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Corporate reporting challenges in times of uncertainty

Recent events remind us that 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.

Pandemic. Floods and other natural disasters. Geopolitical instability. Supply chain constraints. Labour shortages. Inflation, or perhaps stagflation. Rapidly increasing interest rates and energy prices. A newly installed Federal government with different priorities.

The recent experience with the global COVID-19 pandemic and earlier global shocks 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 governance and reporting considerations arising from uncertainties and provide a guide to ensuring your effective response.

Key challenges and uncertainties

Risk management

What are the key messages?

A rather fundamental challenge for organisations in responding to uncertain and unexpected events is designing and implementing a risk management framework that is right-sized and resilient.

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

One of the positive outcomes from recent events 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 the organisation's risk management frameworks to better handle future events.

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
- **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, and an overall requirement to explicitly call out key judgements and estimates 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 a key focus area for regulators.

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 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 long current economic conditions are expected to be sustained. 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 does that need to be reflected over the first 5 years cashflows?

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, we all know is coming.

The determination of discount rates used in cash flow models will also require careful analysis to reflect expected interest rates and optimal funding ratios.

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 – rolling forward previously assumptions is unlikely to cut it in volatile environments.

Inventories

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

With supply chain disruptions and rapidly changing cost profiles, the cost of inventories may increase or involve abnormal costs. Similarly, changing overall economic conditions 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? For entities with interests in Russia or Ukraine, can relevant markets be accessed?

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

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** can affect the timing and amount of outlays.

Changes in inflation and the possibility of higher than expected salary costs can also impact the measurement of long service provisions and other employee entitlements. Such provisions may not have moved significantly in recent years in a low wage growth environment.

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.

In considering to these requirements in an uncertain environment, entities will need to consider:

- The extent of any **operational disruption**
- Potential **diminished demand** for products and services
- **Contractual obligations** due or anticipated
- Potential **liquidity** and **working capital shortfalls**
- Access to **existing sources of capital** (e.g., available lines of credit).

Communication

Transparency is fundamental, and good business

The only certainty is uncertainty. It also means that there will be widespread views on 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 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 vastly superior to 'boilerplate' or generic disclosure and builds investor trust and management credibility.

In this 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 as 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 and fair value measurements.

These disclosures are best presented in plain English, providing a straightforward and entity specific analysis that provides 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 in a rising interest rate environment and entities should ensure the overall picture of the entity's liquidity management is clearly articulated in the financial statements.

Operating and financial review (OFR)

Entities reporting under the *Corporations Act 2001* are required to present a directors' report which must include 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:

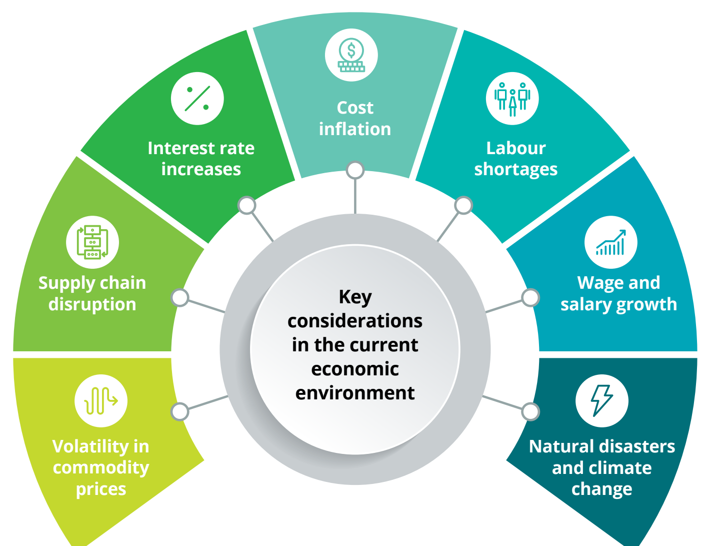
- Tailored to reflect the individual circumstances of the entity and the business environment in which it operates
- Complementary and consistent with the annual financial report and other information
- Balanced and unambiguous
- Presented in a clear, concise and effective manner.

The regulator has increased its surveillance of these disclosures and is focused on transparent disclosure of material business risks in the OFR. 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, and ASIC encourages the voluntary use of the Task Force on Climate-related Disclosures (TCFD) recommendations as the primary framework for voluntary climate-related disclosures.

The establishment of the International Sustainability Standards Boards means environmental, social and governance (ESG) issues will continue to be 'top of mind' for boards, management, investors and regulators and the depth of disclosures will increase.

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

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.



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
- Communicating 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.

1	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?
2	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? 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?
3	What impacts do current circumstances have on our revenue streams? Have our revenue breakdowns and disclosures been reassessed in light of current conditions and is there a clear explanation of the impacts?
4	What are the crucial factors in our liquidity risk planning (e.g., covenants)? How are these impacted by uncertainties? How 'close to the wire' are we and what scenario planning has been undertaken?
5	What is the impact of the changing interest rate and inflation environment? What financial statements amounts are most affected in a rising interest rate environment?
6	How is management responding to supply chain disruption? How long is the disruption expected to last and what 'what if' scenarios have been developed?
7	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?
8	How have our climate-related risks been assessed? What are the key risks and opportunities arising from climate change? Have potential material risks arising from climate been transparently disclosed? Do our disclosures comply with the Task Force on Climate-related Disclosures (TCFD) recommendations?
9	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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