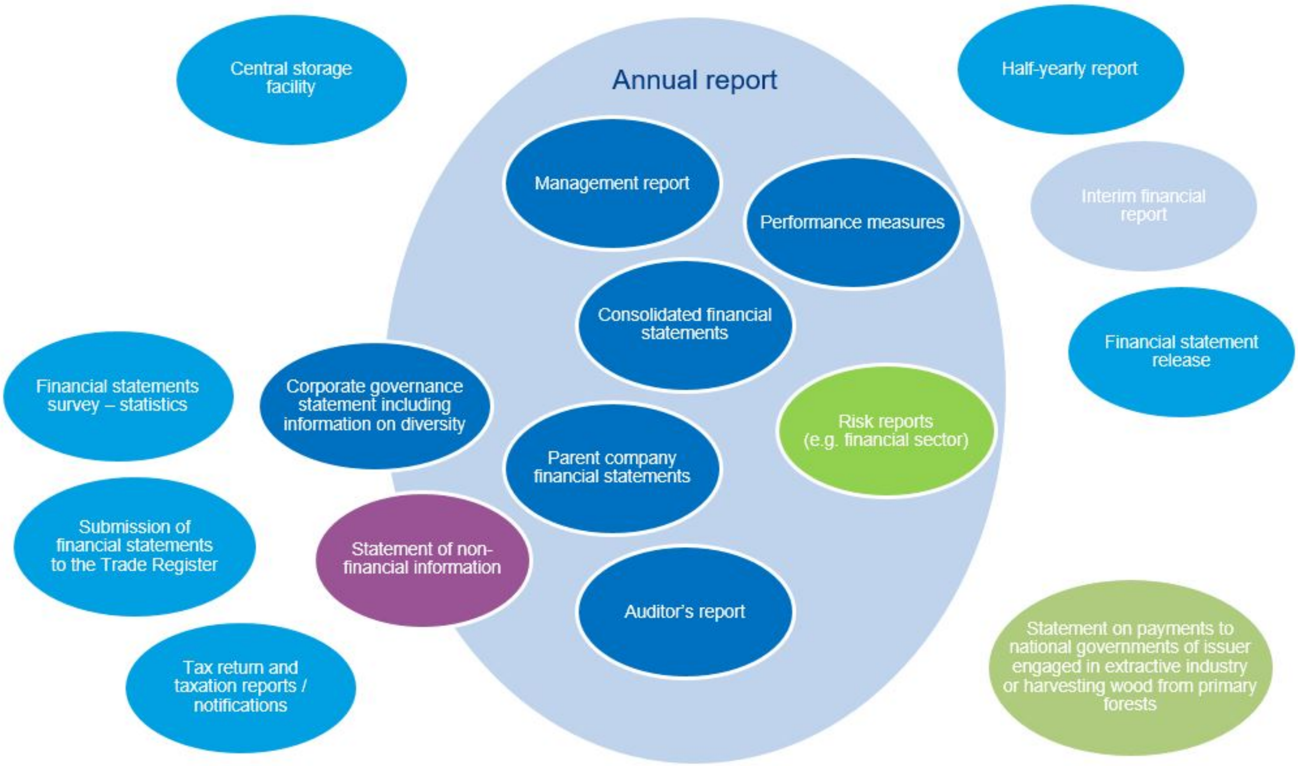
Content

Enforcer’s observations on listed companies’ annual reports

In recent years, listed companies’ financial reporting obligations have increased or changed. For example, large public interest entities must, provide a statement of non-financial information under the Accounting Act. Performance measure presentation practices, moreover, have been affected by the Guidelines on Alternative Performance Measures, published by the European Securities and Markets Authority (ESMA). In addition, an amendment to the Accounting Act (29.12.2016/1376) separated the financial statements and the management report into independent documents, and this has impacted the auditor’s work.

Listed companies publish annual reports on a voluntary basis. As the form of the annual report is not regulated by law, a company may decide on the layout of the publication. The content and structure of the annual report are influenced, however, by legislative changes relating to regulated information. Financial reporting as a whole (Figure 1) has evolved into a challenging undertaking also from the perspective of preparing annual reports.

Figure 1 Listed companies' financial reporting – a challenging undertaking



Financial Supervisory Authority reviewed listed companies' annual reports

In early 2018, the Financial Supervisory Authority (FIN-FSA) reviewed listed companies' annual reports for 2016 and 2017 and analysed their presentation and structure. One objective was to ascertain how listed companies had separated parts of the annual reports from each other as a result of changes in the Accounting Act and Auditing Act whereby the management report is no longer subject to auditing. A further objective was to examine the presentation of performance measures in financial statements.

The review covered 10 non-financial sector companies, of which five were large and five small. In addition, nine Finnish groups or conglomerates operating in the financial sector were subjects of the review. The presentation of performance measures was assessed more widely than this sample. For the sake of comparison, the FIN-FSA also reviewed annual reports of foreign listed companies and banks.

Financial statements, management report and other information must be separated in annual reports

The FIN-FSA observed various presentation styles and solutions. The number of annual report sections and their titling varied. In the case of a few of the companies reviewed, the annual report structure consisted of five sections, which were strategy, corporate sustainability, corporate governance, management report and financial statements. One company had 13 annual report sections.

The most common shortcoming in presentation related to the separation of the audited financial statements, management report and other information. In 2016, half of the companies reviewed presented management report information under the title ‘Financial statements’ and/or labelled the corresponding side or top banners illogically. In their tables of contents, many companies have included the management report within the financial statements and have mentioned at the top of the management report pages that it belongs to the financial statements. In the 2017 annual reports, the portion of companies doing this has fallen to a third. In the FIN-FSA’s view, the number is still too high.

In addition, the FIN-FSA found that in 2016 nine listed companies among the sample had presented alternative performance measures in the financial statements section of the annual report, even though, according to the companies, they belonged to the management report or other information. This information is unaudited.

The auditor’s work and reporting differ with regard to the financial statements, management report and other information. From the perspective of the auditor’s auditing work, the management report is “other information” but, with regard to reporting, further obligations have been imposed to address the conformity of the information with financial statements information as well as compliance with rules governing management reports. This should also be clearly reflected in the structure and labelling of the annual report. Readers of an annual report should be given a true picture of how each section of the annual report has been the subject of the auditor’s work. To the reader, the broader work of the auditor means improved reliability of the information.

Great variation around Europe in presenting performance measures in IFRS income statements

The FIN-FSA extensively reviewed the application of ESMA’s Guidelines on Alternative Performance Measures, and published the results in a Market newsletter in December 2017. The review generated a large number of observations. A key issue in the presentation of alternative performance measures is how companies handle performance measures in their financial statements. From the beginning of 2016, the changes in IFRS regulation relating to balance sheet and income statement items have affected the presentation of performance measures in financial statements. For this reason, the FIN-FSA undertook a review of performance measure practices with regard to the income statements.

The FIN-FSA urges companies to apply ESMA’s Guidelines and IAS 1 with care. Developing best practices in the presentation of performance measures is not simple, as obligations from a number of different sources must be complied with. In terms of implementation, however, companies have a range of options which, if successfully selected, can provide readers with clear and useful information without jeopardising the fulfilment of regulatory requirements.

Adjusted performance measures reviewed

In accordance with IAS 1.85, the income statement shall present items, headings and subtotals not expressly specified or designated by the standard when such presentation is relevant to the understanding of the entity’s financial performance. When an entity presents subtotals, they must fulfil the requirements of IAS 1.85A and IAS 1.85B. Subtotals such as EBITDA or operating profit/EBIT are, as such, unambiguous and can be clearly calculated on the basis of other unadjusted items of the income statement. In assessing fulfilment of requirements, the FIN-FSA examined, in particular, so-called adjusted performance measures. By ‘adjusted performance measure’ the FIN-FSA means performance measures/subtotals such as comparable or adjusted operating profit.

In the financial statements of Finnish companies for 2017, only five companies presented adjusted performance measures within the income statement or additional information that was adjusted on the primary financial statement page. The FIN-FSA also scanned the primary financial statements of several hundred foreign companies. Presentation of adjusted performance measures in the income statement is not unusual in Europe. In some countries, this is more common than in others. Country-specific practices were identifiable in the presentation of adjusted performance measures.

European enforcers addressed the topic in their meetings during 2018. The enforcers are concerned that the extensive use of adjusted performance measures will impair the comparability of income statements between companies, because companies themselves determine the accounting policies of the adjusted items as well as the actual items to be adjusted. The enforcers consider that the management approach included in segment reporting regulation as well as alternative performance measures outside the financial statements provide adequate opportunities to describe company-specific characteristics.

More attention should be paid to the IFRS regulation on presentation of subtotals

The enforcers pay particular attention to IAS 1.85A(b), according to which income statement subtotals must be presented and labelled in a manner that make the line items that constitute the subtotal clear and understandable. When adjusted performance measures/subtotals are presented in the primary financial statement and when the adjustments consist of a number of different types of items attributed to different lines of the income statement, then the requirements of the standard are, in practice, rather difficult to fulfil. The FIN-FSA also found that the so-called column mode of presentation, which in principle fulfils the requirements of the standard, is quite widely used in the UK.[1] However, presentation using columns is uncommon in Finland and may appear complicated to the reader.

Presentation challenges are also associated with labelling. On reading the primary financial statement, the reader should easily be able to understand the nature of the adjusted performance measure, namely what type of items have been adjusted in it and what the adjusted performance measure substantively describes compared with the unadjusted performance measure. The enforcers consider that IAS 1.85A(b) is not fulfilled if labelling is too general in nature. Particular attention should therefore be paid to the labelling of performance measures if adjusted performance measures are presented in the income statement.

In some cases, additional information was presented in income statements as separate lines (e.g. adjusted EBIT) that are not, however, taken into account in the calculation of all subtotals. In other words, the income statement in these cases does not run computationally from top to bottom, if the extra lines of additional information are included in the calculation. The enforcers consider that the requirements of IAS 1.85A(b) are not fulfilled if, in respect of unadjusted subtotals presented below the additional lines, it is not easy to perceive of which items a subtotal is constituted. The enforcers consider that the manner of presentation of lines of additional information could be developed so that the lines fulfil the requirements by separating the additional lines, for example visually, from the regular lines of the primary financial statement. In that case, there are grounds to consider, however, whether this would impair the clarity and readability of the primary financial statements.

[1] *The primary financial statement presents three columns per financial period: unadjusted measure, adjustments and adjusted measure.*

The enforcers also drew attention to IAS 1.85A(d), which prohibits the presentation of other subtotals with more prominence than IFRS-defined measures. The presentation of adjusted performance measures or additional information in the primary financial statement or in connection with it may result in them being presented contrary to the standard with more prominence than IFRS-defined measures.

Non-IFRS information – capital adequacy information of financial sector companies

Seven Finnish groups or conglomerates included in the sample presented capital adequacy information, i.e. Pillar III information in the IFRS consolidated financial statements. All of the foreign banks included in the review published on their websites a separate Pillar III report, which expressly mentioned that the report was not audited.

The FIN-FSA draws companies' attention to the fact that the IFRS financial statements should, in principle, only present IFRS information. Disclosures relating to segment reporting (IFRS 8) and capital management (IAS 1) are, among others, the items of the financial statements where presentation of non-IFRS-based information is most relevant. The regulatory basis for capital adequacy information is not based on IFRSs, so it should not, in principle, be presented within the financial statements. Providing additional information in the financial statements may, however, be based on assessments according to IAS 1.17(c). Additional disclosures may be provided when information complying with specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

The discussions of European enforcers have emphasised the fact that information presented within the financial statements must be audited. In the case of capital adequacy information that may be presented in the financial statements (for example capital management disclosures), a practical problem may also arise where capital adequacy information may not have been audited in the manner required by ISAs.

Statement on non-financial information alongside voluntary corporate social responsibility reports

The amendment of the Accounting Act requires large public interest entities to report non-financial information for financial year 2017 onwards. Entities may provide a statement on non-financial information as part of the management report or as a separate report. Most of the companies in the review disclosed the information in the management report.

The key difference between voluntarily corporate social responsibility reports and non-financial information statements is that the latter must be signed by the Board of Directors. It is the auditor's duty to verify that a statement of non-financial information has been provided and to report on these in certain situations. These requirements also affected the selected reporting methods.

Many of the companies in the review also published a separate report alongside the annual report. The most common separate report was a corporate social responsibility report on financial, social and environmental responsibility. Of these companies, 60% published an online corporate social responsibility report for 2016 and 70% for 2017. All of the foreign companies included in the review published a voluntary corporate social responsibility report on their websites.

Annual report structure highlighted by graphical means

Readers of annual reports wish to find the information they are searching for quickly and in an understandable form. It must be easy for them to gain an overall impression of the report and readily browse through it. The more extensive the annual report, the more important is the role played by various visually distinctive graphical means.

The review revealed that the use of colours, footnotes and edge banners is a good way of communicating to the reader the different sections of the annual report and, among other things, the external assurance associated with them. Various markings help readers form a clear picture of the section of the annual report they are examining and at the same time the level of assurance provided by the external auditor to the information in question.

At best, a few of the companies included in the review marked the section of the annual report in detail on every page. To facilitate reading, these companies indicated at the top or bottom of the pages, in addition to edge banners, precisely what topic was being dealt with in each section. In this way, the readers were constantly aware of what section of the annual report they were reading, what topic it concerned, and what items were still to come.

A good 40% of the companies reviewed mentioned the annual report structure only in the table of contents and in section headings.

Functionality of online annual reports must be safeguarded

All of the companies in the sample published an online annual report, in addition to which half of the companies published a printed annual report. The FIN-FSA found that many companies favour PDF-format files in their online versions. Some of them were not user-friendly, however: the document was difficult to browse, and the search function did not find the desired information. The PDF file of a few companies even closed automatically when the reader tried to print the file or search the annual report for information using a single word.

The number of pages of annual reports has grown significantly in recent years and it is therefore sensible to utilise new technology in online annual reports. Technically well implemented online annual reports include, for example, interactive PDF documents in which it is easy to move from one section to another using top navigation.

A few of the companies reviewed had added a table of contents at the start of every section of the annual report; by clicking a subsection it was possible to move directly to the desired page and to continue reading quickly using arrow functions. Through reader-friendly solutions, companies can ensure that the online annual report is easy to read, increasing the likelihood that the message will reach its readership.

For further information, please contact

Tiina Visakorpi, Head of Division, tel. +358 9 183 5383.