# Considerations for Semi-annual Financial Reporting 2012

## Supervision of Financial Reporting

June 2012

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# The Netherlands Authority for the Financial Markets

The AFM promotes fairness and transparency within financial markets.
We are the independent supervisory authority for the savings, lending, investment and insurance markets. The AFM promotes the conscientious provision of financial services to consumers and supervises the honest and efficient operation of the capital markets. Our aim is to improve consumers' and the business sector's confidence in the financial markets, both in the Netherlands and abroad.
In performing this task the AFM contributes to the prosperity and economic reputation of the Netherlands.

# 1 Summary

This year, the Netherlands Authority for the Financial Markets (AFM) publishes for the first time specific considerations for the semi-annual financial reporting. This is resulting from the conducted desktop reviews of the semi-annual financial reporting 2011 and a further analysis of the findings. In this context, several interviews took place with analysts, significant users of semi-annual financial reporting. In general, the AFM has the impression that the semi-annual financial reporting has improved further in relation to the previous years. Furthermore, findings are included from the review of the disclosure on pensions in the financial reporting 2011.

There is room for improvement in a number of areas. This concerns in particular the following disclosures:

a. Principal risks and uncertainties
b. Outlook
c. Business combinations
d. Highly cyclical revenue

Companies appear to give not a true view in their financial reports 2011 regarding the quantitative consequences of the implementation of the new standard on pensions on 1 January 2013. That is why the AFM also sees room for improvement on the following subject:

e. Pensions

The first four points for improvement will be further explained in paragraph 3 and the final one in paragraph 4. The AFM expects that companies will make use of these points for improvement when preparing their semi-annual financial reporting for 2012.

If you have any specific questions or concerns following this publication you should contact the Financial Reporting Supervision Division at fin.verslaggeving@afm.nl or on +31 (0)20-7973721.

## 2 Introduction

The AFM supervises both the annual and semi-annual financial reporting. The activity report of the AFM on the supervisory year 2011[1] includes some of the findings from the semi-annual financial reporting. In order to help companies preparing their semi-annual financial reporting the AFM publishes the considerations to which it will pay specific attention in its assessment of the semi-annual financial reporting 2012.
In 2012, the AFM will publish the following specific findings regarding the supervision of financial reporting:

- End of July: results of the thematic review 'Valuation of and transparency of sovereign debt and other investments with nation risk'
- Begin of September: announcement thematic reviews 2013
- End of September: preliminary findings desktop reviews and thematic reviews financial year 2012 supervision AFM
- End of October: final results of other thematic reviews 2012
- December 2012 / January 2013: activity report 2012

[1] *http://www.afm.nl/~/media/Files/fin-verslag/2011/activity-report-2011.ashx*

# 3 Findings

**Disclosures seem to have improved further**

Based on the findings from the reviews of the semi-annual financial reporting 2011 the AFM has the impression that the disclosures have improved further in relation to the previous years. Transparency in the semi-annual financial reporting 2011 has improved and as a consequence the provision of information to the investors. In some areas, however, there is room for improvement as previously reported by the AFM[2].

**What needs attention and what can be improved?**

**Disclosure of principal risks and uncertainties**

A good understanding of risks and uncertainties is relevant, particularly in these uncertain times. The notes to the financial statements should include the principal risks and uncertainties. This will put the figures in the (semi-annual) financial reporting in perspective.

The AFM has established that only a small part of the companies reviewed has included a description of the risks and uncertainties in their semi-annual financial reporting. A large majority of the companies refer to the risk section in their most recently published financial report or do not include any information at all. Particularly, when during the publication of the semi-annual financial report new relevant information or developments regarding risk control would become available, attention should be paid to newly identified risks which are not yet included in the financial report and/or specified risks which have become more or less probable for the company. These may include the impact on the company of the debt crisis and euro crisis, the economic situation, the availability of raw materials and relevant political developments.

**Disclosure of outlook**

It is not mandatory to include outlook in the semi-annual financial reporting. A limited number of companies provide information in their semi-annual report 2011 on expected growth, revenue and earnings before interest, taxes, depreciation and amortization (EBITDA). Outlook represents expected growth or decline in relation to the previous periods. In a few cases, outlook is represented as a specific amount.

Several companies describe the expected impact of the current economic uncertainties. These uncertainties, however, are often a reason for companies not to provide any further information on outlook at all. The question is whether this reflex is appropriate in a time when there should be a need for disclosing uncertainties regarding outlook. Users of semi-annual financial reporting indicate that outlook to them, although not mandatory, is a very relevant part of the (semi-annual) financial reporting.

[2] *http://www.afm.nl/en/professionals/afm-actueel/rapporten/2010/halfjaarlijkse-fin-verslaggeving.aspx*

Companies who will satisfy the investor's need for information could provide information on certain reference points for the rest of the financial year, such as minimum or maximum level of, for example, revenue, costs, gross margin (absolute or in percentage), EBIT(DA), cash flows, debt levels and/or bank covenants.

**Business combinations**

In general, the disclosure regarding (material) business combinations has improved. The name of the acquiree, the percentage of voting equity interests acquired, the acquisition date, the purchase price and how control was obtained is included in the (semi-annual) financial reporting in all cases where acquisition was involved. The disclosure of the primary reasons for the business combination, the revenue and results since the acquisition date as recognised in the consolidated income statement and the description of what information could not be disclosed (and the reason) still needs to be improved. In more than half of the cases this information was not or only partially disclosed.

For more detailed findings regarding business combinations please refer to our 'Thematic Review Business Combinations (IFRS 3R)' [3] which was published in October 2011.

**Disclosure of highly cyclical revenue**

Companies should disclose the seasonal or cyclical character of their business activities. A company should include a statement regarding the seasonality of its revenue. The large majority of the companies adequately disclose this information.

Furthermore, according to IAS 34, companies are encouraged in case of highly seasonal influences to disclose additional information on the impact of these influences on the primary statements. Only a small number of companies actually includes this information. Although improvements have been made in relation to 2009, when none of the companies involved disclosed this information, further improvements are needed.

[3] *http://www.afm.nl/~/media/Files/fin-verslag/2011/engels/thematic-review-fv-business-combinations.ashx*

# 4 Consequences of the implementation of the revised standard on pensions as from 2013

**Introduction**

In Chapter 6 of the 'Considerations for Financial Reporting 2011'[4], the AFM emphasises the correct application of IAS 8.30 in case the revised standard on pensions (IAS 19R), which was published in June 2011 and will become effective on 1 January 2013, has not been applied early by companies. The AFM expects that the implementation of IAS 19R will have impact on the financial statements. This is a result of (i) the mandatory implementation of the full recognition of actuarial gains and losses in other comprehensive income, (ii) the introduction of net interest on net liabilities (assets) and (iii) the possible change in the classification of the defined benefit plan. In that case, IAS 8.30 requires that companies estimate the consequences for the financial statements of the future implementation of IFRS standards, which are published by the International Accounting Standards Board (IASB), but are not yet effective.

Given that the consequences for companies with one or more so-called defined benefit plans will be the most profound, the AFM has assessed to what extent the required disclosures are included in the financial statements 2011 of these companies, whose shares are listed on the NYSE Euronext and who are under the AFM's supervision. The review included 69 companies. At the end of 2011, the total defined benefit obligations of these companies amounted to approximately €125 billion and the total plan assets amounted to approximately €116 billion. The total amount of unrecognised actuarial losses amounted to approximately €4.8 billion against approximately €0.5 billion of unrecognised actuarial gains.

*Approximately two thirds of the companies reviewed do not or inadequately disclose the consequences of IAS 19R*

The review carried out by the AFM shows that the quality of the disclosures of the consequences of the implementation of IAS 19R varies widely. The table below provides a summary of the results.

| Disclosure of the consequences of IAS 19R | Percentage companies reviewed |
|---|---|
| Clearly quantitative disclosure of both equity and result | 6% |
| Clearly quantitative disclosure of equity or result only | 26% |
| Qualitative disclosure only | 25% |
| Disclosure is not included and/or disclosure does not give additional information regarding quantitative and/or qualitative consequences for the company | 43% |

[4] http://www.afm.nl/layouts/afm/default.aspx~/media/files/rapport/2011/eng-aandachtspunten-fv-2011.ashx

The AFM and its European colleagues are of the opinion that it is not sufficient for companies just to give a qualitative disclosure. Companies can often make a reasonably reliable estimation of the consequences for the financial statements. Qualitative disclosures will not enable investors to make a clear estimation of the impact of the new or revised standard. It is hard to understand for the AFM that reporting companies cannot give a quantitative estimation of the consequences of the implementation of IAS 19R, because the necessary information such as the recognised actuarial gains and losses, the unrecognised actuarial gains and losses, interest costs, expected return on plan assets and the net liability (net asset) can usually be assumed to be known within the company. An exception can be made for companies where the consequences of risk sharing and/or the calculation of the liability cap can be material. The AFM understands that at present the consequences of the implementation of the revised standard, is not completely clear.

If companies are not transparent in their semi-annual financial reporting this can be interpreted as a token of the fact that the impact is not material. However, this can also mean ‘a calm before the storm’, as we have established that the quantitative impact for companies who have been transparent is relatively large, also in view of the combination of defined benefits combined with prolonged underfunding.

*The consequences of a revised or new standard must also be disclosed in case the standard has not been endorsed yet*

The AFM understands that some preparers of financial reporting are of the opinion that the in IAS 8.30 required disclosures should not be included until the European Commission has endorsed the new or revised standard. The Accounting Regulatory Committee (ARC), the political authority which advises the European Commission on the endorsement of financial reporting standards, has voted in favour of the adoption of IAS 19R on 7 December 2011. On 5 June 2012, the endorsement was made official.

The question rises whether it is necessary to wait for the endorsement of new or revised standards before the in IAS 8.30 required disclosures must be included. During a recent European Enforcement Coordination Session (EECS) organised by the European Securities and Markets Authority (ESMA), European supervisors discussed this matter[5]. After careful reading, the European supervisors share the opinion that whether the new or revised standard is endorsed or not, this does <u>not</u> justify not to include the in IAS 8.30 required disclosures. The European Commission does not set or amend financial reporting standards, but limits itself to the endorsement of international financial reporting standards issued by the IASB. The endorsement of these standards makes them also become effective within the European Union. In addition, IAS 8.30 does not distinguish between standards which have been endorsed or not. Comparability of financial reporting has been a decisive reason for the implementation of international financial reporting standards. It is hard to explain when European companies

[5] *This decision is expected to be published by ESMA as part of an Extract from the EECS’ database of Enforcement, in the course of this year*

consistently fail to keep up with being transparent about the impact of new and/or revised standards.

*The AFM encourages companies to be as transparent as possible towards investors in their semi-annual financial reporting 2012 regarding the quantitative consequences of the implementation of IAS 19R*

The AFM encourages companies who have not yet been or have not adequately been transparent in their annual financial reporting 2011 regarding the quantitative consequences of the implementation of IAS 19R, to be transparent in their semi-annual financial reporting 2012, also in view of the recent endorsement of IAS 19R.

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