PKF Littlejohn LLP

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Accountants & business advisers

CAPITALQUARTER

The newsletter for listed businesses and their advisers

Spring 2020

The Future Fund
What you need to know

Incentivising staff when cash is restrained
What to do if government measures are not enough

Plus:

How internal audit can stay effective and relevant

Companies Regulations 2018 new and enhanced disclosures

Understanding IFRS 15 - Licences

The implementation of IFRS 15 revolutionised how many technology companies recorded revenue from contracts with customers. Read our guide.

CAPITAL MARKETS

Welcome

Welcome to the Spring 2020 edition of Capital Quarter - our newsletter for listed businesses and their advisors. This issue focuses on the Technology sector, covering a number of emerging issues in this space and reacting to the new normal of COVID-19 business interruption.

The implementation of IFRS 15 revolutionised how many technology companies recorded revenue from contracts with customers. But the new regulations are complicated, and we are often asked by our clients to explain how they work – particularly in relation to the treatment of licences. Nick Joel simplifies matters for technology businesses.

The Companies (Miscellaneous Reporting) Regulations 2018 introduced several new and enhanced disclosure requirements for UK companies, effective from periods commencing 1 January 2019. In addition, major recent socio-political events – chiefly Brexit and the COVID-19 pandemic – will require businesses to report additional information in their accounts. But what are the new requirements and how will they affect your business? Imogen Massey explains more.

Also in this issue of Capital Quarter:

- Incentivising staff when cash is constrained
- Government support for start up businesses
- How internal audit can stay effective and relevant

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

Kind regards,

Joseph Archer

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Looking Ahead

Reporting dates for companies

30th Aquis and AIM deadlines for 31 December 2019 year ends (no extensions applied)

30th Premium and Standard List 31 December 2019 years ends with 2 months extension

31st Premium and Standard List 31 March year end no extension

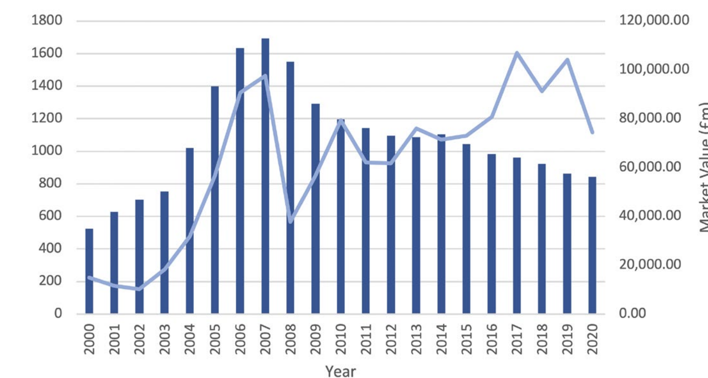
Market Analysis

Time to adapt and stand out

The optimistic outlook that emerged following the General election has long-since vanished. Nobody could have foreseen the shock effect a virus would have on business, borders and daily life – and the markets continue to struggle with the uncertainty about the length and severity of the disruption that COVID-19 is causing.

AIM

The market for the first quarter of 2020 can only be described as turbulent. The decrease in the market capital of AIM of approximately £30 billion in the three months to the end of March 2020 highlights the ongoing effect of COVID-19.



In 2019, for the second year running, AIM recorded a reduction in the number of new issues (2018: 65 vs 2019:23) and money raised as a result (2018: £1.6billion vs 2019: £489million).

The trend of companies delisting from AIM continued for the 12th year running, with the exception of 2014. A total of 831 businesses have now cancelled their placement since 2008.

Main Market

The fall in the Main Market value since the start of the year has been driven by the largest constituents, with 98% (£876m) of the reduction in value coming from the top 200 companies on the exchange. Many of the 'Small cap' companies, although affected, have not seen their share prices affected to the same extent.

The Main Market also saw a reduction in the number of companies on the exchange in 2019 (2018: 1,166 vs 2019: 1,143) and money raised (2018: £19.4 billion vs 2019: £16.8 billion).

How should you respond?

Despite the efforts of governments and central banks around the world to stabilise the situation, we are likely to see further market uncertainty over the coming months. Listed firms are having to adapt, with the most successful sharing some common traits:

- Effective communication with clients, stakeholders and staff members
- Enabling employees to work flexibly to limit disruption to their day to day schedules
- Proactive crisis planning which is regularly reviewed and revised to consider ongoing changes
- Consistent and prudent liquidity monitoring to ensure the best service for clients while making acute business decisions in line with government support
- Providing effective and sensitive information in response to the evolving crisis

In these challenging times, there is an opportunity for companies to stand out. The actions that management teams take now can be the difference between adding real value or damaging long term reputation – so it's important to consider big decisions carefully.

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More to say?

The Companies (Miscellaneous Reporting) Regulations 2018 introduced several new and enhanced disclosure requirements for UK companies, effective from periods commencing 1 January 2019. In addition, major recent socio-political events – chiefly Brexit and the COVID-19 pandemic – will require businesses to report additional information in their accounts. But what are the new requirements and how will they affect your business?

S172 for large companies

The s172 statement is an entirely new requirement and arguably the biggest reporting change affecting many businesses. That said, some entities may have already included some or all of the required disclosures in another form within the annual report – in this case it is possible to cross refer to these areas within the s172 statement.

All large and ineligible entities* must include a separate s172 statement within the Strategic Report, also to be included online, which describes how the directors have had regard to their duties under section 172 of the Companies Act 2006. The following areas must be covered:

- the likely consequences of any long term decisions;
- the interests of the entity's employees;
- the need to further the entity's business relationships;
- the impact of the entity's operations on the community and environment;
- the desirability of the entity maintaining its reputation; and
- the need to act fairly.

*Of note, the available exemption does not include plcs even if small – all plcs must therefore comply with s172 requirements.

Reporting about directors

Directors' Report requirements:

- Engagement with employees – All large and medium sized entities with more than 250 employees must include a statement in the Directors' Report in regard to its engagement with employees;
- Engagement with others – Large entities are required to include a statement in the Directors' Report summarising how the directors have had regard to the need to foster the entity's business relationships with suppliers, customers and others;
- Governance – Entities with either 2,000 or more employees or turnover of £200 million and a balance sheet total of £2 billion, must include a statement of corporate governance in the Directors' Report*.

*Does not apply to those entities already required to provide such a statement as a result of being listed

Directors' remuneration:

- Quoted companies with more than 250 employees are required to disclose the pay ratio information relating to the remuneration of the Chief Executive Officer (CEO) in the directors' remuneration report;
- All quoted companies are now required to disclose information on the share price impact for director remuneration.

Other legislative and reporting considerations

Brexit

Following the UK's exit from the EU on 31 January 2020, there is a transition period to 31 December 2020 during which there will be no changes to the UK's accounting, auditing or corporate reporting framework. After this time (i.e. from financial years ending 31 December 2020), entities currently reporting under EU IFRS will be required to adopt UK IFRS. The two frameworks will be aligned as at 31 December 2020 and therefore no retrospective restatements will arise on transition.

In addition, UK incorporated entities listed on an EEA regulated market will need to comply with EU local regulatory provisions from 31 December 2020, in addition to the need to produce UK Companies Act 2006 compliant financial statements for domestic filing purposes.

Also, some existing exemptions for UK subsidiaries will be removed from 31 December 2020:

- UK intermediate companies with an immediate EEA parent will no longer receive automatic exemption from preparing group financial statements;
- UK dormant companies with EEA parents will no longer receive exemption from filing statements at Companies House; and
- An audit exemption will no longer be available by way of parental guarantee if that parent is an EEA-registered company.

Appropriate disclosure must be made within the Strategic Report in relation to the risks and uncertainties surrounding Brexit specific to the company or group, as far as it is understood at the time of reporting. Key risk areas to consider will be the potential impact on solvency, liquidity and going concern. More meaningful disclosures in this area will be possible following the development of negotiations surrounding future trading between the UK and EU.

Tech focus

The following should be taken into account when considering the impact of Brexit:

- The potential loss and shortfall of key talent as freedom of movement is restricted for workers post-transition;
- The potential interruption to data flow as a result of Brexit – will the UK still benefit from the 'digital single market'? It will be important to monitor any changes in legislation in this area as it could affect alignment;
- The need for responsive and innovative tech platforms within UK businesses as the UK-EU trading relationship emerges and develops – does this present an opportunity?

COVID-19

The COVID-19 pandemic is expected to have a lasting effect on the global economy and no industry will be immune to this. The impact for individual entities will vary enormously depending on the size of the entity and the industry it operates in. However, all entities will be required to carefully consider how the pandemic and its impact are reflected in their annual financial statements.

Relevant disclosures should be made within the financial statements, as a minimum, in the following areas:

- Strategic report
- Going concern note
- Post balance sheet events (for December year ends – later year ends will need to consider timing carefully)
- Principal risks & uncertainties

The key at this early stage is to ensure readers of the financial statements are made aware of the significant uncertainties surrounding the pandemic over the short and medium-term, and what this could mean in the context of the company's operations. Entities may wish to consider the following areas for the purposes of disclosure and preparation of forward-looking financial information, where relevant:

- Travel restrictions – impact on operations
- Key operational cost cutting decisions made - e.g. staffing
- Committed spend vs discretionary
- Impact of low investor confidence and uncertain economic environment - e.g. on availability of fundraising
- Planned or actual use of any available government measures
- Any positive impact – some industries may have seen a growth in activity as a result of the pandemic and this should also be disclosed along with any risks

There will also be an impact on the independent auditor's report and, again, this will depend on the individual entity/group in terms of its financial position and going concern assessment (incorporating the expected COVID-19 impact). In the audit world, the guidance prescribes one of two routes:

1. The use of the 'material uncertainty' paragraph in respect of going concern (drawing out COVID-19) – for entities that either prior to the pandemic, or after revisiting forecasts amidst it, are deemed to have a significant risk surrounding their going concern status; or
2. The use of the 'emphasis of matter' paragraph in relation to the uncertainties surrounding COVID-19 – for entities that prior to the pandemic, would have been expected to have a clean audit report and, having performed an assessment of the impact, are not considered to be severely affected.

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Incentivising staff when cash is constrained

For many companies, the various measures that the government has introduced to help mitigate the impact of COVID-19 will not be enough. Chris Riley and Catherine Heyes explain.

While furlough may be a valid option for reducing payroll costs for those employees who simply have insufficient work, many businesses will still need to retain at least a skeleton staff and those key employees who really make a difference. And even if furlough is a possibility, the government grant of up to £2,500 per month (generous though it is) may not make a significant contribution to the total gross salary of higher paid employees - which could test their loyalty when the job market reverts to something resembling 'normal'.

So, is it possible to square the circle of reducing cash outflows, keeping your employees happy, and rewarding their contribution and loyalty at a difficult time?

A potential solution may be to replace some cash-based remuneration with share awards in the company.

The uncertainty and economic impact of COVID-19 will impute a significant impact on asset values – as can be seen from the performance of all the major stock market indices in recent weeks – and there is little question that this flows through to privately owned companies too (in fact, the discount may be even more significant for these businesses due to a lack of liquidity in their shares). However, when the current crisis clears and uncertainty ceases to have such an impact, it would be hoped that these values will bounce back.

If share-based remuneration is a viable option for your business, you will need to consider carefully how shares are awarded to staff. Your shares will certainly still have some value, so free awards of shares will mean that the employee is taxed on that value in the current tax year - which is not ideal from an 'incentive' perspective, particularly if the individual is concerned that the value could fall further. Issuing share options, by contrast, does not give an immediate tax charge, provides the employee with an effective interest that they can crystallise in the future and, if structured correctly, can be tax efficient for the employee on redemption.

This is where the Enterprise Management Incentive scheme (EMI) comes in. EMI is an option scheme, so tax liabilities are only crystallised when the share option is exercised. However, the scheme is HMRC approved and, as such, the basis of charge is the value of the shares on the date the option was granted – locking in that potentially lower value today, and incentivising your employees to stick with the company through the hard times so that they can benefit from future growth when things return to normal.

It is worth noting that any share award structure will only generate cashflow benefits to the extent that it affects remuneration that is yet to be paid.

Past salary cannot be 'reversed' to generate a PAYE repayment. And of course, if you are changing salaries or bonus entitlements for individuals, you will need to do so in a manner that is compliant with employment law, which is unchanged by the crisis.

Clearly, any share-based reward mechanism in a listed group has wider considerations, with clear justifications needed to support any such award commercially and to not be to the detriment of investors. The directors will need the power to issue such shares (which may be limited to a narrow range of participants), and generally having more than 10% of shares held by Directors and other employees is unusual – but it would seem unlikely that modest current awards here could breach such thresholds. Some form of lock in period, to support the incentivisation element, would seem appropriate and would need to be defined.

PKF Littlejohn has significant experience in advising companies, from start-ups to mature established groups, in providing share incentives to their key staff. For further information, please contact Chris Riley or Catherine Heyes.

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The Future Fund: Government support for start-up businesses

The government has announced a £500 million 'Future Fund' to invest in start-up businesses affected by the COVID-19 (COVID-19) pandemic. John Needham explains.

The Fund, launched in May 2020, will provide unsecured government loans ranging from £125,000 to £5 million to UK-based unlisted companies, subject to at least equal match funding from private investors. The scheme will issue convertible loans that will convert to equity stakes, valued at a discount of at least 20%, in the next qualifying funding round. On sale or IPO, the loan will either convert to equity or be repaid at a 100% redemption premium – whichever provides the best return to lenders.

The funding will be delivered in partnership with the British Business Bank, at a minimum 8% annual interest rate to be paid on maturity of the loan (the rate will be higher if a higher rate is agreed between the company and the matched investors) over a maximum 36 month period.

The Chancellor has stated that the Fund may be a suitable option for businesses that rely on equity investment and are unable to access the Coronavirus Business Interruption Loan Scheme (CBILS).

To be eligible, businesses need to:

- have a substantive economic presence in the UK
- attract the equivalent match funding from third party private investors and institutions
- have previously raised at least £250,000 in equity investment from private third party investors in the last five years.

This is the first announcement in respect of the Future Fund and, as such, the information is therefore reasonably high-level. We expect to see more details of the scheme released prior to launch in the coming weeks.

We anticipate the Future Fund may be of interest to early-stage, high-growth businesses that are still loss-making, and hence unable to benefit from more traditional lending via schemes such as CBILS. However, given the uncertainty of the economic outlook and the depressed state of corporate valuations at the moment, business owners will need to think carefully before approaching external venture capital sources and private investors for match funding.

We remain hopeful that rules that may currently prevent or restrict further fundraising for businesses with existing EIS and VCT Investors will be relaxed in the coming weeks, thereby opening another door to potential investor support.

In addition, the government has also announced £750 million of targeted support for SMEs focusing on research and development. The funding will be available through the grants and loan scheme of Innovate UK, the national innovation agency. The first payments are expected to be made by mid-May.

For more information about the Future Fund, venture capital investment and other forms of business support, please contact

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Understanding IFRS 15 - Licences

The implementation of IFRS 15 revolutionised how many technology companies recorded revenue from contracts with customers. But the new regulations are complicated, and we are often asked by our clients to explain how they work – particularly in relation to the treatment of licences. To simplify matters for tech businesses, we have drafted this overview of the IFRS 15 guidance in respect of licences and assembled a list of key considerations specific to technology companies.

Many tech businesses promise to grant a licence to a customer as well as promising to transfer other goods or services to the customer. Those promises may be explicitly stated in the contract or implied by your business practice, published policies or potentially specific statements.

As with all other types of contracts, when a contract with a customer includes a promise to grant a licence in addition to other promised goods or services, you must assess the performance obligations within the contract. In particular, it is important to understand if the goods or services promised are 'distinct' from the promise of the licence, and therefore need to be recognised individually in the accounts. For the avoidance of doubt, 'distinct' in this sense means both capable of being distinct and, distinct in the nature of the contract.

Key considerations: Licences / consumer assistance / warranties / updates / client customisation

What should you do if goods or services are not distinct?

Where the promise to grant a licence is not distinct from other goods or services in the contract, it should be treated as one performance obligation and recognised collectively.

Some examples of licences that are not distinct from other goods or services include:

- a licence that forms part of the physical product and is integral to the functionality of that product; and
- a licence that the customer can benefit from only in conjunction with a related service (such as an online service provided by you that enables, by granting a licence, the customer to access content).

You will need to assess this performance obligation against the applicable guidance within IFRS 15 for the timing of revenue recognition, whether this is satisfied either over a period of time or at a point in time.

And what happens if they are distinct?

Where goods or services are deemed to be distinct from the promise to grant a licence, separate performance obligations arise. As a result, you will need to consider whether the licence transfers to a customer either at a point in time or over time. In making this determination, you will also need to consider whether the nature of the promise in granting the licence to a customer is to provide the customer with either:

- a right to access the intellectual property as it exists throughout the licence period; or
- a right to use the intellectual property as it exists at the point in time at which the licence is granted

Where the licences of intellectual property are distinct, the licence guidance for revenue recognition should be applied. In theory, the question to ask is: will the software be used in its current form? If the answer is yes, revenue should be recognised at a point in time. Otherwise, revenue will be recorded over a period of time.

Key consideration: Does the software require constant updates?

Sales-based or usage-based royalties?

Sales-based or usage-based royalty promised in exchange for a licence of intellectual property is recognised as revenue only when the later of the following events occurs:

- the subsequent sale or usage occurs; and
- the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

It is important to note that the requirement for a sales-based or usage-based royalty applies when the royalty relates only to a licence of intellectual property or when a licence of intellectual property is the predominant item to which the royalty relates.

In summary, where a royalty relates to, or primarily relates to, a licence for intellectual property and is either sales or usage based, revenue is recognised as the sale or usage occurs. When this is not the case, the general IFRS 15 guidance applies.

Key considerations: minimum royalty arrangements / tiered royalties

Customer options for additional goods or services, variable consideration and determining the transaction price

Are customer options or variable consideration included within your contracts?

Customer options to acquire additional goods or services for free or at a discount come in many forms - including sales incentives, customer award credit, contract renewal options or other discounts on future goods or services.

Where a customer option is included within the contract, the consideration from the exercise of the option is excluded from the transaction price.

IFRS 15 requires you to allocate the transaction price to performance obligations on a relative stand-alone selling price basis. If the stand-alone selling price for a customer's option to acquire additional goods or services is not directly observable, an estimation technique must be used. That estimate must reflect the discount that the customer would obtain when exercising the option, adjusted for both of the following:

- any discount that the customer could receive without exercising the option; and
- the likelihood that the option will be exercised.

Where the transaction price is not directly observable, an estimation method is used. These methods include:

a) Adjusted market assessment approach - referring to prices from competitors for similar goods or services and adjusting those prices as necessary to reflect your costs and margins.

b) Expected cost plus a margin approach – a forecast of your expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.

c) Residual approach - estimate the stand-alone selling price by reference to the total transaction price less the sum of the observable stand-alone selling prices of other goods or services promised in the contract (note – this technique can only be used subject to certain conditions being met).

Key considerations: Discounts / refunds / incentives / transaction and processing fees / allocations of discounts

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How internal audit can stay effective and relevant

The last few weeks have seen a huge upheaval as organisations respond to the COVID-19 crisis. In these uncertain times, many Heads of Internal Audit and Chairs of Audit Committees may be wondering how internal audit can remain effective and relevant. Jessica Wills explains more.

In some businesses, internal audit may be rapidly moving down the organisation's priority list as senior management and the board deal with the immediate effects and operational demands of the crisis. However, internal audit plays a crucial role as an independent and trusted advisor. More so now than ever before, they need to adapt and raise their game to ensure they remain relevant at this time of immense challenge and change.

Maintaining an achievable and feasible internal audit plan

Given the operational upheaval internal audit will be facing a number of practical challenges as they seek to complete their 'in-flight' audits and to plan their next set of audits for the coming months.

It is vital that internal audit remains dynamic and flexible. This might involve:

- Drawing 'in-flight' audits to a swift conclusion - based on the work performed to date, particularly where there are significant barriers to completing the audit fieldwork (such as being unable to perform onsite inspections or visits). In these circumstances, a brief 'flash report' of audit findings/recommendations to management and the Audit Committee may be a sufficient and proportionate approach to take. Any limitation in the audit work achieved can always be revisited at a later stage when circumstances allow.
- Reviewing and re-setting the internal audit plan for Q2 - i.e. an emergency COVID-19 internal audit plan. This might focus on helping the organisation make the right decisions during this time of immense challenge and change, and ensuring that senior management takes appropriate consideration of the risk and control environment as critical decisions are made.
- Putting a provisional plan together for Q3/4 - i.e. a post COVID-19 internal audit plan and beyond (i.e. a BAU internal audit plan). As part of this, there should be a review of the organisation's risk/audit universe to assess what risks are heightened as a result of the crisis and focus on these areas. As always, it is critical that Heads of Internal Audit discuss and approve their audit plans with the Audit Committee.
- Consider moving towards a more flexible resource model - if the internal audit function is under pressure to manage its fixed staff costs. This could be through the secondment/use of staff from elsewhere in the organisation, for example, or through co-sourcing with an external provider, enabling you to draw on resources as and when required.

Focussing on new risks and issues

It is critical that internal audit stays alert and responds to the risks their organisations are facing.

The organisation's immediate focus will have been on operational resilience and business continuity as it moves to remote ways of working. For many, the cash flow and liquidity risk implications of the crisis will now be starting to crystallise. This means that the availability and sources of funding as well as cost management (including capital expenditure, supply chains and human resources) will become key areas of focus.

In the medium to longer term, the following risk areas may become increasingly important:

- Strategic risks such as the ongoing viability of the organisation; the overall business strategy/model will come under closer scrutiny and potentially need to adapt and change.
- Operational risks associated with third parties will be heightened, particularly in those areas where the organisation is dependent on third parties for key functions, services and supplies. There is a risk that these third parties may not survive, or will struggle to remain operational and able to continue to meet contractual arrangements and service levels.
- People and cultural risks will develop as organisations adapt to new ways of working with associated changes to HR policies and procedures. Implementation of the Government's Job Retention Scheme, or redundancy measures, will increase legal risk.

To respond effectively, internal audit needs to engage with the risk function, senior management and the decision-making processes within the organisation. Internal audit often has a unique perspective, meaning it can effectively challenge whether senior management is considering the whole range of risks (and opportunities), both short term and longer term, and putting together appropriate plans to address them.

The impact of remote working on internal controls

It is likely that the internal control framework across organisations may not be operating as designed or as effectively as usual. This is a concern, particularly for key controls.

In light of this, internal audit may want to perform a 'stocktake' or gap analysis of key controls. Talking to key control owners will help to determine whether controls are continuing to be operated and are operating effectively, or if any mitigating measures are needed. Particular attention should be given to those areas which rely heavily on manual controls and the expertise and skills of their control owners/operators during this time of staff disruption.

Deploying your resources in different ways

It is inevitable in the current circumstances that senior management and auditees will be more focussed on their day job. Traditional internal audits may go on hold for the time being and internal audit may deploy itself in different ways. This might include:

- Switching the focus of work – for example, to a greater level of stakeholder engagement and attendance at management committees/forums where key strategic and operational decisions are being discussed and taken.
- Flexing the audit approach – and considering alternative ways to provide assurance, for example by carrying out incident response reviews, follow-ups or limited scope reviews.
- Focussing on key controls – this will provide valuable assurance to senior management and the Audit Committee that the baseline control environment is being maintained and is still fit for purpose during these times of change.
- Investing in knowledge and skills development - to ensure that internal audit is well armed for the challenges that lie ahead, and is able to draw on a wider range of techniques, such as data analytics.

Making sure internal audit adds value

Organisations will be making fundamental strategic and operational decisions and at a quick pace. It is vital that internal audit has a 'voice at the table' when these decisions are taken, ensuring that the risk and control implications are adequately considered.

Other areas where internal audit may add value include:

- Reviewing the status of critical or key projects - there is heightened risk that these projects will be put on hold or their objectives changed. Internal audit can play a role in determining the status of these projects, help the organisation to review and assess which projects should be prioritised and provide project assurance to management as they progress.
- Supporting HR functions - by performing some independent staff listening activity or surveys, for example. Given the likely cultural impact of the crisis, it is important that organisations are proactive in this area.

Completing previously agreed actions

It is important that internal audit and Audit Committees are realistic about what can be expected from previous audits and actions. The focus of everyone's work is likely to have changed and the completion of previous audit actions is unlikely to be a key priority. Internal audit should consider:

- Revisiting and re-prioritising the action tracker, with the approval of the Audit Committee.
- For the priority actions, talk to auditees to confirm the status of actions and whether the deadlines remain feasible.

Heads of Internal Audit need to ensure that they make the Audit Committee aware of any change of approach, and obtain their approval.

Internal audit's role after the crisis

There are, and will continue to be, a huge number of lessons to be learned from this crisis, such as:

- Effectiveness of business continuity plans
- Adequacy of IT systems
- Ability of governance/leadership to make appropriate decisions during times of stress
- Potential cultural issues/learnings demonstrated by staff's ability to adapt and respond to the crisis
- Dependencies on suppliers and other third parties within the business model
- Financial resilience and liquidity
- Potential customer issues.

Never before has the role of internal audit in reviewing and reporting on adverse events been so pertinent. Reflection on the lessons learned and analysis of what went right and wrong are likely to be key drivers and inputs into identifying priorities and setting the forward-looking internal audit plan.

If you would like to talk to our Governance, Risk & Control Assurance team on how your organisation's internal audit function can adapt in the current crisis, please contact:

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