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Practical guide to corporate governance

2013 reporting changes – implementation and disclosure

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What's the issue?

There are two significant new requirements that affect corporate governance reporting as a result of the 2012 version of the UK Corporate Governance Code ('the Code'), which is applicable for September 2013 year-ends onwards.

***'Fair, balanced and understandable'** is a formal statement by the directors, likely advised by the audit committee (as suggested in provision C.3.4 of the 2012 Code):*

"...that they consider the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess a company's performance, business model and strategy". [Code provision C.1.1]

***'Significant issues'** reporting is a requirement for the audit committee to report on:*

"...the significant issues that the committee considered in relation to the financial statements and how those issues were addressed". [Code provision C.3.8]

These new requirements have given rise to much debate around the meaning of the terms 'fair, balanced and understandable' and 'significant issues', which are not defined in the Code.

The FRC is, however, reluctant to issue any guidance, and has been adamant about this. In the case of fair, balanced and understandable, all three of the terms pre-existed (the annual report had to be fair and balanced under the previous version of the Code, and the management report has to be fair under the Disclosure & Transparency Rules ('DTR')) so there should arguably be no need to ask for definitions now.

The FRC has, however, indicated that consistency between the financial statements and the picture painted in the front half of the annual report is a key consideration, and that its programme of corporate reporting reviews will also focus on the balance between good and bad news in companies' narrative reporting.

Ultimately, what is fair, balanced and understandable is also only really determinable on a case by case basis, and the annual report has to be taken as a whole to make the judgement. This is not something that can be easily covered by a checklist.

What constitutes a 'significant issue' is also a matter of judgement. We believe it will normally be an accounting judgement or estimate. Internal control issues may well be listed alongside these but are driven by other Code provisions and the Turnbull Guidance.

On the face of it, any judgement or estimate that the auditors report to the audit committee is likely to be a 'significant issue' for these purposes. The FRC Guidance on audit committees [para 5.3] mentions only going concern as a specific example that should be included, but impairment reviews, revenue recognition on contracts, tax and provisioning in general are other likely topics.

The FRC Guidance on audit committees (para 5.4) also suggests some exemptions from disclosure – the audit committee 'would not be expected to disclose information which, in its opinion, would be prejudicial to the interests of the company (for example, because it related to impending developments or matters in the course of negotiation)'.

How to address the issue

What others have done

A number of companies have adopted some of the reporting changes early, so there is precedent to take account of.

We carried out a survey of early adoption based on the first 50 annual reports for 31 December 2012 year ends that were published after 4 March 2013, and the results were:

'Fair, balanced and understandable'
Few companies (10%) made the formal statement early, though a further 20% noted that the audit committee had considered the matter.

'Significant issues' *reporting - almost half of companies (46%) identified the key accounting judgements and estimates that the audit committee had dealt with in relation to the financial statements, though comparatively few (12%) provided real insight into how they were addressed.*

Examples of the new reporting

Barclays plc

Barclays were at the forefront of significant issues reporting and continue to provide some real insight into the activities of the audit committee through this disclosure. The following (brief extract only) from their 2012 report demonstrates well how it is possible to give transparent information in sensitive areas:

Financial Reporting and Significant Financial Judgements

- *...We considered the presentation of the financial statements and in particular, the presentation of adjusted performance and the adjusting items, including own credit, provisions for product mis-selling redress and the gain on the disposal of Barclays interest in BlackRock, Inc. We discussed the treatment of the LIBOR penalties and agreed with management's judgement that these should not be treated as an adjusting item;*
- *We received reports on the assumptions underlying the provisions made for product mis-selling redress, specifically PPI and Interest Rate Hedging Products. The trend in PPI claims has proved to be volatile during 2012, resulting in provisions being taken in both the first and the third quarter. Provision for Interest Rate Hedging Products was taken at the half-year. We were content after due challenge and debate with the assumptions made and the judgements applied. As part of reviewing the results for 2012, we considered a recommendation from management that further provisions should be taken in respect of PPI and Interest Rate Hedging Products in the financial results for 2012 and, having reviewed the trend data and provisioning assumptions, agreed with management's recommendation;*

[Barclays PLC Annual Report 2012 page 53]

Barclays also made the formal statement that the annual report, taken as a whole, was fair, balanced and understandable at the 2012 year-end. The audit committee advised the board on this and confirmed this in their report:

- *At the request of the Board we considered whether the 2012 Annual Report was fair, balanced and understandable and whether it provided the necessary information for shareholders to access Barclays performance, business model and strategy. We were satisfied that, taken as a whole, the Annual Report is fair, balanced and understandable;*

[Barclays PLC Annual Report 2012 page 53]

Companies adopting this part of the 2012 Code early were faced with a decision as to how to make the fair, balanced and understandable statement. In practice a number of different approaches were taken, and in our view all were acceptable.

All the statements we've seen have exactly mirrored the wording of provision C.1.1 of the Code in full. The statement has generally been added to the existing statement of directors' responsibilities, sometimes as an addition to the formal acknowledgements of responsibility that the directors make under DTR 4.1.12 and sometimes within the body of the responsibilities statement required by the UK Corporate Governance Code.

ARM Holdings plc

Outside the financial services industry, where the FSA was encouraging banks to make these disclosures at their 2012 year end, the number of significant issues identified has typically been smaller and the level of insight has sometimes been lower. However, ARM Holdings struck a reasonable balance with their disclosure at the 2012 year end:

Financial reporting judgments:

Each quarter, the Audit Committee reviewed accounting papers prepared by management on areas of financial reporting judgment.
These included:

- *Consideration of the accounting treatment of substantial transactions, including any judgemental matters in relation to revenue recognition for major licence contracts with customers;*
- *Consideration of the judgments surrounding the goodwill impairment review performed in the fourth quarter of 2012. In light of the strong performance of the PIPD business in the year and a robust order backlog, the Committee was comfortable with management's assessment that no reasonable variation in key assumptions would impact the conclusion that no impairment in carrying value was required;*
- *Consideration of management's judgment of the level of provision required to be carried in relation to ongoing litigation involving either the Group or its licensees and in particular where the Group may be required to indemnify its licensees, including receiving regular updates from the Group's General Counsel; and*
- *Consideration of the key judgements made in estimating the Group's tax change.*

[ARM Holdings plc Annual Report 2012 page 68]

As these examples show, the significant issues reporting provision does not just ask for the issues to be identified – the audit committee is also expected to explain how they were addressed. The lists of issues with no further comment that we saw in a number of 2012 audit committee reports will not pass muster when the Code applies next time round.

Changes to auditors' responsibilities

Under the revised version of ISA (UK&I) 700 'The independent auditor's report on financial statements' that applies to audits of periods beginning on or after 1 October 2012, the matters on which auditors report by exception have been updated to include both the fair, balanced and understandable statement and the significant issues reporting.

In the case of fair, balanced and understandable, auditors will be considering whether the statement is consistent with 'the knowledge acquired by the auditor in the course of performing the audit' – i.e. they will not carry out any specific additional audit procedures.

However, from the auditor's standpoint, this specific reporting by exception raises the bar compared with their previous responsibilities. Borderline cases will be more difficult to accept than they were previously, and we expect to see auditors and audit committees working together to deal with such instances.

In the case of the significant issues reporting, auditors will report if the audit committee section of the annual report does not 'appropriately address' matters communicated by the auditor to the audit committee. Any concerns about the omission of disclosures on the grounds that they are prejudicial (as allowed for in the FRC's Guidance on audit committees) may be relevant here.

The revised version of ISA (UK&I) 700 also requires auditors to describe in their published report the risks that had the greatest effect on the overall audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team, and how the scope of the audit addressed these risks[1].

The revised auditing standard states that the auditor's explanations of these matters shall 'complement the description of significant issues relating to the financial statements'. It will therefore be important that there is consistency where applicable between these elements of the audit report and the audit committee's reporting of significant issues, though the items included will not necessarily be the same. In particular, auditors may include in their report risks identified at the planning stage of their work that do not ultimately relate to, or result in, significant judgements or estimates in relation to the financial statements.

[1] The revised auditing standard also requires the published audit report to include an explanation of how the auditor applied the concept of materiality, and an overview of the scope of the audit.

Supporting the directors' statement

Another area of considerable debate has been the process needed to support the formal fair, balanced and understandable statement by the directors.

A number of companies have been happy to make the statement based on the processes that they have had in place in previous years. To some extent this is logical as all three criteria already applied, as discussed earlier.

However, the fact that there is now a formal statement by the directors has tended to focus attention on the issue, and other companies have elected not to make the statement without enhancing their processes.

Our principal advice on process is set out below. We have assumed that the audit committee will be asked to advise the board on the fair, balanced and understandable statement.

- Ensure that enough time is built into the year-end timetable to allow the audit committee to review the whole annual report and for any necessary amendments to be made;
- If there is likely to be a need for changes to the front half of the annual report compared to previous years – perhaps because of the emergence of difficult or sensitive areas in connection with any aspect of the business model, strategy or performance – it is important to have sufficiently senior involvement early on to give direction;
- As with any other area where the audit committee is being asked to form an opinion, they should be supplied with papers from management setting out the key judgements that need to be made to arrive at the statement;
- Consider involving the disclosure committee where there is one; currently they are often more focussed on complete and timely disclosure to the markets under continuing obligations, so this may involve an update to their terms of reference; and
- Take the opportunity to consider again the overall quality of corporate reporting; even if the report is fair, balanced and understandable, does it contain all the necessary information to allow a reader to assess the performance, business model and strategy and the links between these?

What are the key areas to look at?

The following aspects of the annual report are some of those that, in our experience, generate debate about whether they are fair and balanced.

- 'Highlights' bullet points – where these are carried over from preliminary announcement press release
- Chairman's and/or CEO's statement – these can often focus mostly on positive news and prospects
- Discussions in the review of operations – these can contrast with the information in the financial statements (for a segment or acquired operation, for instance)
- Over-emphasis of matters that are not material, such as new products or services, or other developments in the business
- Discussions of risk – where items can be omitted, played down, buried or just not well described
- 'Bad news' in the financial statements – which can sometimes be hardly mentioned in the narrative reporting

As well as considering specific areas, our advice is to focus on whether the linkage of material through the annual report is clear – can the trail through from business model to strategy, performance and reward be followed and understood? Remember that corporate governance, remuneration and other aspects of non-financial reporting including social & environmental and sustainability matters also need to be taken into account.

Clear linkage is also closely connected to the second half of the fair, balanced and understandable provision – does the report provide the information necessary for shareholders to assess a company's performance, business model and strategy – because the connection between the elements is an intrinsic part of putting a shareholder in a position to make this assessment.

We believe that 'understandable' should be interpreted as 'understandable to a reasonably informed reader', recognising that some annual reports and financial statements will always be inherently more complex than others.

And finally, remember that the fair, balanced and understandable requirement is in respect of the annual report taken as a whole. This should not be about details – the question is: does the annual report get across to the reader the right overall message?

Conclusion

In terms both of the underlying procedures and reporting on them, good practice in this area will develop over the next few years.

As with so much in governance, it would be possible to claim compliance with these changes on the strength of minimal action. If the changes are to have real value, companies need to grasp the opportunity to demonstrate the quality of their stewardship activities by revisiting their corporate reporting processes and the overall quality of their annual reports.

Further information

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More information on the other changes to reporting proposed by the FRC and by the Department for Business, Innovation and Skills can be found in the PwC publication 'Changes to annual reports and auditors' responsibilities from September 2013', which is available from your usual contact or here: https://inform.pwc.com/inform2/show?action=informContent&id=1303120204095184

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