB issued an exposure draft of a draft Practice Statement for comment in October 2015 for which it received widespread support.

The Practice Statement provides guidance to help entities make materiality judgements when preparing financial statements. It also includes 20 examples on how to apply materiality judgement in various scenarios.

For more information please see the following websites:

www.ukaccountingplus.co.uk

www.deloitte.co.uk

A Deloitte 'Need to know' publication provides more detail on the Practice Statement.

## IASB Practice Statement – Making Materiality Judgements

The consideration of materiality in financial statements, including what information should be excluded to avoid 'disclosure overload' remains a significant issue in financial reporting. Recognising this, in September 2017 the IASB issued a Practice Statement providing guidance on how to make materiality judgements in preparing financial statements. The guidance is non-mandatory and, as such, not subject to EU-endorsement so is available for immediate use.

The Practice Statement lays out a four-step process that could be helpful in framing a consideration of whether items are material, although it acknowledges that other methods may also be appropriate.

- Step 1 – Identification of potentially material information, taking into account both the requirements of accounting standards and the information needs of primary users.
- Step 2 – Assessment of whether this information is material through consideration of various quantitative and qualitative factors.
- Step 3 – Organisation of information identified as material to communicate it effectively and efficiently.
- Step 4 – An overall review of the draft financial statements to determine whether all material information has been identified as an item judged immaterial in isolation could be deemed material in the context of other information in a complete set of financial statements.

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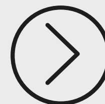



**ESMA Enforcement Priority**

**FRC Focus Area**

## The impact of new accounting standards

As the significant new Standards IFRS 15 *Revenue from Contracts with Customers* and IFRS 9 *Financial Instruments* are both mandatorily effective for periods beginning on or after 1 January 2018, December 2017 annual reports will be published after the date of initial application of those standards. The effective date of IFRS 16 *Leases* (periods beginning on or after 1 January 2019) also draws closer. As such, both the FRC and ESMA have reiterated the need for entity-specific, quantitative disclosure on the likely changes in accounting in line with the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

ESMA's public statements detailing its expectations of disclosure of the likely effect of IFRS 15 and IFRS 9 remain relevant and illustrate an expectation of increasing levels and detail of disclosure as the effective date of these standards approaches. For 2017 annual financial statements, the statements encourage:

- further elaboration and development of information provided in previous financial statements;
- an explanation of the changes to amounts reported under existing Standards, disaggregated as appropriate; and
- a quantitative assessment of the impact of the new Standards as of 1 January 2018.

In its common enforcement priorities, ESMA goes on to state that as December 2017 annual reports will be issued after the effective date of IFRS 15 and IFRS 9 implementation analyses should have been substantially completed. As a result, ESMA expects the impacts of these Standards to be known or reasonably estimable, allowing disclosure of:

- accounting policies to be applied, including in respect of transition and the use of practical expedients; and
- the amount and nature of expected possible impacts compared to previously recognised amounts.

Similarly, the FRC's letter to audit committee chairs and finance directors notes an expectation that companies will have made a 'step change' in the disclosure of the impact of IFRS 15 and IFRS 9 compared to a year ago.

The ESMA common enforcement priorities also include detailed recommendations on disclosure of the impacts of IFRS 15 and IFRS 9 depending on an entity's specific facts and circumstances and (in respect of IFRS 9) whether the company is a corporate entity, credit institution or insurer.

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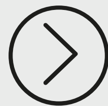



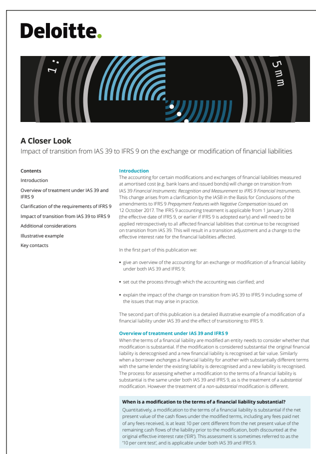

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A Closer Look

Impact of transition from IAS 39 to IFRS 9 on the exchange or modification of financial liabilities

"A Deloitte 'A Closer Look' publication provides more detail on the effect of IFRS 9 on the accounting for modifications of financial liabilities."

## Recent developments on IFRS 9

As the effective date of IFRS 9 approaches, the IASB and IFRS Interpretations Committee have continued to discuss issues arising in the Standard's implementation.

One of these issues resulted in the publication in October 2017 of an amendment to the Standard *Prepayment Features with Negative Compensation*. This adjusts the 'solely payments of principal and interest' (SPPI) criterion to allow, in certain circumstances, for a feature in which a borrower choosing to repay a loan early could receive (rather than, as is more usual, pay) compensation reflecting changes in interest rates. This will allow such loan assets, subject to the other criteria in IFRS 9, to be measured at amortised cost rather than at fair value.

EFRAG (the European Financial Reporting Advisory Group) has accelerated its endorsement advice process with a view to achieving EU endorsement during 2018. This would make the amendment available for use by companies applying IFRS 9 at its mandatory effective date.

The Basis for Conclusions on these amendments also provided clarification on an unrelated issue – that of accounting for a modification or exchange of a financial liability that is not significant enough to result in derecognition of the liability (and recognition of a new liability at its fair value). The Basis for Conclusions states that such a modification should be treated as a revision of estimated cash flows (resulting in an immediate gain or loss) rather than, as is the predominant treatment under IAS 39 *Financial Instruments: Recognition and Measurement*, the changes to cash flows being factored into the interest expense recognised over the remaining life of the liability.

Companies intending to adopt IFRS 16 early are expected also to provide quantitative disclosures of the likely impact, including an explanation of the difference between operating lease commitments disclosed under IAS 17 *Leases* and lease liabilities recognised at the date of transition to IFRS 16.

Companies not intending to early adopt should also be aware of the possibility of additional scrutiny of their operating lease commitments disclosure as it is used as a guide to the likely impact of IFRS 16 and will (depending on the transition method selected) need to be reconciled to the lease liability recognised upon application of IFRS 16.

The need for governance and control over preparation of these disclosures should also not be overlooked. Although not yet reflected in the primary statements, this information is part of the financial statements and should be robust enough to be used for that purpose. In addition, it should be noted that disclosures under IAS 8 are not optional, 'reasonably estimable' effects of applying new Standards are required to be disclosed.

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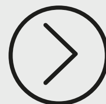



**ESMA Enforcement Priority**

**FRC Focus Area**

## Statement of cash flows

The proper presentation of cash flows and related disclosures remain an area of regulatory focus, with issues raised on amongst other things:

- Purchases of shares from non-controlling interests which should, consistently with their treatment as an equity transaction, be classified as financing cash flows.
- Payments such as acquisition expenses which might be thought of as relating to an investment but do not result in a recognised asset and, as such, should be classified as operating cash flows.
- Factoring transactions, with care needed in the classification of cash in and outflows as operating or financing depending on the circumstances of the transaction. Proper disclosure of an entity's use of, and reliance upon, factoring facilities is also encouraged.

Outside the statement of cash flows itself, it should be noted that amendments to IAS 7, requiring disclosure of changes in liabilities from financing activities (sometimes termed a 'gross debt reconciliation'), are effective for December 2017 year-ends. Presentation of a 'net debt reconciliation' is already common practice in the UK and one which remains acceptable, but previously adopted presentations should be reviewed to ensure they comply with the requirements of the amended standard – particularly that they enable users to link items in the reconciliation to the statement of financial position and statement of cash flows.

More generally, disclosures supporting the statement of cash flows should not be overlooked. For example, policies on the identification of cash and cash equivalents and in respect of uncommitted bank facilities and cash pooling facilities and any 'restricted cash' balances should be clearly explained. Restricted cash disclosures might be particularly relevant for groups operating in jurisdictions with controls over currency exchange or repatriation.

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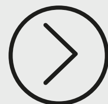



**ESMA Enforcement Priority**

**FRC Focus Area**

## Business combinations

Business combinations are often very large, very complex transactions that can give rise to a variety of issues not encountered in other circumstances. Some of these issues are discussed below.

### Identification of a business combinations and of the acquirer

In characterising a transaction in which, by whatever means, one entity obtains control of another, it is first necessary to ask two questions:

- Is this a business combination?
- If so, which entity is the acquirer?

These questions are significant as they determine, firstly, whether the fair value exchange model of IFRS 3 *Business Combinations* (resulting in the recognition of assets and liabilities at fair value and of goodwill) applies, or whether a cost allocation approach (with no goodwill recognised) is appropriate and, if there is a business combination, which of the entities' assets and liabilities should be fair valued (the acquiree) and which should not (the acquirer). As such, insufficient consideration of these points can give rise to fundamentally incorrect accounting, with several FRC Press Notices in recent years addressing companies who had failed to identify a transaction as a 'reverse acquisition'.

IFRS 3 provides guidance on both of these issues, but by means of a number of indicators that must be considered carefully. This can be a judgemental exercise requiring input from experts, but is not one that should be undertaken in isolation of other elements of financial reporting. In particular, assumptions used to value an intangible asset (for example, its useful life) should be consistent with assumptions used in subsequent impairment reviews and in determining the period over which an asset is amortised.

### Identification and valuation of intangible assets

Business combinations in which a large amount of goodwill, but few or no intangible assets, are recognised are likely to attract regulatory attention.

IFRS 3 requires the recognition at fair value of intangible assets that are either separable (capable of being separated from the acquiree and monetised in some way) or that arise from contractual or legal rights. This results in the recognition of many assets (e.g. brands and customer relationships) that might not be recognised outside a business combination. Careful consideration of which assets should be identified is needed.

Once intangible (and, indeed, other) assets are identified, their fair value must then be determined in accordance with IFRS 13 *Fair Value Measurement*.

### Consideration vs Remuneration

It is often the case, particularly in the acquisition of an owner-managed business, for one or more shareholders of an acquiree to continue as employees of the enlarged group after the business combination has completed. In such cases, it becomes important to determine whether payments due to those people are:

- consideration for the business combination (in which case a liability is recognised at the date of acquisition, with only subsequent movements in its value subsequently recognised in profit or loss); or
- remuneration for post-combination employment (in which case no liability is recognised at the date of acquisition, with the payments recognised in profit or loss in full as an employee cost over the related service period).

Paragraphs B54-B55 of IFRS 3 provide guidance on making this judgement, but should be read in light of the January 2013 agenda decision by the IFRS Interpretations Committee that contingent payments which are automatically forfeited if employment terminates are remuneration for post-combination services.

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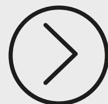



## FRC Case Study – Consideration vs Remuneration

The FRC annual review includes discussion of an issue raised during a review of a company's financial statements in which amounts payable to former shareholders of an acquired business were treated as consideration for a business combination rather than as remuneration of an employee. When challenged by the FRC, the company acknowledged that amounts payable to this individual were linked to continuing employment but argued that:

- Contingent consideration was also payable to other shareholders who had not remained in the business.
- Forfeiture on leaving service was not automatic, occurring only if the individual were a 'bad leaver'.
- The employee's departure was considered highly unlikely.

The FRC did not accept these arguments, citing the IFRS Interpretations Committee's position that contingent payments which are automatically forfeited if employment terminates are remuneration for post-combination services in concluding that the payments should have been accounted for as remuneration. It also noted that leaving for alternative employment would render the individual a 'bad leaver' and, thus, that these were standard employment provisions.

This case study highlights a number of issues:

- How strictly the 'forfeited if employment terminates' criterion is applied, with neither similar payments to exiting shareholders nor a low probability of the employee departing being grounds to override it.
- The need for a thorough analysis of 'good leaver' and 'bad leaver' provisions, most importantly in determining what payments would be forfeited in a 'normal' departure of the employee of their own volition.
- The importance of disclosure of accounting policies applied to these potentially large and unusual transactions, together with judgements applied in their application.

### Bargain purchases

In most business combinations, the value of consideration paid by the acquirer exceeds the fair value of the acquiree's identifiable net assets, resulting in (subject to adjustments in respect of non-controlling interests and previously held equity interests in the acquiree) the recognition of goodwill.

However, in the rare circumstances of a 'bargain purchase' this relationship is reversed, resulting in the recognition of an immediate gain in profit or loss but only after a reassessment of whether all relevant assets and liabilities have been identified and whether the fair values of all relevant items have been appropriately determined.

It is important that such a reassessment is performed robustly and if it is finally determined that a bargain purchase has occurred, that appropriate disclosure is provided on how assets and liabilities were reassessed and why a bargain purchase arose (sometimes due to the requirements of IFRS 3 to measure certain assets and liabilities at other than fair value).

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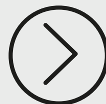



### Transactions not addressed by IFRS 3

Given the range and complexity of business combination transactions, it is perhaps unsurprising that IFRS 3 does not address every possible variant that arises in practice. Notably, the Standard:

- Excludes from its scope the accounting for business combinations under common control (BCUCC), with no other IFRS specifically addressing such transactions.
- Does not address the treatment of a Mandatory Tender Offer (MTO) under which law or regulation requires an acquirer to offer to purchase shares held by remaining non-controlling interests.

An accounting policy for BCUCC is often, using the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, developed by reference to other accounting frameworks, sometimes resulting in the use of 'merger' or 'pooling of interest' accounting.

The IFRS Interpretations Committee discussed the issue of MTOs in March 2013. No final conclusions were reached but the Committee highlighted the need to determine whether either a contractual financial liability (as defined in IAS 32 *Financial Instruments: Presentation*) or an onerous contract (in the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) arise in the circumstances of a particular MTO.

In both cases, it is important that an accounting policy is applied consistently between transactions and is properly disclosed.

### The importance of disclosure

Given the complexity of many business combination transactions and the level of judgement required in measuring resulting assets and liabilities, proper disclosure becomes particularly important.

Amongst other things, clear disclosure should be provided on:

- Business combinations for which the accounting is incomplete at the end of the reporting period in which the combination occurred. In those circumstances, IFRS 3 requires disclosure of the fact that provisional values have been used, why that is the case, the provisional amounts used and any adjustments recognised during the 12 month 'measurement period' permitted by the Standard.
- Assumptions and sensitivities in fair value measurements. For example, contingent consideration based on a company's future performance is required to be measured at fair value on an ongoing basis and is likely to fall into 'Level 3' of the fair value hierarchy, requiring detailed disclosures under IFRS 13.

Non-recurring fair value measurements at the date of a business combination are outside the scope of IFRS 13's disclosure requirements (although IFRS 3 does require disclosure of acquisition date fair values, it does not specify disclosure of the methodology used to determine those values). In its common enforcement priorities, ESMA encourages disclosure of the assumptions and measurement techniques used in business combination valuations in light of the general requirements of IAS 1 in respect of estimation uncertainties.

In instances where more than one business combination has been undertaken in the year, care should be taken before concluding that aggregation of the disclosures is appropriate as IFRS 3 requires each material business combination to be disclosed separately.

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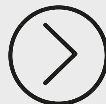



FRC Focus Area

## Defined benefit pension schemes

Defined benefit pension schemes are a complex area of accounting, giving rise to a surplus or deficit figure that is in fact the net of:

- The obligation to pay benefits to members, measured using the projected unit credit method.
- Plan assets, measured at their fair value.
- The effect of IAS 19's 'asset ceiling', a function of the refunds or reductions in future contributions available to the employer.

As a result, even when the statement of financial position shows a small (or even nil) net position, that can result from two or three very large balances subject to future changes subject to different risks and uncertainties. This, in conjunction with the complexity of some pension arrangements (either the plan itself, or the employer's strategy to fund it), means that effective disclosure of the arrangement and of the judgements applied in accounting for it is important to investors.

IAS 19 includes many disclosure requirements in respect of defined benefit schemes (for example, a reconciliation of opening and closing amounts for each of the three balances above and a description of the rules and regulatory framework under which the plan operates). However, high quality financial reporting requires consideration of what detail is needed to **fulfil the purpose** of each disclosure, particularly in respect of the amount, timing and uncertainty of future cash flows.

- **At a minimum**, IAS 19 requires disclosure of the expected contributions to be paid in the next accounting period. A fuller understanding of the funding arrangements affecting future contributions can be provided by disclosure of:
  - Expected contributions for subsequent years, distinguishing between deficit remedy payments and payments relating to current service.
  - The system for revision of contribution levels, often as part of a funding valuation exercise.
  - Any interdependencies between pension contributions and other transactions. For example, it can be the case that, to ensure plan members are not disadvantaged, increased levels of dividend payments require an increase in contributions to a company's pension scheme.
- A sensitivity analysis is required for each significant actuarial assumption (e.g. discount rate, inflation forecast and mortality rates). In uncertain times, the level of variation in these amounts that is deemed '**reasonably possible**' should be reassessed at each reporting date. It should also be noted that the level of possible variation may differ between actuarial assumptions.
- **Asset-liability matching strategies** (for example, longevity swaps) are becoming more common and more complex. Effective disclosure includes not just the existence of such arrangements but also of the underlying nature of such instruments, the risks inherent in the strategy adopted and the means by which they are valued.

In respect of plan assets more generally, an appropriate level of disaggregation (beyond simply quoted and unquoted assets) can provide valuable insight into a plan's investment strategy and the risks to which it is exposed.

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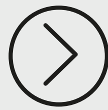



Due to the requirements of IAS 19 and of IFRIC 14 IAS 19 – *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and the Interaction* in respect of the effect of the asset ceiling and the complexity of many funding requirements, a significant level of judgement can be required in determining whether a net surplus (or, indeed, liability for a minimum funding requirement) should be recognised. In circumstances where this is relevant, a clear description (as per paragraph 122 of IAS 1) of the judgements made in respect of this accounting requirement should be provided. This will often need to cover the assessment of **trustees' rights** to either enhance members' benefits or wind up the plan before making any payment back to the employer.

Discussion of a company's pension arrangements should not be limited to the financial statements. A high quality strategic report should provide an explanation of significant changes in a surplus or deficit (addressing, for example, changes in discount and/or inflation rates), actions being taken to remedy a deficit and risks and uncertainties arising from the scheme.

Pensions accounting was the subject of a thematic review by the FRC in 2017. The report resulting from that review covers many of the issues above and also provides examples of good practice.

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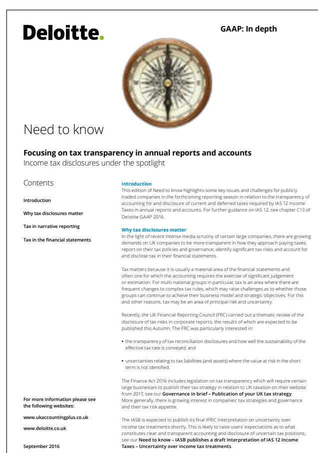

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GAAP: In depth

Need to know

**Focusing on tax transparency in annual reports and accounts**
Income tax disclosures under the spotlight

Contents


**Introduction**

**Why tax disclosures matter**

**Tax in narrative reporting**

**Tax in the financial statements**


**Introduction**
This edition of Need to know highlights some key issues and challenges for publicly traded companies in the forthcoming reporting season in relation to the transparency of accounting for and disclosure of current and deferred taxes required by IAS 12 Income Taxes in annual reports and accounts. For further guidance on IAS 12, see chapter C13 of Deloitte GAAP 2016.

**Why tax disclosures matter**
In the light of recent intense media scrutiny of certain large companies, there are growing demands on UK companies to be more transparent in how they approach paying taxes, report on their tax policies and governance, identify significant tax risks and account for and disclose tax in their financial statements.

Tax matters because it is usually a material area of the financial statements and often one for which the accounting requires the exercise of significant judgement or estimation. For multi-national groups in particular, tax is an area where there are frequent changes to complex tax rules, which may raise challenges as to whether those groups can continue to achieve their business model and strategic objectives. For this and other reasons, tax may be an area of principal risk and uncertainty.

Recently, the UK Financial Reporting Council (FRC) carried out a thematic review of the disclosure of tax risks in corporate reports, the results of which are expected to be published this Autumn. The FRC was particularly interested in:

- the transparency of tax reconciliation disclosures and how well the sustainability of the effective tax rate is conveyed; and
- uncertainties relating to tax liabilities (and assets) where the value at risk in the short term is not identified.

The Finance Act 2016 includes legislation on tax transparency which will require certain large businesses to publish their tax strategy in relation to UK taxation on their website from 2017, see our **Governance in brief – Publication of your UK tax strategy**. More generally, there is growing interest in companies' tax strategies and governance and their tax risk appetite.

The IASB is expected to publish its final IFRIC Interpretation on uncertainty over income tax treatments shortly. This is likely to raise users' expectations as to what constitutes clear and transparent accounting and disclosure of uncertain tax positions, see our **Need to know – IASB publishes a draft Interpretation of IAS 12 Income Taxes – Uncertainty over income tax treatments**.

**For more information please see the following websites:**

**www.ukaccountingplus.co.uk**

**www.deloitte.co.uk**

**September 2016**

A Deloitte 'Need to know' publication provides more detail on issues surrounding the reporting of income tax.

## Reporting the effects of income tax

The reporting of income tax remains an area of high focus, both from the point of view of quality reporting on, for example, the effects of uncertain tax positions and possible future changes to a company's effective tax rate, but more generally as a result of regulatory and media scrutiny of companies' tax affairs.

Many generic elements of quality financial reporting are relevant to income tax. For example:

- **Accounting policies** related to tax should be clear, specific to the group's circumstances and should address all key issues including the recognition and measurement of uncertain tax positions, if relevant.
- Income tax is a common source of **estimation uncertainty**, particularly in respect of uncertain tax positions, to be disclosed in accordance with IAS 1. Significant risks of material adjustment in the next financial year should be disclosed, including quantitative information such as sensitivities or ranges of possible outcomes. The possibility of material adjustments in later periods is also valuable information which could be included in, for example, the tax note.
- The **strategic report** should include appropriate discussion of tax, particularly on variances in and expectations of the effective tax rate. Income tax should also be considered as a potential principal risk.
- The effects of income tax should be appropriately reflected in **reporting financial performance**. For example, a policy on presentation of 'exceptional' or 'non-recurring' items should cover the reporting of items such as one-off tax credits.

The effective tax rate reconciliation required by IAS 12 should also be prepared carefully so that it provides clear information about the key factors affecting the effective tax rate and its sustainability in the future. This can be achieved by describing the nature of reconciling items and why they have arisen and by distinguishing clearly between significant one-off or unusual items and those that are expected to recur.

## Interest and penalties relating to income taxes

The September 2017 IFRIC Update reported an agenda decision by the IFRS Interpretations Committee on the treatment of interest and penalties charged by a tax authority for late payment of an income tax liability. The Committee concluded that the determination of whether such a cost is within the scope of IAS 12 *Income Taxes* (and, as a result, presented within the tax line in profit or loss) or IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (and, as a result, presented as an operating or finance cost) is not an accounting policy choice but should be considered based on the circumstances in which the interest or penalty arose.

It is appropriate to base this judgement on whether interest and/or penalties can be seen as forming part of a larger uncertain tax position (for example, if interest or penalties are accepted as a cost of delaying payment to avoid prejudicing the overall tax position).

Regardless of the judgement reached, information about material interest and penalties should be disclosed.

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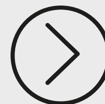



### Uncertain tax positions

IFRIC Interpretation 23 *Uncertainty over Income Tax Treatments* was published in 2017 and whilst it is not mandatorily effective until 2019 the conclusions it reaches are consistent with already effective accounting standards and provide an appropriate approach to dealing with uncertain tax positions.

In brief, its conclusions are as follows:

- Uncertainties in income tax liabilities or assets should be reflected in recognising a tax liability or asset only when payment or recovery becomes probable.
- Judgement is required in identifying the unit of account to be applied in making this judgement (i.e. whether there is a single tax uncertainty or group of related uncertainties).
- Full 'detection risk' (i.e. all relevant information being available to the tax authorities) is assumed in making these judgements.

## Base Erosion and Profit Shifting

The OECD and the G20 project on 'Base Erosion and Profit Shifting' ('BEPS') was initiated in 2015 to address perceived inequalities and inconsistencies in the global tax landscape. This had resulted in a 15-point action plan to modernise the principles underlying today's international tax landscape and to develop a consistent framework for countries to base their tax legislation upon.

Core principles of the project are:

- the elimination of tax mismatches such that all income is taxed;
- the alignment of profits with value creation;
- the increase of transparency with tax authorities; and
- the implementation of change in a coordinated fashion.

While some of the proposals will be seen as increasing tax risk and bringing greater complexity, ultimately having a consistent tax platform is important to global businesses.

Similarly, the European Commission is launching initiatives to address tax evasion and tax fraud with the focus on improving tax transparency and create a more fair tax environment within the European Union.

During 2016 and 2017, individual territories have started to frame their responses to the BEPS initiative. In the UK, announced and enacted legislative changes include restrictions on the deductibility of corporate interest expenses, 'anti-hybrid' provisions restricting the possibility of tax benefits arising from asymmetric tax treatments of the same transaction in different jurisdictions or in entities viewed differently for tax purposes in separate countries and new tax legislation in relation to the use of tax losses.

These initiatives highlight the importance that companies should give to consideration of risks relating to tax as these can have significant effects on the recognition and measurement of tax balances.

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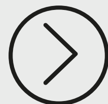
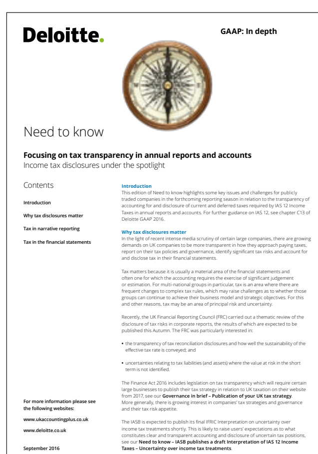




## Recognition of deferred tax assets

IAS 12 requires entities to recognise a deferred tax asset derived from deductible tax differences and unused tax losses (even if the entity is currently loss making) over and above the level of deferred tax liabilities relating to the same taxation authority and taxable entity provided that it is probable that the entity will generate future taxable profits to utilise the benefit from them. In many cases, the assessment as to whether the entity will generate future taxable income involves the use of significant judgement, for example the time period considered (which should be based on the facts and circumstances of the entity rather than an arbitrary limit), tax planning strategies, impact of future contracts etc.

Entities are required to disclose the judgements made and evidence that supports the recognition of those deferred tax assets. For example, where a company is loss making, disclosure of the evidence over the availability of future profits to support a deferred tax asset is required.



Deloitte. GAAP: In depth

Need to know

**Focusing on tax transparency in annual reports and accounts**
Income tax disclosures under the spotlight

Contents

**Introduction**

**Why tax disclosures matter**

**Tax in narrative reporting**

**Tax in the financial statements**

**Introduction**
This edition of Need to know highlights some key issues and challenges for publicly traded companies in the forthcoming reporting season in relation to the transparency of accounting for and disclosure of current and deferred taxes required by IAS 12 Income Taxes in annual reports and accounts. For further guidance on IAS 12, see chapter C13 of Deloitte GAAP 2016.

**Why tax disclosures matter**
In the light of recent intense media scrutiny of certain large companies, there are growing demands on UK companies to be more transparent in how they approach paying taxes, report on their tax policies and governance, identify significant tax risks and account for and disclose tax in their financial statements.

Tax matters because it is usually a material area of the financial statements and often one for which the accounting requires the exercise of significant judgement or estimation. For multi-national groups in particular, tax is an area where there are frequent changes to complex tax rules, which may raise challenges as to whether those groups can continue to achieve their business model and strategic objectives. For this and other reasons, tax may be an area of principal risk and uncertainty.

Recently, the UK Financial Reporting Council (FRC) carried out a thematic review of the disclosure of tax risks in corporate reports, the results of which are expected to be published this Autumn. The FRC was particularly interested in:

- the transparency of tax reconciliation disclosures and how well the sustainability of the effective tax rate is conveyed; and
- uncertainties relating to tax liabilities (and assets) where the value at risk in the short term is not identified.

The Finance Act 2016 includes legislation on tax transparency which will require certain large businesses to publish their tax strategy in relation to UK taxation on their website from 2017, see our **Governance in brief – Publication of your UK tax strategy**. More generally, there is growing interest in companies' tax strategies and governance and their tax risk appetite.

The IASB is expected to publish its final IFRIC Interpretation on uncertainty over income tax treatments shortly. This is likely to raise users' expectations as to what constitutes clear and transparent accounting and disclosure of uncertain tax positions, see our **Need to know – IASB publishes a draft Interpretation of IAS 12 Income Taxes – Uncertainty over income tax treatments**.

**For more information please see the following websites:**

**www.ukaccountingplus.co.uk**

**www.deloitte.co.uk**

**September 2016**

A Deloitte 'Need to know' publication provides more detail on issues surrounding the Apprenticeship Levy.

## The UK Apprenticeship Levy

From 5 April 2017, employers in the UK with an annual 'pay bill' exceeding £3 million have been required to pay a levy which, together with 'top up' amounts provided by government, can be used to fund approved training and assessment programmes for employees.

Companies will need to assess whether they expect to use these funds for training (and, as a result, recognise a prepayment asset) or not (and, as a result, recognise an expense).

## Capital management disclosures

The FRC noted continuing concerns over the use of 'boilerplate' capital management policies and unclear explanations of objectives, policies and processes for managing capital. This can be an issue in particular for companies that are subject to externally imposed capital requirements, who should consider carefully how they manage capital and the role that regulatory capital requirements play in that management.

## Impairment reviews

The performance and disclosure of impairment reviews remains an area of regulatory challenge. In conducting an impairment review under IAS 36 *Impairment of Assets*, it is important to consider carefully all inputs into a calculation of value-in-use (both cash flow forecasts and the discount rate(s) applied to them). It is also important to exercise care in the identification of cash-generating units and in aggregating those cash-generating units for the purposes of testing goodwill for impairment. An appropriate discount rate should also be applied to each cash-generating unit (or group of cash-generating units) rather than the same rate being applied across an entity.

In terms of disclosure, the following should be considered:

- Pre-tax discount rates, reflecting current market assessments of the time value of money and the risks of each cash-generating unit or group of cash-generating units, should be disclosed.
- Key assumptions behind value-in-use calculations (not restricted to discount and terminal growth rates) and the approach to determining those assumptions should be disclosed.
- A quantified sensitivity analysis is required when a reasonably possible change in assumptions would result in impairment of goodwill.
- The reasons for significant changes in, for example, discount rates compared to previous years should also be explained.

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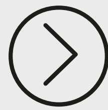



## Other topics

The FRC also noted concerns over:

- **Consolidation** – Specifically, the requirements of IFRS 10 *Consolidated Financial Statements* to assess the possibility of 'de facto' control existing through a holding of less than the majority of voting rights and application of the 'agent-principal' concept by fund managers.
- **Financial instrument disclosures** – Including descriptions of risk classes and the process used in assessing loan portfolios for impairment, the maturity of accrued income balances and the assessment of credit risk for short-term balances such as trade receivables.
- **Fair value measurement** – Clear disclosure of the valuation techniques used (including, when relevant, unobservable inputs and related sensitivities) and of the basis for classification in the IFRS 13 hierarchy is important to investors. The FRC also noted instances in which it was unclear whether contingent consideration from a business combination had been appropriately remeasured to fair value.
- **Related party transactions** – The FRC noted that it has challenged companies on a lack of clarity with respect to the nature of relations with parties described as 'related', on the incomplete disclosure of related party transactions with joint ventures and on failures to include executives other than directors of the company in the disclosure of remuneration of Key Management Personnel.
- **Complex supplier arrangements** – Following the publication in 2014 of its press release on this issue, the FRC continues to encourage the separate disclosure of accrued income from suppliers and noted that it does not consider non-disclosure on the basis of commercial sensitivity to be acceptable.
- **Presentation of financial statements** – Specifically, that accruals and deferred income (and prepayments and accrued income) are different in nature and liquidity and should not be presented on an aggregated basis, that material finance income and finance costs should not be presented net in the statement of profit or loss and that disclosure is required by IAS 1 on current assets (such as, in some industries, inventory) expected to be recovered after more than one year.

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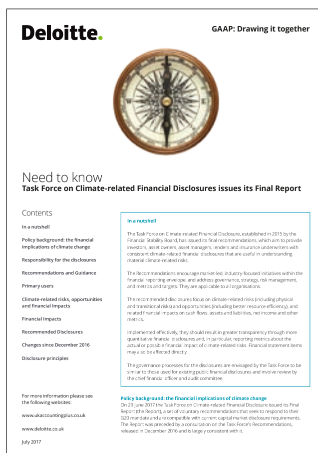
# Wider reporting and legal issues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GAAP: Drawing it together

Need to know

**Task Force on Climate-related Financial Disclosures issues its Final Report**

Contents

In a nutshell
Policy background: the financial implications of climate change
Responsibility for the disclosures
Recommendations and Guidance
Primary users
Climate-related risks, opportunities and financial impacts
Financial impacts
Recommended Disclosures
Changes since December 2016
Disclosure principles

For more information please see the following websites:
www.ukaccountingplus.co.uk
www.deloitte.co.uk

July 2017

A Deloitte 'Need to know' publication provides more detail on TCFD's recommendations.

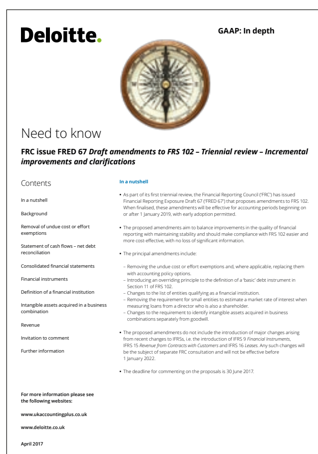
## Climate-related Financial Disclosures

In June 2017, the Task Force on Climate-related Financial Disclosures (TCFD), a body set up by the Financial Stability Board, published its final recommendations for effective disclosure of climate-related financial risks.

The TCFD recommends inclusion in mainstream corporate reporting of information on:

- An entity's governance structure in respect of climate-related risks and opportunities.
- The actual and potential impacts of changes in climate on business, strategy and financial planning. This is expected to take into account a scenario of a 2°C increase in global temperatures.
- How the organisation identifies, assesses and manages climate-related risks.
- The metrics and targets used in assessing and managing climate-related risks and opportunities.

Over 100 CEO's of large, multi-national organisations have publicly stated their support for the TCFD's initiative and urged other companies to support better disclosures of climate-related risks and opportunities.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GAAP: In depth

Need to know

***FRC issue FRED 67 Draft amendments to FRS 102 – Triennial review – Incremental improvements and clarifications***

Contents

In a nutshell
Background
Removal of undue cost or effort exemptions
Statement of cash flows – net debt reconciliation
Consolidated financial statements
Financial instruments
Definition of a financial institution
Intangible assets acquired in a business combination
Revenue
Invitation to comment
Further information

For more information please see the following websites:
www.ukaccountingplus.co.uk
www.deloitte.co.uk

April 2017

A Deloitte 'Need to know' publication provides more detail on the proposed amendments to FRS 102.

## UK GAAP developments

As the new UK GAAP regime has now been in place for two years, preparation of either parent company or subsidiary accounts under either FRS 101 or FRS 102 should now have become a more routine exercise.

It is notable, however, that the FRC has proposed several changes to FRS 102 as part of its first triennial review of the Standard to deal with issues highlighted in its implementation, notably in the classification of financial instruments as either 'basic' (eligible for measurement at amortised cost) or 'non-basic' (to be measured at fair value) and on the identification of separate intangible assets in a business combination.

The amendments are due to be finalised by the end of 2017 and are expected to be available for immediate early adoption.

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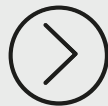

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GAAP: Clear vision

Need to know

FRC's Financial Reporting Lab issues report on disclosure of dividend policy and practice

November 2015

A Deloitte 'Need to know' publication provides more guidance on the Financial Reporting Lab's recommendations and wider issues surrounding distributions.

## Reporting on dividend policy and practice

In October 2017, the FRC's Financial Reporting Lab published an implementation study: Disclosure of dividends – policy and practice, examining how companies have responded to its previous report published in 2015 on a topic which remains an area of high investor interest.

The 2015 report recommended a number of enhancements to the reporting of:

- **Dividend policy**, to provide:
  - An understanding of the board's considerations in setting dividend policy.
  - The rationale for the approach selected.
  - Sufficient detail on how the policy will operate.
- **Dividend practice**, including:
  - The key judgements and constraints considered by the board in applying its dividend policy
  - The availability of resources (including cash and distributable profits) needed to pay dividends, particularly when this is a constraining factor.
  - Clear linkage between the policy and how it has been applied in the period.

The 2017 study reveals an increasing level of uptake of these recommendations amongst FTSE 100 companies, with nearly half now providing either quantitative information on distributable reserves or a reference to them being 'sufficient' or 'significant'. Fewer FTSE 250 companies are providing such disclosures.

The Lab's report also identifies that further improvements could be made on:

- Identification of links between dividend strategy and required elements of narrative reporting, specifically the business model, viability statement and principal risks.
- Enhancing disclosure of constraints on dividend payments through details on the sustainability of a dividend or the levels of cash and distributable profits.
- Explaining more clearly what a dividend policy means in practice, for example by clarifying terms such as 'progressive policy' and 'pay-out ratio'.
- Clarity over structure and process, covering where profit is generated in the group and how that profit flow to the parent company together with any relevant constraints on that flow (for example, a 'dividend block' restricting distribution of profits from a subsidiary to its parent company).

Given the high and continuing level of investor interest in this area, the Lab's suggestions should be carefully considered in preparing 2017 annual reports.

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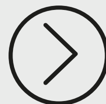



# Appendices

## ESMA guidelines on 'Alternative Performance Measures' and IOSCO statement on 'Non-GAAP Financial Measures'

Concerns over the proper use of performance figures other than those stipulated by IFRSs has been an area of concern for regulators in many jurisdictions around the world. As can be seen below, the ESMA Guidelines on Alternative Performance Measures (APMs) are very similar to a Final Statement on Non-GAAP Financial Measures issued by the International Organisation of Securities Commissions (IOSCO) in 2016.

Other regulators have their own requirements that limit (in some case more strictly than these guidelines) the use of such information.

| ESMA Guidelines on Alternative Performance Measures |
|---|
| **Scope** – Applies to 'Alternative Performance Measures' being financial measures of historical or future financial performance, financial position or cash flows other than a financial measure defined or specified in the applicable financial reporting framework.<br><br>APMs disclosed in financial statements are not within the scope of guidelines.<br><br>The guidelines are also not applicable to:<br>• physical or non-financial measures;<br>• information on major shareholdings, acquisitions or disposals of own shares and total number of voting rights; or<br>• information to explain compliance with the terms of an agreement (such as a lending covenant) or legislative requirement (such as the basis of calculating directors' remuneration). |
| **Presentation** and **Explanation on the use of APMs** – A clear and readable definition of APMs should be provided. APMs should also be given meaningful labels reflecting their content and basis of calculation.<br><br>The use of APMs should be explained to allow users to understand their relevance and reliability. |
| **Presentation** – Overly optimistic or positive labels for APMs should not be used. |
| **Prominence and presentation of APMs** – APMs should not be displayed with more prominence, emphasis or authority than, or distract from, measures directly stemming from financial statements.<br><br>The ESMA Questions and Answers stress that the notion of prominence is a qualitative as well as a quantitative one, covering factors such as font size, frequency of use and location within the document. |
| **Reconciliations** – Each APM should be reconciled to its most directly reconcilable item in the financial statements.<br><br>The ESMA Questions and Answers provide specific guidance on the reconciliation of an 'organic growth' figure to IFRS revenue. |
| **Comparatives** and **Consistency** – APMs should be presented consistently from period to period with comparative information provided.<br><br>Any changes to the definition or calculation of an APM (or cessation of use of an APM) should be explained, with restated comparative figures provided. |
| **Presentation** – Items should not be mislabelled as non-recurring, infrequent or unusual. For example, items that affected past periods and will affect future periods (such as restructuring costs or impairment losses) will rarely be considered as non-recurring, infrequent or unusual. |
| **Compliance by reference** – Disclosure principles in the guidelines may be replaced by a direct reference to other documents previously published which contain disclosures on APMs and are readily and easily accessible to users. |

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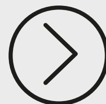



## IOSCO Statement on Non-GAAP Financial Measures

**Scope** – Applies to 'non-GAAP financial measures' being numerical measures of an issuer's current, historical or future financial performance, financial position or cash flow that is not a GAAP measure (defined as a measure determined pursuant to the issuer's financial reporting framework included in, for example, a press release or narrative section of an annual report).

Disclosures contained within the financial statements are not within the scope

An operating or statistical measure that is not a financial measure is not within scope.

**Defining the non-GAAP Financial measure** – The measure should be defined, explained (including a statement that it is not a standardised measure), clearly labelled and the reason for its use (including an explanation of why the information is useful to investors) explained.

**Unbiased purpose** – Non-GAAP measures should not be used to avoid the presentation of adverse information.

**Prominence of presentation of GAAP measures** – Non-GAAP measures should not be presented with more prominence than the most directly equivalent GAAP measure.

**Reconciliation to comparable GAAP measures** – A clear and quantitative reconciliation to the most directly equivalent GAAP measure should be provided.

**Presentation consistently over time** – Comparative values should be presented and non-GAAP measures generally presented consistently from year to year.

Any changes to a non-GAAP measure (or cessation of use of a non-GAAP measure) should be explained with comparative figure adjusted accordingly.

**Recurring items** – In IOSCO's experience, there are rarely circumstances in which restructuring costs or impairment losses can be justified as being 'non-recurring', 'infrequent' or 'unusual'.

**Access to associated information** – Information supporting the use and calculation of non-GAAP measures should be readily available to users either by directly accompanying the measure or by a cross-reference to where the information is available.

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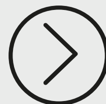



## Amendments to accounting standards mandatorily effective for years ending 31 December 2017

| IFRS | IASB Effective Date – periods commencing on or after: | EU-endorsed effective Date – periods commencing on or after: |
| --- | --- | --- |
| **Amended Standards:** | | |
| Amendments to IAS 12 – Recognition of Deferred Tax Assets for Unrealised Losses | 1 January 2017 | 1 January 2017 |
| Amendments to IAS 7 – Disclosure Initiative | 1 January 2017 | 1 January 2017 |
| Amendments to IFRS 12 issued in the Annual Improvement Cycle 2014-2016 | 1 January 2017 | At the time of writing, this amendment was expected to be endorsed by the end of 2017 with an effective date of 1 January 2017. |

**Amendments to IAS 12 *Income Taxes* – Recognition of Deferred Tax Assets for Unrealised Losses**
The amendments to IAS 12 clarify that unrealised losses on debt instruments measured at fair value for financial reporting purposes but at cost for tax purposes can give rise to a deductible temporary difference and how such a temporary difference should be assessed in determining whether a deferred tax asset should be recognised.

**Amendments to IAS 7 *Statement of Cash Flows* – Disclosure Initiative**
The amendments to IAS 7 require disclosure of both cash and non-cash changes in liabilities arising from financing activities (being liabilities for which cash flows were, or future cash flows will be, classified as being from financing activities).

**Amendments to IFRS 12 *Disclosure of Interests in Other Entities* issued in the Annual Improvements Cycle 2014-2016**
The amendments to IFRS 12 introduced in the 2014-2016 annual improvement cycle clarify that all requirements of that Standard (other than those covered by an existing exemption from disclosure of summarised financial information on interests in subsidiaries, joint ventures and associates) apply to interests classified as held for sale or discontinued operations in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

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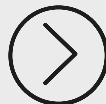



## IFRS Interpretations Committee agenda decisions in 2017

Along with its activity developing formal interpretations of IFRSs and proposing that the IASB make amendments to Standards, the IFRS Interpretations Committee regularly publishes summaries of issues that it has decided not to add to its agenda, often accompanied by a discussion of the accounting issue submitted.

Whilst the commentary included in an agenda decision is not formally part of IFRSs, it is an important source of guidance that should be carefully considered when selecting a suitable accounting policy for a transaction. In many jurisdictions, there is an expectation from regulators that agenda decisions will be considered, with ESMA, for example, publicly stating an expectation to this effect.

In 2017, the following agenda decisions have been published by the Committee.

| | |
|---|---|
| **March IFRIC Update** | IFRS 10 – Investment entities and subsidiaries |
| | IAS 12 – Deferred taxes when acquiring a single-asset entity that is not a business |
| | IAS 28 – Fund manager's assessment of significant influence |
| | Commodity loans |
| **June IFRIC Update** | IAS 19 – Discount rate in a country that has adopted another country's currency |
| | IAS 32 – Centrally cleared client derivatives |
| | IAS 33 – Tax arising from payments on participating equity instruments |
| | IAS 41 – Biological assets growing on bearer plants |
| **September IFRIC Update** | IFRS 1 – Subsidiary as a first-time adopter |
| | IFRS 9 – Financial assets eligible for the election to present changes in fair value in other comprehensive income |
| | IAS 12 – Interest and penalties relating to income taxes |
| | IAS 38 – Goods acquired for promotional activities |
| **November IFRIC Update** | IFRS 3 – Acquisition of a group of assets |

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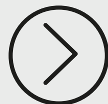



## New and revised IFRSs and Interpretations available for early application in years ending 31 December 2017

Paragraph 30 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires entities to consider and disclose the potential impact of new and revised IFRSs that have been issued but are not yet effective. As discussed above, the sufficiency of these disclosures (particularly as they relate to IFRS 9 on financial instruments and IFRS 15 on revenue) is a current area of regulatory focus.

The list below reflects a cut-off date of 31 October 2017. The potential impact of the application of any new and revised IFRSs issued by the IASB after that date but before the financial statements are issued should also be considered and disclosed.

For those reporting under EU-endorsed IFRSs, to the extent that the below conflict with current standards, such items cannot be early adopted until they have been endorsed for use in the EU.

| IFRS | IASB Effective Date – periods commencing on or after: | EU-endorsed effective Date – periods commencing on or after: |
|---|---|---|
| **New Standards** | | |
| IFRS 9 – Financial Instruments | 1 January 2018 * | 1 January 2018 |
| IFRS 14 – Regulatory Deferral Accounts | First time adopters whose first annual IFRS financial statements are for a period beginning on or after 1 January 2016. | EU has decided not to endorse as very few European companies would fall within its scope. ** |
| IFRS 15 – Revenue from Contracts with Customers | 1 January 2018 | 1 January 2018 |
| IFRS 16 – Leases | 1 January 2019 | 1 January 2019 |
| IFRS 17 – Insurance Contracts | 1 January 2021 | TBC – Endorsement outstanding |
| **Amended Standards** | | |
| Amendments to IFRS 10 and IAS 28 – Sale or Contribution of Assets between an Investor and its Associate or Joint Venture | The IASB decided in December 2015 to defer indefinitely the effective date of these amendments. EU endorsement has, likewise, been indefinitely postponed. | |
| Clarifications to IFRS 15 Revenue from Contracts with Customers | 1 January 2018 | 1 January 2018 |
| Amendments to IFRS 4 – Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts | 1 January 2018 | 1 January 2018 |

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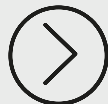



| IFRS | IASB Effective Date – periods commencing on or after: | EU-endorsed effective Date – periods commencing on or after: |
|---|---|---|
| Amendments to IFRS 2 – Classification and Measurement of Share-based Payment Transactions | 1 January 2018 | |
| Amendments to IFRS 1 and IAS 28 issued in the Annual Improvement Cycle 2014-2016 | 1 January 2018 | |
| Amendments to IAS 40 – Transfers of Investment Property | 1 January 2018 | TBC – Endorsement outstanding |
| Amendments to IFRS 9 – Prepayment Features with Negative Compensation | 1 January 2019 | |
| Amendments to IAS 28 – Long-term interests in Associates and Joint Ventures | 1 January 2019 | |
| **IFRIC Interpretations** | | |
| IFRIC 22 – Foreign Currency Transactions and Advance Consideration | 1 January 2018 | TBC – Endorsement outstanding |
| IFRIC 23 – Uncertainty over Income Tax Treatments | 1 January 2019 | |

* For periods beginning before 1 January 2018, previous versions of IFRS 9 may be adopted provided the relevant date of initial application is before 1 February 2015.

** IFRS 14 is available only to first-time adopters of IFRSs who recognised regulatory deferral account balances under their previous GAAP and permits those entities to continue (with limited changes) their previous GAAP accounting for rate-regulated activities, although with separate presentation of balances and items of income and expense arising from that accounting.

As the EU has decided not to endorse this standard for use in the European Union, the option to retain previous GAAP accounting on transition to IFRSs is not available to entities (such as those in the UK) required to apply EU-endorsed IFRSs.

The clarifications to IFRS 15 issued in April 2016 addressed a number of issues highlighted by discussions of the IASB and FASB's joint Transition Resource Group (TRG) for Revenue Recognition. Details of the group's discussions can be found here.

A similar group, the IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) has been instigated by the IASB to discuss issues arising from the expected loss-based impairment model of IFRS 9. Details of this group's discussions can be found here.

A Transition Resource Group for Insurance Contracts has also been set up following publication of IFRS 17 with meetings scheduled to commence in 2018.

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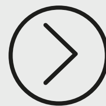




# Deloitte resources

There are a number of resources prepared by Deloitte that can assist you during the upcoming reporting season. Many have been highlighted throughout this publication, key resources are listed below.

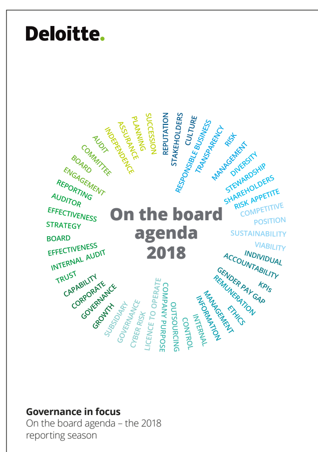
## The Closing Out 2017 page on UK Accounting Plus

A dedicated page on UK accounting plus, providing links to a full suite of resources. This page will continue to be updated to reflect developments after the date of this publication.

## Annual report insights 2017 – Surveying FTSE reporting

Our dedicated annual report insights site provides access to:

- Annual report insights: Surveying FTSE reporting which details the findings from our review of 100 listed UK company reports, covering a variety of contemporary issues in corporate reporting such as the use of Alternative Performance Measures, company purpose and the value generation story and the long-term viability statement.
- An updated **interactive benchmarking tool** enabling you to understand how your annual report stacks up against those of other listed companies.




## Governance in focus – On the board agenda – the 2018 reporting season

This Governance in focus reviews the topics boards and their committees need to focus on in the 2018 reporting season including:

- an update on the UK corporate governance reform agenda and future changes to corporate governance;
- tips on stakeholder management and employee engagement;
- insight into crisis management and resilience – preparing for future crises;
- how to get the most from your internal audit function;
- a summary of developments in cyber risk and General Data Protection Regulations (GDPR); and
- a round-up of other emerging governance themes for 2018.

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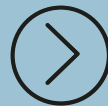

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