Technical findings

of the

Conduct Committee's

Financial Reporting Review Panel

2014 - 2015

Technical findings

- The areas identified in this presentation are those where we asked most questions of boards in the year.
- Accounts closed since last Annual Report had year ends ranging from March 2013 – March 2014.
- Other matters reported in last year's Technical findings remain relevant.

Most frequent areas of questioning

- Strategic Report
  - Business review
  - Principal risks and uncertainties
  - Key performance indicators
- Accounting policies
- Clear & Concise
- Critical judgements
- Estimation uncertainties
- Revenue recognition
- Cash flow statements

Common areas of questioning

- Intangible assets
- Impairment
- Capital management
- Exceptional items
- Income taxes
- Pensions
- Provisions, contingent liabilities and contingent assets
- Business combinations
- Financial instruments
- Industry issues
- Companies Act
- Other

Strategic Report: Business Reviews

- Companies should provide a fair review of the business that is balanced and comprehensive.

- We challenged companies where the review did not appear appropriately balanced, eg:
  - discussion of results based on profits adjusted for exceptional and other items but no discussion of IFRS loss; and
  - focus on profit did not explain that this would have been a loss had the company not acquired a profitable business in the year.

Strategic Report: Business Reviews

- We challenged companies where the review did not appear to be comprehensive because it did not discuss all relevant aspects of performance, eg:
  - effect on effective tax rate of settlements relating to prior years;
  - differences in profitability between segments; and
  - quality of profits generated from long-term contracts versus cash received.
- We also challenged the completeness of the review of the companies' financial position; eg:
  - discussion of pension funding deficits.

Strategic Report: Business Reviews

- We challenged a company where its segment note provided information that was more aggregated than that provided in its Strategic Report.
- We found examples of business reviews in smaller companies that were too brief and lacked a discussion of important information, eg:
  - trends in revenue and margins;
  - segmental results;
  - taxation and share-based payment charges; and
  - cash from operations.

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Strategic Report: principal risks and uncertainties

- We have focused on PRUs for several years and have seen some improvements in this area. However, we continued to challenge where:
  - There was a question whether all PRUs disclosed were genuinely principal;
  - PRUs disclosed in smaller company accounts were missing or not sufficiently detailed; or
  - There was no discussion of how risks are managed or mitigated

Strategic Report: 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:
  - Ratios discussed prominently in the Strategic Report were not included within KPIs; eg cash conversion ratio and capital management ratio;
  - KPIs provided could not be reconciled to IFRS information; eg cash conversion ratios, gearing, free cash flow; and
  - no discussion was provided - noted in some smaller companies.

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Accounting policies

- We questioned:
  - Lack of policies for transactions or balances that were material to the business, eg:
    - discontinued operations,
    - capitalisation of assets under construction and software development,
    - treatment of minimum funding requirement for pensions,
    - modification of debt, and
    - bid costs.
  - General policy descriptions that did not describe the company's specific application in practice.
  - Where the business model implied that certain accounting policies would be relevant but they weren't provided.

Accounting policies

- As part of our drive for company reporting to be more 'Clear & Concise' we informed companies where we identified:
  - accounting policies for items or transactions that were immaterial, no longer relevant or non-existent, eg:
    - accounting policies for hedges that the company did not enter into; and
    - translation of subsidiaries in foreign currency when none existed.
  - unnecessary repetition of policy descriptions; eg separate policies for financial assets and liabilities at fair value through profit or loss
  - discussion of new IFRS requirements with little or no effect on future financial statements.

Clear & Concise

- In addition to identifying where companies' accounting policies could be made more clear & concise we wrote to companies noting:
  - that tables with immaterial information could be replaced by narrative or eliminated;
  - where primary statements included individually small items that could be aggregated;
  - information that was repeated in financial statements but could be cross-referenced; and
  - disclosures that were irrelevant because the fact pattern had changed.

Critical judgements

- We expect critical judgement disclosures to state explicitly what those judgements are and differentiate them from estimates. We challenged general references to critical judgements being included in accounting policies when no further details were provided.

- We queried lack of disclosure where needed to understand how management applied its accounting policies, eg:
  - non-consolidation of potential subsidiary;
  - debt versus equity classification of complex instruments;
  - development cost capitalisation; and
  - revenue recognition on unusual transactions.

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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: period of recovery of a deferred tax asset
- Some companies did not disclose the relevant amounts or provide other useful information, such as sensitivities.
- Where a company's Audit Committee report or audit report mention judgements and estimates not identified in the financial statements we may ask whether these disclosures should have been expanded in the notes.

Revenue recognition

- We challenge companies whose accounting policies are ‘boilerplate’ and insufficiently tailored to all the revenue streams in their business model, eg royalty and licence fee income.
- Our most common challenge was to companies that did not explain how they applied the percentage of completion model to long-term contracts.
- We challenged companies that recognised revenue on long-term contracts in proportion to costs incurred but this did not appear to reflect the progress of those contracts.
- We continue to identify failure to disclose revenue by category.

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Cash flow statements

- We continue to identify cash flows that have been misclassified between operating, investing and financing activities; eg:
  - Business acquisition costs classified as investing but should be operating;
  - Cost of early-settling a foreign currency derivative classified as financing – should have been operating as it wasn’t hedging a financing item;
  - Purchases of own shares classified as investing but should be financing; and
  - Loans to related parties classified as financing but should be investing.

Cash flow statements

- Companies should pay particular attention to the classification of unusual or non-recurring cash flows as these may still meet the definition of operating cash flows – albeit ones that may need to be separately disclosed.

- We still identify cash flows that have been inappropriately netted; eg: payments to, and receipts from, different banks.

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Intangible assets

- We challenged lack of disclosure of:
  - Research and development expense
  - Amortisation methods and useful lives
  - Internally generated versus acquired intangibles

- We remind boards again of the need to disclose any individually significant intangible asset (e.g. brand or trade name) and its remaining amortisation period.

Impairment

- Discount rate(s) should reflect current market assessments of time value of money and asset-specific risks. Pre-tax rate(s) should be disclosed.
- We challenged when a single discount rate was applied to CGUs with apparently different risk profiles.
- We challenged the level at which the company identified its CGUs and the levels at which it tested for goodwill impairment if these appeared to be at higher than operating segment level.

Impairment

- A description is required of each key assumption driving the 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 where companies had little ‘headroom’ but goodwill sensitivity disclosures were not given.

Capital management

- We continue to identify failures to disclose what is managed as capital and provide relevant quantitative data.
- Where capital management policies are provided these are sometime boilerplate and we ask for further details
- We challenge companies when the description of capital in the front half of the annual report appears inconsistent with the capital management note, eg whether net debt is part of capital.

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Exceptional items

- We issued a press notice in December 2013 regarding the presentation of exceptional items and their compliance with IFRS. We have been monitoring how companies have considered the press notice when preparing accounts.
- We will challenge companies where items that appear to recur each year are described as exceptional, eg acquisition costs for a company that makes acquisitions each year.
- We will challenge companies that do not include non-recurring credits in their exceptional items, eg one-off tax credits, release of inventory provisions.
- We expect companies to explain their accounting policy for identifying exceptional items.

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Income Taxes

- We challenged companies' effective tax rate reconciliations where:
    - reconciling items had been aggregated at a level that did not provide sufficient information for investors to understand sustainable tax rates;
    - the description of reconciling items was inconsistent with the Strategic Report and unclear; and
    - only current tax had been reconciled.

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Income Taxes

- 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.
- We challenged the accounting for tax on share-based payments when it was unclear how the company had allocated the tax charge between equity and the income statement, as required by IAS12.

Pensions

- We noted that a number of companies had failed to update their pension accounting policies to reflect the latest version of IAS 19.
- Some companies had not described the applicable regulatory framework for their pension schemes or described the effect of minimum funding requirements. This is particularly relevant when a company is unable to recover a pension surplus.
- Sensitivity analyses were not always given for all significant actuarial assumptions e.g. future pension increases.
- Maturity profiles for defined benefit obligations were not always given or bands were too broad to be useful.

Provisions, contingent liabilities and contingent assets

- We challenged poor disclosure of movements in provisions – additions should be disclosed separately from provisions utilised.
- We challenged when a company did not disclose a contingent liability because it believes it to be seriously prejudicial
- We asked for explanation when apparent contingent liabilities were discussed in the Strategic Report but relevant disclosures were not given in the financial statements.

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 where provisions had been aggregated with other payables.
- Relevant disclosures are required for each class of provision, contingent liability and contingent asset and include uncertainties relating to amount or timing.

Business combinations

- All identifiable assets, subject to qualifying conditions, are to be recognised separately from goodwill.
- We challenged where we did not see the separately recognised intangibles that we would have expected, eg: technology-related intangibles or customer/ brand intangibles.
- We challenged where a company had not identified that a transaction was a reverse-acquisition.
- We enquired where it was not clear whether contingent consideration was actually payments for the continuing services of employees.

Financial instruments

- We challenged whether ‘level 3’ disclosures of items measured at fair value were sufficiently detailed and robust and whether appropriate quantitative sensitivity information was prepared.

- We reminded companies that credit risk disclosures should cover all financial receivables and not just trade receivables, eg deferred consideration receivable.

Presentation of financial statements

- 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 challenged when the Statement of Other Comprehensive Income did not identify when OCI movements could be recycled to the income statement in the future.

Industry issues

Resource companies

- We challenged companies to explain how they applied industry specific terms, such as ‘full cost accounting’, to exploration and evaluation (‘E&E’) assets.
- We asked a company to expand its accounting policy for E&E assets to include the nature of costs capitalised.
- We challenged the use of straight-line depreciation for mine assets.

Companies Act

- We reminded quoted companies:
  - that paragraph 8(c) of Section 414 C of the Companies Act requires absolute numbers of employees of each sex at various levels within the company to be disclosed.
  - of the requirements in Schedule 7 of SI 2008/410 to disclose greenhouse gas emissions. We identified companies that did not disclose: an intensity ratio, the methodology used or total emissions in CO_2 equivalent.

Other

- We challenged classes of property, plant and equipment and intangibles which grouped together assets of dissimilar nature or use; eg, production assets versus assets under construction.

- A general description of leasing arrangements should be disclosed where material and relevant; eg, complex sale and purchase arrangements.