

International experience regulatory risk-based financial statement IFRS Accounting Standards compliance review practices: UK

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 - ▶ International Financial Reporting Standards (IFRS) Accounting Standards; or
 - ▶ The IFRS for Small and Medium-Sized Entities (SMEs) Accounting Standard.

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Objectives

- ▶ This session aims to provide an understanding of bases for resolving IFRS technical issues including observations from mechanisms employed at the international level and for encouraging and enforcing consistent application in South Africa and the UK.

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Risk-based IFRS compliance review mechanism

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Risk-based IFRS compliance review methodology

- ▶ Aim: encourage use of an effective methodology for performing the financial statements compliance reviews.
- ▶ In particular, encourage use of a risk-based approach to:
 - ▶ selecting the financial statements to be reviewed; and
 - ▶ focussing the review on the most significant judgements management made in developing and applying each entity's accounting policies (a disclosure checklist-based approach does little to test the quality of management judgements).

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Principles for risk-based reviewing of IFRS financial statements

- ▶ 1 - Understand the regulated entity
- ▶ 2 - Understand the economic environment
- ▶ 3 - Identify areas of focus
- ▶ 4 - Leverage the work of others
- ▶ 5 - Understand the relevant accounting
- ▶ 6 - Scrutinise significant judgements and estimates
- ▶ 7 - Formulate searching questions
- ▶ 8 - Observe protocols, practices and codes

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Risk-based IFRS compliance review methodology factors to consider in risk-based selection include...

- ▶ Risk-based selection for review in full consider:
 - ▶ Review on a rotational basis (e.g. review in full at least once every five years or so)
 - ▶ Strategically important/potentially impactful entities to the domestic economy (e.g. oil and gas in Central Asian Republics).
 - ▶ High risk for corporate reporting by virtue of economic or other pressures in the period (e.g. during Covid-19 pandemic going concern and impairment of assets).
 - ▶ Industries under particular stress (e.g. economic factors, regulatory developments or the impact of new reporting requirements).
 - ▶ Other sources (e.g. whistle-blowing, relevant press articles etc).
- ▶ Risk-based selection for partial/thematic review consider:
 - ▶ New reporting requirements (e.g. first-time application of major new accounting Standards).
 - ▶ Specific accounting issues involving increased subjectivity, judgement and risk of misstatement.
 - ▶ Key emerging issues (e.g. climate risk accounting effects).
- ▶ Some random sampling to ensure that all companies could be selected.

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IFRS compliance review Why recommend a risk-based methodology?

- ▶ Boilerplate disclosures mask non-compliance: preparers use 'Big 4' disclosure checklists and illustrative financial statements to present disclosures that often seem compliant. However, appropriate judgements are not necessarily being made.
 - ▶ Consequently, a tick-box disclosure-checklist financial statement compliance review is unlikely to be effective in assessing the quality of accounting and reporting.
- ▶ Moreover, a risk-based review methodology likely will focus on more relevant issues by, for example, identifying and analysing:
 - ▶ each entity's most significant judgements; and
 - ▶ selected issues currently of concern to regulators.

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IFRS compliance review

Depreciation example: problem with disclosure checklist approach (1)

Disclosure checklist approach: mandatory disclosure	Reference	Test
Depreciation methods used	IAS 16.73(b)	✓
Useful lives or the depreciation rates used	IAS 16.73(c)	✓
Gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period	IAS 16.73(d)	✓
Depreciation for the period	IAS 16.73(e)(vii)	✓
Nature and effect of a change in an accounting estimate including (a) residual values; (b) costs of dismantling etc; (c) useful lives; and (d) depreciation methods	IAS 16.76 read with IAS 8	✓ procedure in accounting policy note (no material change in the period evident)

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IFRS compliance review

Depreciation example: problem with disclosure checklist approach (2)

Disclosure checklist approach: <u>encouraged</u> disclosure (about PPE that is likely no longer being depreciated)	Reference	Test
Carrying amount of temporarily idle PPE and carrying amount of PPE retired from active use and not classified as held for sale in accordance with IFRS 5	IAS 16.79(a) and (c)	assume N/A and see no evidence to the contrary
Gross carrying amount of any fully depreciated in use PPE	IAS 16.79(b)	✓

Conclusion: ✓ compliant (very good)—entity provides all mandatory disclosures + provides some additional voluntary disclosures.

Concern: non-compliance with the depreciation principle might exist because the judgements made by management when applying the depreciation principle might not faithfully reflect the consumption of the items' service potential in the reporting period.

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Risk-based IFRS compliance review methodology

example: reviewing accounting for depreciation (1)

- ▶ Observe regulatory concerns about depreciation accounting.
 - ▶ IFRIC issues; IASB website; bearer plant industry; etc.
- ▶ Therefore, identify entities in the sample that have significant depreciable assets.
 - ▶ typically including manufacturing, retail, transportation, financial institutions that retain foreclosed assets
- ▶ Understand the relevant accounting:
 - ▶ depreciation principle: reflect the consumption of an item's service potential when it is consumed.
 - ▶ Judgement mindset: critical thinking aiming to reflect the underlying economic service potential consumption

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Risk-based IFRS compliance review methodology

example: reviewing accounting for depreciation (2)

- ▶ Understand how the reporting entity consumes each significant depreciable asset's service potential (the way an entity uses an item informs depreciation judgements!)
- ▶ Identify key judgements as determining:
 - ▶ (i) components, if any; (ii) depreciation method; (iii) useful life; (iv) residual value, if any; (v) when to start depreciation; (vi) when to stop depreciating.
- ▶ Develop your expectations of possible outcomes from making appropriate depreciation judgements for each significant types of depreciable item in the sample entities.
 - ▶ For example: (i) change in accounting estimates likely if depreciation is identified as a key judgement; (ii) no significant in-use fully-depreciated item; (iii) unit-of-production depreciation method unless item consumed evenly over time; (iv) residual values if entity sells depreciable items.

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Risk-based IFRS compliance review methodology

example: reviewing accounting for depreciation (3)

- ▶ Analyse accounting and related disclosures and document findings. For example, finding evidence of significant fully depreciated items that are still in use provides strong evidence of non-compliance with the depreciation principle.
- ▶ Contributory evidence of non-compliance with the depreciation principle includes:
 - ▶ no reference to residual values but entity has gains/losses on disposal of PPE
 - ▶ no reference to components of significant items that likely should have component depreciation
 - ▶ straight-line depreciation of items whose service potential likely evolves over time (for example, customer lists, bearer plants etc)
 - ▶ no disclosures about changes in accounting estimates (when consumption patterns likely changed in the period)

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Risk-based IFRS compliance review methodology

example: reviewing accounting for depreciation (4)

Conclusion: ✗ likely compliance failure - depreciation judgements appear to be inconsistent with the depreciation principle.

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UK: FRC's IFRS compliance review mechanisms

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UK FRC's IFRS compliance review mechanism: 'carrot and stick' approach

- ▶ Carrots (encouraging better reporting)
 - ▶ UK FRC's Financial Reporting Lab¹
 - ▶ Announce thematic reviews²
 - ▶ Published thematic review reports³
- ▶ Sticks (actively monitoring and enforcing the quality of reporting)
 - ▶ Corporate Reporting Review function⁴
 - ▶ Enforcement Division⁵

¹ see www.frc.org.uk/investors/financial-reporting-lab

² see www.frc.org.uk/news/december-2020/frc-announces-its-thematic-reviews,-audit-areas-of

³ see www.frc.org.uk/accountants/corporate-reporting-review/corporate-reporting-thematic-reviews

⁴ see www.frc.org.uk/accountants/corporate-reporting-review

⁵ see www.frc.org.uk/getattachment/f656ea47-872b-4715-98b4-223a6ad07f24/FRC-Annual-Enforcement-Review-2021.pdf

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UK FRC's Financial Reporting Lab 'carrot'

- ▶ The Lab provides an environment for investors and companies come together to develop pragmatic solutions to today's reporting:
 - ▶ As a learning space, companies can use the Lab to test new reporting formats with investors, and investors can indicate areas where management can add greater value through the information they provide.
 - ▶ As a hub to support innovation in reporting, the Lab's focus on gathering and sharing evidence from the market provides the broader corporate community with feedback from shareholders on the value that new reporting formats bring.

Source: www.frc.org.uk/investors/financial-reporting-lab

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UK FRC's thematic IFRS compliance reviews Announcements 'carrots' and reports

- ▶ 10/12/2020 FRC announced:¹
 - ▶ its thematic reviews of corporate reporting for 2021/22;
 - ▶ audit quality inspection—areas of focus for 2021/22; and
 - ▶ priority sectors for 2021/22.
- ▶ Published thematic review reports² in 2022 include:
 - ▶ Business Combinations (IFRS 3)
 - ▶ Deferred tax assets (IAS 12)
 - ▶ Earnings per share (IAS 33)
 - ▶ Judgements and estimates (IAS 1)
 - ▶ Discount rates

¹ see www.frc.org.uk/news/december-2020/frc-announces-its-thematic-reviews,-audit-areas-of

² see www.frc.org.uk/accountants/corporate-reporting-review/corporate-reporting-thematic-reports

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UK FRC's IFRS compliance review focus 'carrot'

Thematic reviews

- ▶ FRC will supplement its routine reviews of corporate reporting for 2021/22 with five thematic reviews. These reviews will identify scope for improvement, as well as examples of better practices, in areas of key stakeholder interest.
 - ▶ Going concern and viability;
 - ▶ IAS 37 Provisions, Contingent Liabilities and Contingent Assets;
 - ▶ Climate Risk follow-up - Streamlined Energy and Carbon Reporting: new UK requirements starting on or after 1 April 2019;
 - ▶ Alternative performance measures; and
 - ▶ Interim reporting.

Source: www.frc.org.uk/news/december-2020/frc-announces-its-thematic-reviews,-audit-areas-of

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UK FRC's IFRS compliance review focus 'carrot'

Priority sectors

- ▶ Sectors the FRC considers high risk for corporate reporting and audit by virtue of economic or other pressures for 2021/22:
 - ▶ Travel, Hospitality and Leisure (including airlines, travel companies, hotels & restaurants)
 - ▶ Retail (particularly involving discretionary expenditure)
 - ▶ Property (particularly retail and office)
 - ▶ Financial Services
- ▶ Note: corporate reports and audits selected for review will not be limited to entities in these priority sectors.

Source: www.frc.org.uk/news/december-2020/frc-announces-its-thematic-reviews,-audit-areas-of

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UK FRC's audit quality review priorities 'carrot'

Audit quality review areas of focus

- ▶ FRC's programme of audit quality inspections for 2021/22 the FRC expects to pay particular attention to:
 - ▶ Covid-19 Impact: to include going concern, impairment of assets, inventory and group audits.
 - ▶ Estimates: particularly the application of ISA 540 revised and IAS 37.
 - ▶ Fraud: the FRC will consider how well auditors identify and assess fraud risks.
 - ▶ Climate Risk: this follows the FRC's recently published review of climate reporting, which identified the need for auditors to improve their consideration of climate-related risks when planning and executing their audits. (see www.frc.org.uk/getattachment/ab63c220-6e2b-47e6-924e-8f369512e0a6/Summary-FINAL.pdf)

Source: www.frc.org.uk/news/december-2020/frc-announces-its-thematic-reviews,-audit-areas-of

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UK FRC's financial statement review activity 'stick'

Supervision Committee (1)

- ▶ FRC seeks to ensure that the provision of financial information by public and large private companies complies with relevant reporting requirements.
- ▶ The Supervision Committee:
 - ▶ develops and operates a programme of review of annual accounts based on risk assessment which is informed by priority sectors that are determined annually;
 - ▶ enquires into accounts falling within its remit which come to its attention, whether through selection for review or through complaints;
 - ▶ ensures that any published findings of the Supervision Committee in respect of the corporate reporting of an entity are brought to the attention of other authorities so that they can decide whether disciplinary or other sanctions should be applied;
 - ▶ liaises with the Financial Conduct Authority and other authorities in the UK and internationally to foster the consistent application of accounting requirements and to improve the compliance of financial information with reporting requirements;
 - ▶ contributes to and seeks to sustain an approach to enforcement that is vigorous, consistent and cost-effective; and
 - ▶ seeks an appropriate level of recognition within the financial reporting community so as to maximise the deterrent effect of the Supervision Committee's corporate reporting review activities.

Source: www.frc.org.uk/accountants/corporate-reporting-review

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UK FRC's financial statement review activity 'stick'

Supervision Committee (2)

- ▶ The Supervision Committee aims to ensure:
 - ▶ timely but fair dealings with entities whose financial information comes under scrutiny;
 - ▶ respect for the confidentiality of the process and the information provided by such entities, subject to the legitimate needs and responsibilities of other regulators;
 - ▶ opportunities for companies to make voluntary corrective changes to their accounts prior to any court application; and
 - ▶ appropriate public reporting of enforcement actions.

Source: www.frc.org.uk/accountants/corporate-reporting-review

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UK FRC's financial statement review activity 'stick'

Selection of accounts for review

- ▶ Risk-based approach to selection of reports and accounts for review.
 - ▶ Considers the probability of non-compliant reporting and the potential impact of any errors on the company, the industry in which it operates and the market more widely.
 - ▶ FTSE 350 are reviewed on a more frequent, rotational basis (aim to review in full at least once every five years with inclusion in at least one thematic review in between times);
 - ▶ Each year, risk-based identification of small number of industries under particular stress (eg economic factors, regulatory developments or the impact of new reporting requirements.) Accounts are selected from these industries across the full range of those within CRR remit - that is, listed companies, UK AIM quoted companies, large private companies and limited liability partnerships. Selection is also sometimes prompted by specific topical accounting issues that may give rise to issues of increased subjectivity, judgement and risk of misstatement in corporate reporting.
- ▶ Risk-based selection is supplemented by an element of random sampling to ensure that all companies within remit stand a chance of having their report and accounts being reviewed by the FRC.
- ▶ Welcome well informed complaints about individual company reports and accounts and respond to relevant articles in the press.

Source: www.frc.org.uk/accountants/corporate-reporting-review/how-we-review-reports-and-accounts

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UK FRC's financial statement review activity 'stick'

Compliance review process

- ▶ FRC Corporate Reporting Review team (CRR) perform the compliance review.
 - ▶ The overwhelming number of cases, matters raised have been satisfactorily addressed by the company through the CRR process set out below without the need for further action.
- ▶ Then the CRR Director writes to the company Chairman
 - ▶ If no compliance question arise, explaining that a review conducted but that there are no substantive points to address at that stage.
 - ▶ If a number of less substantive points found, these are included in a schedule of other matters for the Board to consider when it prepares its next report and accounts. Acknowledgement of receipt of the letters is requested noting the points to consider in future reporting.
 - ▶ (continued...)

Source: www.frc.org.uk/accountants/corporate-reporting-review/how-we-review-reports-and-accounts

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UK FRC's financial statement review activity 'stick'

Compliance review process

- ▶ Then the CRR Director writes to the company Chairman
 - ▶ (...continued) If the review raises more substantial question of potential non-compliance, setting out the relevant issues and asks for further information and explanation to help better understanding of the reporting that has been adopted.
 - ▶ Directors are encouraged to consult their auditors, to involve their audit committee and to take advice.
 - ▶ Generally expect a substantive response within 28 days.
 - ▶ Depending on the issues involved there may be several rounds of correspondence with the entity. In some cases, informal phone calls or technical meetings will be suggested to help progress an enquiry. The process is informal but is intended to combine efficiency with fairness.

Source: www.frc.org.uk/accountants/corporate-reporting-review/how-we-review-reports-and-accounts

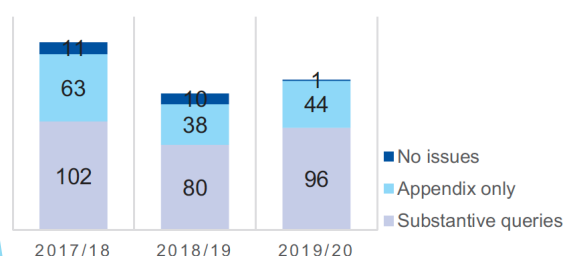
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UK FRC's financial statement review activity 'stick': CRR activity 2019/20

	FTSE 100	FTSE 250	Other	Total
Full scope reviews*	19	52	40	111
Thematic reviews	38	35	32	105
	57	87	72	216

*Includes 19 complaints (see below)



A 'no issues' letter informs the company that we have performed a review and identified no issues of sufficient significance to draw to the company's attention.

'Appendix only' letters convey less significant matters where the company may not have complied with the relevant legal, accounting or reporting requirements or where there is opportunity for enhancing the general quality of reporting, but no substantive queries have been raised.

Working with other regulators

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

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

Source:

www.frc.org.uk/accountants/corporate-reporting-review/annual-activity-reports

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UK FRC's financial statement review activity 'stick': CRR findings

Ten most frequently raised topics

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

Source: www.frc.org.uk/accountants/corporate-reporting-review/annual-activity-reports

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UK FRC's financial statement review activity 'stick' improving CRR

(source: www.frc.org.uk/accountants/corporate-reporting-review/annual-activity-reports)

	The Review recommends ...	Action to implement
24	... that the regulator should consider expanding the volume of CRR activity on a risk-based basis.	The CRR team is growing, to take on more cases. It now comprises 25 Case Officers and Directors, up from 17 in April 2019. We are using additional business intelligence input to enhance our risk-based selection approach.
26	... that CRR findings are reported publicly by the regulator. The regulator should publish full correspondence following all CRR reviews, and the findings should be published in a set timeframe.	As part of its 2020/21 review cycle, with the companies' consent, CRR will start publishing case summaries setting out our principal findings from a review and the outcome of engagement with companies. Pending a change in law to address confidentiality constraints, we will contact each company to explain the extent to which we intend to publish information about the review, to share our proposed text and to obtain consent to its publication.
29	... that the stronger corporate reporting review process described earlier should be extended to cover the entire annual report, including corporate governance reporting. This should be done on a risk-based basis.	In its 2020/21 review cycle, CRR will, for a sample of companies, raise matters on areas outside its current statutory enforcement powers. Where appropriate, we are drawing companies' attention to areas of potential improvement in areas such as their reporting of governance and stakeholder engagement. The effectiveness of this pilot scheme will inform the drafting of potential future legislation.
30	... considering whether there is a case for strengthening qualitative regulation around a wider range of investor information ... to ensure that disciplines to drive up the quality of companies' disclosures in the UK are at least as demanding as best practice internationally.	For a risk-based sample of 2020/21 cases, CRR is reviewing preliminary announcements of full-year results and the related presentation of information to investors and analysts, to identify any material inconsistency with disclosures in the annual report and accounts. The findings of this work will inform the next steps to be taken in collaboration with the FCA.

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UK FRC's financial statement review activity 'stick'

Supervision process (1)

- ▶ Matters not concluded through the CRR staff processes (see earlier slide), are referred to the Executive Director of Supervision.
- ▶ The Executive Director assesses whether to write to the company explaining they are minded to refer the company to the Supervision Committee for it to decide whether to apply to court for an order requiring the directors of the company to prepare revised accounts or a revised report.
 - ▶ The matter may be closed without referral if the company then provides adequate explanation, or volunteers to make the required revisions to its report and accounts.
 - ▶ If the matter is not resolved, the Executive Director will provide a report to the Supervision Committee.

Source: www.frc.org.uk/accountants/corporate-reporting-review/how-we-review-reports-and-accounts

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UK FRC's financial statement review activity 'stick'

Supervision process (2)

- ▶ The Supervision Committee can:
 - ▶ ask directors to explain apparent departures from reporting requirements.
 - ▶ If the Supervision Committee is not satisfied by the directors' explanations, it aims to persuade the directors to adopt a more appropriate accounting treatment.
 - ▶ The directors may then voluntarily withdraw their accounts and replace them with revised accounts that correct the matters in error.
 - ▶ Depending on the circumstances, the Supervision Committee may accept another form of remedial action - for example, correction of the comparative figures in the next set of annual financial statements.
 - ▶ Failing voluntary correction, the Supervision Committee can exercise the FRC's delegated powers to secure the necessary revision of the accounts through a court order. The FRC maintains a legal costs fund of £2million for this purpose.
- ▶ FRC can share otherwise confidential information with specified persons including the Secretary of State for Business, Energy and Industrial Strategy, the Treasury, the Bank of England, Financial Conduct Authority, and HMRC (UK tax authorities).

Sources: www.frc.org.uk/accountants/corporate-reporting-review and www.frc.org.uk/accountants/corporate-reporting-review/how-we-review-reports-and-accounts

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UK FRC's enforcement activity 'stick'

Investigations and enforcement

- ▶ Who can the FRC investigate?
 - ▶ Accountants and Actuaries under the Accountancy Scheme and Actuarial Scheme
 - ▶ Statutory Audit firms and Auditors under the Audit Enforcement Procedure (AEP)
- ▶ UK FRC's Enforcement Division team:
 - ▶ Executive counsel (1)
 - ▶ Deputy Executive counsel (1)
 - ▶ Chief of staff (1)
 - ▶ Lawyers—qualified as either barristers or solicitors (20)
 - ▶ Forensic accountants (21)
 - ▶ Legal and accounting assistants (6)
 - ▶ Administrative assistant (1)

Source: www.frc.org.uk/getattachment/f656ea47-872b-4715-98b4-223a6ad07f24/FRC-Annual-Enforcement-Review-2021.pdf

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UK FRC's enforcement activity 'stick'

Investigations and enforcement: intelligence gathering

Case Examination and Enquiries (CEE) - Intelligence-gathering, initial enquiries

SOURCES

- Horizon-scanning
- Referrals from other FRC teams, regulators, audit firms and professional bodies
- Complaints
- Whistleblowing disclosures

OUTCOMES

- Referral to Conduct Committee for decision on opening of investigation
- Constructive Engagement (AEP only)
- Referral to another FRC team
- Referral to a professional accountancy or actuarial body or regulator
- No further action

Source: www.frc.org.uk/getattachment/f656ea47-872b-4715-98b4-223a6ad07f24/FRC-Annual-Enforcement-Review-2021.pdf

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UK FRC's enforcement activity 'stick'

Investigations and enforcement: outcomes and sanctions

Investigations and Enforcement - Conduct of investigations referred by Conduct Committee

OUTCOMES

AEP:

- Initial Investigation Report (IIR)
- Decision Notice and proposed sanction
- Accepted or Tribunal convened

Scheme:

- Proposed Formal Complaint/ Formal Complaint
- Settlement or Tribunal convened

At any point, Executive Counsel can close a case should the threshold for taking enforcement action not be met

SANCTIONS

Financial:

- Unlimited fines
- Waiver of client fees

Non-financial sanctions e.g.

- Reprimand
- Exclusion as a member of a professional body
- Other remedial actions as appropriate

Sanctions are determined by reference to the [Sanctions Policy \(AEP\)](#), [Accountancy Sanctions Guidance \(Scheme\)](#) and [Actuarial Sanctions Guidance \(Scheme\)](#)

Source: www.frc.org.uk/getattachment/f656ea47-872b-4715-98b4-223a6ad07f24/FRC-Annual-Enforcement-Review-2021.pdf

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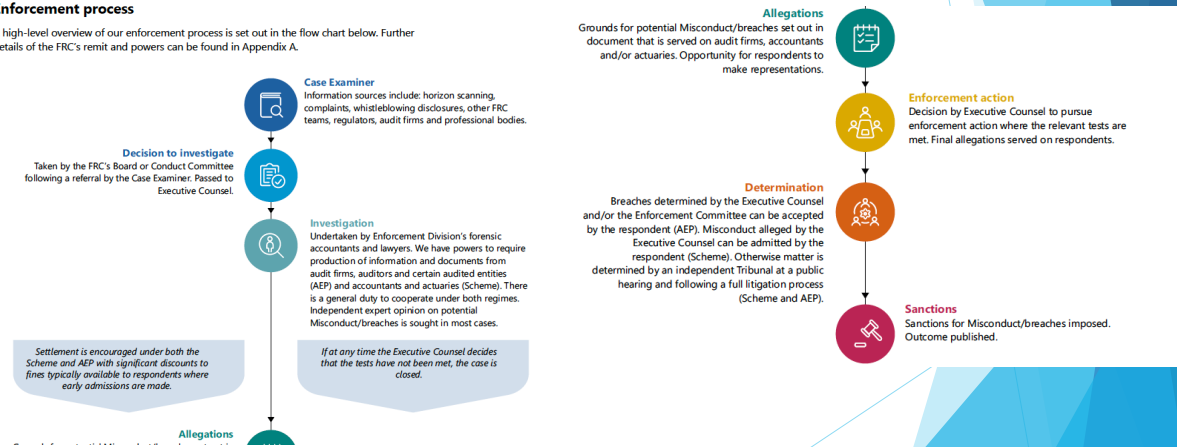
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UK FRC's enforcement activity 'stick'

Investigations and enforcement: enforcement process

Enforcement process

A high-level overview of our enforcement process is set out in the flow chart below. Further details of the FRC's remit and powers can be found in Appendix A.



Source: www.frc.org.uk/getattachment/f656ea47-872b-4715-98b4-223a6ad07f24/FRC-Annual-Enforcement-Review-2021.pdf

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Thank you

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