



**ACCOUNTING STANDARDS BOARD**

**FINANCIAL CAPITAL MANAGEMENT DISCLOSURES**

**DECEMBER 2010**



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## Highlights

- Adequate capital and effective financial capital management underpin a robust business model better able to withstand significant adverse economic shocks and provide a platform for returns to investors.
- Investors and other stakeholders believe that an understanding of what an entity views as capital and its strategy for capital management is important to all companies and is not just a matter for banks and insurers subject to prudential regulation.
- Investors approach capital issues in a diverse manner as do management. Some focus on historical invested capital, others on accounting capital and others on market capitalisation. Some view capital in pure equity capital terms whilst others include longer term debt.
- Disclosures about capital and how it is managed are necessary for a balanced and comprehensive Business Review required by the Companies Act 2006. IFRS also contains specific disclosure requirements.
- A minority of companies whose annual reports were reviewed as part of this study provided an enlightened analysis that explained their financial capital resources and how it related to their strategy for growth, M&A, share buy backs and/or dividends.
- The majority of companies omitted or provided largely boilerplate information about financial capital in a manner that failed to convey meaningfully how they assess capital and how they manage it over the medium to long term. There are significant opportunities for improvement in reporting about capital.

## One – Introduction

The financial crisis has caused many to concentrate on cash and cash flow. Indeed the Financial Reporting Council (FRC) and its operating bodies supported this development by revising the guidance for directors and auditors about making going concern assessments. Liquidity difficulties can be triggered by insufficient financial capital, but sufficient financial capital is also essential as a foundation for growth. This study aims to encourage a better quality dialogue about capital through improvements in financial reporting.

Public debates about financial capital are generally associated with financial services businesses that are subject to explicit regulatory capital adequacy requirements. However, the need for adequate financial capital to help manage adverse economic events is not confined to financial services. Adequate financial capital is vital but may have been overlooked in importance in recent years when debt funding was often easily accessible.

There is no common definition of financial capital. Some define it solely in terms of equity held by shareholders whilst others include debt capital including items such as finance leases. Some measure capital and return on capital employed in terms of historical investments in the business whilst others look to current measures such as a market cap.

Corporate reporting and accounting standards require companies to explain what they see as capital, how it is managed and the key ratios and other quantitative data that they use to measure capital. Business review disclosures are required by the Companies Act 2006 (the Act) and explicit capital disclosures are required by International Financial Reporting Standards (IFRS). Disclosures about capital also feature in the Accounting Standards Board's (ASB) non-mandatory Reporting Statement on the Operating and Financial Review (OFR).

The Financial Reporting Review Panel (the Panel) reported in its 2010 activity report that some companies are omitting capital disclosures and that it had sought undertakings from them to make the necessary disclosures in their next annual reports and accounts. The Panel has also expressed concern about uninformative boilerplate disclosures.

This study was undertaken by the ASB in the latter part of 2010 and was based largely on published annual reports and accounts to 31 December 2009. Discussions were also held with investors and company treasurers to better understand what information about capital is likely to be particularly useful. The study seeks to identify the extent of the disclosures being made by companies, to draw attention to better practice that may be useful pointers for those drafting annual reports and accounts and to reduce the risk of additional boilerplate text being added in this area. The approach adopted in performing this study is set out in Appendix 1 and involved reviewing in detail the capital disclosures in the annual reports and accounts of 40 listed companies.

## Two – Market feedback

In order to better understand the market need for information about capital and how it is managed, a small number of meetings and interviews were held with company management (including company treasurers) and with selected investors during the mid and latter parts of 2010.

Discussions with investors suggest that they do take a keen interest in capital but do not currently make much use of disclosures about capital in annual reports and accounts, perhaps because, as the study shows, they are not always provided in an informative way.

Investors often have specific but different needs depending upon their valuation approach. For example, some investors told us that they base their valuations in part on forecast dividends and are interested in material constraints to the future growth in dividends that might be impacted by a shortage of capital. Others report that they use return on capital employed (some historical capital invested) as a key metric in comparing performance and thus need to understand how much historical capital is employed in the business and its nature.

Some investors flagged areas such as capital headroom as important, for example against banking covenants, and the availability of access to additional capital as useful information. Particularly at times when raising capital can be difficult or expensive, investors suggested that they want to know what cushion is available, and when and under what conditions additional capital might be required.

Treasurers told us that capital matters have risen significantly in importance in recent years, perhaps reflecting the lack of availability of some forms of debt capital given wholesale market conditions. They also reported diversity in practice as to what different companies see as capital and how it is managed.

This diversity of thinking about capital is perhaps no surprise given the diversity of businesses within the UK economy. Capital needs can be very specific to individual businesses. For example, capital levels are often influenced by planned M&A activity, whether there is a long term capital intensive investment cycle to develop new products or services and whether there is a heightened risk of loss. In current market conditions, it appears that the target level of equity capital is influenced particularly by a need to preserve debt ratings, protect covenant triggers and/or provide access to additional finance.

### Three – Business review disclosures

Companies that scored highly for their business review disclosures provided:

- An analysis of capital that was integrated into discussions about strategy, business model and the resources necessary to deliver on that strategy
- A discussion of different sorts of capital (equity, preference share, term loans, leases) and how they were used to manage the capital profile over time
- KPIs such as debt v equity ratios and return on capital.

#### *Disclosure requirements*

*Section 417 of the Companies Act 2006 (the Act) provides that the business review should include a fair review of the company's business and a description of the principal risks and uncertainties facing the company.*

*Section 417(4) provides that the review should be a balanced and comprehensive analysis of the development and performance of the business during the period and the position of the company at the end of the period, consistent with the size and complexity of the business.*

*Section 417(6) further provides that to the extent necessary for an understanding of the development, performance or position of the business, the business review should include an analysis using key performance indicators.*

There is no specific requirement to comment on capital in the Act, but it seems reasonable to conclude that no analysis of a company's financial position can be provided without consideration of how much capital it has and whether it is likely to be sufficient or insufficient for the company's needs.

*The Accounting Standards Board's (ASB) Reporting Statement on the Operating and Financial Review (OFR) comments that the OFR should contain a discussion of the capital structure of the entity.*

The ASB's Reporting Statement comments that this could include:

- The balance between equity and debt
- Maturity profile of debt
- Type of capital instruments used
- Currency and interest rate structure
- Comment on long term funding plans designed to implement business strategy
- Explanation of why the entity has adopted its particular capital structure.

## *Disclosures given*

The disclosures made by the 40 companies reviewed were classified as follows:

	Number of companies
Informative	8
Fairly informative	8
Slightly informative	13
Boilerplate	11
Missing	0
<b>Total</b>	<b>40</b>

The study approach and classification system is set out in Appendix 1.

There was significant variation in company comments about capital reflecting the diversity of UK listed companies and the quality of the narrative. The most informative disclosures linked capital to current issues such as debt renegotiation, dividend reductions and future dividend policy.

Given current economic circumstances it was no surprise that some companies commented upon a need for more and better quality capital to survive current conditions or support future growth. However, there was some evidence of a reduction in quality of capital as convertible debt seemed to be favoured by some companies. By contrast, two companies referred to plans for share buy backs revealing that some larger companies are notably cash and capital rich.

One FTSE 100 company described planned share buy backs and current year debt refinancing in the context of its planned business and funding strategy. Another flagged that the amount of what it termed financial net debt was, in fact, only a small part of its overall liabilities which included substantial store leases and pension liabilities and it provided information about how it managed all of these sources of capital.

One company that had suffered financial difficulties perhaps took matters to an extreme, flagging its successful capital management in the Chairman's statement and follow this with a detailed month by month description of the actions taken to raise cash and reschedule debt .

There was evidence of some companies helping readers of their accounts to think about the longer term. One company, for example, cautioned against reading too much into an increase in balance sheet strength which, it warned, was largely caused by foreign exchange movements.

Despite these positive examples, over a quarter of the business reviews contained no more than boilerplate statements, while others provided scant information such as a comment on short term dividend plans.

## Four – IFRS disclosures

Companies that scored highly for their IAS 1 disclosures provided:

- An analysis of capital that was linked to the amounts reported in the balance sheet and / or other notes for equity and debt instruments
- Explained their key policies for capital management such as target ratios including KPIs
- Explained their process for capital management including how often the policies were revisited, by whom and how performance was assessed.

The principal IAS 1 disclosures require:

### *4.1 Objectives, policies and processes for managing capital*

*IAS 1.134 requires a company to disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital.*

*IAS 1.135 explains that this objective is met by disclosing qualitative and quantitative data. The former should include narrative information such as what the company manages as capital, whether there are any external capital requirements and how those requirements are incorporated into the management of capital.*

### *Disclosures given*

The disclosures made by the 40 companies were classified as follows:

	Objectives	Policies and processes
Fairly informative	3	1
Slightly informative	11	7
Boilerplate	20	18
Missing	6	14
Total	40	40

The study approach and classification system is set in Appendix 1.

14 out of the 40 companies provided some useful information on their capital management objectives. The more informative disclosures commented on specific topics such as:

- maintaining an investment grade credit rating
- managing gearing to balance higher leverage with the advantages of a strong credit profile
- having enough capital to sustain future product development

- maintaining an optimal capital structure to balance financial flexibility and cost of capital
- reducing the cost of capital consistent with the entity's risk appetite.

Some companies discussed the process for and frequency of capital reviews and who was involved in the process.

Others pointed to key ratios used to evaluate capital. For example, one company disclosed that it used the ratio of net debt to EBITDA to assess the appropriateness of its capital structure.

A significant proportion of companies used boilerplate language and a number of seemingly unrelated companies used identical words for one or more sentences suggesting that they had copied from an illustrative example. For example a number stated that sufficient capital was needed to continue as a going concern but without elaboration.

#### ***4.2 A description and summary quantitative data of what is managed as capital***

*IAS 1.135 requires companies to provide qualitative and quantitative data about their financial capital. The latter should include summary data based on the information provided to key management personnel.*

The disclosures made by the 40 companies were classified as follows:

	Description of capital	Quantitative analysis of capital
Informative	2	1
Fairly informative	3	1
Slightly informative	14	6
Boilerplate	0	3
Appeared to be missing	21	29
Total	40	40

Disclosures were most helpful when they listed the various types of capital that were managed together. This provided the basis for the supporting narrative.

One company produced a useful table that helped frame its narrative (amounts have been changed for illustrative purposes):

	2009	2008
	£000	£000
Cash and cash equivalents	6,000	10,000
Bank loans	-	(8,000)
Finance leases	(100)	(100)
Loan notes outstanding	(600)	(1,000)
Equity attributable to equity holders of the parent	(95,000)	(90,000)
Total capital	(89,700)	(89,100)

Some companies also included in their definition of capital their undrawn balances of long term debt facilities. However, there was no supporting discussion of whether the resulting level of capital was to guard against a downturn or to manage uneven working capital requirements.

Specific numerical disclosures were not provided by over 70% of the companies, although all of them did provide balance sheet notes that addressed share capital and debt balances. It was not possible to determine if this was because their key management personnel do not receive regular quantitative information about capital and how it is managed, or whether the requirements had been missed.

#### ***4.3 Qualitative information on how the entity is meeting its objectives for managing capital***

*IAS 1.135 provides that a company should explain how it is meeting its objectives for managing capital.*

The disclosures made by the 40 companies were classified as follows:

	How capital is being managed to meet objectives
Fairly informative	3
Slightly informative	13
Boilerplate	11
Missing	13
Total	40

Particularly informative was one company which explained how it had moved to a net debt position in the year. The company then explained how it planned to reduce its level of

dependence on debt capital in the future referring to planned cost cutting measures, reduction of discretionary capital spend, suspension of dividend payments and plans to sell certain assets.

Those that provided more useful information discussed ratios and other measures used to monitor debt capital. However, companies commenting on earnings related capital measures could have provided an explanation of significant swings such as where there had been a material fall in earnings.

The cost of capital was quoted as a key measure by some companies. However, this was rarely supported by disclosure of any target cost of capital, nor the policy action being contemplated where the cost was showing signs of a material overshoot. Returns on capital, often cited by investors as a key metric, were often not discussed although ROCE was frequently named as a key performance indicator. Dividend policy also often escaped attention, even where companies were cutting dividends marking a significant break with the past.

Almost a third of the companies omitted any explanation about how their capital management objectives were being met. Boiler plate disclosures included the comment that '*consistent with others in the industry, the group monitors capital on the basis of the gearing ratio*'. This statement appeared in a number of sets of accounts spread over a variety of industries, but there was nothing to suggest that the gearing ratio was in fact used by the company or was a recognised industry specific measure.

#### **4.4 Disclosures about externally imposed capital requirements**

*IAS 1.135 requires disclosure of the nature of any externally imposed capital requirements and how they are incorporated into the management of capital. Confirmation is also required of whether the entity has complied with these requirements and, if not, the consequences of such non-compliance.*

The disclosures made by the 40 companies were classified as follows:

	External capital requirements
Fairly informative	2
Slightly informative	5
Boilerplate	12
Missing	6
Likely not applicable	15
Total	40

It was not always possible to identify where externally imposed capital requirements were present. Clearly, financial services businesses are subject to regulatory capital requirements, but other regulated businesses may also be subject to externally imposed capital requirements.

Further, there is some lack of clarity over whether in the UK the restrictions on dividends in the absence of distributable profits are caught by these provisions. Certainly, if dividend policy is constrained by an absence of distributable profits it seems logical that this should be addressed as it will be relevant to those investors that base their valuations, at least in part, on forecast dividend flows.

## **Appendix 1 - Study methodology**

The annual reports and accounts of 65 companies were selected across all market sectors. 25 companies appeared to have given no IAS 1 capital management disclosures at all. The annual reports and accounts of the residual 40 companies were then reviewed in more detail covering both the business review and the audited financial statements.

Disclosures required by the Act, IFRS and those recommended by the ASB's Reporting Statement on the OFR were then reviewed and assessed.

Narrative information was classified as informative if it was clear, concise and clearly linked to other disclosures in an effective and meaningful way.

Narrative information was classified as boilerplate if the text was largely uninformative and could have been (and often was) found in the accounts of an unrelated company.

Judgements were made when disclosures fell between these extremes in order to classify disclosures as fairly or slightly informative.



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