Most Prominent Observations on Listed Companies' Financial Statements Disclosures for the years 2020 and 2021

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هيئة السوق المالية
Capital Market Authority

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Financial Statements Department – Financial Statements and Auditors Division

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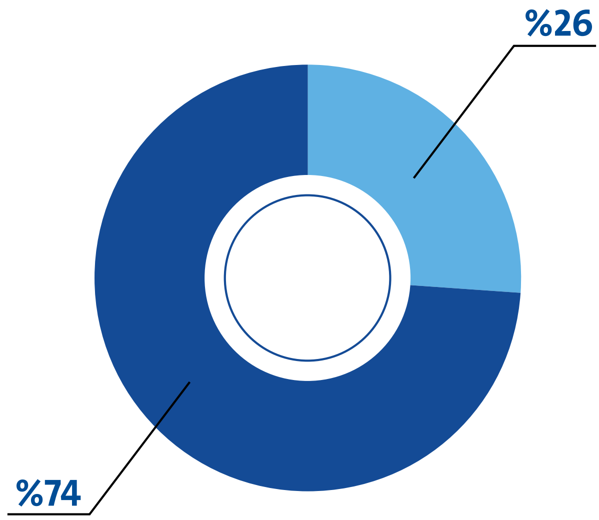
Contents

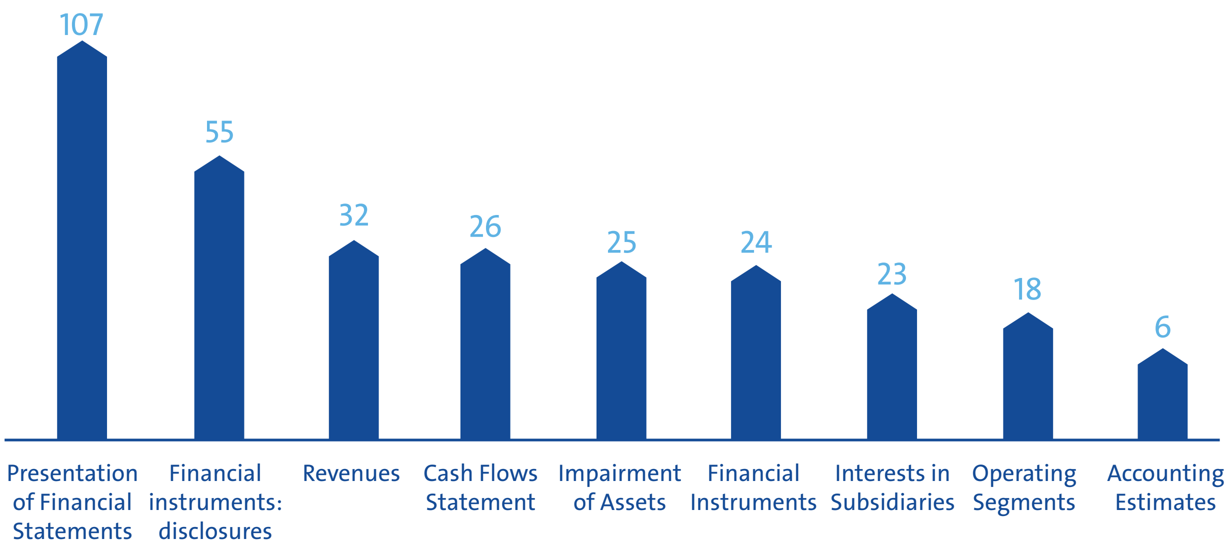
Executive Summary

The Capital Market Authority (CMA) working team annually takes a sample of the financial statements of listed companies, and inspects a number of items within those statements, to assess their compliance with the International Financial Reporting Standards (IFRS) that are endorsed in Saudi Arabia and other standards and pronouncements endorsed by the Saudi Organization for Chartered and Professional Accountants (SOCPA) ("The Standards") In addition, the CMA team analyzes the observations contained in auditors' reports, complaints and the received violation reports regarding the financial statements of listed companies. The present report is intended to provide an overview of the key deficiencies, identified through this financial statement assessment and analysis process, which requires further improvements. It is expected that this report will be a focus of attention to issuers of the financial statements from companies, as well as to auditors of entities subject to CMA supervision, audit committees, investors and other stakeholders interested in enhancing the quality of financial reports. During 2020 and 2021, the CMA working team assessed and analyzed financial statements of 53 companies listed on the Saudi market, whose market value amounted to SAR 330 billion compared to the total market capitalization of all listed companies amounting to SAR 10 trillion.

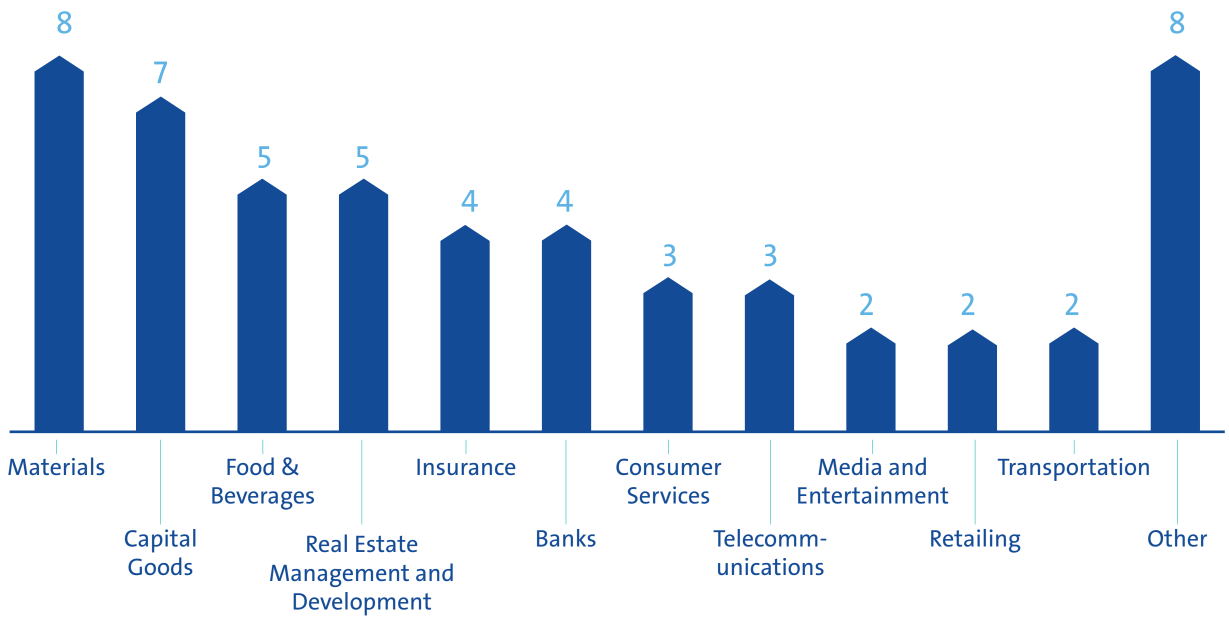


Total number of examined companies to total number of listed companies

The figure below shows the number of key deficiencies categorized by accounting standard.



The figure below shows the number of sampled companies' financial statements, according to the sector to which they belong as classified by Tadawul.



Finally, the report presents some of the lessons learned from the financial statement assessment and analysis process. The lessons learned are centered around the importance of focusing on the role of all participants who contribute to the preparation of the financial statements to achieve the desired financial statements quality.

It should be noted that the observations included in this report do not necessarily mean that there are no other observations on the financial statements of listed companies. The CMA working team also stresses the need to comply with the Standards.

Key Observations in Listed Companies’ Financial Statements Disclosures:

1. Presentation of Financial Statements

Frequent deficiencies were noted in the presentation and disclosures of financial statements, and the use of a (boilerplate) standard disclosures format excluding detailed disclosures of assumptions and estimates underlying the amounts recognized in the financial statements.

A. Going Concern

When preparing financial statements, management shall make an assessment of an entity’s ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern, the entity shall disclose those uncertainties. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern

(IAS 1 paragraph 25)

In a number of instances, companies have not explained how they reached the critical judgements when preparing financial statements on a going concern basis. Some companies have dismissed disclosure of significant matters regarding the company’s ability to continue as a going concern, and have provided general brief disclosures. In some other cases, companies provided prolonged narratives without presenting any material information explaining why management concluded that the company is able to continue as a going concern.

Furthermore, some companies did not provide detailed material information concerning management plans to restore the company financial health. Such disclosures should describe key contingencies that the plan relies upon, especially the existence of uncertain events beyond the company's control (e.g., negotiations with banks to restructure loans). Users need such information to be able to comprehend the critical judgments made by management when preparing the financial statements on a going concern basis.

B. Judgments and Estimates

An entity shall disclose, along with its significant accounting policies or other notes, the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognized in the financial statements.

(IAS 1 paragraph 122)

An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year...

(IAS 1 paragraph 125)

- Some companies tend to use (boilerplate) standard disclosures to disclose the significant estimates and judgments used to prepare financial statements. Some cases included disclosures of judgments and estimates that are not related to the company's financial statements. For example, a company disclosed assets impairment as a significant estimate in accordance with IAS 36 despite not having performed any impairment tests in the same period.

- Through the disclosures viewed, it was noted that some companies disclosed the judgments and estimates without separating them, contrary to what was stated in IAS 1 paragraph 122, which indicated that judgments of the management should be disclosed apart from the estimates.

C. Mixing Nature and Function of Expenses

An entity shall present an analysis of expenses recognized in profit or loss using a classification based on either their nature or their function within the entity, whichever provides information that is reliable and more relevant.

(IAS 1 paragraph 99)

An entity classifying expenses by function shall disclose additional information on the nature of expenses, including depreciation and amortization expense and employee benefits expense.

(IAS 1 paragraph 104)

In several cases, some companies did not disclose cost of sales details when presenting costs based on their nature.

D. Reporting Operating Expenses Outside of Operating Profit

Some companies have reported operating expenses outside of operating profit, despite the fact that expenses occurring infrequently or irregularly or not involving cash flows do not negate being operating expenses (such as impairment losses and provisions). Paragraph 56 of the basis for conclusion of IAS 1 indicated that, in the IASB Board view, it would be misleading and would impair the comparability of financial statements if items of an operating nature were excluded from the results of operating activities, even if that had been industry practice. For example, it would be inappropriate to exclude items clearly related to operations (such as inventory write-downs and restructuring and relocation expenses) because they occur irregularly or infrequently or are unusual in amount. Similarly, it would be inappropriate to exclude items on the grounds that they do not involve cash flows, such as depreciation and amortization expenses.

2. Financial Instruments

Deficiencies directly related to IFRS 9 and IFRS 7 were noted . Below is a brief explanation of the key relevant issues:

A. Credit Risk

The credit risk disclosures made in accordance with paragraphs 35F–35N shall enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. To achieve this objective, credit risk disclosures shall provide: ...

(IFRS 7 paragraph 35B)

- Some companies did not update their disclosures on credit risk since the adoption of IFRS 9. Instead they based their disclosures on IAS 39 and have not applied updates introduced by IFRS 9 to IFRS 7 such as paragraphs 35A to 35N. For example, some companies still used the terminology of the previous standard such as "past due but not impaired", which is not in accordance with the new IFRS 9 accounting requirements.

- Some companies applied the expected credit losses model and provided disclosures related to IFRS 7 for non-financial assets, such as advance payments concerning the right to receive goods and services from suppliers (without the right to a refund), while others applied expected credit losses model only to receivables without applying the same to other financial assets such as customer contracts-generated assets. IFRS 9, paragraph 5.5.1 requires the application of the credit loss model to all financial assets recognized at amortized cost.

B. Liquidity Risk

An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

(IFRS 7 paragraph 31)

Poor disclosure of liquidity risk reoccurred in most of the reviewed financial statements, and the most common observations were as follows:

- Companies used discounted amounts in their maturity analysis rather than undiscounted amounts in liquidity risk disclosure required by paragraph 39 of IFRS 7
- In some cases, when preparing maturity analyses, companies presented less details than the time bands suggested by IFRS 7, although their disclosure of going concern judgments required presenting more time bands for obligations arising in less than a year in light of liquidity risks and critical judgments regarding going concern of the company. This disclosure is necessary to enable the users of the financial statements to understand the nature and extent of risks faced by the company.
- Some companies provided poor standard disclosures (Boilerplate) about how the company manages liquidity risks in the financial statements. Although the amount of disclosures depends on the company's facts and circumstances, it is expected that there will be detailed disclosures about the company's management of liquidity risks especially when the company discloses a critical judgement related to going concern challenges.
- Some companies excluded a number of financial liabilities items such as trade and other payables from the liquidity risk disclosures, while others provided liquidity risk disclosures for non-financial liabilities items such as Zakat obligations.

C. Financial Guarantee Contracts

A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

(IFRS 9 – Financial Guarantee Contract - Appendix A)

- In some cases, companies have classified financial guarantee contracts as contingent liabilities, although IAS 37 has made it explicitly clear in its scope that IAS 37 does not apply to financial instruments including guarantees, but rather such guarantees fall within the scope of IFRS 9, that is, it shall be measured upon initial recognition at fair value and measured subsequently in accordance with IFRS 9 paragraph 4.2.1 (c).
- Some companies, in a number of cases, have provided guarantees for associate companies to borrow from banks without recognizing these guarantees as liabilities, although the standard mandated that the financial guarantee contracts should be recognized as a liability from the date of issuance, regardless of the possibility of the guarantee being called.

D. Borrowing (d.1 Effective Interest Method)

Interest revenue shall be calculated by using the effective interest method. This shall be calculated by applying the effective interest rate to the gross carrying amount of a financial asset...

(IFRS 9 paragraph 5.4.1)

Some companies obtained borrowings with irregular repayment profiles, at which the principal of the loan carrying amount did not match the amortized cost as per IFRS 9. In some cases, companies recognized the debt based on the principal amount and expensed finance charges when paid rather than following IFRS 9. IFRS 9 effective interest method should be applied in all cases. Further, companies shall calculate the effective interest rate implicit in the borrowing and accrue interest at that rate.

D. Borrowings (d.2 Borrowings Classification into Current / Non-Current Resulting from Breach of Bank Loan Covenants)

When an entity breaches a condition of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand, it classifies the liability as current, even if the lender agreed, after the reporting period and before the authorization of the financial statements for issue, not to demand payment as a consequence of the breach. An entity classifies the liability as current because, at the end of the reporting period, it does not have the right to defer its settlement for at least twelve months after that date.

(IAS 1 paragraph 74)

Some companies, that have breached the bank loan covenants at the date of the statement of financial position, recorded the borrowings in breach of covenants as non-current liabilities despite being in breach of covenants at the reporting date, which is considered a violation of the Standards even if the company's management expects that the lender will not call the debt.

D.Borrowings (d.3 Derivatives)

Derivative: A financial instrument or other contract within the scope of this Standard with all three of the following characteristics.

(a) its value changes in response to the change in a specified interest rate,...

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts...

(c) it is settled at a future date.

(IFRS 9 - Derivative Definition - Appendix A)

An embedded derivative is a component of a hybrid contract that also includes a non-derivative host—with the effect that some of cash flows of the combined instrument vary in a way similar to a stand-alone derivative...

(IFRS 9 paragraph 4.3.1)

Some companies have loans with an early repayment option. However, the majority of these companies did not consider this option to determine the possibility of having a separable embedded derivative, and whether the embedded derivative is clearly and closely related to the host contract in accordance with paragraph B4.3.5 of IFRS 9.

3. Revenues

Deficiencies related to recognition policies of revenues and related disclosures were repeated. The following are the results based on the inspected cases:

A. Disclosures & Performance Obligations

The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows...

(IFRS 15 paragraph 110)

- Critical lack of disclosures related to revenue, especially with regard to the requirements of paragraphs 110-129 of IFRS 15. In a number of cases, companies tried to satisfy disclosure requirements by providing a boilerplate disclosure. Some companies did not explain the main activities carried out by the company such as the goods sold and services provided to generate revenue. Further, some companies did not clarify the timing and method of payment in relation to generated revenues.
- Revenue accounting policies for important performance obligations were sometimes unclear or not disclosed (e.g. significant payment terms, nature of goods and services to be transferred, information about remaining performance obligations).
- Some companies have relied on invoices only to determine performance obligations and for allocation of the transaction price. Further, these companies did not, in some cases, have a documented accounting policy for revenues and significant judgments related thereto, despite the complexity of relevant estimates and the requirements of the standards.
- There is room for improvement in disclosures about the timing of revenue recognition, including whether it was at a point in time or over time.
- Some financial statements contained insufficient disclosures about the methods used to recognize revenue from satisfaction of performance obligations over time, how such methods where applied (e.g. Output/ input methods), and how they provide a faithful depiction of the transfer of goods or services.

B.Right to Payment

An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria is met:

(a)...................

(b)...................

(c) The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

(IFRS 15 paragraph 35-c)

In some contracts, a customer may have a right to terminate the contract only at specified times during the life of the contract or the customer might not have any right to terminate the contract. If a customer acts to terminate a contract without having the right to terminate the contract at that time (including when a customer fails to perform its obligations as promised), the contract (or other laws) might entitle the entity to continue to transfer to the customer the goods or services promised in the contract and require the customer to pay the consideration promised in exchange for those goods or services. In those circumstances, an entity has a right to payment for performance completed to date because the entity has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations (which include paying the promised consideration).

(IFRS 15 paragraph B11)

Some companies have recognized all of their revenue at a given point in time, despite selling products that have no alternative use (customized), and hence did not properly assess their right to payment as required by IFRS 15. In addition, it seemed that these companies had overlooked what is referred to in paragraph B11 of the same standard, which makes it clear that the seller has a right to payment for contracts that the customer can't terminate and at which the seller is entitled to require the customer to pay the consideration promised.

4. Impairment of Assets

Deficiencies related to companies' impairment of assets were noted, and the most important deficiencies are as follows:

A. Performance of Impairment Tests

An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired...

(IAS 36 paragraph 9)

- Some companies did not conduct impairment tests of their assets despite the existence of indicators of impairment, which led to auditors' qualified opinions in a number of cases.
- Some companies did not use realistic assumptions in their tests or failed to appropriately adjust for risk in their impairment tests.

B.Inadequate Disclosures

An entity shall disclose the following for an individual asset (including goodwill) or a cash-generating unit, for which an impairment loss has been recognized or reversed during the period:

(a) The events and circumstances that led to recognition or reversal of the impairment loss.
(b) The amount of impairment loss recognized or reversed.
(c) For an individual asset:
(i) nature of the asset; and
(ii) if the entity reports segment information in accordance with IFRS 8, the reportable segment to which the asset belongs.

(IAS 36 paragraph 130)

An entity shall disclose the information required by (a)–(f) for each cash-generating unit (group of units) for which the carrying amount of goodwill or intangible assets with indefinite useful lives allocated to that unit (group of units) is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives...

(IAS 36 paragraph 134)

Severe lack of disclosures was observed, as some companies failed to provide the majority of the required disclosure. Some companies did not even specify the asset that was impaired, despite the fact that the impairment losses recorded were material to the financial statements.

5. Statement of Cash Flows

Quality of the statement of cash flows continues to be one of the major weaknesses for certain companies. The following are the main observations based on the inspected cases:

A. Inclusion of non-cash items within the Statement of Cash Flows

Investing and financing transactions that do not require the use of cash or cash equivalents shall be excluded from a statement of cash flows...

(IAS 7 paragraph 43)

Some companies have included non-cash items in the investing and financing activities section of the Statement of Cash Flows. For example, the inclusion of previous years restatements as a cash item.

B. Disclosures of changes in liabilities arising from financing activities

An entity shall provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes.

(IAS 7 paragraph 44A)

A number of companies demonstrated poor level of compliance with the required disclosures; these companies' disclosures failed to provide users of financial statements with important information about the nature and basis of the movement during the year in liability balances, arising from financing activities, disclosed within the statement of financial position.

C. Reporting cash flows on a net basis

Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:

(a) Cash receipts and payments on behalf of customers when cash flows reflect the activities of the customer rather than those of the entity; and

(b) Cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

(IAS 7 paragraph 22)

With regard to reporting cash inflows and outflows on a net basis, many companies have netted cash inflows and outflows from financing activities such as the cases of receipt of loan proceeds and payment of loans on a net basis, despite not meeting the conditions of the IAS 7. This may constitute more ambiguity of information about the entity's borrowings that can be very important to users.

6. Operating Segments

Disclosure of Operating Segments

The amount of each segment item reported shall be the measure reported to the chief operating decision maker for the purposes of making decisions about allocating resources to the segment and assessing its performance. Adjustments and eliminations made in preparing an entity's financial statements and allocations of revenues, expenses, and gains or losses shall be included in determining reported segment profit or loss only if they are included in the measure of the segment's profit or loss that is used by the chief operating decision maker. Similarly, only those assets and liabilities that are included in the measures of the segment's assets and segment's liabilities that are used by the chief operating decision maker shall be reported for that segment. If amounts are allocated to reported segment profit or loss, assets or liabilities, those amounts shall be allocated on a reasonable basis.

(IFRS 8 paragraph 25)

It was noted that some companies demonstrated weak understanding of the Standard's requirements. Disclosures in the notes to the financial statements about the operating segments must be for the same segments used by the company's management to review the company's performance and allocation of resources. In a number of cases, when CMA requested the internal management financial reports that were submitted to the Chief Operating Decision Maker (CODM), and upon which they have relied on segment disclosures, some companies have provided an annual working paper prepared at the year end, which separates the revenues and expenditures figures into different segments for the purposes of preparing financial statements. Accordingly, it was surprising to find the segment disclosure amounts reported internally in full conformity to the amounts stated in the financial statements which are in line with the Standards, without the need to reconcile the numbers. Further, it is hard to believe that the CODM is regularly provided with IFRS compliant total comprehensive income figures on a segment by segment basis with all income and expenses (including Zakat and all items of OCI) allocated between segments.

7. Interests in Other Entities

An entity shall disclose information that enables users of its consolidated financial statements:

(a) to understand:

(i) the composition of the group; and

(ii) the interest that non-controlling interests have in the group's activities and cash flows; and

(b) to evaluate:

(i) the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group

(ii) the nature of, and changes in, the risks associated with its interests ...

(iii) the consequences of changes in its ownership interest in a subsidiary...

(iv) the consequences of losing control of a subsidiary...

(IFRS 12 paragraph 10)

An entity shall disclose information that enables users of its financial statements to evaluate:

(a) the nature, extent and financial effects of its interests in joint arrangements and associates, including the nature and effects of its contractual relationship with the other investors with joint control of, or significant influence over, joint arrangements and associates; and

(b) the nature of, and changes in, the risks associated with its interests in joint ventures and associates.

(IFRS 12 paragraph 20)

Poor level of compliance by a number of companies with the requirements of IFRS 12; for example, some companies that have material equity investments or material non-controlling interests failed to provide a summary of financial information disclosures of these entities as per the requirements of the Standards.

8. Accounting Estimates

As a result of uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated. Estimation involves judgments based on the latest available, reliable information...

(IAS 8 paragraph 32)

- Some companies failed to record some accounting entries during the appropriate reporting period because of the uncertainty about the estimated amount of the transaction or write down. Uncertainty about estimates shall not be deemed an excuse to defer recording a transaction or event unless specified by the Standards. IAS 8, paragraph 33, states clearly that the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. Where estimates are particularly significant they should be disclosed appropriately in the financial statements in accordance with the relevant standards. Further, it is required to revise such estimates regularly and as new information becomes available. As an example, some companies failed to record the estimated amount arising from a decision made by regulatory authorities, which have been available on the date of the financial statements.
- Some companies made unrealistic estimates, as the management of such companies has made estimates without considering the relevant data and evidence available when preparing the financial statements. For example, some companies failed to regularly measure the residual value of assets when estimating the depreciation expense. It is worth noting that IAS 8, paragraph 32 requires the accounting estimates to rely on the most updated available information.

Lessons Learned:

Given that the financial statements and financial information are key for promoting confidence, and enhancing transparency and disclosure in the Capital Market, and the main method used by the entities to communicate financial information to financial statements' users for their decision making, it is important to activate the roles related to the preparation of financial statements, its audit and quality by all involving parties as follows:

1. Role of The Management of Listed Companies:

The responsibility for the preparation and fair presentation of the financial statements and related disclosures as required by IFRS endorsed in the Kingdom of Saudi Arabia and the laws and regulations to which the listed companies are subject, rests with management. This responsibility includes designing, implementing, and maintaining internal controls relevant to the preparation and fair presentation of the financial statements that are free of material misstatement, whether due to error or fraud.

It is critical for the management of a company to have sufficient, competent staff with the right skills to ensure that the financial statements are in compliance with current accounting standards and financial reporting requirements.

Company's management is considered one of the major factors for enhancing the quality of financial statements. The improvement can be done through modernizing the internal controls within its organization through the implementation of leading practices, innovation, and technology to increase the level of precision of the performance of the internal controls. It is critical for management to have documentation of their financial reporting processes which includes evidence related to the process flows and related risks and internal controls. Ultimately, these actions may serve to reduce the cost of compliance and increase the reliability of financial reporting.

2. Role of The Board of Directors:

Companies Law, as well as the Corporate Governance Regulations, include provisions that expressly state that the Board of Directors shall be responsible for preparing the financial statements. Moreover, the Board shall hire the competent persons to manage the company and competent persons who have the necessary accounting and financial knowledge to run the finance affairs.

3. Role of The Audit Committee:

The audit committee shall be competent in monitoring the company's activities and ensuring the integrity and effectiveness of the reports, financial statements and internal control systems. Based on the Corporate Governance Regulations, the Audit Committee competencies, powers and responsibilities include analyzing the interim and annual financial statements of the company before presenting them to the Board of Directors and providing its opinion and recommendation thereon to ensure the integrity, fairness and transparency of the financial statements. It is worth noting that it is important that the Audit Committee includes a member specialized in finance and accounting.

4. Role of The External Auditor:

Auditors and audit firms are key elements of the financial reporting eco-system, and the quality of their work is pertinent to the success of the capital market. The purpose of an audit is to enhance the degree of confidence of intended users of financial statements. This is achieved by auditors gathering sufficient appropriate audit evidence in order to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. It is expected that the registered accounting firms to audit entities subject to CMA supervision will consider the findings in this report as they continue to develop efforts to enhance their own audit quality.

End of the report