FINANCIAL REPORTING COUNCIL

Bulletin on Review of Annual Reports

for the quarter ended 31 December 2010

1.0 Review of Annual Reports

As part of its function, the FRC reviewed annual reports to ensure compliance with the National Code of Corporate Governance and with the International Financial Reporting Standards issued by International Accounting Standards Board. Such exercise allows FRC to meet its objective of promoting quality reporting by Public Interest Entities (PIEs).

The annual reports of 24 PIEs were reviewed during the quarter ended 31 December 2010.

These PIEs consisted of:

- 5 Official Market Listed companies;
- 3 DEM Listed companies; and
- 16 'Other PIEs (2 public companies and 14 private companies).

The PIEs selected for the review came from the sectors listed below:

Sectors	No	Listed PIEs	Other PIEs	
		Public	Public	Private
Banking and Insurance	4	3	-	1
Commerce	10	2	-	8
Investments	1	1	-	-
Leisure & Hotels	3	1	-	2
Sugar	1	-	1	-
Services	3	1	1	1
Textile and Manufacturing	2	-	-	2
Total	**24**	**8**	**2**	**14**

This report is based on the annual reports for the years ended 30 June 2009 (2), 31 December 2009 (18), 31 March 2010 (3) and 30 June 2010 (1). The findings highlighted below represent areas where non-compliances may impact on the quality of reporting and the PIEs were informed of same.

2.0 Compliance with the National Code of Corporate Governance

Section 75 of the Financial Reporting Act 2004 ("FRA") provides that Public Interest Entities are now required to adopt corporate governance in accordance with the National Code of Corporate Governance. Any entity that does not adopt corporate governance is required to explain its reasons for non-compliance in its annual report, as well as in any financial statement or report which it is required to prepare. The above section of the FRA is effective for all accounting periods beginning on or after 30 July 2009.

For the quarter ended 31 December 2010 FRC considered whether the relevant disclosures required under the Code of Corporate Governance ("Code") were duly addressed by the PIEs in their annual reports.

The following were observed:

- **Out of the 24 annual reports, it was noted that 13 'Other PIEs' (including 1 public company) had <u>not reported on corporate governance</u>. This means that only 3 'Other PIEs' had complied either fully or partly with the Code**.

- **1 Listed PIE in the Insurance sector had <u>fully complied</u> with the Code and;**

- **10 (7 Listed – 2 Insurance, 2 Commerce, 1 Investment, 1 Leisure and Hotels and 1 services – and 3 'Other PIEs' (including 1 public company)) had <u>partly complied</u> with the Code.**

The 10 entities which complied partly with the Code had in particular not complied with the following areas of the code:

- Directors' responsibilities for internal control and description of internal control
- Description of non-audit services
- Information on director's remuneration
- Information on key risks and risk management
- Attendance of directors at board and board committees
- Profile of directors and senior management
- Directors responsibilities for financial statements and accounting records
- Details of internal audit function including statement as to whether internal audit function has been established
- Information relating to the material clauses of the constitution
- Integrated Sustainability Reporting
- Composition of board and board committees
- Terms of reference of board committees

Auditors to report on the extent of compliance

Section 39(3) of the Financial Reporting Act 2004 (FRA) states that 'where, in the annual report of the entity, the <u>directors</u> disclose the extent of compliance with the Code of

Corporate Governance, the auditor shall report whether the disclosure is consistent with the requirements of the Code'.

Where the directors had stated the extent of compliance with the Code, the auditors of the 2 entities (one listed company from the Insurance sector and one 'Other PIEs') had reported on the consistency of the requirements of the Code.

FRC reiterated that the requirements of the FRA had to be complied with by the auditors.

2.1 Audit and non-audit fees

Disclosure of audit and other services are required under the Companies Act 2001 and the Code of Corporate Governance. These requirements are conducive to the maintenance of auditor's independence and objectivity.

It also assists users of financial statements in assessing the nature and amount of non-audit services being provided and potential threat to auditor's independence.

The following points were observed from the review of the annual reports of the 24 PIEs with respect to audit and non-audit fees:

- 5 'Other PIEs' (including one public company) had paid fees for audit services only.

- 14 PIEs (8 Listed – 3 Insurance, 2 Commerce, 1 services, 1 Leisure and Hotels and 1 Investment and 6 'Other PIEs' (including one public company)) had paid fees for audit services as well as 'other services' provided by the same firms of external auditors. The 'other services' were mainly tax services.

  3 'Other PIEs' had not disclosed the audit and/or non-audit fees after having complied with section 218(2) of the Companies Act 2001 which stipulates that 'The shareholders of a private company or small private company may resolve by unanimous resolution that this section shall not apply to the company, and from the date of that resolution the Board shall not be required to comply with this section and sections 219 to 221…'. Hence, the company is not required to disclose the audit and non-audit fees paid or payable to the auditor.

  FRC requested that this information should be disclosed in the annual reports as required by the National Code of Corporate Governance.

- The remaining 2 'Other PIEs' had not disclosed the fees for audit and other services and explanations were requested from these PIEs.

2.2 Working Capital (Net Current Liabilities)

Working capital is an important indicator to assess the liquidity position of the entity and its ability to pay its debts in the near future. It is often used under section 6 of the Companies Act 2001 to assess the solvency of an entity.

Where an entity has negative working capital, it may indicate that the entity will be unable to meet its short-term liabilities with its current assets (cash, accounts receivable and inventory) and may not be able to meet the solvency test of the Companies Act 2001.

During the annual reports review exercise, FRC noted that, out of the 24 PIEs, 6 entities (4 Listed – 2 Commerce, 1 Investment and 1 Leisure and Hotels and 2 'Other PIEs' (including one public company)) had negative cash flows and net current liabilities at year end.

FRC observed that in most cases the net current liabilities situation arose for the following reasons:

- Share buy-back
- Acquisition of subsidiary
- Purchase of investments and associates
- Increase in repayment of loans and finance leases

A net current liabilities situation might indicate that the company would require additional financial support to address the liquidity problem to be able to continue to be in business for the next 12 months.

Out of the 6 entities which had net current liabilities, 3 listed PIEs - 1 Commerce, 1 Investment and 1 Leisure and Hotels and 1'Other PIE' had distributed dividend out of retained earnings.

An entity which pays dividend in a net current liability situation may further put pressure on its available cash flow resources and its ability to pay its debts as they become due in the normal course of business. The company may also not be able to meet the solvency test as defined in Companies Act 2001

2.3 Presentation of Financial Statements - IAS 1

IAS 1 sets overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content.

Based on the annual report review exercise, FRC noted that:

- **One 'Other PIEs' had not disclosed the relevant <u>accounting policies</u> for trade and other payables**

  Disclosure of significant accounting policies assists users in understanding how transactions, other events and conditions are reflected in the reported financial performance and financial position.

- **One listed PIE in the Commerce sector had not disclosed the <u>nature and amount of material</u> items of income or expense.**
- **Two PIEs (one listed PIE – Services and one 'Other PIEs') had not disclosed additional information on the <u>nature of expenses</u>, including depreciation, amortisation and employee benefits.**

  Information on the nature of expenses is useful in predicting future cash flows.

2.4 Inventories - IAS 2

The objective of this standard is to prescribe the accounting treatment for inventories.

One 'Other PIEs' had not disclosed in its annual report, the amount of inventories recognised as an expense as required under IAS 2.

This information is important to users of the financial statements as it discloses the inventories expense incorporated under cost of sales.

2.5 Accounting Policies, Changes in Accounting Estimates and Errors - IAS 8

This Standard is applicable in the selection and application of accounting policies, and accounting for changes in accounting policies, changes in accounting estimates and corrections of prior period errors.

FRC noted that most companies complied with IAS 8. Two entities (one listed PIE involved in the Insurance sector and one 'Other PIEs') were not fully compliant with this standard.

The 'Other PIEs' did not make disclosures when initial application of an IFRS has an effect on the current period or any prior period, or might have an effect on future periods. In both annual reports, inadequate disclosures were made in respect of new IFRS that has been issued but is not yet effective.

The above information is important as it:

- *assists in assessing the possible impact that application of the new IFRS will have on the entity's financial statements in the period of initial application.*
- *enhances the relevance and reliability of an entity's financial statements, and the comparability of those financial statements over time and with the financial statements of other entities.*

2.6 Property, Plant and Equipment - IAS 16

IAS 16 is the financial reporting standard pertaining to property, plant and equipment.

Two Listed entities from the Insurance and Commerce sectors had not revalued their land and buildings every three or five years as required under IAS 16.

Regular revaluation provides more relevant information to users of financial statements and ensures that the values used in the financial statements are fairly stated and up to date.

2.7 Revenue - IAS 18

This standard provides guidance on the recognition of revenue.

One listed entity involved in the insurance sector was informed that it had not complied with IAS 18.

As per IFRS, interest shall be recognised using the effective interest method and dividend when the shareholder's right to receive payment is established. However, the listed entity recognised these incomes on a receipt basis.

The effective interest method will exactly discount estimated future cash receipts and hence takes into consideration the time value of money.

2.8 Employee Benefits - IAS 19

Employee benefits consist of pension plans, social security contributions, paid annual leave and paid sick leave. Pension plans include defined contribution plans and defined benefit plans. The nature of the defined benefit plans varies significantly from relatively straightforward provisions for severance pay to complex pension plans of groups.

IAS 19 prescribes the accounting and disclosures of such benefits.

- **10 entities (4 listed – 2 Insurance, 1 Services and 1 Investment and 6 'Other PIEs') had fully complied with the requirements of IAS 19**

- **12 entities (4 listed – 1 Insurance, 2 Commerce, and 1 Leisure and Hotels and 8 'Other PIEs') had partly comply with the requirements of IAS 19**

The figures disclosed in the financial statements were usually based on an actuarial report which has to be carried out on a regular basis.

In one instance, the annual report review indicated that one 'Other PIEs' (a public Company) shared the risks of a defined benefit plan which was operated by its ultimate holding company. In this respect, only contribution was expensed and liability was recognised at the holding level.

With respect to those 12 PIEs that had partly complied with IAS 19, the following incomplete/missing disclosures were identified:

- accounting policy for recognising actuarial gains and losses

  Given the wide range of views on the treatment of actuarial gains and losses and past service cost, the required disclosures highlight their impact on the income statement and the impact of any unrecognised actuarial gains and losses and unamortised past service cost on the balance sheet.

- best estimate of contributions expected to be paid to the plan during the annual period beginning after the reporting period

Details of estimated contribution to be paid in next period provide useful information about the entity's cash flows in the immediate future that cannot be determined from the other disclosures about the plan.

- the amounts for the current annual period and previous four annual periods of:
  - the present value of the defined benefit obligation, the fair value of the plan assets and the surplus or deficit in the plan; and
  - the experience adjustments arising on:
    - the plan liabilities expressed either as (1) an amount or (2) a percentage of the plan liabilities at the end of the reporting period and
    - the plan assets expressed either as (1) an amount or (2) a percentage of the plan assets at the end of the reporting period.

  Disclosure about the amounts for the current annual period and previous four annual periods is important as users have a view of the plan over time as this information enables users to interpret future cash flow implications of the plan.

- for each major category of plan assets, which shall include, but is not limited to, equity instruments, debt instruments, property, and all other assets, the percentage or amount that each major category constitutes of the fair value of the total plan assets.

- the amounts included in the fair value of plan assets for:
  - each category of the entity's own financial instruments; and
  - any property occupied by, or other assets used by, the entity.

- a narrative description of the basis used to determine the overall expected rate of return on assets, including the effect of the major categories of plan assets

- the actual return on plan assets

  Information about plan assets enables users to assess the level of risk inherent in each category of assets

- an analysis of the defined benefit obligation into amounts arising from plans that are wholly unfunded and amounts arising from plans that are wholly or partly funded

- a reconciliation of the opening and closing balances of the fair value of plan assets

  Reconciliations showing the changes in plan assets and defined benefit obligations give clearer information about the plan.

- general description of the type of plan

  Information about the nature of the plan ensures that the description of the plan is complete and includes all the terms of the plan that are used in the determination of the defined benefit obligations.

One 'Other PIEs', had not made disclosures relevant for unfunded defined benefit as per IAS 19 even though it had made provision for severance allowance as per the Employee Rights Act 2008.

In this respect, the entity had been notified that even if the Employee Rights Act 2008 was complied with, severance allowance should be accounted for as a defined benefit plan under IAS 19 as:

- it falls under the definition of post-employment benefits - employee benefits are payable after the completion of employment.

- it is unfunded and is an arrangement under which an entity provides post-employment benefits for one or more employees.

Information about defined benefit plans is particularly important to users of financial statements because other information published by an entity will not allow users to estimate the nature and extent of defined benefit obligations and to assess the risks associated with those obligations.

2.9 Investments in Associates - IAS 28

This IAS applies to entities holding investments in associates.

One Listed entity from the insurance sector had not met some of the disclosure requirements of IAS 28.

The PIE had significant influence on an associate in which it held less than 20 per cent of the shares. However, it had not disclosed the reasons for the presumption of significant influence.

Disclosures were also not made regarding summarised financial information of associates including the aggregated amounts of assets, liabilities, revenues and profit or loss.

Information about presumption of significant influence is useful as it provides financial statement users evidence that significant influence exists either through representation on the board of directors, participation in policy-making processes, material transactions between the investor and the investee, interchange of managerial personnel; or provision of essential technical information.

Summarised financial information of associates highlights the financial impact of associates on the entity's financial statements.

2.10 Intangible Assets- IAS 38

IAS 38 applies –

- on acquisition to the accounting for intangible assets acquired in business combinations
- to all other intangible assets

Two listed PIEs – 1 Insurance and 1 Commerce did not make the following disclosures:

- the amortisation methods used for intangible assets with finite useful lives
- additional information explaining the figures shown under intangible assets

It is important for users to be informed of the measurement basis or bases used in the financial statements because the basis on which the financial statements are prepared significantly affects users' analysis. Lack of detail provided in the notes also further inhibits the ability of users to evaluate the impact of the intangible assets on the financial statements.

2.11 Business combinations - IFRS 3

IFRS 3 applies to a transaction or other event that constitutes a business combination.

Four entities (3 1isted entities – 1 Insurance, 1 Commerce and 1 Investment and 1 'Other PIEs') had not complied with IFRS 3. The following disclosures were found to be missing in the annual reports:

- disclosure of the primary reasons for the business combination;
- a description of how the acquirer obtained control of the acquiree;
- a qualitative description of the factors that make up the goodwill recognised by the acquirer.
- The acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date; and
- The amount of any gain or loss recognised as a result of remeasuring to fair value the equity interest in the acquiree held by the acquirer before the business combination and the line item in the statement of comprehensive income in which that gain or loss is recognised.

The above information is useful to investors, creditors and others in evaluating the financial effects of the business combination.

2.12 Insurance Contracts- IFRS 4

The IFRS applies to all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs.

FRC noted that 2 entities (one listed and'Other PIEs') had not properly disclosed the following in accordance with IFRS 4:

- Impairment of reinsurance assets
- Explanations of the amounts recognised in the financial statements arising from insurance contracts
- Information about insurance risk (both before and after risk mitigation by reinsurance), including information about:
    - sensitivity to insurance risk
    - actual claims compared with previous estimates (ie claims development)

IFRS requires disclosure to help users understand:

- *the amounts in the insurer's financial statements that arise from insurance contracts*
- *the nature and extent of risks arising from insurance contracts*

2.13 Financial Instruments: Disclosures - IFRS 7

IFRS 7 deals with the disclosures requirements of all risks arising from financial instruments.

FRC noted from the review exercise that 12 PIEs (5 Listed – 2 Insurance, 1 Commerce, 1 Services and 1 Investment and 7 'Other PIEs' (including 1 public company)) did not comply fully with IFRS 7.

The following non-disclosures were identified:

- net gains or net losses on:
  - available-for-sale financial assets, showing separately the amount of gain or loss recognised in other comprehensive income during the period and the amount reclassified from equity to profit or loss for the period;
  - held-to-maturity investments;
  - loans and receivables; and
  - financial liabilities measured at amortised cost.

- Interest income on impaired financial assets accrued

- Carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities

- Objectives, policies and processes for managing risk

- Information on credit risk such as:

  - the amount that best represents its maximum exposure to credit risk at the end of the reporting period
  - description of collateral held as security and other credit enhancements
  - information about the credit quality of financial assets that are neither past due nor impaired
  - the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated
  - an analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired
  - an analysis of financial assets that are individually determined to be impaired as at the end of the reporting period, including the factors the entity considered in determining that they are impaired.

- Sensitivity analysis for each type of market risk to which the company is exposed and the methods and assumptions used in preparing the sensitivity analysis.

<u>Significance of disclosures required under IFRS 7</u>

Information about net gains or net losses on financial assets is needed for users to understand the financial performance of an entity's financial instruments, given the different measurement bases in IAS 39.

Disclosure about interest income on impaired financial assets accrued is important because it identifies the part of interest income that involves a higher risk of receiving payment.

Details about an entity's exposure to risks arising from financial instruments should be required as it provides a useful insight into how the entity views and manages risk.

IFRS 7 also requires specific information about credit risk. This improves users' understanding as:

- Details of maximum exposure to credit risk
  - provides users of financial statements with a consistent measure of an entity's exposure to credit risk; and
  - takes into account the possibility that the maximum exposure to loss may differ from the amount recognised in the balance sheet.

- Information about credit quality provides a greater insight into the credit risk of assets and helps to assess whether such assets are more or less likely to become impaired in future.

- An analysis of impaired financial assets by factors other than age (e.g nature of the counterparty, or geographical analysis of impaired assets) helps to understand why the impairment occurred.

- Details of collateral held as security and other credit enhancements provide useful information about the loss the entity might incur in the event of default.

- Information about the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated helps users assess whether such assets are more or less likely to become impaired in the future.

- An analysis of the age of financial assets that are past due at the reporting date but not impaired provides users with information about those financial assets that are more likely to become impaired and helps users to estimate the level of future impairment losses.

Sensitivity analysis is important because it is informative to users of financial statements.

2.14 Operating segments: IFRS 8

IFRS 8 Operating Segments applies to listed entities and is effective for the audited financial statements for periods beginning on or after 1 January 2009. It sets out requirements for disclosure of information about an entity's operating segments and also about the entity's products and services, the geographical areas in which it operates, and its major customers. The requirements of the IFRS are based on the information about the components of the entity that management uses to make decisions about operating matters.

The following were observed during the annual report review exercise of the 8 listed entities:

- **Four entities - 1 Insurance, 2 commerce and 1 Leisure and Hotels – had <u>fully complied</u> with the requirements of IFRS 8;**

- **Three entities - 1 Insurance, 1 Services and 1 Investment – had partly complied with the requirements of IFRS 8;**

- **One entity from the Insurance sector had not complied with the requirements of IFRS 8 as this IFRS is not applicable.**

The following disclosures were found to be missing in the financial statements of the above 4 PIEs:

- factors used to identify the entity's reportable segments, including the basis of organization
- for each reportable segment:
  - revenues from transactions with other operating segments of the same entity
  - interest revenue
  - Reconciliations of the total of the reportable segments' revenues to the entity's revenue
- information about the extent of reliance on major customers.

This information provides sufficient explanation of the basis on which the information was prepared. Moreover, it assists users of financial statements in understanding segment disclosures and evaluating the nature and financial effects of the business activities it engages and the economic environments in which it operates. It also enhances comparability between reporting segments.

3.0 Status of reviews carried out in previous quarter ended 30 September 2010

During the quarter ended 30 September 2010, FRC reviewed the annual reports of 22 PIEs. These comprised of:

- 11 Official Market Listed companies – 1 Insurance, 3 Commerce, 3 Investment, 2 Leisure and Hotels and 2 Services;
- 1 DEM Listed company from the Sugar sector; and
- 10 'Other PIEs'(1 public company and 9 private companies).

It was good to note that the majority of PIEs respond to FRC's queries on a timely basis. Following an analysis of the entities' replies, the observations listed below were made:

- The entities duly noted the points raised and/or issued explanations in respect of non-compliances. Some PIEs stated that disclosures would be made in their next annual reports.

- FRC reiterated its comments to 3 entities in respect of the following:

  - the auditor's report on the consistency of the Code of Corporate Governance (1 listed entity from the Commerce sector)
  - disclosures for each type of risk arising from financial instruments (1 'Other PIEs'):

- the exposures to risk and how they arise
- its objectives, policies and processes for managing the risk and the methods used to measure the risk

- accounting policy on IAS 19 (1 'Other PIEs')
- a description of the facts and circumstances of the sale, or leading to the expected disposal, and the expected manner and timing of that disposal (1 listed PIE - Investment)

- 7 'Other PIEs' had not submitted their corporate governance reports in the previous quarter. All of them undertook to include same in future annual reports.

4.0 Conclusion

FRC noted that there was an overall good response among the PIEs to improve compliance with the International Financial Reporting Standards and the National Code of Corporate Governance.

It was noted that many PIEs took account of the non-compliances raised from last year in their current annual reports. Compliance with IFRS by PIEs is required by various laws such as the Companies Act 2001, Financial Reporting Act 2004, Banking Act 2004 (for institutions regulated by the Bank of Mauritius) and the Listing Rules (for the listed entities).

FRC would continue to monitor issues that were addressed to the PIEs. This would be done as a follow-up exercise.

FRC expects PIEs to improve their financial reporting as they familiarize themselves with the requirements of IFRS and give due consideration to market conditions and developments in IFRS.

Prepared by FRC
24 January 2011