FRC

Financial Reporting Council

An update for directors of listed companies:

responding to heightened country and currency risk in interim financial reports

June 2012

Executive Summary

This Update for Directors has been prompted by the continuing economic uncertainties facing a number of countries around the world. This Update draws together a number of significant issues directors may need to consider in preparing interim reports in the context of heightened economic uncertainty. These include, where relevant:

- The company's exposure to country risk, direct or to the extent practical indirect[1], through financial instruments, through foreign operations, and through exposure to trading counterparties (customers and suppliers);
- The impact of austerity measures being adopted in a number of countries on the company's forecasts, impairment testing, going concern considerations, etc.;
- The possible consequences of currency events that are not factored into forecasts but may affect reported exposures and the sensitivity testing of impairment or going concern considerations; and
- Post balance sheet date events that require enhanced disclosures to adequately inform investors and other users.

The examples referred to in this Update are not intended to be comprehensive but to help directors and Audit Committees in their thinking about the relevance of these issues to the company's particular circumstances. This Update does not deal with directors' more general obligations to keep the market informed.

This Update follows one issued on 17 January 2012 in advance of the main Annual Reporting season. Subsequently the FRC has seen a number of good practices in the reporting of country and currency risks in subsequent Annual Reports (see for example the Vodafone 2012 Annual Report, p53[2]).

Introduction

The purpose of this Update is to draw directors' attention to the importance of conveying in their Interim Reports a balanced and understandable assessment of a company's position and prospects in the context of heightened country and currency risk. In particular, it identifies in the Appendix some of the more significant interim reporting requirements that Directors of Listed Companies may consider if a company has a material exposure to country and currency risk.

Country and currency risks have been significant in the last year. The possibility of a country leaving the Eurozone has persisted, as have the widespread challenges to growth in many of the world's economies. The outcome of these events remains uncertain. However, the austerity measures being widely adopted in Europe appear to be already dampening growth rates and demand globally as well as in the EU.

1. Given the current economic uncertainties, companies may not be able to assess all indirect exposures. In such circumstances, it should identify such indirect exposures to the extent it is practical to do so.

2 Vodafone Annual Report can be found here http://www.vodafone.com/content/dam/vodafone/investors/annual_reports/Vodafone_Annual_Report_12.pdf

These conditions may give rise to delays or other defaults on contracts with customers and other trading partners or counterparties exposed to, or based in, countries experiencing difficulties, and may affect expectations of future business volumes and margins. The impact on supply chains may also be particularly critical for some companies.

The high volatility in prices in the commodity markets is another source of risk.

Analysts and investors will pay particular attention to disclosures about these risks in interim reports given the very high level of uncertainty about further developments. Thus, it is particularly important that directors focus sufficient attention on the relevant strategic, operational and financial risks facing their companies and that they make clear the nature and scope of their direct and, to the extent practical, indirect exposures to these country and currency risks. A statement that certain risks are absent or not significant is also helpful.

Interim reports are an opportunity for directors to explain how risks are managed so that markets do not misunderstand exposures. Clear explanation of relevant material risks and how management is mitigating them will enable markets to be kept up to date as further developments arise. It is important to avoid boilerplate and focus on company specific issues.

Particular care should be taken with segmental disclosures. IAS34, paragraph 16A sets out the required disclosure for segments in interim reports, as users may use these to quantify risk in the absence of other information.

The various reporting and disclosure requirements derive from different sources and may often appear in different parts of an interim report. However, it may be helpful to investors and other users if they are brought together in one section of an interim report so that all of the effects and risks of the current uncertainties can be more easily understood.

Audit committees are likely to need a detailed understanding of country and currency risks facing the business in order to review whether there are material risks and the reported level of mitigation actions taken. For material exposures they are likely to want a full understanding of how those risks have been identified, assessed and managed, their impact on the reported level of assets and liabilities and how sensitive those amounts are to reasonably possible changes in the estimates and assumptions used by management when preparing the interim report.

APPENDIX

REQUIREMENTS FOR INTERIM REPORTS

Overall position

The Corporate Governance Code requires that the board present a balanced and understandable assessment of the company's position and prospects in the Interim Report.

Going concern and principal risks and uncertainties

The Listing Rules require a description of the principal risks and uncertainties for the remaining six months of the financial year. The Financial Reporting Review Panel of the FRC has indicated that this requirement is not met by a bullet point list of risks. If the risks and uncertainties are the same as those disclosed in the directors' report at the end of the previous financial year, a cross reference to that report will only satisfy the requirement if it is accompanied by a summary of the relevant key risks and uncertainties.

The IFRS requirement for directors to make an assessment of the entity's ability to continue as a going concern [IAS1.25-26] also applies to interim financial statements. Going concern and principal risks and uncertainties change over time as a business develops and as the business environment changes. Thus these disclosures need to be revisited when preparing each set of annual or interim report and accounts.

Directors may wish to read the report by Lord Sharman on going concern which was published on 13 June 2012 and is available on the FRC web site.

Where a company is significantly exposed to increased country and currency risks, Directors may need to enhance their disclosures in this area including how these risks are mitigated. For example, a company that has significant balances outstanding or contractual relationships with the public or private sector in a country in severe financial difficulties (and/or implementing austerity measures) will likely need to disclose that fact and indicate the future events that could impact on amounts outstanding and future trading volumes. In such instances, consideration will also need to be given to additional disclosures such as the key assumptions made by management as part of the going concern assessment.

In assessing a company's liquidity risk, reliance on bank facilities, or the expected renewal of loans, from banks in countries where banks are facing solvency or liquidity pressures will particularly need to be revisited.

The opportunity should also be taken to look at the disclosures in aggregate to ensure that risks which have become less relevant are reduced or removed from the report.

Potential impairment of non-financial assets

IAS36 contains specific requirements to test non-financial assets for impairment. In relation to goodwill and intangibles which are not amortised, they must be tested at least on an annual basis. Other non-financial assets should be tested whenever there is an indication of impairment.

A material exposure to adverse developments in country and currency risks where an entity has a material exposure is likely to trigger an impairment assessment at each annual and interim reporting date. For example, a company that sells most of its output in a country implementing austerity measures which cause significant changes in the market environment is likely to need to consider whether the property, plant and equipment is impaired given the potential impact of those measures on growth rates, consumer spending, etc. This may be particularly the case where the company's customer is the public sector.

IFRS provides specific procedures to be undertaken when assessing whether there is an indication that a non-financial asset has been impaired and how to measure the non-financial asset. The most likely approach is to make a best estimate of future cash flows and to discount these cash flows at the rate that would be required at the balance sheet date by an investor.

Potential impairment of financial assets

IAS39.58 also contains specific requirements for impairment assessments of financial assets. Specific impairment calculations should be made depending upon the classification of the financial asset.

Impairment losses need to be determined on a case by case basis reflecting the specific facts and circumstances. The fact that government debts have already been provided against would not necessarily mean that all debts due from companies in that country should be provided against, but it is likely that an impairment assessment would be warranted. For example, UK banks have already recognised impairment charges against loans to the Greek Government but that does not mean that all Greek corporate debt requires an impairment charge (although it may be subject to risks). Further, in light of the decline in the equity markets, consideration should be given to whether there has been a significant or prolonged decline in fair value below cost of equities classified as available for sale.

Disclosures concerning financial assets and liabilities

IAS 34 sets out guidance and suggested disclosures for interim reports, including "changes in the business or economic circumstances that affect the fair value of the entity's financial assets and financial liabilities, whether those assets or liabilities are recognised at fair value or amortised cost" (IAS 34.15B(h).

Post balance sheet events

In the current economic uncertainty events after the interim date could well have an important effect on the interim financial statements, if they are adjusting events, or at least require adequate disclosure.

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