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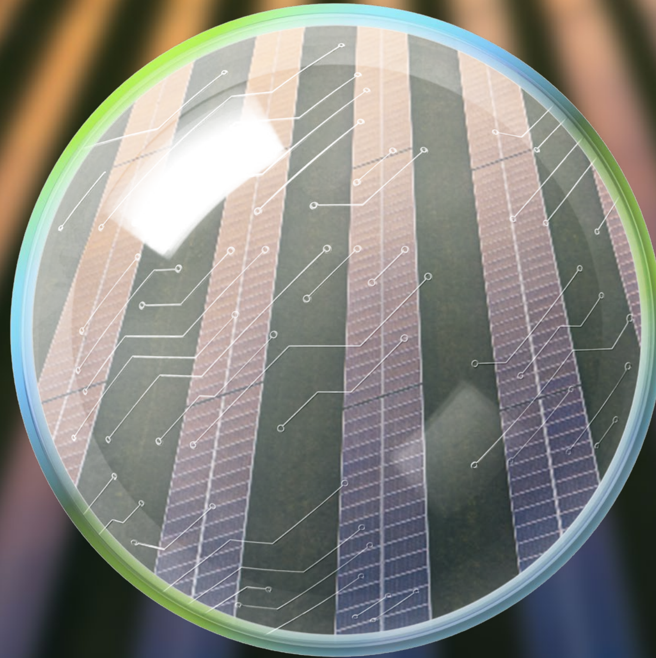


Business resilience: corporate reporting challenges for 2023 financial reporting

Uncertainty is at the heart of business. Building a resilient risk management structure enables organisations to thrive in challenging environments, whilst transparent communication enhances brand and value and responds to regulatory expectations.

Rapidly rising interest rates. Inflation. Uncertain economic outlook. Geopolitical instability. Supply chain constraints. Labour shortages. Rapid decarbonisation. Investor and pending regulatory demands for environmental, social and governance (ESG) disclosure. Artificial intelligence (AI). Changing regulatory and tax requirements.

Experience with the series of global shocks in recent times shows the impact on society and the economy of these types of events can be immense.

One thing is clear: there are no easy answers. But there are some key strategies that directors can deploy to find a balance between risk and reward, whilst responding to the often-conflicting demands of a broad group of stakeholders.

It is fundamental in the face of challenges and uncertainty, that the Board should act as the ultimate stewardship body of the entity, guiding and supporting management in its decision making.

So how does this work in practice? In this publication we explore the immediate governance and reporting considerations arising from current economic conditions and regulatory developments to provide a guide to ensuring your effective response.

Key challenges and uncertainties

Risk management

What are the key messages?

There is a long-running requirement for organisations to manage risks and report on those risks to stakeholders. The regulator has again highlighted the critical importance of these processes and the related disclosures, particularly in the operating and financial review (OFR).

A fundamental challenge for organisations in responding to uncertainty and current economic conditions is designing and implementing a risk management framework that is right-sized, adaptable and resilient.

In addition to identifying risks – and opportunities – facing the organisation, it is critical that so-called 'black swan' events are addressed. These events are unknown and unexpected by their very nature. Recent developments in artificial intelligence may have been unexpected. Other events may be plausible, or even likely, but the 'when and where' may be unknown – for example, the impacts of climate change.

Furthermore, a changing legislative environment, with a focus on climate-related financial disclosures and multinational tax initiatives, sees a need for additional compliance and information gathering processes.

One of the positives from the events of recent years is that organisations have a unique insight into pinch points in their systems, processes and business models. In the spirit of not wasting a crisis, now is the perfect time to find common themes, exposures and opportunities and tweak risk management frameworks to better respond to the current economic climate, future unexpected events and regulatory developments.

What should directors do?

Whilst management has the key responsibility for risk management, directors have a crucial role to play. This includes:

- Understanding and approving **the broad risk management parameters** for the organisation.
- Ensuring that **appropriate oversight** is in place and exercised, particularly where developments such as artificial intelligence may be implemented in short time frames.
- **Overseeing implementation of the entity's policies** and **processes** to respond to investor and legislative requirements around climate and ESG more broadly, and ensuring relevant disclosure is provided.
- **Challenging management** based on the boards' cumulative experience and expertise.
- **Benchmarking** against peers and other organisations.

Financial reporting impacts

Why it matters

Uncertainty is pervasive in accounting and reporting. Accounting Standards accommodate this uncertainty through specific measurement requirements and associated disclosure requirements. There is also an overall requirement to explicitly call out key judgements and estimates made in applying the entity's accounting policies, and to provide 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 a key focus area for regulators.

ASIC has reminded directors that they have the primary responsibility for the quality of financial reporting.

It is therefore incumbent on directors to understand the financial reporting impacts of the current economic environment and ensure that financial reports reflect and explain impacts.

Below we explore some areas where uncertainties and unexpected events impact financial reporting.

Impairment

Entities are not permitted to carry assets on their balance sheets at amounts greater than their value, which for non-financial assets is referred to as 'recoverable amount' based on the higher of 'value in use' and 'fair value less costs to sell'. The regulator is also wary of entities relying on market capitalisation in lieu of formal assessments.

The rules around the determination of recoverable amount are complex and addressing uncertainties and other developments requires the exercise of a significant amount of judgement.

Cash flows used in recoverable amount models must be reasonable and supportable, consistent with both prior year performance (including the accuracy of prior year forecasts) and external information.

As part of this process, entities must determine how current economic conditions will change over time. For instance, should inflation and supply constraints be considered temporary? Are employee costs forecast to increase? What does forward demand look like? Can cost increases be passed onto customers in the short and medium term? Is the business model transitioning due to climate impacts and decarbonisation and how is this being reflected in the first 5 years' cashflows? What impact will artificial intelligence have on our operations, demand and competitors?

In times of higher uncertainty, it may be necessary to perform probability weighted analysis of various outcomes to arrive at the recoverable amount. This probability weighted approach is also particularly valuable when business models are changing. Business model change is accelerating as the world transitions to be less reliant on fossil fuels and a probability weighted approach or sensitivities can allow businesses to proactively manage and transparently communicate the change.

The pace and extent of increases in interest rates may not have been expected in past reporting periods. The determination of discount rates used in cash flow models will also require careful analysis to reflect expected interest rates and optimal funding ratios in this new environment.

Expected credit losses (ECL)

Determining the recoverability of financial assets such as trade and other receivables depends on expected credit losses (ECL). This requires forward looking information involving significant assumptions and judgements. These judgements need to consider the credit quality of the debtor, overall economic conditions and entity-specific factors.

ECL models are often complex and must evolve to reflect current conditions at each reporting date – a slowing global and domestic economy will result in additional judgement and estimation.

Furthermore, current economic conditions may see customers looking to change or delay existing payment arrangements.

The regulator expecting forward looking assumptions and possible future losses to be adequately factored in ECL calculations – and for all entities, not just financial institutions.

It is important judgements are clearly disclosed and based on sound and documented rationale.

Inventories

Inventories are generally carried at the lower of cost and net realisable value.

With significant inflation and wage pressures causing rapidly changing cost profiles, the cost of producing inventories may increase or involve abnormal costs. Similarly, the slowing economic environment may result in excess stock that may require discounting to sell.

A careful assessment of both inventory costing and expected selling prices ensures inventories are not overstated.

Fair value measurements

The determination of fair value measurements – for example of investment property, certain financial instruments and agricultural assets – occurs within a 'fair value hierarchy'.

Level 1 of the hierarchy is mostly straightforward – using prices directly from markets, such as using the share price to measure an investment in listed shares. But what if market transactions are not available?

Other levels of the hierarchy can be problematic as they rely on judgement, particularly 'level 3' which includes 'unobservable' inputs such as the entity's own data. Derivatives and unlisted equities will fall into these levels and can result in volatility in financial statements.

Provisions and other liabilities

Unrecorded and under-recorded liabilities have been a long-term focus of regulators. This includes areas such as the recognition of make-good obligations in leases, environmental and decommissions obligations. Recently ASIC has also made it clear that estimations are a key feature of financial statements and therefore it is not possible to argue that that no liability is recognised on the basis that the obligation cannot be reliably measured.

ASIC is also focusing on the completeness of the contingent liability disclosures. Where organisations identify possible exposure as part of its risk management processes, the contingent liability disclosures should be consistent.

It is therefore critical that the directors ensure they understand what obligations exist and how they are measured and disclosed.

Changes in circumstances can create new obligations. For example, increasing cost structures may cause contracts to become onerous and therefore require a provision for 'locked-in' losses to be recognised.

Furthermore, liabilities for long term obligations such as rehabilitation, decommissioning and similar obligations can be significantly impacted by many factors, for example:

- **Changes in interest rates** can impact discount rates used to measure present value
- **Inflation in costs** (including employee costs) will impact expected cash outlays
- **Impacts of climate change** and **decarbonisation commitments** can affect the timing and amount of outlays.

High inflation and salary costs can also impact the measurement of long service provisions and other employee entitlements.

Revenue

Revenue is the lifeblood of organisations and is a key regulatory focus area.

Current economic conditions may change business models, see customer contracts being renegotiated and a need for the reassessment of terms for new contracts and modifications.

New and changed contracts should trigger a review of their accounting treatment to ensure appropriate outcomes in the financial statements.

In addition, a high inflationary environment has increased investor and analyst focus in the ability of the entity to pass on cost increases to customers. Careful disclosure of revenue streams and their pricing terms will respond to this user need.

Income taxes

The Federal Government is currently implementing a number of multinational tax initiatives. These may have flow on impacts for the financial statements.

The OECD 'Pillar Two' top-up tax reforms are being implemented by more than 130 countries globally and seek to ensure a minimum tax rate of 15% on multinational organisations with more than €750 million (approximately A$1.2 billion) in revenue. The Australian implementation is expected to commence from 1 January 2024.

The calculation of Pillar Two top-up tax liabilities is complex and based on accounting information, and often requires the collection of many more data points from foreign operations in order to ensure compliance.

From a financial reporting perspective, although relief from difficult deferred tax calculations has been provided, there are immediate disclosures required in financial reports. Furthermore, the regulator is expecting impacts to be disclosed.

In addition, other pending measures such as thin capitalisation and franking credit reforms can have financial reporting impacts.

It is imperative that financial reporting and tax teams work together to ensure tax and financial reporting outcomes are thorough and accurate. Directors should ensure they understand the likely impacts of these measures and that financial reporting clearly communicates material impacts.

In addition, where the entity has net deferred tax assets that are recognised, robust assessment supporting recognition must be documented, and be consistent with impairment and other models.

Going concern

The board and management of organisations need to consider whether the entity has the ability to continue as a going concern for at least 12 months from the date of signing the financial report.

In addition, the directors' declaration for an entity reporting under the *Corporations Act 2001* requires an explicit statement that the entity can pay its debts as and when they fall due. There are also specific provisions prohibiting an entity from trading while insolvent.

Making these assessments involves judgements about inherently uncertain future outcomes of events and conditions.

Consistent with a slowing economic environment, we have begun to see an increase in insolvencies and voluntary administrations in recent times.

In an uncertain environment, entities will need to consider:

- Cash flow needs to fund higher interest rate payments
- Potential diminished demand for products and services
- Contractual obligations due or anticipated
- Potential liquidity and working capital shortfalls
- Access to existing and needed sources of capital (e.g. available lines of credit) and likely pricing of those sources.

Transaction and industry specific areas

These additional matters can have significant impacts on particular entities:

- Entities holding **investment property** need to ensure that valuations are realistic, reflecting current market rentals and appropriate capitalisation rates.
- **Insurance contracts** for insurers and other entities with insurance-like exposures. A new Accounting Standard, AASB 17 Insurance Contracts can see significant changes in accounting and disclosure.
- Entities with facilities captured under the **Safeguard Mechanism** need to consider the impacts of the new regime commencing 1 July 2023 – including matters such as impairment impacts at June 2023.
- Superannuation funds need to immediately prepare for a new financial reporting and regulatory environment commencing on 1 July 2023.

Communication

Transparency is fundamental, and good business

The only certainty is uncertainty. This also means widespread views of future expectations.

How do directors and management ensure the market understands the entity's perspective? Transparent and direct disclosure to the market is a critical step, backed up by rigorous and tested documented analysis.

Ensuring all crucial decisions are researched and documented by management, and tested and approved by the board, will ensure an 'ahead of the curve' outcome. It also means that continuous disclosure obligations are met and regulatory perusal is easily addressed – as the thinking, discussion and justification has been completed ahead of time.

The information in these analyses also form the basis of disclosures included in financial statements, the operating and financial review, sustainability and other reports, market releases and more.

Directors should ensure that these processes are embedded in the entity's control environment.

Finally, meaningful disclosure of the entity's specific circumstances is superior to 'boilerplate' or generic disclosure and builds investor trust and management credibility – so moving from disclosure compliance to an investor dialogue is critically important.

In this next section, we explore some of the key disclosures arising throughout the annual report.

Judgements, estimates and assumptions

Accounting Standards require the disclosure of:

- **Sources of estimation uncertainty** – such a forecast cash flows used in models
- **Assumptions made** – how the various uncertainties have been taken into account (such as for growth and discount rates used in determining recoverable amount as discussed above)
- **Sensitivity and scenario analysis** – particularly for impairment testing.

In addition, there are specific disclosures required in various topic areas. For instance, there are specific disclosures that are required in relation to expected credit losses, fair value measurements and financial risk exposure and management.

These disclosures are best presented in plain English, to provide a straightforward and entity specific analysis giving insights into how the entity has responded to uncertainty.

Liquidity risk management

Managing liquidity risk is fundamental to an entity's survival. Accounting Standards accordingly require disclosure of how the entity manages its liquidity risk, including its policies and procedures and the entity's overall objectives.

These disclosures are supplemented by maturity analyses providing quantitative contractual maturities and other information.

These disclosures take on additional importance with higher interest rate settings and a slowing economic environment. Entities should ensure the overall picture of the entity's liquidity management is clearly articulated in the financial statements.

Climate and ESG

The Federal Government is rapidly moving toward mandatory climate-related financial disclosures and the release of the initial IFRS® Sustainability Disclosure Standards by International Sustainability Standards Boards provides greater certainty on the way forward. In the meantime, ASIC encourages the voluntary use of the Task Force on Climate-related Disclosures (TCFD) recommendations as the primary framework for voluntary climate-related disclosures.

ESG issues will continue to be 'top of mind' for boards, management, investors and regulators and directors should ensure they are ready for the reforms.

How does uncertainty play into these disclosures? Consistent with the other disclosures discussed in this publication, readers should be able to clearly understand how ESG-related uncertainties have impacted the entity during the year, and importantly, the possible impacts on entity in future periods.

Operating and financial review (OFR)

Entities reporting under the *Corporations Act 2001* are required to present a directors' report which includes an operating and financial review (OFR) providing information that investors would reasonably require to assess an entity's operations, financial position, and business strategies and prospects for future financial years.

ASIC has published a regulatory guide setting out its expectations on how the OFR should be presented and the information it should contain.

The disclosures should be:

- **Tailored** to reflect the individual circumstances of the entity and the business environment in which it operates
- **Complementary** and **consistent** with the annual financial report and other information
- **Balanced** and **unambiguous**
- Presented in a **clear**, **concise** and **effective** manner.

The regulator has increased its surveillance of these disclosures and is focused on transparent disclosure of material business risks in the OFR with 16 entities providing additional market disclosures in response to ASIC's inquiries in the last 12 months.

Climate-related risks are also front and centre, with ASIC identifying climate change as a systemic risk that could have a material impact on future financial position, performance or prospects of entities. Directors reviewing the disclosures prepared by management should ensure the information presented is clear, consistent with their understanding of the business and focuses on the crucial factors. Information disclosed publicly should also be consistent with internal information.

More recently, the explosion of interest in artificial intelligence may result in new systems and processes, create new business risks and also result in pressure to illustrate progress, especially where competitors are implementing measures.

Directors reviewing the disclosures prepared by management should ensure the information presented is clear, consistent with their understanding of the business and focuses on the crucial factors. Information disclosed publicly should also be consistent with internal information.

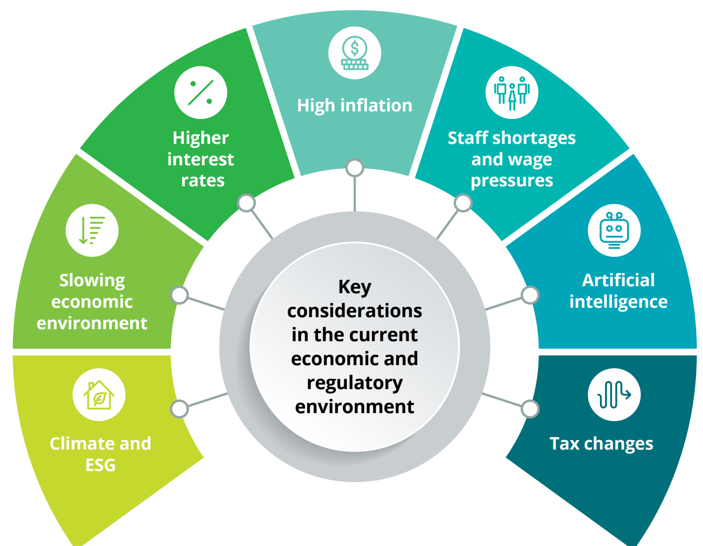
With the regulator focusing on 'greenwashing', it is vitally important that information is specific, supportable and consistent across the organisation – broadly to all communications including marketing materials. As part of this, the information disclosed in the OFR must be consistent with the judgements applied in the financial statements. How does uncertainty play into these disclosures? Consistent with the other disclosures discussed in this publication, readers should be able to clearly understand how ESG-related uncertainties have impacted the entity during the year, and importantly, the possible impacts on entity in future periods.

Top three regulator focus areas in the OFR

1 Disclosure of material business risks and the impact on the organisation

2 Disclosure of non-IFRS measures in a way that are not given undue prominence and are reconciled to the equivalent IFRS measure

3 Greenwashing



What are the questions audit & risk committees should be asking?

A framework

In essence, dealing with uncertainties comes down to:

- Understanding the uncertainties that the entity faces
- Ensuring the right policies, planning and people are in place
- Communication clearly to stakeholders.

The ten questions to the right illustrate some key topics for discussion on uncertainties between the board (and its committees) and management in understanding and responding to uncertainties and their impacts on the organisation.

01 What are the uncertainties in our crucial business drivers? How are our budgets and forecasts estimated and how do we respond to changes both expected and unexpected, controllable and uncontrollable? Is our remuneration structure aligned with controllable variables?

02 What budgets and forecasts are used in our impairment testing of assets, deferred tax assets and provision calculations? Are they consistent and what are the explanations for differences? How have uncertainties been included in these models? What are the impacts of climate change and decarbonisation? Where recoverable amount is based on fair values, has the use of external information been maximised and what documented support for any management estimates used in the calculation is in place?

03 What impacts do current circumstances have on our revenue streams? Have our revenue breakdowns and disclosures been reassessed in light of current slowing economic conditions and is there a clear explanation of the impacts? Have we explained how our revenue is impacted by inflation and our ability to pass on increased costs to customers?

04 What are the crucial factors in our liquidity risk planning (e.g. covenants)? How are these impacted by uncertainties and higher interest rates? How 'close to the wire' are we and what scenario planning has been undertaken?

05 What is the impact of higher interest rates and inflation? What financial statements amounts are most affected in this higher interest rate environment?

06 What are the impacts of pending tax changes? Are we affected by the Pillar Two tax reforms and if so, how progressed are we to understanding the impacts? Are we ready for the disclosure of impacts and what messaging are we planning around these disclosures?

07 Do our financial reports, operating and financial review (OFR) and other communications clearly explain the material business risks and uncertainties we face and how we respond?

08 How have our climate-related risks been assessed? What are the key risks and opportunities arising from climate change and decarbonisation? Have potential material risks arising from climate been transparently disclosed? Are we ready for mandatory climate-related financial disclosures?

09 In addition to climate change impacts, what broader environmental, social and governance risks is the entity exposed to? How do we manage these risks and have they been appropriately taken into account in our forecasts and models and clearly discussed in our disclosures?

10 Do we have prepared and reviewed position papers on our critical judgements, assessments and 'house view' on various uncertainties and their impacts? Have these been appropriately reviewed by the audit and risk committees and the board where necessary?

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