Technical findings

of the

Conduct Committee's

Financial Reporting Review Panel

2013-2014

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Technical findings

- The areas identified in this presentation are those where we asked most questions of boards in the year.

- Accounts under review were from December 2012 – September 2013.

- Other matters reported in last year's Technical findings remain relevant.

Common areas of questioning

- Business reviews
- Accounting policies
- Critical judgements
- Estimation uncertainties
- Revenue recognition
- Cash flow statements
- Intangible assets
- Property, plant and equipment

Common areas of questioning

- Impairment
- Capital management
- Income taxes
- Provisions, contingent liabilities and contingent assets
- Business combinations
- Presentation of financial statements
- Industry issues
- Other

Business reviews: balanced and comprehensive

- We challenged companies where there was no discussion or explanation of significant items featured in the accounts:
  - eg potential financial effect of disputed tax

- We questioned the omission of significant explanations on the grounds that they had been previously published in the interims.

- We also identified examples of poor discussion of performance
  - eg profit after substantial and/or unexplained adjustments

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Business reviews: balanced and comprehensive

- We challenged lack of reference to key matters impacting and explaining performance eg
  - amortisation halved on drug licence;
  - figures included in financial review, but not discussed;
  - broad discussion of changes in financial review, without reference to the amounts; and
  - omission of significant explanations of performance previously published in the interim report.

Business reviews: principal risks and uncertainties

- We challenged where there was a question whether:
  - all PRUs disclosed were genuinely principal;
  - PRUs were not company-specific; eg, regulatory risk did not explain the most relevant regulations; or
  - all PRUs were disclosed; eg, reliance on a major customer, exposure to pension scheme, operating lease commitments.

Business reviews: key performance indicators

- Key performance indicators (KPIs) are required ‘to the extent necessary’ to provide an understanding of a company’s position or operations.
- We challenged companies where:
  - KPIs were not clearly identified;
  - indicators could not be recalculated;

    eg debt/earnings ratio after capitalising leases
  - there was no appropriate level of discussion.

Accounting policies

We questioned:

- Policy descriptions that summarised the standard;
- Policy descriptions that did not describe the company’s specific application in practice;
  - eg : insurance contract valuation methods.
- Policy descriptions that used ‘standard-speak’ rather than plain, understandable English.

Accounting policies

We questioned:

- Lack of policies for transactions or balances that were material to the business, eg: supplier rebates, shares classified as liabilities, conditional land purchases, vehicle purchases on consignment, bill and hold;
- Unnecessary repetition of policy descriptions;
- Descriptions of policies where no other disclosure made;
- New IFRS requirements with little or no effect on future financial statements.

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Critical judgements

- We challenged disclosure of critical judgements not sufficiently specific to enable an understanding of where judgement was exercised or its effect
  - eg ‘revenue recognition’
- We queried lack of disclosure where needed to understand management’s decisions
  - eg classification of debt /equity, held for sale assets, lease renewal, intangible or financial instrument classification, non-consolidation of investment subsidiary controlled by regulator.

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Estimation uncertainties

- We challenged the lack of disclosure of uncertainties around estimation when it was apparent from the accounts that a significant uncertainty existed.
  - eg evidence supporting non-impairment of capitalised exploration/ evaluation expenditure, contingent consideration receivable
- The quality of explanation often fell short of what was needed to help users understand judgements made relating to the estimate and uncertainties.
  - eg lack of sensitivities.

Revenue recognition

We queried :

- lack of explanation of the point at which risks and rewards are transferred to the customer for significant business streams, including stage of completion
- Lack of specific policy for unusual items:
  - Deferred income on onerous contracts
  - Barter transactions with house-builders
  - Success or incentive fees
- Failure to disclose revenue by category

Revenue recognition

We challenged disclosure of revenue policies that appeared inconsistent with the business model:

- Partnerships, concessions, franchises and outsourcing featured in various business models but the policies did not explain how they affected revenue.
- The company indicated that it acted as agent but this was not supported by the stated policy.
- The impact of delays in revenue recognition on costs and the timing of release of deferred income were not explained.

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Cash flow statements

- We continued to note a range of minor mistakes indicative of a lack of care
- Instances of misclassification included:
  - Pension cash flows classified as financing;
  - IPO costs unrelated to new share issue classified as financing; and
  - Amounts to buy or sell rental assets classified as investing rather than operating.

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Cash flow statements

- We challenged instances of inappropriate netting eg:
  - Loan drawdowns/ repayments
  - Excessive aggregation and netting of adjustments from profit to operating cash flows
- We challenged the disclosure of non cash items in the cash flow statement eg:
  - Conversion of convertible debt
  - Dividend in specie

Intangible assets

- We challenged:
  - Justification for long amortisation periods
  - Extremes of capitalisation of internally generated intangibles - where all or no development costs were capitalised we asked for nature of costs and queried how capitalisation criteria were applied in practice
  - Failure to disclose R and D expense
- We reminded boards of the need to disclose any individually significant intangible asset and its remaining amortisation period.

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Property, plant and equipment

- We challenged classes of property, plant and equipment which grouped together assets of dissimilar nature or use.
- Companies who, in the course of their ordinary activities, routinely sell items of PP&E that they have previously held for rental, should transfer the assets to inventory at their carrying amount and record the proceeds as revenue.
- Disclosure of assumptions used to calculate FV of revalued property, plant and equipment.

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Impairment

- Discount rate(s) should be pre-tax reflecting current market assessments of time value of money and asset-specific risks.
- We challenged when a single discount rate was applied to CGUs with apparently different risk profiles and when a range was given for all CGUs.
- Estimation uncertainties were uninformative.
- For PP&E, we challenged CGU aggregation and why a market capitalisation indicator was ignored.

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Impairment

- A description is required of each key assumption driving cash flow projection determining value in use. The discount and terminal growth rates were often incorrectly identified as the only key assumptions.
- A description is also required of the approach to determining the values attributed to assumptions, including how past experience or external sources of information have been used.
- We challenged unclear and generic sensitivity disclosures.

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Capital management

- Qualitative and quantitative disclosures required in respect of identified capital were at times inconsistent.
- We challenged failure to identify what is managed as capital.
- We asked boards to explain their policy for capital management and how it was applied.

Income Taxes

- We queried the quality of explanations in tax reconciliations, including where the message appeared to differ from the business review, eg prior year items, non taxable income
- We challenged items that would not be expected in a reconciliation of total tax eg: adjustment to share based payments, adjustments for timing issues, capital allowances.
- Deferred tax should be measured at the tax rates expected to apply when the asset/liability is realised or settled, based on tax rates enacted or substantively enacted at the period end.

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Income Taxes

- We challenged lack of deferred tax on fair value adjustments to assets acquired in business combinations.
- The nature of evidence supporting a deferred tax asset is a required disclosure when its use depends on future profits and the company is loss-making.
- Some companies are still confused about where to recognise current and deferred tax relating to items recognised outside the income statement; if the item is recognised in equity, tax should also be recognised in equity and not OCI.

Provisions, contingent liabilities and contingent assets

- We challenged poor disclosure of movements in provisions.
- We challenged the justification for cash outflows being remote where contingent liabilities were not quantified and explained.
- We challenged the amount recognised for PPI mis-selling and other provisions.

Provisions, contingent liabilities and contingent assets

- We asked for details of the components of provisions classified in a significant class of ‘other’ provisions.
- We challenged aggregation of accruals and provisions.
- Relevant disclosures are required for each class of provision, contingent liability and contingent asset and include uncertainties relating to amount or timing.

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Business combinations: recognition

- All identifiable assets, subject to qualifying conditions, are to be recognised separately from goodwill.
- We queried the lack of customer-related intangibles and mineral rights acquired.
- Identifiable assets acquired and liabilities assumed are to be measured at the acquisition date fair values.

Business combinations: consideration

- Acquisition-related costs (except debt/equity issuance amounts) are to be expensed in the period.
- Disclosures should enable users to evaluate the nature and financial effect of business combinations.
- We challenged the accounting treatment and disclosures around deferred and contingent consideration.

Presentation of financial statements

- We challenged non-disclosure of proposed dividends.
- We challenged the aggregation of accruals and deferred income as these liabilities are different in nature and liquidity. Similar challenges were made in respect of prepayments and accrued income.
- We questioned reclassifications and restatements where no quantified explanation was provided.

Industry issues

Resource companies

- Unclear disclosure of key policies; eg recognition and impairment of exploration and evaluation assets
- No definition of industry specific terms; eg ‘commercial reserves’ and ‘successful efforts accounting’
- Reserves used in impairment and depreciation unclear

House-builders

- Interest in ensuring transparency in income statement about movements in inventory provisions set up through exceptional items during the financial crisis

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Industry issues

Property Development

- Allowance needs to be made for the developer’s profit in valuation of partly constructed buildings.

Investment Trusts

- Failure to disclose risks and affects of derivatives.

Other

- Where operating leases represented a significant cost and future commitment, we challenged bland descriptions of the lease terms which did not reflect their impact.

- We challenged the thresholds at which an unrealised loss on equity investments became significant or prolonged.

Other

- Where it appeared that there were significant off balance sheet commitments, we challenged the lack of disclosure under the Companies Act (Section 410 A).

- We challenged the classification of financial assets as level 2 in the hierarchy based solely on the fact that the values had been provided by a pricing agency.