

## **Accounting and reporting framework for the construction and business support services sectors**

In the light of the collapse of Carillion, the Financial Reporting Council (FRC) reminds Boards of companies in the construction and business support services sectors of their reporting obligations. This guidance will also be relevant to other companies.

The annual report and accounts must provide sufficient, clear and relevant information, segmented between business lines where necessary.

Users must be able to:

- understand the company's performance, financial position and prospects;
- assess its going concern status; and
- assess its longer term viability.

The accounts must give a true and fair view of the assets, liabilities, financial position and profit or loss. The analysis presented in the strategic report must be fair, balanced and comprehensive. Boards of companies applying the UK Corporate Governance Code must ensure the annual report and accounts are fair, balanced and understandable.

These requirements require careful consideration of the content and clarity of the disclosures provided.

In November 2017, the FRC announced its priority sectors for 2018/19, including construction and business support services. Consequently our regular audit quality review, corporate reporting review and thematic activities for the period will encompass companies in this sector.

### **Going concern basis of accounting**

Directors must assess the company's ability to continue to adopt the going concern basis of accounting and disclose any material uncertainties. In doing so, the directors should consider all available information about potential outcomes of events, changes in conditions and the realistically possible responses that would be available to them.

Further guidance is provided in the FRC's *Risk Management, Internal Control and Related Financial and Business Reporting*<sup>1</sup>.

If directors decide that the going concern basis of accounting continues to be appropriate and that no material uncertainties need be disclosed, but that decision required the application of significant judgement, the Board should consider carefully whether further disclosure is needed to meet the requirements of paragraph 122 of IAS 1 *Presentation of Financial Statements*.

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<sup>1</sup> [FRC's Guidance on Risk Management, Internal Control and Related Financial and Business Reporting](#)

## **Strategic Report, risk and viability reporting**

The purpose of the Strategic Report is to inform members of the company and help them assess how the directors have performed their duty under section 172 of the Companies Act.<sup>2</sup>

Section 172 requires a director to act in the way considered most likely to promote the success of the company whilst having regard to the interests of stakeholders. These stakeholders include employees and proper consideration should be given to their interests and to those of members of the company pension scheme.

The Strategic Report must, by law, contain a fair, balanced and comprehensive analysis of the company's development, performance and financial position. This may include, for example, explanations of material sources of finance and how such sources have changed.

For a quoted company, the Strategic Report should include a description of the business model(s), setting out how it generates and preserves value over the longer term. This is supplemented by the key trends and factors affecting the business and the environment in which it operates.

In the construction and business service support sectors, this is likely to require an explanation of the factors that are most important to the outcome of key contracts, and thereby, the continued success of the company. Information on risks borne by the company, how these have changed and the risk appetite of the Board will also provide insight into the corporate culture.

The FRC's 2017 Annual Review of Corporate Reporting<sup>3</sup> highlighted the need for all companies to provide clear and detailed descriptions of their principal risks and uncertainties, and the judgements made by directors in their identification of these.

The Financial Reporting Lab's ("the Lab") report on risk and viability reporting<sup>4</sup> highlights that companies should also consider how the principal risks link to other parts of the annual report and accounts, in particular:

- the viability statement;
- business model;
- strategy;
- KPIs; and
- risk reporting in the financial statements.

The Lab's report also highlights the need to provide a good understanding of how management is addressing these risks.

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<sup>2</sup> Companies Act 2006, Section 414C

<sup>3</sup> [FRC Annual Review of Corporate Reporting 2016/17](#)

<sup>4</sup> [Lab report: Risk and viability reporting \(November 2017\)](#)

The report encourages Boards to enhance their disclosures supporting the viability statement. It suggests applying a two-stage approach to the viability statement:

- Firstly, the directors should assess the future prospects of the company taking into account its current position and risks.
- Secondly, they should state whether they have a reasonable expectation that the company will be able to continue to operate and meet its liabilities as they fall due over the period of that assessment, drawing attention to any qualification or assumptions as necessary.

The viability statement should be based on a robust assessment of those risks that would threaten the business model, future performance, solvency or liquidity of the company.

As explained in the FRC's *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting*<sup>5</sup>, stress and sensitivity analyses can aid an assessment of the business model's resilience to the operational and financial risks a company faces, especially where profit margins are small. Describing how principal risks have been tested and the range of assumptions considered gives greater insight into the company's resilience and its risk management processes. The 2016 issue of the FRC's *Developments in Corporate Governance and Stewardship* highlighted the need for more meaningful disclosures in this area.

### **Judgements and estimates applied in preparing the financial statements**

The measurement of revenue and recognition of profits over time is dependent on reliable estimates of contract outcomes. Effective systems and balanced judgement based on all current and relevant evidence are required when estimating the cost to complete long term contracts and future revenue streams from those contracts. This is especially important where significant risks (for example, demand risk, costs changes and contractual targets) are borne by the company.

Such judgements can have a material effect on a company's results. The FRC's recent thematic report on judgements and estimates sets out clear expectations on the disclosures required.

Users of the accounts rely on disclosure of the key judgements and estimates management make when preparing them. This helps them understand the impact of management's accounting policy decisions, the recoverability of assets recognised and the extent to which assets and liabilities may be subject to significant change over the following twelve months.

There are some situations where management may need to quantify the key assumptions underlying their estimates in order for users to understand the company's position and performance, and to facilitate intercompany comparison. We draw attention to paragraphs 125 to 133 of IAS 1 *Presentation of Financial Statements* on this matter.

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<sup>5</sup> [FRC's Guidance on Risk Management, Internal Control and Related Financial and Business Reporting](#)

Companies should consider the impact of IFRS 15 *Revenue from Contracts with Customers*, which is mandatory for years commencing on or after 1 January 2018. Where known or reasonably estimable, detailed quantitative disclosures of the effects of adopting the standard, with explanations of how accounting policies will change, should be provided in the last accounts before first time application. Whilst reporting on the implementation of IFRS 15, companies should consider the clarity and comprehensiveness of existing disclosures.

The impact of a company's judgement as to which costs can be capitalised and spread over the life of the contract and which costs should be expensed can be material. Clear articulation of the company's policy assists users of the accounts to understand the judgements being made.

Directors should ensure that there has been an assessment of any contingent liabilities arising from their contractual arrangements and that these are properly disclosed in the financial statements.

Boilerplate and generic disclosures should be avoided. Disclosures are improved by providing more granular information about a smaller set of judgements and estimates that had a significant impact on results, differentiating between business segments where necessary and explaining why certain assets were subject to significant risk of material change.

#### **Cash flow and net debt indicators**

As explained in our letter to Audit Committee Chairs and Financial Directors in October 2017, clear information on the levels of debt, cash flows and the conversion (including the processes of conversion, such as invoice discounting and reverse factoring) of operating profits into cash is also important.

Users have an interest in good quality net debt reconciliations that clearly identify cash and non-cash drivers of changes. We draw attention to the amendments to IAS 7 *Statement of Cash Flows* (effective for periods beginning on or after 1 January 2017) which require an explanation of changes in a company's financing obligations over the period.

It is sometimes unclear whether operating cash inflows recorded represent cash received from the customer/paid to the supplier or cash received from/paid to the third-party provider of these financial facilities. The new requirements provide an opportunity for companies to improve the clarity of their disclosures, particularly in those areas where investors have voiced disappointment; for example, on the disclosure of financing facilities such as invoice discounting and reverse factoring arrangements.

Lack of disclosure in this area, particularly in non-recourse arrangements where the customer receivables are derecognised, may hide reliance or changes in the reliance that a company has on such facilities. We strongly encourage companies to provide detail about, and explanation of their reliance upon, these facilities.

We draw attention to the disclosure requirements of IFRS 7 *Financial Instruments: Disclosures*, and in particular, the overall disclosure objectives on the significance of financial instruments (paragraph 7) and on the nature and extent of risks arising from financial instruments (paragraph 31).

## **Complex employee pension arrangements**

Within the business services support sectors, contracts can often include the transfer of staff from customers to the service provider. Where this leads to the transfer of defined pension obligations from multiple customers with differing schemes, the combined defined benefit obligations of the company can become complex, making it difficult for users to fully assess any associated risks and the company's ability to meet its obligations.

Boards are reminded of the disclosure requirements of IAS 19 and of the need to explain, in the strategic report, any principal risks and uncertainties identified with respect to its pension obligations.

## **The role of auditors**

The requirements on auditors in respect of going concern were last revised in June 2016, when the FRC issued enhanced requirements on auditors in respect of going concern.

Auditors are required to:

- report by exception on whether the going concern basis of accounting is appropriate and whether management have disclosed all identified material uncertainties in the annual report; and
- evaluate those disclosures when a material uncertainty exists, and, where those disclosures are adequate, report in a separate section of the auditor's report on the material uncertainty;

In situations where both the Board and the auditor has concluded that the going concern basis is appropriate and that there are no material uncertainties to be disclosed they must:

- evaluate whether disclosures are adequate;
- consider whether further disclosures are necessary for the accounts to give a true and fair view;
- determine whether a key audit matter should be included in the auditor's report to describe the work the auditor undertook in respect of going concern; and
- describe management's and the auditor's responsibilities in relation to going concern.

Auditors should understand the nature of each key long term contract and the pressures faced by management. They should obtain sufficient appropriate audit evidence to support and challenge the judgements and estimates reached on key long term contracts and clearly communicate their findings to the Audit Committee. They should challenge the related disclosures in the annual report and financial statements, including narrative disclosures, as to whether they comply with the requirements and provide useful information to users of the financial statements to help them to evaluate the company's performance and financial position.

The auditor's report is required to communicate key audit matters which are those issues the auditor considers were of most significance to the audit of the financial statements. These include the most significant assessed risks of material misstatement which have the greatest

impact on the overall audit strategy. The auditor should describe the work they undertook to address those risks, and, where relevant, their findings in respect of that work.

If the Board concludes that the going concern basis is appropriate and there are no material uncertainties to be disclosed, the auditor will determine whether that assessment is appropriate in the circumstances. The auditor should include in their report whether this was a key audit matter. Additionally, the auditor is required to report their audit findings to those charged with governance.

The audit of 2017 financial statements may already be underway. Auditors will need to remain alert to any events or conditions that may cast significant doubt on the company's ability to adopt the going concern basis of accounting throughout the audit. They should continue to revisit the appropriateness of their risk assessment and consider whether it needs to be revised to reflect the circumstances they find when carrying out their audit of the financial statements.

### **The role of Audit Committees**

The work of the Audit Committee helps investors have confidence that the annual report and financial statements can be relied upon for their decision making.

The Audit Committee's own report in the company's annual report should address how the Committee has satisfied itself as to the independence of the auditor, and how it challenged the auditor in order to determine the quality of the audit work carried out.

Where the auditor reports on risks in the auditor's report, the committee is also expected to set out what work it has carried out in respect of any significant financial reporting risks and judgements made in connection with the preparation of the financial statements. The Committee's report is also considered by the auditor, as part of their wider responsibilities in respect of the annual report, to determine whether it is consistent with the auditor's knowledge of the company obtained during the audit.

Given the particular nature of the construction and business support services sectors, auditors and Audit Committees should be robust and challenging of accounting policies, judgements and estimates, principal risks and uncertainties and management's assessment of whether it is appropriate to adopt the going concern basis of accounting.

Where any material uncertainties exist which need to be disclosed, or where the Directors have concluded that there are no material uncertainties, the significant judgements made by the Directors in reaching this conclusion must be disclosed.