ASIC releases results of first integrated surveillance program and December 2023 focus areas

Focus continues on key judgments related to impairment, revenue and provisions and disclosures of material business risks

- ASIC released its inaugural annual financial reporting and audit findings surveillance report for the year 2022-23 (**Report 774**) after previously communicating that its financial surveillance program would receive a shake-up
- The reinvigorated program leverages a risk-based and data informed method of selection of entities for review
- Key findings revolve around familiar themes including the:
  - **Operating and financial review**
  - **Impairment and asset values**
  - **Revenue**
  - **Provisions**
- ASIC subsequently issued a **media release** which announced its focus areas for 31 December 2023 financial reports. Areas of focus are, as expected, consistent with the findings noted in the surveillance report
- Careful consideration should be given by entities when preparing their annual report, particularly with regards to disclosures in the operating and financial review (OFR), and forward-looking assumptions used to develop accounting estimates.

"This approach acknowledges that everyone in the financial reporting chain, from report preparers to directors to auditors, have a role to play in improving the quality of financial reports and audits."

Greg Yanco
ASIC Executive Director for Regulation and Supervision

Reporting in an increasing challenging environment

What has changed?

To say that 2023 was yet another challenging year for all may be an understatement. Despite record low unemployment in Australia benefitting households, interest rates rose to a 12-year recorded high, impacting debt repayments and increasing cost of living pressures. Australia experienced weather patterns that would have been advantageous to some and a bottleneck for others – while certain agricultural activities benefitted from high rainfall, the same wet weather caused delays in construction, supply chain delays and disruptions in productivity. Global conflict drove up the price of commodities and supplies which trickled into the local economy, causing companies to tighten the purse strings.

What is evident though, is that our current economic circumstances in Australia were not the result of a single year of circumstances but a build-up over several years of economic volatility starting with extreme bushfires. With continuous change occurring, stakeholders are naturally questioning the stability of their investments and are seeking better information to make more informed investment decisions not just from a financial perspective but from a sustainability one as well. At the same time, regulators are wanting to be positioned to respond flexibly to increased instability and uncertainty in order to uphold the standards they enforce.

In early 2023, ASIC chairman Joe Longo announced that the regulator would undergo a restructure during the year that would enable it to act more efficiently and deliver faster decision-making. As part of this, the teams that oversaw financial reporting surveillance and audit inspections were merged together in the restructure. The new team will not only be responsible for ASIC surveillance but also sustainable finance and climate oversight. Prior to this, ASIC's audit surveillance program was largely unchanged for the preceding 15 years. In October 2023, ASIC released its first annual financial reporting and audit surveillance report for the year 2022–23 (**Report 774**) under the new group structure and process.

Instead of running two separate workstreams for annual report reviews and audit surveillance, ASIC has now rolled these into a single integrated program that uses risk-based selection criteria. The new approach is designed to consider information and assess risk in financial reporting from the beginning to the end of the financial reporting chain. For example, ASIC made use of internal and external data such as market releases and investor information to make their selections for financial report reviews. Due to the correlation between findings in financial reports and findings in audit quality, the findings from financial report reviews then informed ASIC's audit surveillance selections.

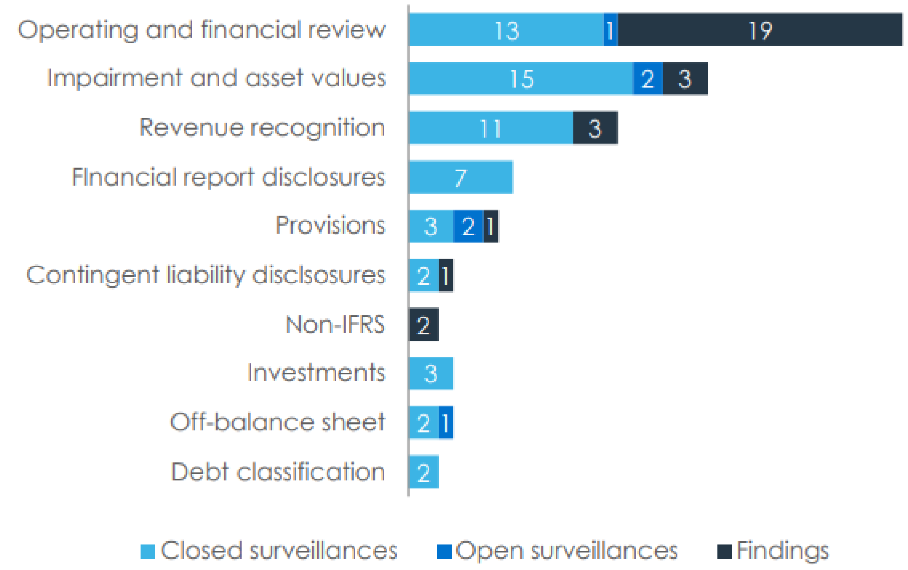
ASIC has made use of a wide range of available information – both public and information available only to itself. Public information included sources such as **ASX announcements and prior year financials and market capitalisation**. ASIC-only intelligence included information such as **reports of misconduct by external parties and reported misstatements**. ASIC also considered **industry-specific factors** that may give rise to specific judgmental accounting policies – for example, volatility in commodity prices places more focus on asset values and potential impairment for the mining and extractives sector.

In its inaugural combined review, ASIC reviewed **180 financial reports of ASX-listed entities and other large unlisted entities**. From this, **55 surveillances** were conducted that covered **93 issues** and **15 associated audit files** were reviewed. Adjustments totalling **$215 million** were made to previously released financial information, and extensive further adjustments made to **qualitative and risk disclosures** in the operating and financial review (OFR) as a result of ASICs findings.

Key findings of ASIC's program

Issues raised by ASIC through their surveillance findings were clearly weighted towards those that had been identified as focus areas for 30 June 2023 reporting, which were:

Figure 6: Issues raised in financial reporting surveillances



Source: ASIC, "REP 774 Annual financial reporting and audit surveillance report 2022-23," October 18, 2023

Key industries that covered these issues included materials, software and services, insurance, capital goods, media and entertainment, and energy.

ASIC focus areas for 31 December 2023 reporting

Following on from its findings, ASIC also released its periodic focus areas for 31 December 2023 reporting. There are perhaps no surprises in this release as the focus areas are consistent with those top issues raised in the surveillance, with the exception of revenue recognition. The areas noted by ASIC are:

- Impairment and asset values
- Provisions
- Events occurring after year end and before completing the financial report
- Disclosures in the financial report and OFR
- The impact of a new accounting standard for insurers.

ASIC focus areas for 31 December 2023 reporting are consistent with findings from its 2022-23 surveillance reporting

Consideration of key areas

Operating and financial review (OFR) disclosures

OFR findings up to the 30 June 2023 period easily outstripped other findings by category. Industries where ASIC identified findings included materials, software and services, and energy. This is not surprising given the nature of those industries and the impact of our fluctuating economic environment creating challenging conditions. On top of this, it is fair to say that climate reporting is front of mind for preparers given the upcoming mandatory reporting requirements.

Fundamentally, an OFR cannot be generic and must be tailored to a company's specific circumstances. it must "speak" uniquely to the financial report that comprises the second half of the annual report. Specifically, when reviewing the OFR disclosures, a reviewer would look for narratives that describe a company's key business risks, and where present, consistent narratives between the two halves of the annual report.

Specifically on climate, Australia has historically had a relatively high instance of voluntary adoption of TCFD disclosures amongst ASX 100 companies, so there already exists some level of maturity regarding climate reporting in these entities. Nevertheless, the mandatory requirements that will be set by the Australian Sustainability Reporting Standards (ASRS) will capture a proposed much larger population of entities and also require more detailed disclosures relative to what has historically been prepared under the TCFD recommendations.

In the meantime, ASIC expects that climate is a pervasive challenge that all businesses will be required to adapt to and therefore expects climate impacts to be disclosed to the degree that climate forms a material risk or opportunity. With regards to disclosures, however, companies must be careful about greenwashing statements and greenhushing[1], as these are issues that ASIC is aware of and are increasingly scrutinising.

All material business risks, including climate, remains a key focus in the operating and financial review

Going forward, we expect that the focus on OFRs will continue for several years to come as a result of the proposed tiered adoption of mandatory reporting for climate-related disclosures, where the first tier is expected to be caught for financial years ending 30 June 2025 and the last tier for financial years ending 30 June 2028 (subject to final legislation and Treasury seeking feedback on a potential six-month deferral for the first tier of entities). This will obviously spotlight climate reporting from both a qualitative and quantitative perspective, and ASIC will be expecting to see consistent themes presented in a company's climate reporting and its other published information, particularly any potential impact on financial information.

It is expected that companies will experience challenges particularly in the ability to define, capture, and report quantitative information such as measuring carbon footprint metrics disaggregated into Scope 1, 2 and 3 greenhouse gas emissions, scenario analysis modelling as part of climate resilience assessments, and the determination of anticipated financial effects of climate risks and opportunities. For this reason, we strongly encourage impacted companies, if not already started, to begin the process of assessing their readiness for upcoming mandatory disclosure requirements and establish the organisational framework and processes they will need to report against these requirements.

[1] 'Greenhushing' refers to where companies seek to minimise risks (e.g., reputational risks, regulatory risk etc) associated with climate-related statements or disclosures by saying little to nothing on things such as their key risks, emission reduction targets and/or transition plans

Despite the immediate spotlight on climate, we cannot forget that there are other significant business risks and opportunities that will continue to impact businesses at the same time that should also be disclosed. This includes the increasing prevalence of cybercrime, and the impact of global conflict on business sustainability due to the impact on supply chain logistics and prices. It is important to note that while these risks may be wide-ranging across entities, an entity should only disclose tailored risks that are specific to that entity – disclosure of generic risks are not encouraged. Given ASIC's risk-based approach for selection criteria, these issues will be front of mind when considering what industries and companies to focus on for financial reporting surveillance.

Key takeaways – OFR disclosures

- Ensure the OFR contains informative and tailored disclosure of material risks to the business, including climate considerations
- Check that disclosures in the OFR are consistent with the narrative in other published information, such as market announcements or disclosure of forward-looking estimates underpinning material accounting policies in the financial statements
- Review governance frameworks and consider whether they are robust and flexible enough to react quickly to emerging business risks.

For more information on climate reporting in Australia, see our Clarity in financial reporting *Australia's first climate standards: no more waiting* publication, and a co-authored publication by Deloitte, MinterEllison and the AICD *A director's guide to mandatory climate reporting*.

Impairment of goodwill and other asset values

Impairment is a topic that has long been an ASIC focus area. It is commonly observed that Australia's economy has been a particularly strong performer in light of economic conditions in recent years, particularly with regards to the impact of the COVID pandemic. This was partly due to the economic support being provided by the government to businesses and workers through various support payments. With those supports being wound back and the increased volatility in the economy since then, it is understandable that ASIC would increase surveillance in this area of recoverable asset values and that it continues to be a focus area. This is because the risk of overstatement of assets on the balance sheet is one that can have significant run-on impacts on factors such as shareholder returns, the ability to raise capital, and business valuations to name a few. Industries where ASIC identified impairment issues include materials, media and entertainment, and energy.

Regardless of climate, companies must ensure that their impairment assessments are up to date. Importantly, it is not just assessment of goodwill, but other non-financial assets such as property, intangible assets such as brands and trademarks, as well as financial instruments assessed for impairment under AASB 9 *Financial Instruments* (AASB 9), which should be given sufficient consideration. While the mechanics of how an impairment assessment is performed has not changed, forward-looking assumptions are judgmental and should be supported by reasonable and supportable assumptions.

Quantitative factors such as the discount rate used, particularly in the context of Australia's significant increase in interest rates since May 2022, terminal growth rate, and gross margin projections to name a few, should be challenged critically. Qualitative assessments such as the determination of cash-generating units or the level at which goodwill is tested should be reconsidered where there have been changes to business structure through acquisitions or disposals, and also changes in business governance processes. In all cases, companies must have robust documentation supporting all impairment assessments as ASIC has the ability to request this information as part of its surveillance. ASIC notes that an entity's market capitalisation is not sufficient evidence of its fair value assessment, as it is more appropriate as a secondary valuation cross-check to support further work in assessing recoverable amounts. It is also important to remember that a market capitalisation deficiency is an automatic indicator of impairment and therefore the entity must perform a recoverable amount assessment for all cash-generating units where this exists.

Key takeaways – impairment and asset values

- Critically review current year calculations of recoverable amount to ensure that key assumptions such as the discount rate, gross margins, growth rates, terminal values and capital costs are appropriate for use in the current year
- Consider whether the impact of any material business risks disclosed in the OFR have been appropriately incorporated into future cash-flow forecast assumptions
- Review the appropriateness of the identification of cash-generating units in light of any changes to the business composition or business model.

Revenue recognition

Revenue and revenue growth has and always will be a key metric for a large proportion of companies. Therefore, how revenue Is recognised and the information disclosed about it, is deemed to be relevant and useful information to stakeholders.

The introduction of AASB 15 *Revenue from Contracts with Customers* (AASB 15) was associated with a great deal of activity as companies reassessed their material revenue contracts in conjunction with the implementation of the new standard. In doing this, it was clear that there were consistent "pain points" that were encountered when considering the five steps of the standard. Not surprisingly, those pain points were centred around areas of significant judgment. For example, identifying the correct number of performance obligations was found to be complex as different people reading the same words in a contract could reach different outcomes, when generally there can only be one conclusion under the standards. This was particularly noticeable in more complex contracts with multiple contractual promises. Put differently, the more complex a contract, the more judgmental the determinations made are.

Moreover, one of the strengths of the standard is turning out to be a point of contention. As a universal standard, AASB 15 was written to be able to be applied to all contracts in all industries consistently. However, as we have found since, material contracts within a single entity are quite different and small nuances between contracts could result in very different revenue recognition outcomes. On top of this, principles that the standard considers such as the transfer of control of goods and services, can be quite difficult to apply in digital industries, as opposed to that of traditional goods and services.

Industries where ASIC identified issues include software and services, capital goods (construction contracts) and media and entertainment. This is consistent with our understanding that in these industries there can be significant complexity in these arrangements regarding the nature of the promised goods or services to be transferred to the customer. For this reason, disclosure of the significant judgments made, and how they were determined, is critical for stakeholders to understand the basis of revenue recognition.

Key takeaways - Revenue

- Identify any new and significant revenue contracts and review these individually under AASB 15 – do not merely rely on the business' general accounting policy or precedent from previous similar contracts
- Ensure that there is detailed supporting accounting analysis for all material contracts that walk through the five steps of the standard
- Review the disclosure of the revenue accounting policy and the level of disaggregation of material revenue streams in the financial statements. Consider whether these are detailed but also sufficiently clear to give stakeholders an informed understanding of how the business' revenue is earned and recognised.

Provisions

Similar to assessing assets for impairment, accounting for provisions is becoming increasingly difficult due to the requirement of consideration of forward-looking assumptions. Although not a new requirement, current economic volatility and uncertainty inherently creates more uncertainty and judgement in measurement of provisions.

ASIC specifically calls out provisions for onerous contracts, make good of leased properties, mine site restoration, financial guarantees and restructuring provisions. Disclosures of climate-related risk and transition plans could also impact the timing and recognition of provisions - for example, decisions made about existing specific assets, such as a coal-fired power plants, may bring forward restoration obligations for rehabilitation.

We also note that there has been considerable debate regarding the recognition of provisions in relation to an entity's announced commitment to net-zero carbon emission targets. In all cases, the recognition of a provision and its subsequent measurement will be facts and circumstances specific. This is supported by the recent discussion at the IFRS Interpretations Committee meeting in November 2023 where, after significant debate relating to whether a net zero commitment meets the criteria for recognition as a provision, it was decided to publish a **tentative agenda decision** outlining how IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* applies to climate-related commitments.

The timing of when a provision is recognised can also require significant judgment. It is important to note that the consideration of whether a provision exists needs to be grounded in the existence of a present legal/contractual or constructive obligation. Where a present obligation exists that will result in a probable future outflow, ASIC has asked questions of entities who have asserted that no reliable estimate can be made of an obligation due to uncertainties in measurement and therefore no provision is required to be recognised. In some cases, entities like to "play it safe" and only recognise a provision when it's certain, or when it's easier to measure. However, ASIC has highlighted that making accounting estimates is an essential part of financial statement preparation, and determining a range of possible outcomes and therefore making an estimate of the obligation with sufficient reliability should be possible except in only extremely rare cases.

Key takeaways - Provisions

- Perform a holistic review of your business' potential, significant future cash outflows and consider whether a provision should be recognised for these – this includes, for example, lease restoration clauses, rehabilitation requirements, and restructuring or organisational change plans
- Review measurement estimates made for recognised provisions and reconsider the appropriateness of forward-looking assumptions made
- Identify any current obligations where a provision has not been made due to an inability to measure and critically re-evaluate if this is a reasonable claim.

New insurance accounting standard

AASB 17 *Insurance Contracts* (AASB 17) applies to reporting periods beginning on 1 January 2023 onwards. As the majority of Australian reporters have a June year end, this means that December 2023 is the first half-year reported where AASB 17 applies to those entities.

ASIC has noted in its past inspection findings, and particularly in a limited scope review performed for 31 December 2022 full year financial reports of 14 insurers, that there were deficiencies in the quality of disclosures made regarding the impact of transition to AASB 17. ASIC therefore remains vigilant in reviewing these entities going forward.

Further, we note that there is added complexity with AASB 17 as it also applies to non-insurer entities that have contracts that meet the definition of an insurance contract under the standard. Therefore, identifying contracts that fall within the scope of AASB 17 is critical. A commonly overlooked example is an entity that self-insures for its workers compensation and public liability, which could result in insurance contracts in the separate financial statements of group entities.

Key takeaways – Insurance

- Insurers should ensure that all transition disclosures are of a high-quality and are tailored for their business' specific circumstances
- Even if you are not an insurance entity, consider if there are any contracts you have written where you take on a financial risk that may be considered an insurance risk, such as self-insurance of workers compensation, public liability or fixed-fee revenue service contracts.

Next steps

With the 3 December 2023 reporting season underway, we encourage clients to reach out to their Deloitte contacts as necessary for support during this period.

In order to help entities prepare, **Deloitte model financial statements for 31 December 2023** have been published, with the **What's New** section containing helpful information of significant changes and illustrative disclosures. In particular, it contains further information relating to ASIC focus areas for financial reporting (section B1.5.2), the upcoming Pillar 2 taxes (section B1.4.6) and AASB 2021 2 *Amendments to Australian Accounting Standards - Disclosure of Accounting Policies and Definition of Accounting Estimates* (section B1.4.1).

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