PKF Littlejohn LLP

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Accountants & business advisers

CAPITALQUARTER

The newsletter for listed businesses and their advisers

SUMMER 2019

Audit world set for a shake-up

Corporate collapses trigger independent probes

The financial reporting screws are tightening

How to stay the right side of IFRS 9 and 15

Business travellers under spotlight

HMRC revisits employment tax and mobility

CAPITAL MARKETS

Welcome

Welcome to the Summer 2019 edition of Capital Quarter - our newsletter for listed businesses and their advisors.

The world we live in and the markets we work in face unprecedented changes over the coming years, and it is more important than ever for business leaders to have the foresight and knowledge to adapt their organisations to these changes.

In this issue, we take a look forward and try to analyse trends and offer insight into the future for various issues affecting listed business and their employees.

In this issue:

- We examine the future of Global Mobility, and HMRC's increasing focus on Business Travellers in a world where new technology is allowing people to work in one country and live in another;
- The audit market is in line for a big shake-up in the coming years, we predict the developments;
- We provide an overview of IFRS 15 and IFRS 19 – what they mean for your business, and how we can help;
- Plus, our latest market analysis. We review the latest development in the markets as well as looking forward with predictions for the future.

We hope you find this edition useful, and we are always keen to hear your comments and suggestions for future articles.

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Looking Ahead

Reporting dates for companies

26th Public Holiday (markets closed)

30th NEX deadline (March year ends)

6th Due date for UK registered AIM entities (March year ends)

30th Due date for non-UK registered AIM entities (March year ends)

30th Due date for Half-yearly reports – Premium, Standard & AIM listed (June period ends)

31st Due date for Premium & Standard listed entities (June year ends)

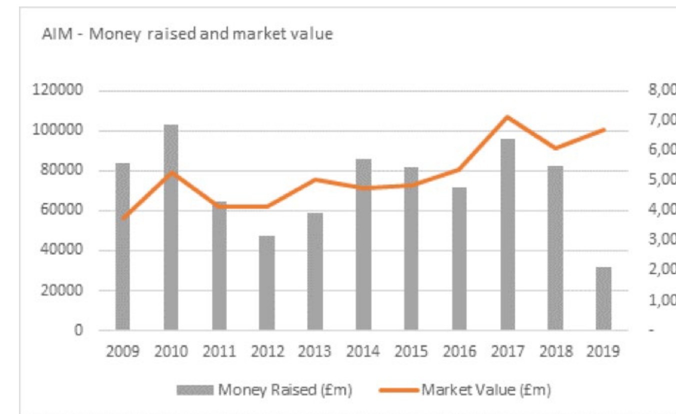
Market Analysis

Buoyancy versus unpredictability

It's a mixed picture for the markets half way through 2019: cautious resilience in spite of political uncertainty.

AIM

The first six months of 2019 have seen an increase in AIM market capital to £100.2million following a tough end to 2018. There were 15 new issuers during the period, with the financial, oil & gas and technology sectors continuing to dominate activity.



During the first three months of 2019, the AIM market saw only one IPO. This represents the lowest IPO activity for 10 years (since Q1 2009) and the lowest volume since Q1 2013.

Whilst IPO activity is at an all-time low, it appears investors are still comfortable taking part in AIM companies' secondary fundraises. This suggests they are adopting a more cautious approach to businesses that are yet to float. Looking at the first six months of 2018, 24% of funds raised related to new issues. That compares to 6.4% in 2019, demonstrating investors' reluctance to invest in new issues.

The recent reforms, which oblige AIM companies to comply with a recognised corporate governance code, should continue to enhance the reputation of entities listed on this market. The tighter regulatory environment is likely to further increase investor confidence. Likewise, high profile companies such as ASOS and Fevertree are attracting investors to look at the market for other potential opportunities.

Over the next 12 months Brexit continues to pose economic uncertainty and is likely to still have an impact on the volume of IPOs taking place across all markets. However, the first six months of the year has seen the AIM market strengthen through further issues of funds. What's more, given AIM's dominance and history of raising funds even during challenging times, its success is expected to continue.

Main Market

During the first six months of 2019, £11.4billion was raised on the Main Market. This was an increase of 39% compared to the same period last year. There were 28 new issuers, raising a total of £2.6billion, compared to new issuers in the first six months of 2018 raising £1.5billion.

There continues to be a decrease in company size on the Main Market. This has been a trend over the past two years, with smaller companies electing to list on the Main Market rather than AIM.

One reason may be a knock-on effect of the corporate governance reforms for AIM companies implemented in September 2018. That's because companies may assume fewer compliance issues and associated fees when listing on the Main Market.

Stability versus uncertainty

Looking at both the AIM and Main Market's position and results for the first part of 2019, it's clear they are showing signs of emerging from a difficult period in the latter part of 2018.

However, the future of both markets during the remainder of 2019 is likely to depend on the wider political environment. With the uncertainty surrounding Brexit and the potential impact on the economy and the value of sterling, it can certainly be described as unpredictable.

What's more, ever increasing political tensions outside Europe could lead to unforeseen changes in the attractiveness of the UK market for investment. Whilst the future may be hard to call, the first six months of 2019 certainly show the stability we would expect from these markets.

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Business travellers under the spotlight

As businesses seek out new markets and technology allows people to work in one country but live in another, cross-border mobility is growing. In the last 18 months HMRC has increased its focus on international business travellers. Louise Fryer explains.

The traditional assignment framework is changing as international travel becomes more commonplace. Rather than sending individuals to a location for two or three years and tax equalising them, businesses are looking for less costly alternatives. That means more flexibility from employees and an expectation for them to travel more widely.

It is mandatory for any UK company that receives employees from a subsidiary or overseas branch in a double tax treaty country to have a Short Term Business Visitors Arrangement (STBVA) with HMRC. The alternative is to add the individuals to UK payroll, capturing all visits of one day or more. We have also seen the introduction of a special arrangement payroll for visitors from non-treaty countries or overseas branches of UK companies who have fewer than 30 UK workdays.

Further changes for Short Term Business Visitors

After recent consultation HMRC extended the special arrangement payroll, which will now be known as Appendix 8, to those who visit for up to 60 days (effective from April 2020). Furthermore the filing deadline will be 31 May following the tax year end to align with the STBV filing deadline, in order to ease the reporting burden on employers.

It is not just the UK that's focusing on business travellers. It is of worldwide interest. The US has developed a platform that allows someone to log on to the US immigration website, enter passport details and generate a report that details visits to the US. Meanwhile the UK is identifying people (via an entry in their passport) who visit frequently from the US, and they will be subject to more scrutiny at immigration.

Rules for non-resident directors

HMRC's development of its short term business visitors regime has highlighted the number of non-resident directors of UK companies who come to the UK for work purposes. Directors are not covered under an STBVA, as HMRC deems all director duties to be substantive in nature.

Different rules apply for non-resident directors. They will almost always be considered taxable in the UK when they work here, and this means obligations for both the company and the individual. Different tax treaties treat director income in different ways. So it's important to seek professional advice and consult the appropriate treaty to check.

Implications of Making Tax Digital

HMRC recognises the complexity of individuals working cross border. For that reason it has said that this will be the last area to tackle in the development of its digital tax revolution. For example, there are various issues connected with sharing confidential information and whether HMRC would ever be able to capture the 'whole picture' digitally. The jury is still out on that one.

Off payroll rules for private sector

The 2018 budget extended the off-payroll rules (IR35) to private sector workers (effective from April 2020). Many companies employ people through personal service companies to work on special projects. These rules will apply to those who come from overseas or are contracted outside the UK.

Senior Accounting Officers beware

The SAO regime is another development that is bringing employment tax and mobility to the fore. That's because an SAO is personally liable if things are not correctly reported and this is an area which can fall into the cracks between HR and payroll. It is a wise SAO, therefore, who targets this area of tax to ensure compliance.

Brexit or no Brexit

When, or perhaps if, the UK leaves the EU HMRC will continue to take a keen interest in the global mobility and tax arena. That's because they see it as a lucrative source of revenue. We have seen Requirement to Correct (RTC) and other offshore disclosure projects, which have targeted people with offshore assets around the world. The OECD/G20 BEPS project, the international collaboration to end tax avoidance strategies, has focused on the tax being paid where the profit is generated.

We expect more initiatives like these, particularly as the exchange of information between countries gathers pace.

If we leave the EU, the tax treaty framework will remain (although it may be subject to change) as this is OECD based. But what of social security agreements between the UK and EU countries and the validity of A1/ certificates of coverage for mobile employees? HMRC and the Department for Work and Pensions have been noticeably silent on how they expect to take things forward. Clearly more work is needed.

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The financial reporting screws are tightening: IFRS9 & IFRS15

IFRS 9, the standard which applies to periods beginning on or after 1 January 2018, affects not only large financial institutions but non-financial entities too. IFRS 15, which deals with how to report on revenue arising from customer contracts, focuses on timing and how to cope with variables. Nicholas Joel from our Business Services division helps you to navigate the rules.

IFRS 9

Revenue wasn't the only recent shake-up that rocked the accounting world. There is also the implementation of IFRS 9 Financial Instruments to contemplate.

There's a common belief that IFRS 9 is applicable only to large financial institutions. But that's not true. Not only does IFRS 9 also affect non-financial entities, it can have a significant impact on financial reporting.

IFRS 9 replaces IAS 39 Financial Instruments – Recognition and Measurement for periods beginning on or after 1 January 2018. The implementation of the new standard was intended to eradicate the inconsistencies of IAS 39 relating to how entities manage risk and the timing of recognition of the credit losses on receivables.

IFRS 9 addresses accounting for financial instruments and deals with three main elements: classification and measurement of financial instruments; impairment of financial assets; and hedge accounting.

Where an entity holds equity investments or financial assets at amortised cost, there are likely to be consequences from the adoption of IFRS9. These might include:

1. Immediate recognition of credit losses. Entities must recognise a 12-month expected credit loss on acquisition of a financial asset.
2. Movement in fair value of investments. It's no longer possible to carry equity investments at cost. Instead they must be measured at fair value, with any gain or loss recorded in profit or loss as they arise.

What are they key changes?

Overall, the changes with IFRS 9 relate to:

1. Classification and measurement of financial assets and liabilities
To measure a financial asset after initial recognition, IAS 39 classified financial assets under four categories: financial assets at fair value through profit or loss; held-to-maturity investments; loans and receivables; and available-for-sale financial assets.

With IFRS 9, these classifications have gone. After initial recognition, an entity must now measure financial assets at amortised cost, fair value through other comprehensive income (FVTOCI) or fair value through profit or loss (FVTPL).

The classification of financial assets will depend on the entity's business model for managing these, and on the contractual cash flow characteristics of the financial asset.

2. Embedded derivatives
Where a hybrid instrument contains a host contract which is an asset within the scope of IFRS 9, the embedded derivative will not be separated from the host contract. This means the classification rules in IFRS 9 will apply to the hybrid instrument as a whole.

Under IAS 39 the embedded derivative and the host contract were separated if they were not 'closely related'.

The entity also had an option to classify the hybrid instrument at FVTPL in its entirety, subject to certain conditions. This option is still available under IFRS 9, where the host asset is not within the scope of IFRS 9.

3. Reclassification of financial assets and liabilities
IFRS 9 allows an entity to reclassify its financial assets if it changes its business model for managing those assets.

But, for this to apply, these changes must be significant to the entity's operations, as well as demonstrable to external parties. As a result, changes in the classification of financial assets will be unusual.

If an entity does reclassify its financial assets following a change in the business model, it must apply the reclassification prospectively from the first day of the first reporting period following the change. The entity cannot restate any previously recognised gains, losses, or interest.

4. Impairment methodology
IFRS 9 introduces an 'expected loss' approach to account for credit losses. This requires entities to use forward-looking information for earlier recognition of credit losses.

We can blame the financial crisis for this change, as it was thought the IAS 39 impairment approach contributed to the delay in credit losses recognition.

Expected credit losses are recognised in three stages:

1. Performing – a loss allowance equal to 12 months' expected credit losses is recognised with interest income calculated on the gross carrying amount of the asset;
2. Underperforming – a loss allowance equal to the entire expected credit losses, with interest income still calculated on the gross carrying amount;
3. Non-performing - a loss allowance equal to the entire expected credit losses, with interest income calculated on the net carrying amount (i.e. after loss allowance).

Under IAS 39, any loss allowance was recognised at the non-performing stage.

How will the changes affect you?

As I said at the start, the impact of IFRS 9 on financial reporting is significant. This applies particularly to the expected loss model. Management must continuously monitor the effect of both historical performance and potential future economic factors.

IFRS 15

Like IFRS 9, this standard is also effective for reporting periods beginning on or after 1 January 2018. So here are some timely tips on the more confusing elements.

IFRS 15 (Revenue from Contracts with Customers) sets out the principles for reporting the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers and replaces IAS 18 Revenue.

Crucially, the IFRS 15 standard does not change the total amount of revenue an entity must recognise, but just the timing of recognition.

It's true that the new standard has the biggest impact on entities in industries with long-term contracts. But it will also significantly affect those where bundled contracts are common. So it is vital that all entities carefully analyse these changes and make sure they are appropriately reflected in their financial reporting.

Revenue recognition model

IFRS 15 replaced the broad principles of revenue recognition under IAS 18 with a new core principle where an entity must recognise revenue at the time it transfers goods or services to a customer, based on the amount it expects to receive from that customer. The goods or services are deemed to be transferred when the customer has control of them.

The new standard sets out a 'five-step' approach that entities must follow when determining how, and when, to recognise revenue.

Unlike IAS 18, IFRS 15 requires entities to account for two or more contracts entered into at or near the same time with the same customer as a single contract - subject to certain criteria.

IFRS 15 also identifies conditions under which a contract modification must be accounted for as a separate contract. Where these conditions do not apply, the accounting method depends on the nature of the modification.

Other implications

So there may be significant changes to an entity's revenue recognition criteria. But along with financial reporting requirements, entities must also consider wider implications, such as:

- Breaches of loan covenants
- Availability of reserves for dividend distribution
- Changes to key performance indicators.

Variable consideration

One common conundrum is how to recognise revenue when there is a variable consideration element.

For example, revenue contracts in the mining sector can include significant variables that are only finalised several months after shipment to the customer. New specific requirements for such cases mean that amounts are only included in the transaction price if it is 'highly probable' that the amount would not be subject to significant future reversals.

For variable considerations, then, the entity must estimate the sum to which it will be entitled under the contract for the transfer of promised goods or services. IFRS 15 allows one of the following two methods to calculate the estimate:

1. Expected value – the sum of the probability-weighted amounts
2. Most likely amount – the single amount management believe they will receive

Entities should apply the chosen method consistently throughout the life of each contract.

So how could, for example, a mining company deal with the 'high probability of no significant reversals' rule, given commodity price swings? IFRS 15 then requires an estimate of how much of the consideration would likely be immune from such a reversal. This tricky area is seen as a subjective estimate, so involves careful consideration by management.

How we can help

PKF Littlejohn has an experienced team with an in-depth knowledge of IFRS 15 who can offer advice.

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Audit world set for a shake-up

The collapse of companies such as Carillion and Patisserie Valerie has triggered stronger scrutiny of the audit sector through a series of independent reviews. Georgie Berry reports.

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These high-profile corporate crises have highlighted pre-existing concerns over audit quality and the need for robust reforms of the UK audit market. In response to these failures, and the increasing awareness and scepticism of the public and media, there have been three separate reviews in the last 12 months.

After the collapse of Carillion, Sir John Kingman led an independent review into the operation of the Financial Reporting Council (FRC), the audit sector's regulator. The review also considered auditor appointments and remuneration, particularly in major companies of public interest.

New regulator proposed

Kingman published his findings last December, setting out 83 recommendations for fundamental reform. Foremost is the idea to replace the FRC with an independent statutory regulator (proposed as ARGA – the Auditing, Reporting and Governance Authority). ARGA would be accountable to Parliament, with a new mandate, new leadership and increased powers and responsibility. The goal of Kingman's recommendations is to establish an audit regulator with the resources and ability to identify and take early action to reduce the risk of corporate collapse.

'Big Four' split suggestion

The Competition and Markets Authority (CMA) published its final report in April following a formal market study into the audit sector. The report focused on concerns about inadequate choice and competition. It also highlighted the vulnerability of the sector because of its reliance on the 'Big Four' firms – which conduct over 95% of the audits of FTSE 350 companies. The third focus was on incentives for producing high-quality audits.

The CMA's recommendations include an operational split between audit and non-audit services for the 'Big Four'. Its aim would be to ensure professional scepticism was not hindered by potential conflicts of interest.

To open up competition in the sector and allow firms outside the 'Big Four' a role in auditing the UK's major companies, the CMA has proposed a 'joint audit' regime. FTSE 350 companies would be audited by two firms, one of which would be outside the 'Big Four'.

The CMA also proposes closer scrutiny of audit appointments so that those doing the appointing are held to account. There would also be guidelines to ensure they were independent enough to make such a decision.

Government response

In response to both the Kingman and CMA reports, the Department for Business, Energy & Industrial Strategy (BEIS) has commissioned an independent review into the quality and effectiveness of the UK audit market. This review, led by Sir Donald Brydon, is ongoing and is expected to conclude by the end of the year.

It aims to consider how the audit product should be adapted in the future to serve public interest and expectations more effectively, by addressing the points raised in both reports as well as wider quality issues.

In a keynote speech the former Chair of BEIS, former Secretary of State Greg Clark, put forward suggestions for the evolution of audit. These included issuing graduated audit findings to develop a more informative audit, and a broader remit for audit to include a wider consideration of the effectiveness of a company's corporate governance.

Appetite for reform

Although there isn't yet a definitive conclusion on the reforms or on changes to legislation relating to the UK audit market, it's clear there is an appetite and intent for a fundamental shake-up of the sector.

Amid the uncertainty over Brexit, there is no better time to regain the lost confidence and trust in audit, in order to serve the public interest and strengthen the perception of the UK's business environment.

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