Corporate Reporting Review Briefing

A message from Carol Page, Director, Corporate Reporting Review ('CRR'[1])

This Briefing sets out CRR's current 'hot topics', many of which will be relevant to forthcoming 2018 interim reports. Most listed companies will adopt IFRS 9 'Financial Instruments' and IFRS 15 'Revenue from Contracts with Customers' in 2018. Their 2018 interim reports will be the first prepared under these new standards and, as we announced in November last year, we will be monitoring companies' disclosure of their effects.

However significant the impact of the new standards may be, existing reporting requirements should not be overlooked. This Briefing reminds preparers and auditors about our expectations in respect of the new standards and identifies other areas where our recent monitoring activity has identified room for improvement. We will also have a focus on the accounting for, and disclosure of, certain types of supplier financing arrangements in response to concerns expressed by stakeholders.

Particularly in the current environment, directors need to make objective judgements and not be overly influenced by a spirit of optimism. For that reason, we will consider the bases for directors' judgements and estimates when considering, for example, the forecast future cash flows underlying impairment calculations.

We hope that this Briefing is useful to preparers, and to auditors engaged to review their interim reports.

[1] CRR monitors the quality of corporate reporting in the UK and enforces compliance with accounting standards and relevant company law.

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New accounting standards

Companies about to issue their first interim reports under IFRSs 9 and 15 will be required to quantify and explain the effects of the new standards. They should consider the materiality of their impact when deciding the extent of their disclosures, which should be clear, concise, company-specific, and focus on the areas of change.

For banks applying IFRS 9, the key focus will be on impairment, where the information provided needs to be sufficient to allow users to understand the change from the model for key portfolios adopted in accordance with IAS 39 'Financial Instruments: Recognition and Measurement'. Non-financial services companies will need to consider the impact of the requirements on trade receivables - particularly if they have long-term balances, such as lease commitments, contract assets under IFRS 15 or intercompany receivables. Where they adopt the simplified approach, they will need to make clear how the lifetime expected credit losses have been determined.

Changes in revenue accounting policies required by IFRS 15 need to be fully explained with reference to performance obligations in order to improve the value content to users. Interim reports are now required to disaggregate revenue from contracts with customers, consistent with the full standard.

We expect directors to disclose significant judgements made in applying the new standards and to quantify and explain sources of estimation uncertainty. These may include:

- long-term contract accounting under IFRS 15, where companies need to consider the effects of bid and mobilisation costs, contract variations and retentions, and the judgements involved in allocating revenue to multiple-element contracts; and
- expected credit losses under IFRS 9.

The FRC will be conducting thematic reviews on the effects of implementation of both IFRS 9 and IFRS 15, based on selected companies' interim reports.

Topical issues

Supplier financing arrangements

Stakeholders have raised concerns around the accounting for, and disclosure of, certain types of supplier financing arrangements; for example, reverse factoring. These arrangements generally involve a company's suppliers being paid on its behalf by a financial provider. The liability to the provider is subsequently settled by the company. These arrangements may be a key component of companies' working capital management. Concerns have been raised about the transparency of these arrangements and whether the creditor and subsequent cash paid to the financial provider have been appropriately classified in the balance sheet and statement of cash flows, respectively.

IFRS 7 'Financial Instruments: Disclosures' requires companies' accounts to disclose information that allows readers to understand the nature of and risks around financial instruments, including liquidity risk. Companies' strategic reports are required to give a fair review of the company's business, including a balanced and comprehensive analysis of its position at the end of the year. We would expect these requirements to lead companies to disclose the nature of any material supplier financing arrangements, the implications for the company's liquidity and the relevant amounts. We would also expect any significant accounting judgements to be disclosed. Our press release on complex supplier arrangements[2], issued in December 2014, is also relevant to supplier financing.

The transparency of supplier finance arrangements will be an area of specific FRC focus during 2018.

Asset impairment

IAS 36 requires companies to assess at the end of each reporting period whether there is an indication that an asset may be impaired. This is in addition to the requirement to test annually cash generating units containing goodwill and indefinite lived assets. Examples of indicators of impairment include significant adverse changes in the technological, market, economic or legal environment in which entities operate, or where a company's market capitalisation falls below the carrying amount of its net assets. We will pay particular attention to the impairment disclosures of companies in the FRC's priority sectors[3] and market sectors where there have been a number of profit warnings and asset write-downs.

[2] https://www.frc.org.uk/news/december-2014/frc-urges-clarity-in-the-reporting-of-complex-supp
[3] https://www.frc.org.uk/news/november-2017/frc-announces-2018-19-thematic-reviews-to-stimulat

Issues identified by CRR's monitoring activities

Investors tell us that compliance with relevant reporting requirements is the solid foundation underpinning high quality corporate reporting. In the light of this, we highlight four areas identified by our recent monitoring activity.

First, we remind preparers and auditors that, when considering whether a matter is material, regard must be had to the amounts determined in accordance with IFRS, not just management's alternative performance measures.

Second, in the past year, we have asked several companies to refer to our correspondence in their report and accounts, following a restatement of their cash flow statement. We have previously expressed our concern whether companies are correctly classifying cash flows as arising from either their operating, investing or financing activities. Having seen some improvement in recent years, it is disappointing to see classification issues recurring. We remind companies that only activities resulting in a recognised asset on the balance sheet can be classified as investing activities[4]. Financing activities[5] are those that result in changes in the size and composition of the contributed equity and borrowings of an entity. Operating activities[6] are the company's principal revenue generating activities and other activities that are not investing or financing.

IAS 33 'Earnings per Share' ('EPS') explains[7] that, following a change in the number of a company's shares outstanding following a share split or consolidation, the prior year comparative EPS amounts should be restated using the new number of shares. We have identified companies where this IFRS requirement was not complied with, distorting EPS trends. We remind all companies, but particularly those who have undertaken capital reorganisations, to follow the specific requirements of IAS 33 when calculating EPS.

Finally, the FRC's 'Annual Review of Corporate Reporting 2016/17'[8] drew companies' attention to potential breaches of the Companies Act 2006 ('the Act') requirements for the payment of dividends. The Act requires individual company interim accounts to be filed with the Registrar before paying a dividend in excess of the distributable profits shown in the relevant accounts, which is usually the company's most recent audited accounts. We continue to see examples of companies that do not appear to have considered these requirements or that have identified the issue themselves and are considering, together with their professional advisors, how best to resolve the issue. We will continue to draw this matter to companies' attention when relevant.

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[4] IAS 7 'Statement of Cash Flows', paragraph 16
[5] IAS 7, paragraph 6
[6] IAS 7, paragraph 6
[7] IAS 33, paragraph 64
[8] https://www.frc.org.uk/getattachment/311af48c-bdfa-4484-8e7d-6de689fd8f4b/Corporate-reporting-SoN-FINAL.pdf