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Quarterly Financial Reporting Brief

January 2019

The final quarter of 2018 has seen new international developments in areas such as business combinations, fair value measurement, share- based payment and materiality, while there has been continuing momentum in relation to the new standards for 2018. There have been significant reports issued by enforcers at both the European and Member State levels. Sustainability accounting made a major move forward and corporate governance for large private companies was also an area of significant development.

The International Accounting Standards Board (IASB) has published amendments to IFRS 3 'Business Combinations', the conclusions drawn from its post-implementation review of IFRS 13 'Fair Value Measurement, a report on the complexities of IFRS 2 'Share-based Payment' and a statement on the definition of Materiality. The IASB has tentatively decided to deter the effective date of IFRS 17 'Insurance' to periods beginning on or after 1 January 2022.

The new reporting standards applicable in 2018 were subject to further comment and developments, particularly IFRS 9: 'Financial Instruments', with the European Financial Reporting Advisory Group (EFRAG) and the UK Financial Reporting Council (FRC), amongst others, being engaged in the process. The European Banking Authority has carried out its first post-implementation review of IFRS 9.

The European Securities and Markets Authority (ESMA) has published a statement setting out its enforcement priorities relevant for the examination of listed companies 2018 financial statements. Enforcers in Member States have similarly issued statements with the FRC writing an open letter to relevant parties and, in September, the Irish Auditing and Accounting Supervisory Authority (IAASA) publishing its 'Observations' document.

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The FRC, either directly or through its Lab, has also published guidance documents on reporting by smaller companies, performance metrics, business model reporting and the auditors' work on the 'front end' of company reports. The FRC has also launched a major project on The Future of Corporate Reporting. On corporate governance, the FRC has published a new Code for the Governance of Large Private Companies, setting out six key principles.

IAASA has been very active during the quarter, publishing selected financial reporting decisions and reports based on desk top reviews of business combinations, bank covenants and corporate taxes and revenue. The European Commission has adopted proposals for a single electronic reporting format.

This Brief comments on financial reporting and legal/regulatory developments during the final quarter of 2018.

International Accounting and Related Developments

Amendments to IFRS 3: Business Combinations

The IASB has issued 'Definition of a Business (Amendments to IFRS 3)' making narrow scope amendments aimed at resolving the difficulties that arise when an entity determines whether it has acquired a business or a group of assets.

The amendments clarify a number of accounting matters including that to be considered a business, an acquired set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. Guidance and illustrative examples are added to help entities assess whether a substantive process has been acquired.

The amendments are effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2020.

IFRS 13: post-implementation review

The IASB has completed its post-implementation review (PIR) of IFRS 13 'Fair Value Measurement'. The report concludes that the information required is useful to users of financial statements. Some areas of IFRS 13 present implementation challenges, largely in areas requiring judgement. However, evidence suggests that practice is developing to resolve these challenges. No unexpected costs have arisen from application of IFRS 13. Thus, the Board concluded that the standard works as intended. The Board will continue liaising with the valuation profession, monitor new developments in practice and promote knowledge development and sharing.

IASB share-based payment research project

The IASB has issued 'Share-based Payment — Research on Sources of Accounting Complexity', which summarises the work performed and conclusions reached in the share-based payment research project.

The research project identified two main sources of complexity and, thus, of requests for interpretations - the variety and complexity of terms and conditions of share-based payments; and some features of the grant-date fair value measurement model used by IFRS 2 for share-based payments settled in shares or share options.

Definition of material

The IASB has issued 'Definition of Material (Amendments to IAS 1 and IAS 8)' to clarify the definition of 'material' and to align the definition used in the Conceptual Framework and the standards themselves. Three aspects of the new definition should especially be noted:

Obscuring: The existing definition only focused on omitting or misstating information, however, the Board concluded that obscuring material information with information that can be omitted can have a similar effect

Could reasonably be expected to influence: The existing definition referred to 'could influence' which the Board felt might be understood as requiring too much information as almost anything 'could' influence the decisions of some users even if the possibility is remote.

Primary users: The existing definition referred only to 'users' which again the Board feared might be understood too broadly as requiring preparers to consider all possible users of financial statements when deciding what information to disclose

IFRS 9 – equity instruments

EFRAG has published its final response to the EC request to investigate the potential effects on long-term investments in equity instruments of the requirements of IFRS 9. The response is supportive of an impairment model similar to that currently used in IAS 39. EFRAG maintains that a degree of rigour in the use of the impairment model is essential to ensure comparability.

Expected credit loss disclosures

A report from the task force comprised of three UK regulators, including the FRC, sets out the principles of the expected credit loss disclosures of IFRS 9, as well as considerations applicable to all the recommended disclosures in respect of the scope, timing, frequency, location and granularity. It also summarises what the taskforce views as the most important considerations regarding expected credit losses and explains the related disclosures, why they matter to users, and sets out a series of specific disclosure recommendations.

The report acknowledges some of the recommendations are difficult and may require a number of years to be implemented, building on the requirements of both IFRS 7 and IFRS 9.

IFRS 9 – Post-Implementation Review

The European Banking Authority has carried out its first review scrutinizing the implementation of IFRS 9 to provide preliminary observations. The most notable feature is to firm up on indications of increased loan loss provisions. Monitoring of IFRS 9 is just beginning and it will need to be reviewed through time.

IFRS 9 and IFRS 15 company disclosures

The FRC has published reports on two thematic reviews carried out to analyse the disclosures in a sample of companies' June 2018 interim reports in relation to the adoption of the new standards and provide examples of better practice in explaining their effect.

The FRC's review identified a number of areas where disclosure could be improved especially with respect to explanations of the impact of adoption of IFRS 15. It highlights that the best disclosures were those that were specific to the company and that provided additional detail for the benefit of providing a relevant and robust explanation of the impact of IFRS 15.

The main impact of IFRS 9 will be felt by banks and the FRC thematic review focused on the adequacy of disclosures regarding the effect of the transition to IFRS 9 in the first year of adoption. The FRC review highlights some areas where disclosure could be improved and some areas where no disclosure had been provided at all. In particular, the FRC highlights that some smaller banks did not sufficiently explain the impact of adopting IFRS 9.

Financial Instruments Valuation Standards Board

The new Board of the International Valuation Standards Council (IVSC) includes representatives of international banks, prudential regulators, valuation and accounting firms. It will begin work to develop international standards in early 2019.

Deferral of IFRS 17 effective date

The IASB has tentatively decided to defer the effective date of IFRS 17 'Insurance Contracts' to annual periods beginning on or after 1 January 2022, and will be continuing to explore potential amendments.

EFRAG – FICE bulletins

EFRAG has issued two bulletins to help constituents better understand the IASB's discussion paper DP/2018/1 'Financial Instruments with Characteristics of Equity' and participate in the debate on it - (1) the classification criteria included in the DP, and (2) the presentation and disclosure requirements included in the DP.

Responses to the EC fitness check

Stakeholders from 23 EU Member States and 25 third countries (among them stakeholders from Australia, Canada, China, Japan, South Africa, and the United States) submitted 338 responses to the consultation. The majority of respondents, both EU and outside the EU, are satisfied that the framework for public reporting works well as it brings added value, is coherent, effective and relevant for achieving its intended objectives.

The status quo is supported as regards the EU IFRS endorsement process and almost all cautioned strongly against "carve-ins" and "carve-outs" that could lead to "EU-IFRSs'.

ESMA enforcement priorities

ESMA considers the following key topics to be especially relevant for the examinations of listed companies' 2018 financial statements:

- application for the first time of IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers*,
- disclosure of the implementation and expected impact of IFRS 16 *Leases*

In addition, this year's priorities highlight the requirements to disclose non-financial information, with a focus on environmental matters, and specific aspects of ESMA's Guidelines on Alternative Performance Measures.

SASB standards

The SASB has issued the world's first set of industry-specific sustainability accounting standards covering financially material issues in 77 industries. The standards aim at providing investors with in-depth information about the impact of a company's actions on society and the environment. The SASB standards can be used alongside other sustainability frameworks, are well-aligned with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and are complementary to the Global Reporting Initiative (GRI).

Ireland and UK – New Developments

Improved quality reporting

In an open letter to Finance Directors and Audit Committee Chairs, the FRC has called for improvements in key areas of corporate reporting, including key accounting judgements and estimates, eliminating basic errors and how companies have applied the Principles of the UK Corporate Governance Code.

The letter draws on findings from the FRC's work on corporate governance and corporate reporting in the Annual Review of Corporate Governance and Reporting, it also refers to topical areas of reporting, including the UK's exit from the EU.

Key findings of the corporate reporting review include:

- judgements and estimate disclosures
- cash flow statement
- the use of alternative performance measures and whether strategic reports are fair, balanced and comprehensive
- viability statements to be enhanced to show more clearly how companies have assessed their prospects and viability.

Key findings of the corporate governance review include:

- Reporting on how companies have applied the Principles in the Code has been inadequately covered due to an excessive reliance on compliance with the provisions
- Companies remain reluctant to explain clearly when they don't comply with Code provisions, the quality of explanations is disappointing.

Reporting by smaller companies

Smaller companies should provide more specific disclosures of significant accounting judgements and more quantitative information on key sources of estimation uncertainty according to a new report by the FRC - Reporting by Smaller Listed and AIM Quoted Companies.

The FRC reviewed the reports and accounts of 40 smaller listed and AIM quoted companies to consider:

- Alternative performance measures (APMs) and strategic reports
- Pension disclosures
- Accounting policies, including critical judgements and estimates
- Tax disclosures
- Cash flow statements

Performance metrics

The Financial Reporting Lab (The Lab) has published guidance for companies on the presentation of performance metrics in their reporting following calls for clarity from investors.

While some examples of better reporting have been identified in reviews carried out during the year, investors continue to emphasise the importance of applying the principles when companies are preparing their metrics.

Companies are, in many cases, addressing expectations but do not always report on this clearly. Investors want performance metrics to be aligned to strategy, transparent, in context, reliable and consistent.

Business Model Reporting

Investors are still looking for companies to make business model, risk and viability disclosures more useful, according to a new report from the FRC Lab.

The report considers how reporting practice has changed since the Lab published its original reports in 2016 and 2017, and includes practical examples from companies that have implemented the recommendations. Investors continue to emphasise the need for reporting to be more consistent and clearly linked throughout a company's annual report.

Sources and uses of cash

The FRC Lab is calling for investors and companies of all sizes to participate in a new project to consider how reporting on the location, nature and availability of cash within a group, as well as future uses of cash, can be presented in a way that is most useful to investor decision-making. The closing date is 15 January 2019.

'Front end' of company reports

Auditors' work on the information in the front end of company reports outside of the financial statements does not meet the requirements of Auditing Standards consistently, according to a new report from the FRC on the quality and consistency of auditors work on Other Information in the Annual Report. The FRC expects auditors to

- Place greater emphasis on their review of key non-financial information
- Increase their scepticism and pay more attention to the completeness of information, particularly in relation to principal risk disclosures and their linkage to Viability Statements
- Require Boards to prepare, on a timely basis, appropriate documentation to support key areas of the OI such as the Viability Statement

The Future of Corporate Reporting

The FRC has launched a major project to challenge existing thinking about corporate reporting and consider how companies should better meet the information needs of shareholders and other stakeholders.

The FRC will review current financial and non-financial reporting practices, consider what information investors and other stakeholders require and fundamentally, the purpose of corporate reporting and the annual report. The different types of corporate communications produced by companies will also be examined.

A thought leadership paper will be published in 2019.

Governance of Large Private Companies

A new Code for the Governance of Large Private Companies has been launched, providing a framework to help them not only meet legal requirements but to promote long term success. The Wates Principles encourage companies to adopt a set of key behaviours to secure trust and confidence among stakeholders and benefit the economy and society in general. These Principles are part of a number of changes made this year to the UK corporate governance framework.

The six principles are:

- Purpose and Leadership – An effective board develops and promotes the purpose, values and culture of a company
- Board Composition - Effective board composition requires an effective chair and a balanced board.
- Board Responsibilities - The board of directors should have a clear understanding of their accountability and responsibilities.
- Opportunity and Risk - A board should promote the long-term sustainable success of the company by identifying opportunities
- Remuneration - A board should promote executive remuneration structures aligned to long-term sustainable success
- Stakeholder Relationships and Engagement - Directors should foster effective and aligned stakeholder relationships

Reporting against these principles will take effect for years beginning on or after 1 January 2019.

FRS 102: FRC staff factsheets

The FRC has published a suite of staff factsheets on aspects of FRS 102, including the 2017 triennial review and transition. The factsheets are intended to assist stakeholders by highlighting certain requirements of FRS 102. These include specific factsheets on cash flows, financial instruments, business combinations and property fair value.

Limited Liability Partnerships

The Consultative Committee of Accountancy Bodies (CCAB) has published a revised Statement of Recommended Practice (SORP) for UK limited liability partnerships.
The changes to the previous SORP mainly arise from the revisions made to FRS 102 in the triennial review including guidance on cash flow statements, revised recognition rules for intangible assets and guidance on merger accounting.

Legal and Regulatory Developments

IAASA - Financial reporting decisions and guidance

IAASA has published selected financial reporting decisions regarding the accounting treatments applied by a debt issuer and three equity issuers on topics which included financial instruments, business combinations and related party disclosures. IAASA has also published reports based on desk-top reviews:

Revenue - The IAASA review shows that many companies failed to provide complete information on their revenue disclosures in the 2018 half-yearly accounts, examples of which are as follows:
(a) seven companies did not explain the timing of their revenue recognition
(b) eight companies did not explain the nature and effect of the change in their revenue recognition accounting policy following the adoption of IFRS 15
(c) nine companies did not provide a description of the criteria applied to determine when control passes to the customer;
(d) six companies did not refer to the disaggregation of the revenue in their half-yearly accounts, while others did not appear to adequately disclose.

Business Combinations - many companies fail to provide complete information on their acquisitions in the annual accounts. The IAASA desk-top review identified, inter alia:

- provisional accounting of acquisitions by companies, without final disclosures
- absence of disclosures:
    - estimates made at the acquisition date
    - the amount of acquisition-related costs
    - basis for the contingent consideration payment
    - valuation techniques

Bank covenants - a number of companies did not disclose a description of their covenants or how they measured against them, including:

- the rationale for not disclosing a description of the covenants imposed by the company's lender
- non-disclosure of the calculation of the covenants per the lending agreement
- non-disclosure of the penalties in the event of a bank covenant being breached, and the reporting disclosures required by accounting standards.

Corporate taxes - The IAASA review reveals that for almost 2 in every 3 companies selected, corporate income taxes were a principal risk and uncertainty and a source of estimation uncertainty. Macro-economic factors and other events such as Brexit, US tax reform and OECD initiatives related to base erosion and profit shifting (BEPS) can hugely impact companies' tax exposure.

The survey provides IAASA's observations on the disclosure of the effective tax rate, the tax reconciliation disclosed in the notes to the annual accounts, and the disclosure of uncertain tax positions (UTPs).

ESEF Regulation

The European Commission has adopted the ESMA draft for a single European electronic reporting format (ESEF) as Delegated Regulation. This regulation is to be applied to annual financial reports containing financial statements for financial years beginning on or after 1 January 2020. The taxonomy to be used builds on the IFRS Taxonomy developed by the IFRS Foundation.

Contact Us

Our firm's website, www.iasplus.com, provides a world-leading continuously updated information source on international financial reporting developments and includes a link to our freely accessible IFRS eLearning programme, and a focused subsite, UK Accounting Plus.

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