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Technical Accounting Alert

TA 2019-14

ASIC focus areas for 31 December 2019 financial reports

Introduction

The purpose of this Alert is to draw attention to the Australian Securities and Investments Commission's (ASIC) Media Release 19-341MR *Financial reporting focuses for 31 December 2019*, which outlines ASIC's areas of focus for 31 December 2019 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 Impact of the new lease and other accounting standards
2 Impairment testing and asset values
3 Revenue recognition
4 Expense deferral
5 Off-balance sheet arrangements
6 Tax accounting
7 Operating and financial review
8 Non-IFRS financial information
9 Estimates and accounting policy judgements

These areas are similar to the ASIC areas of focus for the 30 June 2019 reporting period (TA Alert 2019-04), except a greater emphasis on the application of AASB 16 *Leases* which applies to 31 December 2019 full year and half-year financial statements for the first time.

The ASIC media release makes it clear that ASIC considers right of use (ROU) assets arising from the application of AASB 16 as 'intangible assets' and thus such assets need to be excluded from the calculation of 'Net Tangible Assets' (NTA) which is a requirement for many Australian Financial Services Licence (AFSL) holders and listed entities. This interpretation also applies to contract assets arising from the application of AASB 15 *Revenue from Contracts with Customers*. ASIC requires directors and auditors to report affected entities to report any breaches to ASIC as required by *Corporations Act 2001*. It is important to note that the financial condition requirements applicable to AFSL holders are on an 'at all time' basis so compliance needs to be considered from the commencement of the financial year to which the standard first applied (even if ASIC were to subsequently change a licencee's conditions to allow ROU to be counted in NTA calculations).

Another notable addition for 31 December 2019 is ASIC's announcement of a review of the governance processes over financial reporting of several companies, generally where reported net assets and profits were materially changed following ASIC's inquiries on financial reports for recent reporting periods. ASIC's work will cover how

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audit committees and directors fulfilled their role in ensuring the quality of the financial reporting and supporting the audit of the financial statements. The regulator will also review the identification and effectiveness of actions by audit firms to address root causes from an audit perspective. ASIC will consider whether the results of this review indicate a need to improve governance at the company and/or audit firm, and anticipate completing this work by 30 June 2020.

Specific commentary is provided on the following areas:

New accounting standards

Major new accounting standards will have the greatest impact on financial reporting for many companies since the adoption of International Financial Reporting Standards (IFRS) in 2005.

Full-year reports at 31 December 2019 must comply with AASB 16 *Leases*, which requires lessees to recognise lease liabilities and a right-of-use asset for all leases, not just leases formerly classified as finance leases. Some leases and similar arrangements are covered by other accounting standards such as mining leases and leases of biological assets.

1 Impact of the new lease and other accounting standards

New accounting standards that will affect reported results of many companies significantly include:

- AASB 16 *Leases* (applies from years commencing 1 January 2019);
- AASB 17 *Insurance Contracts* (applies from years commencing 1 January 2021, subject to the one-year deferral currently being considered by the International Accounting Standards Board); and
- Amendments to standards to apply the new definition and recognition criteria in the Conceptual Framework for Financial Reporting (applies from years commencing 1 January 2020).

The new lease accounting standard can significantly change the financial position and performance of lessees by bring leases formerly classified as operating leases on balance sheet. The standard also introduces a new measurement basis.

This is also the second year of application of the following standards that applied from years commencing 1 January 2018:

- AASB 9 *Financial Instruments*; and
- AASB 15 *Revenue from Contracts with Customers*.

These new accounting standards may significantly affect how and when revenue can be recognised, the values of financial instruments (including loan provisioning and hedge accounting), reported assets and liabilities relating to leases, accounting by insurance companies, and the general identification and recognition of assets, liabilities, income and expenses. The standards also introduce new disclosure requirements.

The new standards can have real business impacts (e.g. compliance with debt covenants or regulatory financial condition requirements, tax liabilities, dividend paying capacity, and remuneration schemes) as well as the need to implement new systems and processes.

Public disclosure on the impact of the standards is important for investors and market confidence. Information that there has been (or will be) no material impact may also be important information for the market.

Companies affected by the new insurance standard and changes to the conceptual framework need to ensure appropriate disclosures on the future impact of those new requirements in the notes to 31 December 2019 financial reports. For example, the new conceptual framework contains new definition and recognition criteria for assets, liabilities, income and expenses that apply where they are not inconsistent with a specific requirement of an accounting standard.

For further information, refer to ASIC media release 16-442MR.

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Accounting estimates

2 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 focus.

It is important for directors and auditors to ensure:

- Cash flows and assumptions are reasonable having regard to matters such as historical cash flows, economic and market conditions, and funding costs. Particularly where prior period cash flow projections have not been met, careful consideration should be given to whether current assumptions are reasonable and supportable;
- Discounted cash flows are not used to determine fair value less costs of disposal where forecasts and assumptions are not reasonable and supportable;
- Cash flows used are matched to carrying values of all assets that generate those cash flows, including inventories, receivables and tax balances;
- Discount rates and other key assumptions are reasonable and supportable;
- Cash generating units (CGUs) are not identified at too high a level, including where cash inflows for individual assets are not largely independent; and
- For testing goodwill, CGUs are not grouped at a higher level than the operating segments or the level at which results are monitored for internal management purposes.

A company's weighted average cost of capital may be relevant in determining recoverable amount using discounted cash flows. Where borrowing rates change or the split of debt and equity changes, care needs to be taken as to whether the recoverable amount has changed. In particular, a change in the split of debt and equity from recognising more liabilities under the new lease accounting standard is unlikely to affect asset values.

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

Asset values may also be affected by climate change, market changes, digital disruption, technological change, or Brexit. ASIC has drawn attention to disclosures relating to the effects of climate change in recent public announcements and speeches.

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.

Accounting treatments

3 Revenue recognition

In applying the new revenue accounting standard, directors and auditors are reminded to review an entity's revenue recognition policies to ensure that revenue is recognised in accordance with the substance of the underlying transactions. ASIC notes that the new revenue standard is considerably more detailed than the previous standard and focuses on performance obligations.

4 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;

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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.

5 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*.

6 Tax accounting

Tax effect accounting is often complex. Accordingly, 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

7 Operating and financial review (OFR)

Listed companies are reminded that they should provide useful and meaningful information in the OFR about underlying drivers of the results and financial position, as well as business strategies and prospects for future financial years.

Entities should disclose risks and other matters that may have a material impact on their future financial position or performance. This could include, for example, matters relating to climate change, market changes, digital disruption, new technologies, Brexit or cyber-security. More information is available in ASIC Regulatory Guide RG 247 *Effective disclosure in an operating and financial review*.

Directors may also consider whether it would be worthwhile to disclose additional information that would be relevant under integrated reporting, sustainability reporting or the recommendations of the Task Force on Climate-related Financial Disclosures where that information is not already required for the OFR.

8 Non-IFRS financial information

Directors should also consider whether any non-IFRS financial information in the OFR or other documents outside the financial report is potentially misleading and is presented in accordance with ASIC Regulatory Guide RG 230 *Disclosing non-IFRS financial information*. RG 230 also covers limitations on the use of non-IFRS measures in the financial report (RG 230).

9 Estimates and accounting policy judgements

Historically, ASIC has identified 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.

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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.

Other matters

The ASIC media release also reminds directors that they are primarily responsible for the quality of the financial report. This includes ensuring that management produces quality financial information on a timely basis. Companies must have appropriate processes, records and analysis to support information in the financial report. Companies should also 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.

Further information can be found in ASIC Information Sheet 183 *Directors and financial reporting* and ASIC Information Sheet 203 *Impairment of non-financial assets: Materials for directors*.

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.

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