A QUARTERLY PUBLICATION ON ACCOUNTING & AUDITING MATTERS

CLARITY

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WINTER
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NEW ACCOUNTING STANDARDS – A STEEP MOUNTAIN TO CLIMB

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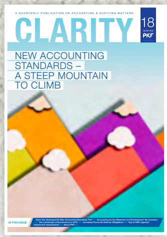
WELCOME TO THE WINTER EDITION OF CLARITY



Welcome to our Winter 2018 edition of Clarity. Our aim is to deliver greater clarity and understanding to our clients on the current and emerging accounting and audit issues. We also look to provide thought leadership, and share our knowledge and expertise, in areas that will solve problems and create solutions for clients. We hope you find this edition of value and please feel free to contact your local Audit Partners for any further assistance.

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“ ASIC will be scrutinising financial reports this reporting season to ensure that boilerplate disclosures are not continuing to be made with no impact assessment. ”

HAVE YOU ASSESSED THE NEW ACCOUNTING STANDARDS YET?

As we enter into another financial reporting season, financial report preparers are in the process of drafting their annual reports.

It is this time of the year when the Australian Securities and Investments Commission (ASIC) release its media release which sets out the top seven focus areas for 30 June 2018 financial reports of listed entities and other entities of public interest. These have generally been consistent over the last few media releases, being:

1. Impact of the new standards[1] ;
2. Impairment testing and asset values;
3. Revenue recognition;
4. Expense deferral;
5. Off-balance sheet arrangements;
6. Tax accounting; and
7. Estimates and accounting policy judgements.

1 The new standards referred to are AASB 9 Financial Instruments, AASB 15 Revenue from Contracts with Customers, and AASB 16 Leases.

These have been based on the previous accounts surveillance program that ASIC conduct, and are expecting to review more than 200 full year financial reports at 30 June 2018 and selected half-year reports.

Currently the topical focus has been on the first of these, as you would have noticed within recent financial press articles, there has been numerous comments from various regulatory and accounting bodies made in relation to the unpreparedness of companies with the upcoming commencement of the new accounting standards. In particular comments have been made on the following new Accounting Standards:

- AASB 15 Revenue from Contracts with Customers – Companies lagging on revenue recognition accounting changes (AFR -19 June 2018); and
- AASB 16 Leases – Companies in dark on new leasing standard (AFR - 29 May 2018).

ASIC reiterated that it is the responsibility of directors and management to ensure that entities are ready for these standards and inform stakeholders of the impact of the standards in notes to the financial reports as required by AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*. The expectation is that the disclosures will include quantification of the impacts for the reporting date that coincides with the start of the first comparative period, depending on the chosen transitional method.

The appropriate disclosures that the standard requires:

- A detailed description of how key concepts will be implemented, and where relevant, that differs to the current approaches;
- An explanation of the timeline of implementation, including expected use of any of the transition practical expedients;
- If known or reasonably estimable, quantification of the possible impact; and
- When the quantitative information is not disclosed because it is unknown or not reasonably estimable, additional qualitative information enabling users to understand the magnitude of the expected impact on the financial statements of the issuer.

If your entity has not initiated a review of the impact of these new accounting standards (if any), then you may have a steep mountain to climb to reach the summit. However, there is still time to attend to this. PKF is able to provide you with guidance on what is required, as well as review your assessment of these impacts including proposed disclosures. As noted, ASIC will be scrutinising financial reports this reporting season to ensure that boilerplate disclosures are not continuing to be made with no impact assessment. ■

ACCOUNTING FOR THE RESEARCH & DEVELOPMENT TAX INCENTIVE

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Lately, we are increasingly being asked for guidance on the correct accounting for Research and Development (R&D) Tax Incentives received. As an investment tax credit is accounted for either as a government grant or as income tax or as both but alarmingly it falls outside the scope of both relevant accounting standards AASB 112 Income taxes and AASB 120 Accounting for Government Grants and Disclosure of Government Assistance.

Without clear guidance from these standards and historically given different interpretations of the standards by accounting professionals, management must determine the most appropriate accounting policy to apply and in so doing they can have a material impact on the earnings before interest and tax (EBIT) of the company and the effective tax rate. With no applicable accounting standard, this is a matter of judgement that is covered under AASB 108 Accounting Policies, Changes in Accounting Policies and Errors to determine the most appropriate accounting treatment. Management should therefore consult with all major stakeholders and their auditor in setting this policy.

The Government currently provides a tax offset for some of a company's cost of doing eligible R&D activities by reducing a company's income tax liability. **Refundable tax offset of 43.5%** apply for companies with an aggregated worldwide turnover of less than $20 million per annum, or a **Non-refundable tax offset of 38.5%** for all other eligible companies.

The Government is currently preparing draft legislation to implement reforms to the R&D Tax Incentive announced in the 2018 Federal Budget although the fundamentals of the incentive are not expected to change.

Refundable tax offset of 43.5%

In our experience, the common accounting policy for refundable tax offset of 43.5% is to account for them as a government grant adopting the accounting principles of AASB 120.

Under this policy, a credit should be recognised in EBIT over the periods necessary to match the benefit of the credit with the costs for which it is intended to compensate. Where the R&D was expensed during the year it is expected that the refund will be recognised in full in EBIT for the year.

However, where the R&D has been in whole or in part capitalised, the entity should either account for the tax benefit as deferred income that is recognised in EBIT on a systematic basis matching the useful life of the asset, or through adjustment to the carrying value of the asset, which is therefore effectively recognised in EBIT through a reduced amortisation charge over the life of the asset. ■

“ As an investment tax credit is accounted for either as a government grant or as income tax or as both but alarmingly it falls outside the scope of both relevant accounting standards AASB 112 Income taxes and AASB 120 Accounting for Government Grants and Disclosure of Government Assistance. ”

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THE LANDSCAPE OF GOVERNANCE IN 2018

In late May/early June, the Governance Institute of Australia held a series of Governance and Risk Management Forums across Australia. PKF was pleased to act as national sponsor for these events and to have an active role in each Forum as they moved across the country exploring current themes.

In most cases these events moved to a two-day format reflective of what the Institute's CEO Steve Burrell described as "unparalleled times for governance professionals".

Context for Governance in 2018

The 2018 governance landscape is being dominated by a number of major events which have Boards and management teams racing to ask – "tell me we don't do that, do we?"

The year started with Larry Fink, Chairman and CEO of Blackrock, the world's largest investor, commenting as follows in his annual letter to shareholders:

"…to prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society…Companies must benefit all of their stakeholders, including shareholders, employees, customers and the communities in which they operate..."

From global to more local matters, these themes of positive contribution, impact and the role of culture were continued when the ASX's Corporate Governance Council released the fourth edition of its Corporate Governance Principles and Recommendations for public consultation.

Between these two documents however, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry commenced under the Honourable Kenneth Hayne, AC, QC.

The related collateral events of the crisis at AMP on the back of a fee for no service scandal and the report by the Australian Prudential Regulation Authority (APRA) into conduct at the CBA underline this point. Chairman, Directors and CEOs have fallen at AMP following an investigation by AUSTRAC, the federal financial intelligence agency, and CBA has accepted the largest fine in Australian corporate history – $700 million.

During the commission hearings, a series of revelations played out publicly – and they continue to do so. Together with the AMP cases and the *"must read"* APRA CBA Report, they demonstrate all too vividly, what happens when organisations and individuals lose sight of 'how' and 'why' they do business and they become complacent about the governance and risk levers designed to offer protection.

Against this context, several key thinking points came out from the Forums as follows:

Culture: All businesses large and small can learn from the APRA report and the Royal Commission

- Remember the movie Jaws? For some it is a morality tale about the dangers of extramarital sex and the inability of a weak father to control his family and his community.
- Just as Jaws is not about the shark, the APRA report is not about financial services!
- Many businesses will aim for what APRA described as a collegial and collaborative working environment which places high levels of trust in peers, teams and leaders and the 'good intent' of staff.
- However, these positive elements of a sound culture can also have a downside when acting with integrity as a non-negotiable.
- Pursuit of consensus can lessen constructive criticism and lead to slower decision-making, lengthier and more complex processes, and a slippage of focus on outcomes.

Key question: ***What are the positive elements of your culture hiding?***

Complacency: The real danger when it comes to risk management is complacency

- Australia has enjoyed 26 years of economic growth with a 27th more than likely next

year. Many large organisations seem to perform 'well' or 'well enough' and that 'we don't need to worry about all that risk stuff'.

- Success can dull the senses and complacency can lead to inadequate challenge.
- How robust are your models – both macro and at the individual product or business unit level? Is your organisation thinking about stress tests or contingency planning?
- Or are you complacent:

a) around your economic environment

b) and/or what does this mean for your control environment?

Key question: ***Do you tend to rationalise problems away more in hope than in true mitigation?***

Data & cyber risk: As risks go, cyber and data loss is high profile, damaging, often invisible and impacts reputation immediately

- Many organisations taking this risk seriously see cyber as a non-delegable risk for the CEO and there is increasing talk in the market now around Data Ethics Committees.
- Are you strategically positioning your Chief Information Officer, or your Chief Technology Officer? Or is that who you call when your mouse is not working?
- A powerful video was shared in the Forums – search Deloitte, Companies Like Yours in YouTube and you can see why major organisations such as IBM have banned USB sticks.
- This is a small example of what can be done, but what else are you doing?

Key question: ***If large corporates and government departments with significant resources are falling foul of this, why do you think you won't?***

Climate Change & Environmental, Social and Governance (ESG) risks: What was once a fringe topic, is moving into the mainstream

- Speakers from Climate Works, Aither, Morrow Sodali, KPMG and others presented research from shareholder groups confirming that climate change and ESG topics are increasingly important in shaping investment decisions.
- Even if you as an individual are less convinced, more and more of those you are dealing with in your supply chain, customer base and investors are concerned about these issues. The tone and message of the Larry Fink letter sends a clear signal of this.
- Last year CBA faced a class action around the inadequacies of its climate change disclosures within its investment and lending base. Just under a quarter of the questions at the recent AMP AGM were on the topic.
- Will consumers and stakeholders switch away from you, possibly forever, if a greener, cleaner, more socially responsible alternative presents itself? If you are not asking this question, then you should be.

Key question: ***Are we being tolerated simply because there is not a more socially responsible alternative?***

Conclusion

Drawing these themes together, what is on the mind of today's Chief Risk Officer? Speakers such as the risk leaders from Santos and Bendigo & Adelaide Bank concluded as follows:

- Culture, culture, culture. This word has been around business for some time now, but this is surely the moment when it becomes unavoidable. There is a key difference between the culture you *'want'* as opposed to the culture you actually *'have.'*
- A key challenge for risk is to consider how do we as individuals and teams concentrate in today's digital world, given fast moving innovation and the automation of many tasks.
- Risk needs to be a *'do-ocracy'*, in that it needs to get things done and as such, the 'Risk team' alone cannot be the sole owners of risk behaviour.
- Imagine yourself sitting beside a customer when you make your decisions – would it change your behaviours? ■

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“ASIC have taken the view that, despite financial statements being prepared by a finance team and subject to external audit, relevant company directors must be aware of their responsibilities under the Act with respect to all aspects of financial reporting and compliance with Australian Accounting Standards.”

INCREASED FOCUS ON DIRECTOR OBLIGATIONS

It's fair to say that the expectations and skill sets demanded of company directors has never been higher. With significant requirements around corporate governance, keeping abreast of corporate regulations and other relevant legislation – not to mention the ever-dynamic changes in financial reporting and accounting standards – being a Director in these current times is challenging.

It's also fair to say that due to these expectations, smart directors will surround themselves with a strong team with expertise in areas such as legislative and regulatory compliance, financial reporting and disclosure.

Certainly, for larger companies and listed public companies, this team may also include internal auditors, and external parties such as external auditors, valuation experts, tax and research and development consultants and advisory boards.

Surely having the access to, and benefit of, significant and talented resources will help mitigate the many risks faced by directors, or possibly 'band aid' some of the possible knowledge short-comings of directors?

As a result of a recent case - *ASIC v Godfrey* – ASIC (Australian Securities and Investments Commission) have re-asserted their ongoing view that directors be alerted to their obligations regarding the financial reporting requirements of the *Corporations Act 2001* and the Accounting Standards. In essence, the court held that directors cannot discharge their obligations solely with reliance on management of the company, its internal audit and corporate governance committee or its external auditors.

The case centred around Mr Godfrey, who was the former Managing Director of the Banksia Financial Group, of which Banksia Securities Limited was one of the entities of the Group. Receivers were appointed to Banksia Securities Limited and the entity was subsequently liquidated during 2014.

ASIC commenced proceedings against Mr Godfrey in June 2017 alleging that Banksia Securities Limited's (Banksia) financial reports for the years ended 30 June 2011 and 30 June 2012 (and the half year financial report for the half year ending 31 December 2011) did not comply with the relevant accounting standards, nor did they give a true and fair view of the financial position and performance of the entity. The specific area noted by ASIC was in relation to the adequacy and completeness of the entity's provisioning against bad or doubtful debts, with ASIC stating (publicly), that Mr Godfrey "did not have, and failed to obtain,

a proper understanding of the requirements of the relevant accounting standard, AASB 139 *Financial Instruments: Recognition and Measurement* (AASB 139)" as it applied to the determination of:

- The value at which a loan or receivable was to be recognised in Banksia's financial reports;
- Whether or not there was objective evidence that a loan or receivable was impaired; and if so,
- The proper amount of any provision for impairment.

In a court judgment handed down in December 2017, the Court made declarations that Mr Godfrey had breached the *Corporations Act 2001* as alleged and disqualified him from managing corporations for five years with a pecuniary penalty of $25,000.

Importantly, ASIC have taken the view that, despite financial statements being prepared by a finance team and subject to external audit, relevant company directors must be aware of their responsibilities under the Act with respect to all aspects of financial reporting and compliance with Australian Accounting Standards. Failure to do so may result in the above issues and dealings – which aside from physical costs and time costs, could also create long-standing reputational damage to both companies and individual directors.

PKF have significant expertise in corporate governance and assurance and advisory services, specifically in relation to the application of accounting standards – please do not hesitate to contact us if we can assist. ■

TOP OF ASIC AGENDA - IMPAIRMENT ASSESSMENTS

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As we roll past the 30 June 2018 financial year end, many companies will be turning their attention to the preparation of annual impairment assessments over their major assets. As in previous reporting periods Australian Securities and Investments Commission (ASIC) continues to have a significant focus on impairment testing and asset values.

Impairment is a tricky area involving a significant number of estimates and judgements and is an area that some companies continue to struggle with.

1. Key areas of focus

Impairment testing focuses on the comparison of recoverable amount vs the carrying amount. *The recoverable amount is determined as the higher of fair value less costs to sell and value in use.* These calculations carry a great deal of subjectivity and therefore the assumptions used need to be clearly understood, supported and disclosed.

Below are some common key assumption areas and what needs to be considered.

2. Cash flow forecasts

Forecasting future cash flows can seem like a crystal ball exercise, however reliable and supportable sources of information must be used when preparing cash flow forecasts including:

- Historical evidence of accurate budgeting and forecasting;
- Margin increases and growth rates, supported by sound plans which are considered reasonably achievable and supported by external evidence; and
- Consideration of economic, market and other factors outside of the control of the business.

Be careful not to base the forecast on the hopes and dreams for the business, but on the reality of the times ahead and any rough times you may face.

3. Discount rate

A discount rate is usually the most judgemental part of an impairment assessment and requires benchmarking and industry comparison.

Your discount rate calculation should consider:

- The rate expected to reflect the future value of money, adjusted for risks specific to the asset or cash generating unit (CGU);
- Discount rates must be pre-tax; and
- Discount rates may differ between assets or CGUs.

4. Appropriateness of the CGU

A CGU represents a group of assets for which the impairment assessment will be performed. At a minimum, a CGU should be no smaller than an operating segment of the business. For example, this should be the way in which management monitors the performance of the assets or business.

5. Terminal value

The use of a terminal value in an impairment assessment, demonstrates when the present value of all future cash flows and future growth rates will be stable indefinitely.

A model is usually applied using growth rates, discount rates and normalised cash flows. These inputs are very subjective, and the calculations are often not well understood.

Terminal values often comprise the majority of the cashflow model, so it is essential to be prepared with well supported assumptions.

Do not assume that the assumptions used last year will automatically be the same this year.

Where can it all go wrong?

Of the 54 inquiries made by ASIC over financial reports for 30 June 2017, 20 related to the impairment of assets.

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In March 2018, following ASIC's enquiry regarding the reasonableness and supportability of cash flow models used, Myer Limited were required to write down their assets by $515 million. Similarly subject to ASIC inquiries, AusTex Oil Limited and Wonhe Multimedia Commerce Limited wrote down assets by $6.17m and $5.4m respectively.

To avoid being in the ASIC spotlight, be diligent when preparing your 2018 impairment assessments. Ensure these are prepared in a timely manner to provide time for robust discussion and challenge. Consider seeking advice from PKF if you require an independent review. ■

About PKF

PKF brings clarity to business problems with simple, effective and seamless solutions that break down barriers for sustainable growth.

PKF Australia firms are members of the PKF International Limited (PKFI) network of legally independent firms in 440 offices, operating in 150 countries across five regions. PKFI is the 10th largest global accountancy network.

In Australia, PKF offers clients the expertise of more than 80 Partners and 750 staff, across audit, taxation and specialist advisory services.

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