Technical Accounting Alert

TA 2020-19

ASIC findings from review of 30 June 2020 financial reports

Introduction

The purpose of this Alert is to draw attention to the Australian Securities and Investments Commission's (ASIC) Media Release 20-329MR *ASIC review of 30 June 2020 financial reports*, announcing the results of ASIC's inspections of 170 listed entities and other public interest entities with many stakeholders.

This is a timely reminder for entities and their auditors who are currently in the process of preparing 31 December 2020 financial statements.

ASIC has specifically comment on the Asset values and disclosures under COVID-19 conditions by stating that many companies made useful and meaningful disclosures on the impact of COVID-19 conditions. However, some entities with businesses adversely affected by the pandemic did not appear to give sufficient attention to the reporting of asset values and financial position.

COVID-19 conditions may create uncertainties which necessitate the use of probability weighted scenarios. Disclosure of assumptions is key in this context. ASIC will continue to make inquiries where companies have made unrealistic and unsupportable assumption about future cash flows, and where disclosures did not clearly identify the impacts of COVID-19 conditions on the business.

Overview

ASIC's findings categories are largely in line with its focus areas for 30 June 2020 financial reports in COVID conditions (refer to TA 2020-13). The findings are divided into eight broad categories, with specific commentary below on each:

1 Asset values and impairment testing

2 Operating and Financial Review (OFR)

3 Revenue recognition

4 Tax accounting

5 Provisions

6 Non-IFRS financial information

7 Operating segments

Accounting estimates

1 Asset values and impairment testing

ASIC's inquiries on assessments of the recoverability of the carrying values of assets, including goodwill and property, plant and equipment include:

(a) Reasonableness of cash flows and assumptions: ASIC continue to note cases where the cash flows and assumptions used by entities in determining recoverable amounts are not reasonable or supportable having regard to matters such as historical cash flows, economic and market conditions, or uncertainties due to COVID-19 conditions.

In particular, ASIC found a case where the entity's forecast cash flows did not appear reasonable and had exceeded actual cash flow for a number of reporting periods.

(b) *Determining the carrying amount of cash generating units*: ASIC has made inquiries to understand how entities have identified cash generating units (CGUs), given indications they may be at too high a level despite cash inflows being largely independent.

(c) *Treatment of leases by lessees*: whether entities that are lessees and impacted by the new lease accounting requirements have adjusted their impairment models to include all right of use assets in the carrying amounts of assets tested for impairment and appropriately adjusted the cash inflows and discount rate used in determining recoverable amount.

(d) *Estimates of fair value*: ASIC has made inquiries of two entities that use discounted cash flow techniques to estimate fair value where the calculations are dependent on a large number of management inputs.

(d) *Disclosures*: ASIC still finds a number of entities not making necessary disclosure of:

- sensitivity analysis where there is limited excess of an asset's recoverable amount over the carrying amount and where a reasonably possible change in one or more assumptions could lead to impairment;
- key assumptions, including discount rates, growth rates, and how uncertainties were addressed; and
- for fair values, the valuation techniques and inputs used.

These disclosures are important to investors and other users of financial reports given the potential uncertainties and differing assumptions under COVID-19 conditions. These disclosures enable users 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.

This item includes matters arising from the finalisation of impairment matters identified in ASIC's reviews of 31 December 2019 financial reports.

2 Operating and Financial Review

ASIC has raised several inquiries about the quality of an entity's OFR, and the extent to which it complemented the financial report and told the story of how the entity's business is impacted by the COVID-19 pandemic.

There were several entities that did not present their OFRs as set out in RG 247 *Effective disclosure in an operating and financial review*. ASIC observed some instances where:

- no information was provided on the entity's business model, including key features;
- information was not provided on business strategies and prospects. While the impact of the COVID-19 pandemic presents challenges in providing information about prospects, some entities did not explain why this was not disclosed.
- some entities relied on the `unreasonable prejudice' exemption from making disclosure of strategies and future prospects where this did not appear justified while their competitors in the same industry did not; and
- there was no discussion of risks that could affect the entity's future performance, including sustainability and climate risks where relevant.

These observations aim to refocus listed entities and their directors on the important principles within RG 247 for the upcoming reporting season.

3 Revenue Recognition

ASIC has followed up seven matters concerning revenue recognition. In one matter, ASIC is inquiring into the entity's franchise fee arrangements, which in some instances have been varied as a result of COVID-19 factors. In another matter, ASIC have made inquiries about an entity's commission-based revenue, which relies on estimates about future sales, which has also been impacted by COVID-19.

ASIC has also made inquiries with an entity about its change in accounting policy for revenue from the previous year. The entity did not disclose any information about the reasons for the change.

4 Tax Accounting

ASIC has made inquiries of four entities concerning their accounting for income tax, including whether it is probable that future taxable income will be sufficient to enable the recovery of deferred tax assets relating to tax losses. For further information, we recommend reading TA 2019-12 Guidance on Recognition of Tax Operating Losses.

5 Provisions

ASIC has inquired with four entities on the adequacy of provisions, including possible onerous lease contracts and site rehabilitation. ASIC has also made inquiries of a company regarding possible obligations for casual employees.

6 Non-IFRS measures

ASIC has followed up four entities about their use of non-IFRS profit measures, and the prominence of these over statutory information. In one instance, the entity has presented a split of profit or loss between pre-COVID-19 and post-COVID-19 and prominence has been given to the pre-COVID-19 period in the directors' report.

7 Operating Segments

ASIC has made enquiries of three entities in relation to the disclosure of operating segments. In one instance, the entity has identified significant items of expense which have not been allocated to a reportable segment.

Material changes

ASIC's risk-based surveillance of the financial reports of public interest entities for reporting periods ended 30 June 2010 to 31 December 2019 has led to material changes to about 5 per cent of the reviewed financial reports. The main changes were to impairment of assets, revenue recognition and expense deferral.

When a company makes material changes to information previously provided to the market following inquiries made by ASIC, ASIC makes a public announcement. In addition to improving the level of market transparency, these announcements are intended to make directors and auditors of other companies aware of ASIC's concerns so they can avoid similar issues.

Other matters

Given the impact of COVID-19 asset values and related disclosures are important areas for the focus of the directors, prepares and auditors for financial reports at 31 December 2020, ASIC reminds directors and auditors need to focus on impairment of non-financial assets in financial reports to ensure the market is properly informed about asset values and expected future performance implied by those values.

Further information

If you wish to discuss any of the information included in this Technical Accounting Alert, please get in touch with your Grant Thornton Relationship Partner or a member of the Financial Reporting Advisory team at FRA@au.gt.com.