Technical Accounting Alert
TA 2017-11

ASIC focus areas for 31 December 2017 financial reports

Introduction

The purpose of this Alert is to draw attention to the Australian Securities and Investments Commission's (ASIC) Media Release 17-423MR *ASIC calls on preparers to focus on financial report quality and new requirements*, which outlines ASIC's areas of focus for 31 December 2017 financial reports of listed entities and other entities of public interest with many stakeholders.

Overview

The Media Release highlights ASIC's focus in the areas of:

1 Impairment testing and asset values
2 Revenue recognition
3 Expense deferral
4 Off-balance sheet arrangements
5 Tax accounting
6 Estimates and accounting policy judgements
7 Impact of new revenue, financial instrument, leases and insurance standards

These areas are very much identical to the ASIC areas of focus for 30 June 2017 financial year (TA Alert 2017-04).

Specific commentary is provided on the following areas:

Accounting estimates

1 Impairment testing and asset values

The recoverability of the carrying amounts of assets such as goodwill, other intangibles and property, plant and equipment continues to be an important area of ASIC's focus.

Directors and auditors need to ensure that:

a Cash flows and assumptions are reasonable having regard to matters such as historical cash flows, economic and market conditions, and funding costs. Where prior period cash flow projections have not been met, careful consideration should be given to whether current assumptions are reasonable and supportable.

b Discounted cash flows are not used to determine fair value less costs to sell where forecasts and assumptions are not reliable. Fair value less costs to sell should not be viewed as a means to use unreliable estimates that could not be used under a value in use model.

c Value in use calculations:

    i Use sufficiently reliable cash flow estimates;

    ii Do not use increasing cash flows after five years that exceed long term average growth rates, and without taking into account offsetting impacts on discount rates;

    iii Do not include cash flows from restructurings and improving or enhancing asset performance.

d Cash flows used are matched to carrying values of all assets that generate those cash flows, including inventories, receivables and tax balances.

e Different discount rates are used for cash generating units (CGUs) where the risks are different and the CGUs are located in different countries, and that similar discount rates are used where the risks are similar.

f CGUs are not identified at too high a level, including where cash inflows for individual assets are not largely independent.

g CGUs for testing goodwill are not grouped at a higher level than the operating segments or the level at which goodwill is monitored for internal management purposes.

h Corporate costs and assets are allocated to CGUs on an appropriate basis where it is reasonable to allocate them.

i Appropriate use of fair values for testing exploration and evaluation assets during the exploration and evaluation phase.

Further information can be found in ASIC Information Sheet 203 *Impairment of non-financial assets: Materials for directors.*

Particular consideration may need to be given to values of assets of companies in the extractive industries or providing support services to extractive industries, including assets during the exploration and evaluation phase.

In addition to considering asset values in the extractive industries, Directors and auditors should also focus on the adequacy and treatment of any liabilities required for mine restoration and closure costs.

Asset values may also be affected by the risk of digital disruption, technological change, climate change, Brexit or cybersecurity.

Focus should also be given to the pricing, valuation and accounting for inventories, including the net realisable value, possible technical or commercial obsolescence, and the substance of pricing and rebate arrangements.

Directors and auditors are urged to focus on the valuation of financial instruments, particularly where values are not based on quoted prices or observable market data. Fair values should be based on the appropriate models, assumptions and inputs. Directors and preparers should also be mindful of the need to disclose the impact of the new financial instruments standard.

Accounting policy choices

2 Revenue recognition

Directors and auditors should review an entity's revenue recognition policies to ensure that revenue is recognised in accordance with the substance of the underlying transactions. This includes ensuring that:

a Services to which the revenue relates have been performed;

b Control of relevant goods has passed to the buyer;

c Where revenue relates to both the sale of goods and the provision of related services, revenue is appropriately allocated to the components and recognised accordingly;

d Assets are property classified as financial or non-financial assets;

e Revenue is recognised on financial instruments on the basis appropriate for the class of instrument.

The appropriate timing of revenue recognition may also need careful consideration in industries with complex sale and licensing arrangements that may include continuing obligations, such as software providers.

3 Expense deferral

Directors and auditors are advised to ensure that expenses are only deferred where:

a There is an asset as defined in accounting standards;

b It is probable that future economic benefits will arise;

c The requirements of AASB 138 *Intangible Assets* are met, including:

  i Expensing start-up, training, relocation and research costs;

  ii Ensuring that any amounts deferred meet the requirements concerning reliable measurement;

  iii Development costs meet the six strict tests for deferral in paragraph 57 of AASB 138.

4 Off-balance sheet arrangements

Directors and auditors are advised to carefully review the treatment of off-balance sheet arrangements, the accounting for joint arrangements and disclosures relating to structured entities, and ensure compliance with AASB 10 *Consolidated Financial Statements*, AASB 11 *Joint Arrangements* and AASB 12 *Disclosure of Interests in Other Entities*.

5 Tax accounting

ASIC notes that tax effect accounting can be complex and preparers of financial reports should ensure that:

a There is a proper understanding of both the tax and accounting treatments, and how differences between the two affect tax assets, liabilities and expenses;

b The impact of any recent changes in legislation are considered;

c The recoverability of any deferred tax asset is appropriately reviewed.

Key disclosures

6 Estimates and accounting policy judgements

ASIC continues to identify inadequate disclosures regarding sources of estimation uncertainty and significant judgements in applying accounting policies.

Disclosures regarding sources of estimation uncertainty and significant judgements in applying accounting policies are important to allow users of the financial report to assess the reported financial position and performance of an entity. Accordingly, Directors and auditors are urged to review the disclosures to ensure the necessary disclosures are made and are specific to the assets, liabilities, income and expenses of the entity.

ASIC also notes that disclosure of key assumptions and sensitivity analysis are important. These enable users of the financial report to make their own assessments about the carrying values of the entity’s assets and risk of impairment given the estimation uncertainty associated with many asset valuations.

Preparers should be particularly mindful to make these disclosures as this information may be revealed under key audit matter disclosures in the new enhanced audit reports for listed entities. Key audit matters may also refer to matters that should have been discussed in the Operating and Financial Review.

7 Impact of new revenue, financial instrument, lease and insurance standards

Where a new accounting standard has not yet been applied, AASB *108 Accounting Policies, Changes in Accounting Estimates and Errors* requires disclosure of this fact and known or reasonably estimable information relevant to assessing the possible impact that application of the new standard will have on the entity's financial report in the period of initial application.

ASIC states that Directors and auditors should ensure that notes to the financial statements disclose the impact on future financial position and results of new requirements for recognising revenue (AASB *15 Revenue from Contracts with Customers*), for valuing financial instruments (AASB 9 *Financial Instruments* (2014)), accounting for leases (AASB 16 *Leases*) and accounting for insurance businesses (AASB 17 *Insurance Contracts*). These new requirements will apply to future financial reports and may significantly affect how and when revenue can be recognised, the values of financial instruments (including loan provisioning and hedge accounting), and assets and liabilities relating to leases, and accounting by insurance companies.

ASIC believes the introduction of these new standards will have the greatest impact on financial reporting since Australia's adoption of IFRSs in 2005 and states that:

"*It is important that directors and management ensure that entities are prepared for these new standards and inform investors and other financial report users of the impact on reported results. There can be real business impacts and a need to implement new systems and processes. There is also a requirement to disclose the impact of the standards in notes to current financial reports ahead of the operative dates for the new standards.*

This may well mean quantification of the impacts for the reporting date that coincides with the start of the first comparative period that will be affected in a future financial report. Subject to transitional arrangements, that would mean 31 December 2016 for new standards on revenue and financial instrument valuation, and 31 December 2017 for the new lease standard. For the revenue and financial instrument standards 31 December 2016 marks the commencement of the new standards 'going live'."

Other matters

The ASIC media release also includes commentary on:

- the role of directors and management – directors are primarily responsible for the quality of the financial report and this includes ensuring that management produces quality financial information. Companies must have appropriate processes and records to support information in the financial report rather than simply relying on the independent auditor. Companies should apply appropriate experience and expertise, particularly in more difficult and complex areas such as accounting estimates (including impairment of non-financial assets), accounting policies (such as revenue recognition) and taxation. Information should be produced on a timely basis and be supported by appropriate analysis and documentation for the independent audit.
- operating and financial review – Listed companies should continue to disclose information on risks and other matters that may have a material impact on the future financial position or performance of the entity. This could include, for example, matters relating to digital disruption, new technologies, climate change, Brexit or cyber-security. Refer to ASIC Regulatory Guide RG 247 *Effective disclosure in an operating and financial review* for more information.
- enhanced audit reports – Auditors of listed entities are required to issue enhanced audit reports which outline key audit matters (i.e. those matters that required significant auditor attention in performing the audit). Preparers and directors should be mindful that these matters may relate to accounting estimates and significant accounting policy choices that also require specific disclosures in financial reports, as well as matters relating to the business that should be covered in the operating and financial review.

- material disclosures – Efforts should be made to communicate information more clearly in financial reports and ASIC will not pursue immaterial disclosures that may add unnecessary clutter to financial reports.
- client monies – Australian financial services licensees should ensure that client monies are appropriately held in separate, designated trust bank accounts, and that monies are applied in accordance with client instructions and the requirements of the *Corporations Act.*

Further information

If you wish to discuss any of the information included in this Technical Accounting Alert, please get in touch with your local Grant Thornton Australia contact or a member of the National Assurance Quality Team at national.assurance.quality@au.gt.com.