Corporate Reporting Review

Technical findings 2016/17

Executive Summary

- This presentation describes the accounting and corporate reporting issues commonly identified in the year ended March 2017.
- It supplements the wider discussion of the quality of corporate reporting in the UK in the ‘Annual Review of Corporate Reporting’.
- We believe compliance with the accounting framework in the UK remained generally good for the 2017 year.
- All matters reported in last year’s presentation remain relevant.

Most frequent areas of questioning

- Judgements & Estimates
- Strategic Report
- Accounting policies
- Business combinations
- Adjusting/ one-off/ exceptional or similarly described items Revenue
- Impairment of assets
- Financial Instruments: Disclosures
- Fair value measurement
- Cash flow statement

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Critical judgements

- We expect critical judgement disclosures to state explicitly what those judgements are and differentiate them from estimates.
- We challenged the disclosure of critical judgements where no further details of the judgements made were provided or it was unclear why the judgements were considered significant e.g. classification of joint venture arrangements.
- We queried lack of disclosure of the judgements needed to understand how management applied its most significant accounting policies,e.g.:
  - whether a debt refinancing was a modification or extinguishment;
  - the accounting for a complex property transaction;
  - the recoverability of a disputed VAT receivable; and
  - whether a transaction was a lease.

Estimation uncertainty

- Some companies provided only generic disclosures, or did not disclose the relevant amounts or other useful information, such as sensitivities.
- We questioned disclosures of estimation uncertainty that did not:
  - quantify or indicate the range of estimation uncertainty, e.g.;
    - Inventory provisions;
    - the recoverability of deferred production stock;
    - uncertain tax provisions; and
    - complex supplier arrangements.
  - explain what element of a balance was subject to estimation uncertainty and what was not;
  - distinguish estimation uncertainty from judgements made; and
  - make it clear whether there was a significant risk of a material adjustment within the next financial year as a result of the estimation uncertainty.

Strategic Report: Business Reviews

- Companies should provide a fair review of the business that is balanced and comprehensive (Section 414C of CA 2006).
- In considering this we took into account whether alternative performance measures were disclosed in a manner consistent with the ESMA Guidelines on Alternative Performance Measures.
- We challenged companies where the review did not appear appropriately balanced, most commonly in relation to non-IFRS / adjusted performance measures, e.g.:
  - insufficient discussion of the IFRS audited numbers;
  - not clear that the results discussed were not the audited IFRS numbers;
  - incomplete explanation of why alternative measures used;
  - unclear how adjusted measures reconcile to the audited IFRS numbers; and
  - discussion mainly based on pro-forma results.

Strategic Report: Business Reviews

- We challenged companies where the review did not discuss all relevant aspects of performance, e.g.:
  - insufficient description and commentary on a major source of revenue;
  - movement in underlying operating margin not adequately explained; and
  - segment EBITDA not discussed.

- We challenged the comprehensiveness of the review of financial position, e.g.:
  - movements in working capital not adequately explained; and
  - limited discussion of financial position and cash flow (smaller companies).

Strategic Report: Other

- We have continued to challenge the reporting of principal risks and uncertainties (PRUs) including where:
  - the description of the PRUs was unclear or insufficiently detailed;
  - only one PRU was disclosed; and
  - the judgements made by the directors in determining the reported PRUs were unclear such as risks relating to climate change in an oil and gas company.
- We questioned the basis on which some disclosed key performance indicators had been calculated where this was unclear.

Accounting policies

- We questioned:
  - Lack of, or unclear policies for transactions or balances that were material to the business, e.g.:
    - allocation and recognition of site wide infrastructure costs by a housebuilder;
    - basis for policy on licence fees relating to investment properties under construction unclear;
    - policy for warranty provision unclear;
    - uncertain tax positions; and
    - contingent consideration on business combinations linked to future employment.
  - Accounting policies that had not been updated for new standards, such as IFRS 10 and IAS 19 (revised).
- We expect companies to replace boilerplate statements lifted from accounting standards with tailored, relevant disclosures.

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Accounting policies

- Consistent with 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;
  - unnecessary repetition of accounting policy descriptions and other narrative; e.g. separate policies for impairment of goodwill and of indefinite-lived intangible assets; and
  - boilerplate or irrelevant disclosures of the impact of new accounting standards that are not yet effective.

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Business combinations

- All identifiable assets, subject to qualifying conditions, should be recognised separately from goodwill.
- We challenged:
  - where we did not see the separately recognised intangibles that we would have expected, e.g. customer/ brand intangibles, favourable leases; and
  - whether deferred revenue liabilities reflected the fair value of the obligations.

Business combinations

- We challenged when a business combination appeared to be an asset acquisition. We asked for the difference between the two to be described more clearly.
- We queried when only aggregated disclosures were given where some individual acquisitions appeared to be material.
- We questioned the inclusion within consideration of contingent payments linked to post combination employment.

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Adjusting/ one-off/ exceptional or similarly described items

- We expect companies to explain their accounting policy for identifying such items.
- We questioned companies that did not adequately explain why items were separately identified.
- We challenged companies:
  - where the items identified appeared inconsistent with the accounting policy, e.g. the policy referred to non recurring items but the items were recurring, e.g. restructuring;
  - who did not include non-recurring credits in their exceptional items, e.g. one-off tax credits; and
  - who did not provide reconciliations of adjusted measures.

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Revenue

- We challenged companies whose accounting policies are 'boilerplate' and insufficiently tailored to all the significant revenue streams in their business model.
- We continued to challenge companies that did not explain:
  - their application of the percentage of completion model to long-term contracts;
  - how revenue was recognised for separately identifiable components of a customer contract and any related judgements;
  - when the risks and rewards transfer to the customer on sales made through distributors; and
  - the circumstances in which the company acts as a principal or agent.

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Impairment of assets

- Discount rate(s) should reflect current market assessments of time value of money and asset-specific risks. Pre-tax rate(s) should be disclosed.
- 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.
- We questioned disclosures of wide ranging assumptions covering multiple cash generating units.

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Impairment of assets

- 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 disclosures where:
  - no explanation was provided of why the discount rate used was significantly changed from the prior year;
  - sensitivity analysis did not include numerical disclosures; and
  - the assumptions used were unclear, e.g.:
    - the extent to which mineral resources and reserves were included in the calculation of recoverable amount for a natural resources company; and
    - the operational asset lives assumed.

Financial instruments

- Financial instrument disclosures should be sufficient to understand the risks the company faces. We identified instances where:
  - the descriptions of the risk classes and disclosure of the loan impairment process were generic or unclear;
  - Companies Act disclosures of off-balance sheet arrangements relating to ‘own use’ contracts were insufficient;
  - there was insufficient explanation of why amounts payable were accounted for as a contingent liability rather than as a financial liability;
  - the explanation of cash flow hedging was incorrect;
  - no maturity analysis was provided for significant accrued income receivable considered to be a financial asset; and
  - assessment of credit risk not explained for short term balances.

Fair value measurement

- We questioned instances where it was unclear whether the fair value of contingent consideration for an acquisition had been re-measured at the year-end reporting date.
- We challenged companies where it was unclear how the requirements of IFRS 13 had been addressed, e.g.:
  - the valuation techniques used;
  - incomplete or no disclosure of significant unobservable inputs or sensitivities; and
  - the basis for the categorisation of investments into the three levels of the fair value hierarchy, e.g. where the categorisation appeared inconsistent with the description of the investments.

Cash flow statements

- We commonly question the classification of items between 'operating', 'investing' and 'financing' activities.
- We queried the classification of cash flows as 'investing' (rather than 'operating') relating to:
  - revenue producing activities such as the purchase of media rights licensed to customers; and
  - acquisition expenses charged to operating profit.
- Cash flows relating to transactions with shareholders, such as the acquisition of a non controlling interest, should be classified as 'financing' rather than investing.
- We challenged the classification as 'operating' (rather than 'financing') movements in factoring balances included as borrowings on the balance sheet.
- Any restrictions over cash should be clearly explained.

Other common areas of questioning

- Income taxes
- Pensions
- Capital management
- Presentation of financial statements
- Consolidation
- Related parties
- Dividend payments
- Other

Income taxes

- ‘Corporate Reporting Thematic Review – Tax Disclosures’, issued in October 2016, sets out our detailed findings from the follow up of our Press Notice – ‘FRC calls for transparent disclosure of tax risks in corporate reports’.
- Additionally we challenged companies where:
  - the description of reconciling items in the effective tax rate reconciliation was unclear or appeared inappropriate, e.g. reversal of timing differences in a reconciliation of the total tax charge;
  - uncertain tax positions were not quantified or explained; and
  - the nature of evidence supporting recognition of deferred tax assets was not disclosed.

Pensions

- We asked companies to explain:
    - their basis for recognising a pension surplus as an asset including whether its recoverability was dependent on trustees future actions;
    - how the fair value of scheme assets had been determined, e.g. where there was no quoted market price; and
    - unusual contribution arrangements, e.g. contributions contingent on the level of inflation.

Capital management

- We have seen improvements in the narrative disclosures and quantitative information.
- However, we continue to see boilerplate capital management policies or unclear explanations, e.g.:
  - incomplete disclosures of objectives, policies and processes for managing capital;
  - unclear what was meant by reference to possible future ‘technical breach of covenants’; and
  - the strategic report indicated that the company was subject to regulation in various jurisdictions but did not refer to any capital requirements.

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Presentation of financial statements

- We continue to challenge 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. This is particularly relevant to companies with long-term contracts where revenue recognition is a critical judgement.
- We also questioned:
  - material finance income and costs shown net in the income statement; and
  - where disclosure of balance sheet amounts expected to be recovered after more than one year was omitted such as in relation to inventory recoverable over ten years.

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Consolidation

- We have a continuing focus on whether companies should consolidate investments based on ‘de facto’ control.
- We challenged the non consolidation of entities and related disclosures, e.g.:
    - wholly owned Special Purpose Vehicle where the company was also general partner and investment manager; and
    - significant equity interests held by investment manager.

Related parties

- We questioned lack of, or unclear, disclosures of transactions or balances required by IAS 24, e.g.:
  - incomplete disclosure of loan balances, impairment provisions, rental and other service agreements with joint venture companies;
  - unclear how the parties referred to in the disclosure are related to the company; and
  - members of the executive management team who were not directors should also have been included as Key Management Personnel.
- We reminded a company of the disclosure requirements of the Listing Rules in respect of a controlling shareholder's relationship agreement with the company.

Dividend payments

- We observed that the payment of dividends in excess of the parent company's reported retained profit reserve may not have been made in accordance with the Companies Act requirements for distributions.
- Two companies acknowledged these requirements were not met and have taken steps to rectify the matter.

Other

- Other matters brought to the attention of companies included reminders that:
  - non disclosure of supplier arrangements due to commercial sensitivity is not acceptable;
  - IAS 38 requires details of individually material intangible assets to be disclosed;
  - tax deductions on share-based payments in excess of the accounting charge are required to be taken to equity rather than the income statement; and
  - the disclosure of the amount of inventory charged to cost of sales should include attributable rebates and discounts.