A&A Accounting Technical

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Clarity in financial reporting

Learnings from ASIC findings - considerations for next reporting season

Talking points

- The Australian Securities and Investments Commission (ASIC), in its role as a regulator, announces its focus areas related to financial reports twice a year. ASIC also conducts reviews of financial reports, makes inquiries relating to financial reporting and accounting matters and releases its findings related to these reviews bi-annually
- Over the last three years, we have noticed a steady increase in ASIC's surveillance activity. This is evident from the increase in the number of inquiries made by ASIC every year. To date impairment of non-financial assets has received strong focus and we anticipate that this will continue
- Some of the inquiries made by ASIC have resulted in entities having to amend their financial statements. The details of these are publicly available and communicated via ASIC's media release channels. We note that 50% of the media releases in 2019 to date are related to impairment
- During August 2019, ASIC released its financial reporting surveillance findings relating to 31 December 2018 financial reports. Inquiries made by ASIC covered a range of matters, the more prevalent being:
    - **Impairment and other asset values**
    - **Revenue recognition**
    - **Non-IFRS measures**
    - **Tax accounting**
    - **Consolidation accounting**
- We strongly recommend that entities carefully consider ASIC's findings, and published focus areas, and pay close attention to the areas listed above in the upcoming reporting season.

For more information please see the following websites:

www.iasplus.com

www.deloitte.com

Introduction

The objective of this publication is to provide a summary of the most recent ASIC findings for 31 December 2018 reports and our insights into them in order to help entities prepare for the next reporting season. We have also analysed historical findings over the past three years to highlight ASIC's focus areas through the surveillance program.

ASIC findings – historical trends

On 8 August 2019, ASIC released its financial reporting surveillance findings relating to 31 December 2018 financial reports (**ASIC Findings from 31 December 2018 financial reports**). ASIC reviewed 125 entities (including 40 half-year reports) during the July 2018 to 31 December 2018 period. It made inquiries of 26 entities on 40 matters about financial reporting matters. ASIC has clearly indicated its intention that both full year and half-year financial reports are within the scope of the surveillance program.

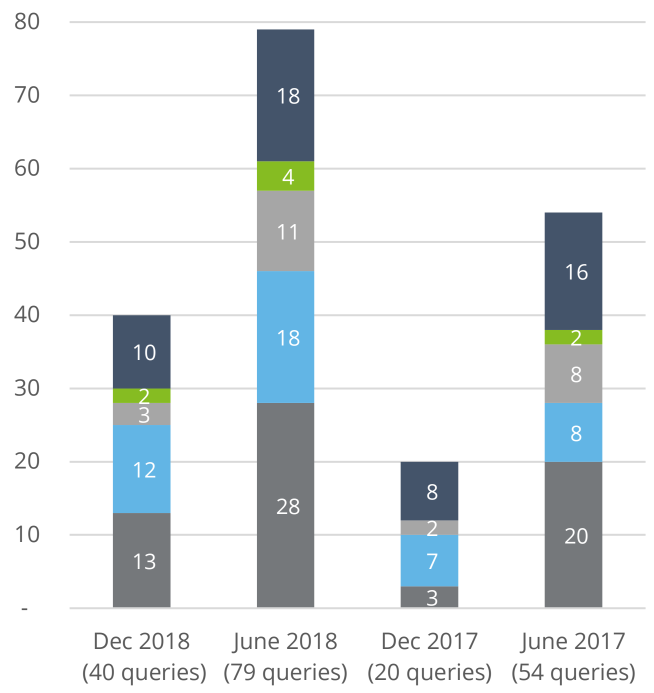
ASIC focus areas and media releases

In June 2019, ASIC confirmed its focus areas for 30 June 2019 financial reports. These focus areas are largely consistent with the key areas of findings from 31 December 2018. For more information on the ASIC focus areas, see the Deloitte Clarity publication **ASIC focus areas for June 2019 reporting** and the ASIC media release **Major financial reporting changes and other focuses**.

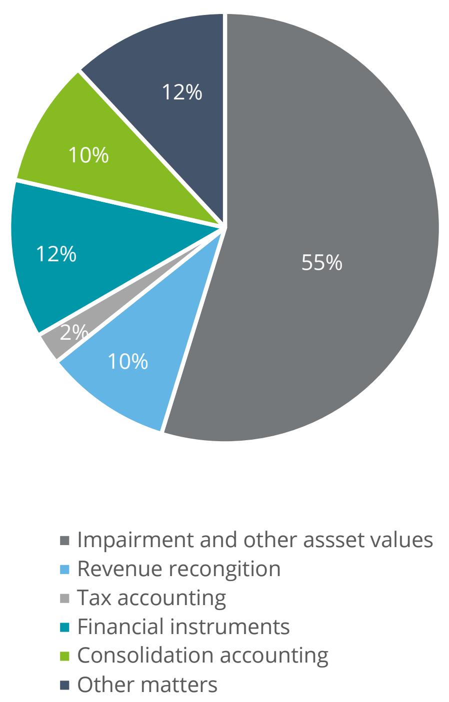
In addition to general findings, ASIC also publishes media releases identifying cases where specific entities have amended their financial statements following an inquiry. These media releases identify the name of the entity and communicate details of any amendments made to financial reports, including the dollar value and description of the issue, resulting from inquiries through the surveillance program. The details of these are publically available and communicated via ASIC's media release channels. In line with ASIC's increased surveillance activity, we note an increase in the number of such amendments since 2017. ASIC published 16 media releases in 2019 (to date), 5 in 2018 and 21 in 2017.

ASIC has demonstrated strong focus on impairment of non-financial assets, such as goodwill, brands and property, plant and equipment and we anticipate that this will continue. Entities that operate in industries affected by current depressed economic conditions and entities whose market capitalisation does not support recognised net carrying values should pay attention to this area when preparing financial reports. Further, we have seen an increasing focus on revenue recognition and we expect this to continue.

ASIC review areas



ASIC findings leading to amendments (since 2017)



From the data above, ASIC's increased surveillance activity is evident and 50% – 70% of ASIC's findings on financial reports since 2017 relate to issues on impairment testing of assets, revenue recognition and tax accounting.

ASIC findings from December 2018 review

1. Impairment and other asset values

ASIC identified 13 matters related to impairment and has indicated that it will continue to focus on the recoverability of the carrying amounts of assets such as goodwill, other intangibles and property, plant and equipment. Directors and auditors should ensure that the methodology and assumptions used for determining the recoverable amounts of individual assets and cash-generating units (CGUs) are appropriate. Some of the key findings include:

Cash flow assumptions

- Cash flow assumptions and other inputs used by entities in determining recoverable amounts are not reasonable or supportable. In particular:
  - Assumptions derived from external sources were not assessed for consistency and relevance – for example, use of growth rate assumptions that are not consistent with the entities industry or key competitors
  - The entity's forecasted cash flows did not appear reasonable and had exceeded actual cash flows for a number of reporting periods – bringing into question the entities historical forecasting accuracy.

Identification of CGUs

- Instances where the carrying amount of CGUs were not appropriately determined. In particular, some entities were found to have:
  - Identified CGUs at too high a level despite cash inflows being generated independently at lower levels in the organisation
  - Excluded certain assets from the carrying amount of a CGU, for example, working capital, corporate assets and goodwill
  - Inappropriately deducted certain liabilities from the carrying amount of a CGU.

Other matters

- Using inappropriate valuation techniques to estimate fair value
- Not having sufficient regard to impairment indicators – in other words stating that no impairment indicators existed when market and media information suggested otherwise
- Not providing sufficient disclosures in terms of AASB 136 *Impairment of Assets*, such as key assumptions in determining value in use, valuation techniques and inputs used for deriving fair values and sensitivity analyses of reasonable possible changes in key assumptions.

Thinking it through

Cash flow assumptions

Entities need to ensure that the capital expenditure assumptions in the terminal value are reasonable. In many cases, a good proxy is depreciation expenditure. Assumptions used in impairment calculations should be consistent with those used to support the recoverability of deferred tax and going concern assessments.

Market capitalisation as an impairment indicator

Where market capitalisation is less than the carrying amount of the net assets, this may raise questions around the recoverability of goodwill, intangible assets and other tangible assets. In this case, consideration should be given to the appropriateness of assets measured at fair value, for example investment property.

Impact of new leasing standard, climate change and other external factors

With the adoption of AASB 16 *Leases,* the right-of-use asset recognised will be subject to impairment testing, either on a stand-alone basis or as a part of a CGU. Entities need to carefully work through their impairment models, considering inter alia cash flows beyond the lease term, renewal options, appropriateness of discount rates and the treatment of the lease liability in the carrying amount of the CGU and the value in use calculation.

Entities affected by climate change, market changes, digital disruption, technological change or Brexit should consider the impact of these changes on their asset values. Entities potentially affected by such issues are expected to provide sufficient information to help users understand how the entity's financial position and performance may be impacted. This may require entities to provide a sensitivity analysis on the impact of their assumptions on how these factors will affect their business model on estimates made, for example, in determining the value in use of CGUs.

Accessing information

See **ASIC Information Sheet 203 Impairment of non-financial assets: Materials for directors (INFO 203)** and Deloitte's Clarity publication **Focusing on impairment issues for June 2017** for further guidance.

2. Revenue recognition

ASIC made inquiries on 12 matters related to recognition of revenue, in particular on the recognition of revenue on contracts that involve multiple performance obligations (e.g. sale of goods and provision of related services) where the timing of satisfaction of the multiple performance obligations differ.

AASB 15 *Revenue from Contracts with Customers* requires entities to disaggregate revenue in a way that explains how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. ASIC noted numerous instances where revenue disclosures were not disaggregated in this manner and made inquiries in this regard.

Thinking it through

Judgements involved

The application of the new revenue guidance is complex and requires the exercise of judgement. Specific consideration should be given to judgements involved with:

- Identifying the performance obligations
- Determining the timing of revenue recognition, being either over time or at a point in time
- Estimations of stand-alone selling prices of distinct performance obligations.

Modification of contracts

Application of the modification guidance can be complex. Companies need to ensure that they have a deep understanding of the commercial substance of the amendments to the terms and conditions of the existing arrangements to determine whether the modification needs to be accounted for as part of the existing contract, a new contract, or a termination of the existing contract and a creation of a new contract.

Changes in the transaction price

Sometimes the transaction price may change after contract inception for various reasons, e.g. the resolution of an uncertain event. Companies need to consider the guidance carefully to ensure that the change is accounted for appropriately.

Extensive disclosure requirements

AASB 15 has more extensive disclosure requirements in comparison to the previous revenue recognition standards. More specifically, the disclosure of disaggregated revenue is a new requirement. We expect to see an increasing number of inquiries from ASIC focusing on this disclosure. For example, an entity whose disaggregation of revenue differs from how it describes its operating segments in the segment note or in the Directors report, could be asked for an explanation.

A further new requirement is for companies with revenue recognised over time, to make disclosure about its remaining performance obligations, i.e. the revenue expected to be recognised in the future under existing contracts.

Accounting policies to be updated

Entities should also take care to ensure their accounting policies are updated to reflect the requirements of AASB 15. Any inconsistencies between the wordings in the revenue accounting policy and AASB 15, or between the wording in the revenue accounting policies and other notes to the financial statements are likely to result in inquiries from ASIC.

Accessing information

See Deloitte's Clarity publication **AASB 15 disclosure in the year of adoption and beyond – what you need to know** for further guidance.

3. Non-IFRS financial information

ASIC made inquiries of four entities related to disclosure of non-IFRS financial information. The inquiries made focused largely on instances where:

- The communication of the non-IFRS information gave undue prominence compared to the equivalent statutory measure
- Lack of clarity on how the non-IFRS information was determined. For example, instances where the basis of calculation of the non-IFRS information was not adequately explained or the non-IFRS information was presented without appropriate reconciliations to the statutory IFRS information.

Thinking it through

Increasing inquiries from ASIC

We are seeing an increasing number of inquiries from ASIC in this area. If preparers believe that non-IFRS information is necessary to enable users to understand an entities financial performance, these should always be reconciled to statutory IFRS figures in the financial report and should not be given undue prominence.

Applicability of ASIC Regulatory Guide

ASIC Regulatory Guide 230 *Disclosing non-IFRS financial information* sets out the detailed regulatory requirements whenever entities present or disclose non-IFRS information. It is important to note that regulatory requirements apply not only to the use of non-IFRS information in the notes to the statutory financial statements ('back half' of the annual report), but also to the use of these in the 'front half' as well as any other published information, including media releases.

Accessing information

See ASIC Regulatory Guide **RG 230 Disclosing non-IFRS financial information** and the Deloitte Clarity publication **Non-IFRS measures – enhancements or embellishments?** for further guidance.

4. Consolidation accounting

ASIC made inquiries of two entities in respect of the non-consolidation of other entities, including an entity that holds a significant interest in an investee. For example, despite holding less than 50% of the voting rights, entities could nevertheless be able to exercise power to direct the relevant activities of an investee through other potential voting rights, or exercise de facto control based on the spread and dispersion of the other shareholders of the investee.

Thinking it through

Assessment of control

Sometimes the assessment of control as required by AASB 10 *Consolidated Financial Statements* is straightforward and it may be clear that control over the investee is exercised solely by means of ordinary shares that give the holder majority voting rights. However, in some cases, this assessment could be quite complex and judgemental, for example, when control results from contractual arrangements rather than voting rights.

5. Tax accounting

ASIC has made inquiries of three entities about their income tax accounting, including:

- Questioning the adequacy of the tax expense, including current and deferred tax expense
- In instances where entities were loss making in current or previous years, whether it is probable that future taxable income will be sufficient to enable the recovery of deferred tax assets recognised relating to tax losses.

Thinking it through

Recoverability of deferred tax assets

With respect to tax accounting, entities should review the sufficiency of future taxable profits to support the recoverability of any deferred tax assets at the end of each reporting period. Entities should also ensure that the assumptions used to support the recoverability of deferred tax, impairment calculations and going concern assessments are internally consistent and not contradictory.

Tax rate reconciliation

Entities are required to accurately disclose the numerical reconciliation between the average effective tax rate and the applicable tax rate. If there are instances where this does not reconcile, or if there are material amounts disclosed within the reconciliation as 'other', ASIC could inquire about this.

Prior period adjustments

Entities are required to appropriately disclose and explain any adjustments recognised related to current tax of prior periods. Careful consideration should be given to determine if the amount is an adjustment related to prior periods that can be recognised in the current year or if it should have been accounted for in the prior period.

Uncertain tax positions

With respect to uncertain tax positions, entities must consider the measurement and disclosure requirements in Interpretation 23 *Uncertainty over Income Tax Treatments* (effective for financial years beginning on or after 1 January 2019). The Interpretation requires an entity to consider the probability of whether the taxation authority will or will not accept an uncertain tax treatment when measuring its tax related balances. These considerations include the expected changes in company tax rates or the application of specific tax legislation, such as thin capitalisation rules.

Accessing information

See Deloitte IFRS in Focus publication **IASB issues IFRIC 23 Uncertainty over Income Tax Treatments**

6. Other matters – Estimates and accounting policy judgements

ASIC notes that it has observed instances where entities needed to improve the quality and completeness of disclosures in relation to estimation uncertainties and significant judgements made in applying the entities accounting policies. Information including key inputs and assumptions necessary for investors and other users to understand the judgements made, and their financial effects, should be adequately disclosed. These include reasons for judgements, alternative accounting treatments if applicable, and appropriate quantification of the estimates and the impact of judgements made.

Thinking it through

Estimates and judgements related to the new accounting standards

Management should carefully consider whether all key judgements and sources of estimation uncertainty have been disclosed, including those related to the new accounting standards and interpretation (i.e. AASB 9, AASB 15 and AASB 16). For example, areas of significant judgement could include the following:

- The principal vs agent determination under AASB 15
- Key assumptions relating to impairment of assets
- Lease term where extension or termination options exist
- The measurement of rehabilitation provisions.

7. Other matters – New accounting standards

New accounting standards that were effective for 31 December 2018 financial reports are as follows:

- AASB 9 Financial Instruments: *Recognition and Measurement*
- AASB 15 *Revenue from Contracts with Customers*.

ASIC observed instances where entities provided inadequate explanations of the impact of adopting new accounting standards, particularly in the half-year reports. AASB 108 *Change in Accounting Policies, Change in Estimates and Errors* as well as the transitional provision of these new standards contain specific disclosure requirements that entities should take cognisance of when adopting a new standard. This includes an explanation of the nature, and cause, of any changes to the financial statements due to the adoption of these standards.

Thinking it through

AASB 16 effective for upcoming reporting period 31 December 2019

Accounting implications of the impact of new accounting standards adopted is one of ASIC's key focus areas. AASB 16 is mandatorily effective for the first time for both half-year and annual reports at 31 December 2019. Entities impacted should provide appropriate disclosure related to the impact of adoption and transition to AASB 16. Entities preparing annual reports should ensure that relevant disclosures are included, for example:

- An explanation of any difference between previous operating lease commitments disclosed under AASB 117 *Leases* to the lease liability on date of initial application of AASB 16
- Weighted average incremental borrowing rates applied to the entities lease portfolio.

We also expect that judgements around reasonable certainty of exercising extension options and early termination options when determining lease term of a lease will be a key focus area for regulators.

8. Other matters – operating and financial review (OFR)

ASIC identified certain cases where it appeared that companies could have provided better analyses of the underlying drivers of results and explanation of the impact of relevant business risks on future strategies and prospects.

Thinking it through

Economic, political and technological risks

ASIC continues to emphasise that listed companies should disclose information on risks and matters that are likely to have a material impact on the future financial results. Some of these risk areas include, matters relating to climate change, market changes, digital disruption, new technologies, Brexit or cyber-security.

ASIC also highlighted that directors should consider disclosing information that would be relevant under integrated reporting, sustainability reporting or the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) where that information is not already included in the OFR.

Unreasonable prejudice exemption

The *Corporations Act 2001* provides an exemption from disclosing information about business strategies and prospects for future financial years, if disclosure of that information is likely to result in 'unreasonable prejudice' to the entity. Entities must carefully evaluate and establish the basis for relying on the exemption before any information is omitted. Given their public accountability, we would generally not expect listed entities to avail themselves of this 'commercial prejudice' exemption.

Accessing information

Directors should consider the guidance in ASIC Regulatory Guide **RG 247 Effective disclosure in an operating and financial review** on providing useful and meaningful information to shareholders or unit holders when preparing an OFR to be presented in the directors' report.

Regulators’ reactions globally

Globally the regulators have voiced similar views focussing on the above matters. Apart from the above, some of the other matters raised globally are:

- **Earnings per share (EPS)** – common pitfalls in EPS calculations include failure to adjust both basic and diluted EPS retrospectively for changes in the number of shares on issue without a corresponding change in resources and errors in the treatment of treasury shares, or shares held in an employee benefit trust or similar vehicle. These shares are not considered ‘outstanding’ and are excluded from the ‘number of shares’ in basic and diluted EPS and have no further effect on the calculations
- **Business combinations** – specifically the measurement and disclosure of deferred and contingent consideration and whether payments to former owners of an acquiree should be treated as consideration or as remuneration for post-combination services
- **Provisions and contingent liabilities** – the appropriate discount rate should be applied to provisions balances (not the rate used for impairment reviews, as the requirements of IAS 36 *Impairment of Assets* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* are quite different in this respect). Further, reimbursement rights such as insurance assets should not be netted against provisions in the statement of financial position.

Conclusion

Through the announcement of its surveillance findings from 31 December 2018 financial reports and focus areas for 30 June 2019 financial reports, ASIC has indicated that directors and auditors need to specifically focus on, *inter alia,* impairment of non-financial assets, revenue accounting and non-IFRS measures. We strongly recommend that entities carefully determine the areas of complexity that require further attention in determining the appropriate application of Australian Accounting Standards and providing meaningful disclosures in their financial statements in the upcoming reporting season.

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