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Putting ASIC areas into focus

Financial reporting in times of risk and uncertainty

- The Australian Securities and Investments Commission (ASIC) recently issued its focus areas for December 2022 full and half-year reports
- ASIC has emphasised a stronger focus on the **impact of current economic conditions**, including *inter alia* increasing interest rates, availability of skilled staff and expertise, general inflationary pressures, geopolitical risk, volatile global energy and oil prices and the impacts of climate and climate-related events
- There is a continued focus on **disclosures** in both the financial report and the **operating and financial review (OFR)**, emphasising that directors should "put themselves in the shoes of investors" to ensure information responds to their needs. In particular, disclosure of significant **business risks** (on which ASIC has also released a separate media release) has been an area that a number of entities have received inquiries from ASIC. Further information can be found in ASIC RG 247
- Preparers should pay particular attention to the impact of changing economic conditions (including climate change) on the **impairment of non-financial assets** (in determining both the assumptions used and disclosures made), values of property assets, expected credit losses (ECLs) and the value of other assets (e.g. net realisable value of inventories including costs necessary to sell and deferred tax assets)
- The adequacy of **provisions** for matters such as onerous contracts, make good provisions, mine site restoration, financial guarantees and restructuring, as well as going concern assessments and subsequent events continue to be areas of inquiry
- Other **changes** from the focus areas announced previously for June 2022 include:
  - Continuing support for **climate-related disclosures** using the TCFD recommendations, now noting that this will help to position companies for future reporting under the IFRS Sustainability Disclosure Standards being developed
  - The need for **cyber security risks** to be disclosed in the OFR where they may have a material impact for the entity
  - ASIC expects **insurers** to disclose the impact of AASB 17 *Insurance Contracts*, including the quantification of the impact
  - Advising **private health insurers** to consider the impact of delayed procedures on deferred claim liabilities and the need for a liability for any commitment to return health insurance premiums for savings during the pandemic
  - Adding **audit focus areas**, including the need for auditors to use their knowledge of the entity's business in auditing the financial report and reviewing the OFR, and the need for documentation and consideration of "greenwashing".

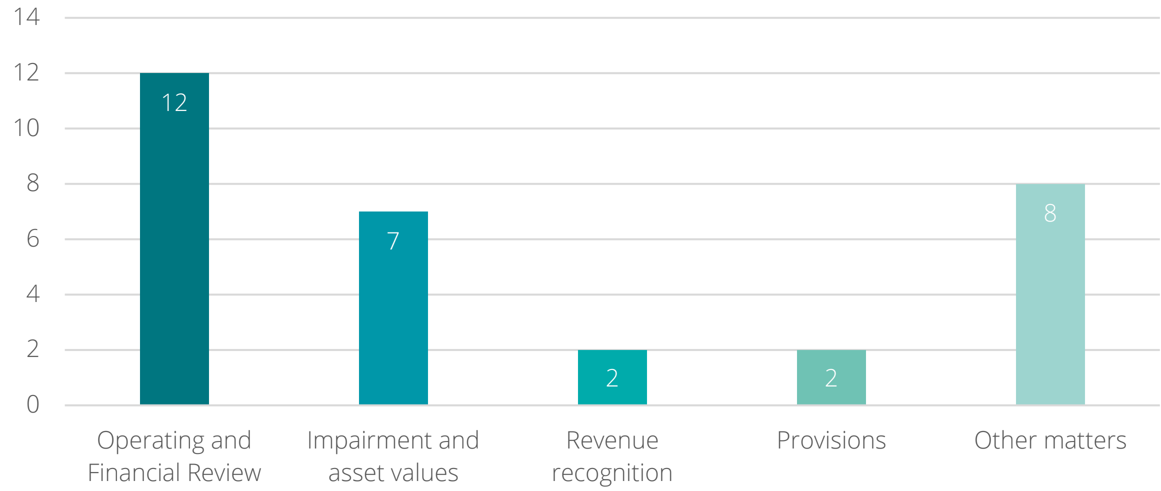
> Directors should ensure financial reports provide investors with useful information on the impact of uncertain market conditions and should assess the impact on asset values and provisions and disclose uncertainty, key assumptions, strategies and risks.
>
> **Sean Hughes, ASIC Commissioner**

Areas of most surveillance attention from ASIC this year

ASIC has formed their focus areas to respond to the prevalence of current economic conditions that have increased the risk and uncertainty within which businesses operate. Rising inflation and interest rates, supply chain disruptions, volatile commodity prices, labour shortages, wage growth as well as natural disasters and climate change are key considerations in the current economic environment.

Transparent communication and disclosure in each company's financial report, OFR and related disclosures of significant judgements, sources of estimation uncertainty and key inputs and assumptions applied in preparing financial reports, including sensitivity and scenario analysis, enhances value and responds to regulatory expectations. Companies will be affected differently depending on their business model and industry. Industries identified by ASIC that may be particularly affected by these factors include the construction industry, owners of commercial property, large carbon emitters and the agriculture industry.

The table below shows the areas where ASIC made inquiries of entities during their most recent financial reporting surveillance cycle (which is for the 31 December 2021 financial reporting period).



We have observed that the trend evident from the graph above has continued in the current financial reporting surveillance cycle. In 2022 to date, ASIC in media releases announced five entities made changes to their financial reports following ASIC inquiries, relating to either OFR disclosures, impairment of non-financial assets or provisions.

Discontinuation of time extensions for December 2022 reports

Unlike in previous reporting periods where ASIC provided extended deadlines for certain entities in order to provide adequate time for the completion of the audit process, ASIC will not be providing a general extension of December 2022 reporting deadlines for listed or unlisted entities .

The previous extensions to deadlines were always intended to be temporary relief due to the impacts of COVID-19. ASIC's justification for the decision not to extend deadlines for December 2022 includes the fact that impacts on audit firm resources have reduced, observations that extension to deadlines can interfere with preparation for the following period audits and the view that there is a lower workload for audit firms for December reporting relative to June reporting.

Changing and uncertain market conditions remains key

We have outlined in detail the focus areas communicated by ASIC at June 2022 in our previous publication which are broadly consistent with those for December 2022 reports and should be equally be referred to in preparation for your December 2022 reporting. However, we have summarised particular areas of emphasis or new areas relevant to December 2022 to be aware of below and included in the Appendix a more comprehensive summary of matters that have been raised by ASIC in past periods:

Operating and financial review (OFR)

- Disclosure of material business risks that may affect the achievement of an entity's strategies and prospects
- The entity's exposure to climate change risk in particular should be considered in this context. ASIC has specifically called out that consideration of the Taskforce for Climate-related Financial Disclosures (TCFD) recommendations will help position companies for future reporting obligations under the International Sustainability Standards Board (ISSB) standards. ASIC remain engaged locally and overseas in this process
- Cybersecurity-related risks have been identified by ASIC, including the consideration of the impacts of cybersecurity events such as the extent and nature of personal data held and possible impacts on revenue
- Disclosing non-IFRS financial information should only be done outside of the financial statements, should be clearly reconciled to IFRS information and consistently defined to avoid being misleading.

Impairment and asset values

- Estimation uncertainties and key assumptions should be reviewed in light of changing conditions
- Assumptions in fair value less cost of disposal models should be supported with reference to market data, including consideration of comparable industry multiples
- Cash flow forecast periods for value in use models should be a maximum of five years, unless a greater period can specifically be justified
- Consider historical forecasting accuracy and whether any current underperformance is an impairment indicator, as well as how this impacts the forecast cash flows in impairment models
- The impact of rising interest rates and inflation on forecast cash flows, noting inflation may differ between revenue and cost items due to the price elasticity of products and services
- The impact of the rising interest rate environment will also require a reassessment of whether the discount rate is still appropriate and reasonable. This may impact both the cost of equity and the cost of debt, along with the ability of the organisation to secure suitable levels of debt
- Any historical transactional benchmarks may need to be reconsidered as to relevance in the current environment
- Consistency of assumptions used across impairment, deferred tax asset (DTA) recoverability and expected credit loss (ECL) calculations
- ASIC is calling for increased information on the impact of current market conditions on ECLs in both the financial and other sectors, including assessment of significant increases in credit risk for particular groups of lenders, adequacy of data, modelling and controls around ECLs and disclosure of key assumptions.

Revenue recognition

- Licensing arrangements with multiple performance obligations that can impact timing of revenue recognition
- Timing of revenue recognition, in particular non-refundable upfront fees for setup activities and upfront loan establishment fees that should form part of the effective interest rate of the related financial instrument
- Communication of the entity's business model in the OFR, segment report, sustainability report and other market communication should be consistent with the entity's level and extent of disclosures of disaggregated revenue.

Provisions

- Consideration of the existence of legal or constructive obligations relating to lease make good provisions, rehabilitation or decommissioning liabilities (e.g. mine sites) and onerous contracts
- Rising interest rates and risk premiums impacting discount rates used in measuring and discounting liabilities
- Identifying existence of contingent liabilities including the disclosure of the nature, timing and amount thereof.

Other matters

- Once off gains, for example, on sale and leaseback transactions
- Off balance sheet structures (e.g. interests in unconsolidated entities)
- Consideration of solvency and going concern assessments
- Subsequent events, including going concern, and whether they relate to conditions at year end
- Disclosures in the notes of the impact of AASB 17 *Insurance Contracts*, (effective 1 January 2023) including quantification thereof, noting that AASB 17 also applies to non-insurers issuing 'insurance contracts'
- Private health insurers should consider the impact of backlog of delayed procedures on deferred claim liabilities and the need for a liability for any commitment to return premiums for savings during the pandemic
- Aged care providers should review the book values of bed licenses in view of the announcement and the decision by the Australian Government that the licenses will be discontinued from 1 July 2024.

Further information

Clarity in financial reporting: Responding to ASIC areas of focus for 30 June 2022

Audit focus areas

ASIC has taken steps to align their financial reporting surveillance program more closely with the audit inspection focus areas review cycle and have noted that the financial reporting focus areas outlined in their media release are also important focus areas for auditors.

Auditors do not form an opinion on the OFR, however ASA 720 *The Auditor's Responsibilities Relating to Other Information* requires auditors to read the OFR for consistency or material misstatement of facts. In this regard, auditors should use their knowledge of an entity's business, risks and strategies obtained in the process of auditing the financial report in reviewing the OFR.

Auditors should document their consideration of disclosures on matters such as the underlying drivers of results, material risks, strategies and future prospects. It may be insufficient for auditors to document that they have read the OFR and have not identified any matters of concern but should rather document that certain risks have been identified, whether that information is consistent with the auditor's knowledge and concluding with reasons on whether the OFR disclosures are adequate or not.

In terms of ASA 250 *Consideration of Laws and Regulations in an Audit of a Financial Report*, auditors may need to report suspected contraventions of the *Corporations Act 2001* to ASIC where, for example, disclosures in the OFR are materially inadequate or misleading.

Misleading statements could include instances where there is possible 'greenwashing' (further, refer ASIC information sheet 271 on greenwashing). For example, an entity's aspirational statements of achieving net zero targets, if misleading or untrue, could amount to a breach of the *Corporations Act 2001*.

Conclusion

In the current environment and changing market conditions, we strongly recommend that entities carefully determine those areas of focus that require further attention in determining the appropriate application of Australian Accounting Standards.

Uncertainty is pervasive in accounting and reporting. Accounting Standards accommodate this uncertainty through specific measurement requirements and associated disclosure requirements, and an overall requirement to explicitly call out key judgements made in applying the entity's accounting policies, information about assumptions about the future, and sources of estimation uncertainty. These disclosures are critical to a reader's understanding of the financial report and are key focus area for regulators.

Providing meaningful disclosures in the financial report so that users can clearly understand the impact of the current economic conditions of risk and uncertainty, including significant changes in circumstances since the prior period on the entity and its financial report will provide useful information to users and investors and meet expectations of regulators.

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APPENDIX: POINTS TO CONSIDER IN RESPONDING TO ASIC FOCUS AREAS

For more detail on the areas listed below, see our previous Clarity publication.

Impairment and other asset values

Non-financial assets, including goodwill and intangible assets

- ❑ Reasonable and supportable cash flows prioritising external inputs, historical forecasting accuracy considered, use of probability weighted scenarios
- ❑ Fair value models using supportable inputs (particularly where significant management inputs used)
- ❑ Appropriateness of discount rates given rising interest rates and uncertainties
- ❑ Consideration of differing inflationary impacts between costs and revenues
- ❑ Disclosures of key assumptions, sensitivity analyses and the impact of changing market conditions

Inventories

- ❑ Impact and change in accounting policy disclosures of recent IFRIC agenda decision on net realisable value of inventory

Deferred tax assets (DTAs)

- ❑ Consistency of DTA recoverability assumptions with those in the asset impairment models and ECL calculations where appropriate
- ❑ Appropriate disclosures of support for DTAs recognised
- ❑ Management's evaluation of assumptions around the recognition of tax positions in relation to tax disputes

Fair value of properties and unlisted investments

- ❑ Potential changes in valuations to reflect changes in the economy, market and customer preference on impact around fair value measurement (including level 3 measurements)

Expected credit losses (ECL)

- ❑ Models should reflect impact of changes in current economy and market on collectability of receivables
- ❑ Consider ECL for all financial assets within scope of AASB 9

Liabilities, revenue and other matters

Onerous contracts, site restoration, lease make-good and restructuring provisions

- ❑ Adequacy of provisions to meet legal/constructive obligations
- ❑ Measurement impact due to economic conditions e.g. changes in interest rates, discount rates, inflation, climate
- ❑ Identification of the existence of contingent liabilities and related disclosures thereof
- ❑ Impact of delayed procedures on deferred claim liabilities and the need for a liability for any commitment to return premiums for savings by private health insurers.

Off balance sheet arrangements

- ❑ Examples include interests in non-consolidated entities and receivables under debtor securitisation facilities

Revenue recognition

- ❑ Accounting policy is assessed against the requirements of the Accounting Standard and the relevant contractual documentation
- ❑ Assessment of performance obligations and impacts on the timing of revenue recognition
- ❑ Clearly disclosed revenue accounting policy
- ❑ Entity specific disaggregated revenue disclosure
- ❑ Appropriate recognition of licencing revenue and capitalisation of development costs

Lease accounting

- ❑ Appropriate accounting of sale and leaseback transactions depending on whether a 'sale' is met under AASB 15
- ❑ Appropriate accounting for rental concessions by lessees and lessors
- ❑ Inclusion of right-of-use assets in impairment assessments

Insurance recoveries

- ❑ Consideration of virtual certainty of the claim, supported by legal advice

Contingent payments in business combinations dependant on employment

- ❑ Recognised as post acquisition remuneration

Written put options over non-controlling interest

- ❑ Recognised as a 'gross obligation' (amount that is expected to be paid, not a derivative) and remeasured through profit or loss

Going concern and subsequent events

Going concern and solvency

- ❑ Impact of current economic conditions that may challenge the going concern and solvency assessments and the going concern basis of preparation

Subsequent events

- ❑ Adjusting events appropriately adjusted for and non-adjusting events adequately disclosed

Disclosures

Significant judgements and estimates

- ❑ Disclosures include sources of estimation uncertainty, key assumptions made, sensitivity and scenario analysis and any subsequent changes thereof

Current and non-current classification

- ❑ Impact of current conditions such as maturity dates, payment terms and covenants on classification

Operating and financial review (OFR)

- ❑ Entity specific material business risks clearly disclosed
- ❑ Clear explanation of how current economic conditions have impacted the entity
- ❑ Consistency with information in financial statements (e.g. revenue disclosures, segment reporting, judgements and assumptions, recoverable amount)

Climate and cyber disclosures

- ❑ Explaining climate change risks and their potential impact on future prospects, including considering the TCFD recommendations
- ❑ Whether the entity is exposed to cybersecurity risks, including through loss of personal data or a denial of service attack

Government and other support

- ❑ Disclosure and impact of discontinuation of government and other support previously received

Non-IFRS financial information

- ❑ Non-IFRS measures appropriately calculated, not given undue prominence and reconciled to financial statements

Half-year financial reports

- ❑ Need for enhanced disclosures to explain changing conditions and significant developments

Impacts of new standards

- ❑ Disclosure of the impacts of AASB 17 *Insurance Contracts* (including quantification)

ASIC's uncertainties and risk examples

- ❑ Availability of skills staff and expertise
- ❑ Impact of rising interest rates
- ❑ Inflationary impacts
- ❑ Increases in energy and oil prices
- ❑ Geopolitical risks (including the Ukraine/Russia conflict)
- ❑ Climate change and climate-related events
- ❑ Government action on climate and carbon emissions
- ❑ Technological change and innovation
- ❑ COVID-19 conditions and restrictions
- ❑ Changes in customer preferences and online purchasing trends
- ❑ Use of virtual meetings and flexible working arrangements
- ❑ Discontinuation of government and other support
- ❑ Legislative and regulatory changes
- ❑ Other economic and market developments