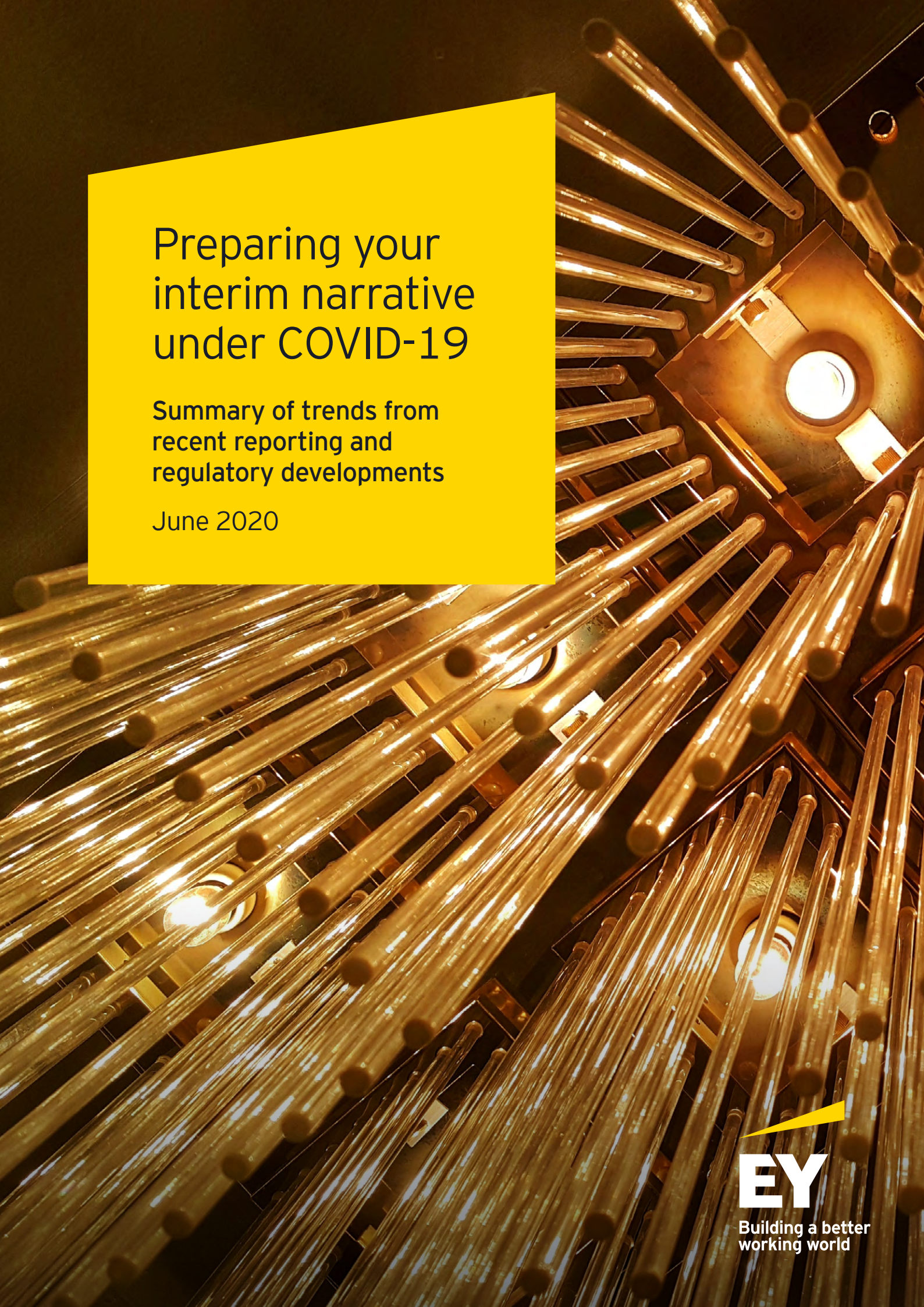
Preparing your interim narrative under COVID-19

Summary of trends from recent reporting and regulatory developments

June 2020



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Contents

This paper provides an overview of the trends in interim (or half-yearly) reporting based on a review of a sample of interim reports of UK issuers with a 31 March period end. In the appendix we have also summarised the key regulatory requirements governing interim reporting for UK premium listed entities. In light of COVID-19, both the European Securities and Markets Authority (ESMA) and the Financial Reporting Council (FRC) have issued updated guidance on interim reporting and corporate reporting more broadly. Investors and their representative organisations have also outlined their expectations and information needs. We provide an overview of all of these where relevant.

Together with our COVID-19 acid test, this paper will be useful to companies who are due to issue their interim reports soon.

As of June 2020, the full impact of the pandemic is still unfolding and, given it is lasting longer than initially thought, boards and management will continue to have to make difficult decisions in the coming months to manage its impact. Many of the actions taken now will have long lasting implications on the operating models and strategies of companies, on their culture, as well as on companies' stakeholders. This makes good communication and reporting about the risks, the decisions and actions taken, and the governance exercised by the directors extremely important in the context of building trust with all stakeholders.

A Overview

We have noted an increasing trend towards the narrative in interim reports becoming closer to disclosures traditionally seen only in annual reports and accounts (ARAs) – both in terms of the level of detail as well as the breadth of topics covered. This is especially true of disclosures relating to how companies are realising their purpose and having regard for their stakeholders.

Some companies have assessed their trading performance as better than expected. In trading updates they have announced that, where possible to do so, they intend to repay the government subsidies claimed to cover the period of uncertainty or bring forward the settlement of tax deferrals. In our view this throws the gauntlet down to challenge others in a similar position to follow suit and report on this at the half year.

The going concern narrative has also begun to mirror viability statements – often setting out several scenarios, detailing the stress testing performed, and the mitigating actions being considered. Reporting on principal risks has also evolved to provide an analysis of the impact of COVID-19 on previously identified risks as well as, in many cases, the inclusion of a new pandemic-related risk.

In our view, it will become increasingly important to discuss how boards have ensured that a company's control environment remains effective. This is exacerbated by remote working as well as the fact that controls which may have been relied on historically may no longer be effective – for example, if internal audit's scope has been restricted/limited due to the pandemic. While there is no explicit requirement to include such disclosure in interim reports, and neither have we seen such disclosures in interim results published to date, it may become more relevant, especially as the situation is lasting longer than many first expected.

There is no legal or regulatory requirement for external auditors to perform interim reviews. However, feedback received by the FRC from investors indicates that such a review provides valuable assurance, and this may be particularly so in the current environment.

With all this in mind, and to achieve meaningful communication and reporting, where necessary, companies should take advantage of the temporary one-month extension to publish their interim results as announced by the Financial Conduct Authority on 27 May 2020.

EY's Corporate Governance team recently updated its acid test – a tool that we have developed and used for over six years to qualitatively assess narrative reporting within an ARA – to cover matters that are particularly pertinent in these times. **In light of the current expectations about the themes and level of detail to be included in interim reports, many of the questions we pose in this COVID-19 acid test are also likely to be helpful when drafting interim reports.** For example:

- How are some of the difficult decisions the board has made/will make aligned to the company's purpose? Are there any that may challenge the company's purpose in the long-term?
- How resilient is the business model to any anticipated long-term impact of COVID-19 e.g., on buying patterns, trends and consumer behaviours?
- How has the board's assessment of principal risks considered COVID-19? Has this resulted in a new principal risk(s) or have existing principal risks been updated, or both?
- What principal decisions are being made during this time? How has the board considered the impacts of these on stakeholders, including the company's efforts to mitigate/minimise adverse consequences?

B Observations from our review of interim reports

with a 31 March 2020 period end

Overview of the impact of COVID-19

In ESMA's public statement providing recommendations on areas of focus in interim reporting it notes that, for a large proportion of issuers, COVID-19 will constitute a significant event under paragraphs 15 – 15C of International Accounting Standard 34, *Interim Financial Reporting*. It recommends that issuers should therefore adjust and potentially expand the level of detail of the information provided in their interim reports. ESMA highlights the need to update information included in the latest ARA to reflect the impacts of COVID-19. In particular in relation to significant uncertainties and risks, going concern, impairment of non-financial assets, presentation in the income statement as well as the expected future impact of COVID-19 and any mitigating actions put in place to address its effects.

In its latest report issued in June 2020 COVID-19 – Resources, action, the future, the Financial Reporting Lab (FR Lab) notes that, in order to keep investors up-to-date, companies should

> "provide information in the most appropriate form (whether through results announcements, trading updates, interim or annual reports) on a timely basis."

As stated in Section A, this mirrors what we have seen i.e., that certain communications which, in the past, may have been deferred until the ARA are being brought forward (or should be) to the half-year report.

To build confidence with stakeholders, companies will need to carefully consider the longer-term impact of COVID-19 on their business model and its resilience, and communicate their plans and actions very clearly.

Most interim reports we reviewed included an upfront and prominent COVID-19 section. In earlier reporters these sections were limited to setting out the impact of COVID-19 on the company, its market and industry alongside the immediate actions that had been taken. More recently, companies have started to detail their plans for recovery and include their views on the longer-term impacts that shifting trends will have on their business model, outlining initial thoughts on how they may transform and adapt. This upfront overview is then cross-referred to, as needed, throughout the interim report.

Purpose

There is a high expectation from investors and society that business will 'do the right thing' and investors have stated that they will support companies that do so.

The narrative on how companies are realising their societal purpose in response to the pandemic has started to shift from explaining how companies have earmarked funds to support the plight caused by COVID-19, to detailing how they are contributing to fighting the virus in the context of their business, for example:

- **Stock Spirits plc** references manufacturing and donating hand sanitiser.
- **Compass plc** discusses support for initiatives to prepare and provide food for the elderly, vulnerable and those in financial distress.
- **Shaftesbury plc** mentions providing rent free apartments for National Health Service (NHS) workers.

> "We encourage companies not to focus solely on their shareholders but to focus on stakeholder primacy and include all stakeholders, especially their employees, supply chain relationships, the environment and the communities in which they operate."

Sacha Sadan, Head of investment stewardship at LGIM. *FT Article 22 April 2020: UK's top asset manager urges companies to take care of their employees.*

Stakeholder lens

The current crisis has created a test case for many boards who are having to finely balance the survival of the company against the interests of its stakeholders. Some companies have stopped paying dividends, prioritising liquidity over shareholder returns, and concluded that it would be inappropriate to pay dividends whilst benefitting from government support and funding. Managing working capital by delaying payments to suppliers may be a choice between the survival of the company versus their suppliers. Staff redundancies may be the difference between the long-term viability of the company and health and well-being of hundreds of families.

CEO's statements often include personal reflections about the pandemic's impact on the stakeholders of the company. Earlier on in the pandemic the narrative focused predominantly on the welfare of employees. More recently companies have broadened their disclosures to other stakeholders, for example:

- **Virgin Money plc** discusses working with the Government, regulators and the industry to introduce new measures to support customers impacted by COVID-19.
- **Grainger plc** refers to increasing contact with and support for customers, suppliers and partners.

Often in the spirit of fairness, and also to show solidarity with employees whose livelihoods have been impacted, many companies have announced temporary reductions to executive remuneration. Companies should ensure their narrative takes into account the expectations set out by the Investment Association, of the need to balance incentivising executives and ensuring that the executive experience is commensurate with that of employees and other stakeholders.

None of the interim reports to date have gone as far as including an 'interim section 172(1) statement'. It is probable that certain decisions made by the board in the first six months are indeed 'principal decisions' for the year and will benefit from a narrative that clearly sets out the board's stakeholder considerations.

Capital allocation decisions, and especially changes to dividend policies, are likely to fall into this category. Many companies have decided not to pay, or at least postpone, dividends, prioritising prudent cash-flow management. This approach is supported by the Investment Association, which advocates that companies should consider the suitability and sustainability of dividend payments in light of the current uncertainties and ensuring that employees and suppliers can be paid.

Going concern and liquidity

In its recently updated guidance the FRC emphasised the information needs of investors in respect of liquidity, viability and solvency of companies. The FR Lab summarised these in a helpful infographic issued in March 2020 and further elaborates on this in two reports issued in June 2020. Whilst neither the extent and duration of the COVID-19 pandemic nor its consequences for the global economy can be predicted, investors expect companies to be able to articulate their expectations of the possible impacts on their specific business in different scenarios.

The FRC also expects that, in the current circumstances, more companies will disclose 'material uncertainties to going concern'[1].

What we have seen to date

It is therefore not surprising that the narrative around managing liquidity, headroom, covenants and setting out the levers available to management to reduce expenditure has become very detailed and linked to a much more thorough going concern assessment.

The going concern note has taken on many of the characteristics of a viability statement, with references to 'severe but plausible downside scenarios', 'reverse stress-testing' along with setting out mitigating actions available to management. The narrative is extensive, even in the case of companies where there is no material uncertainty regarding going concern — so as to assure investors that the issue has been examined closely.

The discussion tends to cover both actions that have already been taken as well as potential courses of action available to management — for example, drawing down on revolving credit facilities, availability of lines of credit and eligibility for government support. Some companies also disclose their 'cash burn per month.'

Commonly discussed cost control measures to mitigate the potential negative impacts include control of discretionary expenditure; recruitment freezes; reducing freelancer/contractor expenditure; reduced working hours and furloughing of employees, as well as a natural decrease in travel expenses.

- **Victrex plc** includes a detailed discussion of two stress scenarios in its going concern narrative.
- **Hyve plc** presents a separate narrative regarding downside scenario planning, mitigating actions, liquidity considerations that it refers to in its basis of preparation note.
- **Wizz Air plc** states that the directors assessed the cash burn rate of the business in the event of a full grounding of the airline for the going concern period.
- **Sage plc** explains that implementation of mitigating actions to manage costs and cash in the near term exclude staff reductions or government subsidies.

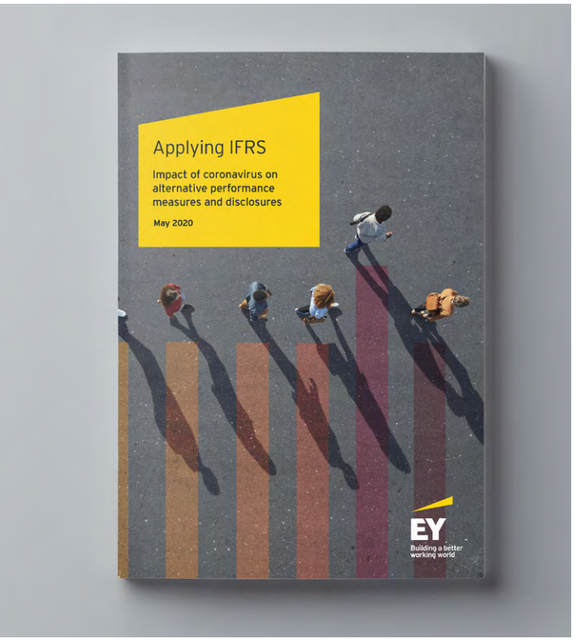
As companies start to discuss their planned route to recovery, the narrative around the assumptions relating to the cash-flow implications will need to evolve. More information will be needed in respect of working capital implications of reflating balance sheets, the extent of deferred payments that may have accumulated and will need to be settled etc.

[1] Uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern. In other words, if boards identify possible events or scenarios (other than those with a remote probability of occurring) that could lead to corporate failure, then these should be disclosed. When identifying such events or scenarios, boards may take account of realistically possible mitigating responses open to them. Events could lead to corporate failure because of the scale of their adverse impact on the company and its ability to avoid liquidation or because of their timing.

Exceptional items and alternative performance measures (APMs)

ESMA, issued a Q&A document to provide guidance to issuers on the application of its APM Guidelines in the context of the COVID-19 pandemic. In question 18, ESMA urges issuers to improve their disclosures and include narrative information rather than adjusting existing APMs or including new ones, especially when the impacts of COVID-19 had a pervasive effect on the overall financial performance, position, and/or cash flows.

The FRC's recent guidance also addresses reporting of exceptional items and APMs. It advises against splitting discrete items on an arbitrary basis in an attempt to quantify the portion relating to COVID-19 and warns about the subjectivity and unreliability of APMs which attempt to provide a measure of 'normalised' or 'pro-forma' results. This guidance is particularly important given the requirement in the Disclosure Guidance and Transparency Rules (DTR) for the management report to provide a fair review of important events.



What we have seen to date

The most common items that are being adjusted to arrive at APMs include:

- Impairment of goodwill, intangibles and shares in joint ventures
- Inventory provisions
- Credit losses

Many companies are, however, choosing not to separate out such items in the income statement, or even within the notes. They are instead discussing an estimated impact within the accompanying narrative.

If companies are contemplating introducing measures such as 'unabsorbed COVID-19 costs' and 'incremental COVID-19 costs', they should carefully consider whether they are able to accurately capture, and therefore reflect, the full effect of the pandemic without including costs that have not been impacted.

In the current environment, the presentation of additional line items should be accompanied by adequate definitions explaining their composition and providing information that improves their relevance. However, the comparability of COVID-19 related APMs among entities will be a major challenge without a universally accepted way to objectively structure them.

Depending on the specific facts and circumstances, entities may find it less controversial to provide a separate disclosure explaining the impact of the virus, rather than introducing a new APM or adjusting their APMs.

Risk reporting

Interim reports issued since the announcement of the pandemic have approached the DTR's requirement in relation to the reporting of principal risks and uncertainties in the following broad ways:

- Inclusion of a high-level statement that risks remain the same as in the year-end ARA, other than the impact of COVID-19 (e.g., **Diploma plc**).
- Inclusion of a more detailed statement explaining that principal risks have been re-assessed in light of COVID-19 and including a brief narrative of the key changes (e.g., **ABF plc**).
- Inclusion of a tabular disclosure that specifies the impact of COVID-19 on pre-existing principal risks. (e.g., **Sage plc**).
- Detailed analysis of principal risks and uncertainties included as an appendix to the interim report (e.g., **Greencore plc**).

With the first two approaches, it is sometimes unclear whether COVID-19 has been identified as a separate principal risk or whether it is seen as impacting the risks previously disclosed. As most companies now include a separate COVID-19 overview section, including actions taken by the company in response (as explained above), risk narratives often cross refer to such an earlier section for additional detail.

> "Companies should be considering whether they should update their risks for the half-year disclosures. Given the circumstances, it is likely that they will need to provide an update to the market in their half-year report. The most successful risk disclosures are likely to consider the issues raised by COVID-19 holistically, and with specific reference to the company's circumstances."

COVID-19 – Going concern, risk and viability.
FR Lab June 2020

Appendices

Appendix A:
Overview of key regulatory requirements governing interim reporting for UK premium listed entities[2]

This is a brief summary of the regulatory requirements governing interim reporting and we recommend you refer to source requirements for fuller detail.

1. Disclosure Guidance and Transparency Rules (DTR)

Premium listed companies, have to comply with DTR 4.2 which requires the following narrative disclosure:

a. **A fair review** of the important events that have occurred during the first six months of the financial year, and their impact on the condensed set of financial statements.

b. Information about **related parties'** transactions in the six-month period as well as changes in related parties' transactions described in the last ARA that have materially affected the financial position or the performance during the period.

c. A description of the **principal risks and uncertainties** for the remaining six months of the financial year. This may require directors to update the assessment made in the previous ARA or, when such risks and uncertainties have not changed, summary disclosure may be provided and disclosures within the previous ARA referred to.

d. **Responsibility statements** confirming:

- The interim financial report has been prepared in accordance with the applicable set of accounting standards; and gives a true and fair view of the assets, liabilities, financial position and profit or loss.
- The interim management report includes a fair review of the information in a-c above.

2. IAS 34 *Interim Financial Reporting*

DTR4.2 also mandates IAS 34. IAS 34 sets out the minimum content of an interim financial report as well as principles for recognition and measurement.

3. UK Corporate Governance Code 2018 (the Code)

Provision 30 of the Code requires boards to state whether they consider it appropriate to adopt the going concern basis of accounting in preparing the half-yearly financial statements and identify any material uncertainties to the company's ability to continue to do so over a period of at least twelve months from the date of approval of the interim financial statements.

The FRC's **Guidance on Risk Management, Internal Control and Related Financial and Business Reporting**, states that the same considerations should apply in relation to going concern assessments and disclosures in the interim period as for the annual financial statements.

4. ESMA guidelines on APMs

Where interim reports include the use of APMs, ESMA's APM guidelines apply.

[2] Issuers of debt securities on a regulated market are also subject to certain requirements in respect of interim reporting. These have not been covered in this paper. The AIM market is not a regulated market and AIM companies therefore do not have to comply with IAS 34 or the DTR.

Appendix B:
Further insights from EY

Recent and related publications

Visit EY's COVID-19 hub for further insights and materials: ey.com/uk/covid

EY's UK Corporate Governance team provides guidance and thought leadership on governance issues to help management and boards. The team also contributes to wider discussions on good governance, based on our research and engagement with investors, boards and regulators.

We can provide further insights, bespoke governance advice and annual report reviews.

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