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Heads Up
ASIC's focus areas for December year ends

"Talking Points"

- ASIC continues its focus on the quality of financial reporting.
- ASIC also calls on directors to challenge the accounting estimates and treatments applied in the financial report and review the cash flows and assumptions used in the calculations prepared by management or experts.
- Impairment of goodwill and other assets remains a priority with ASIC encouraging preparers and auditors of financial reports to carefully consider the need to impair. Cautionary language is included around inappropriate use of unrealistic cash flows and assumptions.
- Asset valuations in extractive industries or those providing support services to extractive industries and those industries/assets exposed to digital disruption are specifically noted.
- In regards to Intangible assets, appropriateness of the cost capitalisation, recognition as an indefinite or finite life asset and the period over which the asset is amortised are identified as focus areas.
- ASIC continues to encourage preparers and auditors of financial reports to focus on the appropriateness of key accounting policy choices that can significantly affect reported results.

Background

ASIC has recently announced its areas of focus for 31 December 2014 financial reports of listed entities and other public interest entities. ASIC publish its areas of focus in financial reporting on a half yearly basis. The communication, issued in the form of a media release, is aimed at both directors and auditors and typically identifies those areas of financial reporting that are judgmental, entity specific and for which investors and other users typically demand high quality information. In our experience, when companies receive letters from ASIC in respect of their financial statements under ASIC's ongoing surveillance programme, the matters raised by ASIC are often consistent with these areas of focus.

On occasion, as a result of ASIC's financial statements surveillance programme, ASIC may agree with an entity that a restatement of the financial statements is appropriate. In 2014 ASIC commenced issuing media releases when such restatements are made and companies have recently made restatements in respect of intangible assets and impairment, consistent with ASIC's areas of focus.

Whilst over time the areas of focus remain broadly constant, specific matters may be given more prominence at various times reflecting changing market conditions. For example, in this latest release, specific mention is made of asset valuations in extractive industries, reflecting the impact of current commodity prices, and those asset values that may be affected by digital disruption. Furthermore, both the impact of newly effective accounting standards and newly issued standards receives a special mention.

ASIC also calls on preparers and auditors to focus on the appropriateness of key accounting policy choices that can significantly affect reported results. These may include, for example, judgements made around off-balance sheet structures, the accounting for group reorganisations, revenue recognition, expense deferral and tax accounting. We believe that entities should pay particular attention in ensuring that such disclosures are both relevant and meaningful to their circumstances, and relevant to events and transactions that have occurred in the reporting period, including consideration of whether alternative accounting treatments may have been applied and, potentially, the impact of the actual treatment adopted compared to available alternatives.

Accounting standards also require that an entity disclose information about the assumptions it makes about the future and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amount of assets and liabilities within the next financial year. This disclosure should include details of both the nature of such assets and liabilities and their carrying amount at the end of the reporting period. Examples of where such disclosures may be appropriate include assumptions made about estimated costs to complete, potential settlement of litigation and the impact of future changes in prices on the recoverability of inventories. The accounting standards comment that these requirements relate to those estimates that require management's most difficult, subjective or complex judgements.

ASIC also commented specifically on the role of directors whilst acknowledging that directors need not be accounting experts. In performing their roles as directors, ASIC has called for directors, where appropriate, to challenge the accounting estimates and treatments applied in the financial report, and seek explanations and appropriate professional advice supporting the accounting treatments chosen, particularly where a treatment does not reflect their understanding of the substance of an arrangement. Directors should also review the cash flows and assumptions used in the calculations prepared by management or experts, bearing in mind their knowledge of the business, its assets, and the future prospects of the business.

This Heads Up provides an overview of ASIC's areas of focus for 31 December 2014 financial reports and the issues directors and preparers of financial statements should consider to ensure that they have appropriately addressed ASIC's concerns.

ASIC areas of focus for 31 December 2014 financial reports

ASIC's surveillance of 31 December 2014 financial reports will focus on listed entities and other entities of public interest with a large number and wide range of stakeholders considering factors such as the nature and size of the business and the number of its employees.

ASIC's surveillance continues to focus on material disclosures of information useful to investors and other users of financial reports, such as key assumptions supporting accounting estimates. ASIC has specifically noted that it does not pursue immaterial disclosures that may add unnecessary clutter to financial reports. We encourage all entities to critically review their financial reports and disclosures to ensure that the information presented is meaningful, relevant and value added in enhancing a user's understanding of the entity and its performance and financial position for the period and concur with the sentiment that disclosures are not required if the information is not material (AASB 101 paragraph 31).

For 31 December 2014 financial reports, ASIC's key areas of focus are:

<u>Accounting estimates</u>

- **Impairment testing and asset values** – specifically, recoverability of the carrying amounts of assets such as goodwill, other intangibles and property, plant and equipment. In this regard, ASIC has drawn specific attention to the following issues:
  - Reasonableness of cash flows and assumptions – including consideration of historical cash flows, economic and market conditions, and the funding structure of the entity. Specific comment is made that careful consideration is required as to whether current assumptions are reasonable and supportable when prior period cash flow projections have not been met.
  - Appropriateness of using a fair value less costs of disposal model – specifically, whether a discounted cash flow model developed for this purpose is sufficiently reliable to determine a fair value. ASIC states that in the absence of a reliable fair value, value in use models must be used, and reference is made to some of the specific requirements of AASB 136 *Impairment of Assets*, including

restrictions on the cash flows used and the requirement to exclude cash flows from restructurings or expansionary capital expenditure.

- Congruence of cash flows to the carrying values of the assets subject to impairment testing, i.e. ensuring that the cash flows are matched to the carrying values of all assets that generate those cash flows, including inventories, receivables and tax balances as appropriate.
- Identification of cash generating units at an appropriate level as required by AASB 136.

ASIC has specifically noted that particular consideration may need to be given to values of assets of companies in the extractive industries or providing support services to extractive industries, as well as values of assets that may be affected by the risk of digital disruption.

Our experience is that there are a wide range of impairment issues addressed by ASIC in the performance of their reviews and the list above is not exhaustive.

- **Amortisation of intangible assets** – specifically amortisation periods, the treatment of renewals and contractual restrictions that may limit the entity's ability to use an asset, the appropriateness of identifying assets as indefinite life assets and commencement of amortisation.

Accounting policy choices

- **Off-balance sheet arrangements** – careful review should be made of accounting policy choices made in respect of off-balance sheet arrangements, the new accounting requirements for joint arrangements and the disclosure requirements of AASB 12 relating to structured entities.
- **Tax accounting** – specifically the proper understanding of the tax and accounting treatments, impacts of legislative changes, unexplained or sundry items in the tax rate reconciliation which reduce the effective tax rate and the recoverability of any deferred tax asset.
- **Revenue recognition** – revenue should be recognised in accordance with the substance of the underlying transactions and when all the relevant revenue recognition criteria met. Specific reference is made to complex sale and licensing arrangements
- **Expense deferral policies** – expenses should be deferred only where they meet the definition of an asset under the accounting standards and demonstrate future economic benefit. Start-up, training, relocation and research costs should be expensed as incurred. Specific consideration should be given to intangible assets and items where the standards permit deferral in other comprehensive income.

Key disclosures

- **Estimates and accounting policy judgements -** The ASIC reiterated the need to disclose estimates and accounting policy judgements as these are important to allow users of the financial report to assess the reported financial position and performance of an entity. They also provide insights into asset valuations and impairment risks. It is generally considered as best practice to provide a sensitivity analysis of the estimates made, including the nature and reasons for the sensitivity.
- **Impact of new revenue standard -** Directors and auditors should ensure that financial reports disclose the impact of upcoming requirements for recognising revenue. This standard may significantly affect how and when revenue can be recognised. At the date of issue of this Heads Up, the Australian equivalent to IFRS 15 has not yet been issued; however, these disclosures are still required with respect to IFRS 15. We expect the Australian equivalent to IFRS 15 to be issued before 31st December 2014.

External Links

- ASIC media release (14-294MR) Focus for 31 December 2014 financial report