CPA Australia Podcast
Transcript – Episode 45

Intro: Hello and welcome to the CPA Australia Podcast, your source for business, leadership, and public accounting information.

Ram Subramanian: Hello and welcome. I'm Ram Subramanian, policy advisor in reporting at CPA Australia. Joining us today is Doug Niven, senior executive leader for financial reporting and audit at the Australian Securities and Investments Commission. ASIC published its focus areas for 31st of December 2017 period on the 8th of December 2017. Doug is here with us today to discuss ASIC's focus areas and other important initiatives of ASIC to uphold quality of financial reporting in Australia. Welcome Doug, and thank you for joining us today.

Doug Niven: Thank you, Ram.

Ram Subramanian: The headline from ASIC's latest iteration calls on preparers to improve the quality of financial reports. This suggests there may be a need for improvement in financial report quality, which has been highlighted through ASIC's surveillance programme. Could you perhaps give us some examples of shortcomings identified through the programme, and what remedial action has been taken to address such shortcomings?

Doug Niven: Definitely, Ram. Um, we recently did also put out a release around our findings, which were for reviews of 30 June 2017 financial reports, and that can be found on our website. In terms of the findings, a consistent runs at a rate of 4% of the financial reports that we look at. Ah, After we follow them through, it results in material changes to the net assets and profits. Now, on one hand you might say 4% doesn't sound like a lot, on the other hand, ah 4% if you were able to extrapolate that to the whole say, listed company population, you could probably work out for yourself that, you know it can be a significant number of companies.

Ram Subramanian: Sorry to interrupt, Doug. So, out of all the financial reports you examine, ah, you find 4% with material errors.

Doug Niven: That's right.

Ram Subramanian: Okay.

Doug Niven: And, oh, obviously we are not doing a full audit.

Ram Subramanian: Yes.

Doug Niven: But to give you an idea of the magnitude, um, in ah the last six months, ah and you can this from the media release that we put out, because we do put out media releases in each case where there is a material change. We added up what the ah, impact was and it was $750 million, that's across a number of companies of course. So it does illustrate the fact that ah, while financial reporting in Australia is good compared to other countries, that there are still significant areas that need to be focused on by Directors and preparers of financial reports and ah, the sorts of errors we're calling out ah in the focus that is released, and I won't go through the whole list, but around asset values, revenue recognition and so on. Um, and obviously the focus is about making sure that the market is informed and so ah, generally find the companies are quite cooperative in moving forward when something's pointed out to them and correcting matters in the market.

Um, but it's also a matter of Directors thinking about um, how they can have good processes within the company ah, ask the right questions of management to ensure quality financial reports. You know, a culture focused on quality financial reporting, you've got the right experience and expertise within the organisation or you're calling on it from external parties, um, accountability mechanisms that focus on not just profitability, but also, you know, quality financial reporting. But thinking about deadline pressures, not rushing things at the end, proper analysis of issues and so on.

Ram Subramanian: Thank you Doug. There seems to be a continuing theme in ASIC's um, media releases on this topic, um that financial reports should be useful and meaningful. And, the latest media release has also called for financial reports to be both useful and meaningful. Could you tell the listeners what this means in real terms.

Doug Niven: Hmm. There are a number of aspects to this. Um, clearly, there's a focus around compliance with the standards. But when we're talking about useful and meaningful information it goes a bit beyond that. Um, yes the standards are being drafted to create financial reports which present consistent comparable information between companies and over time as well. And, ah, mindful of the sorts of disclosures that should be made, but of course they're not really um, contemplating every circumstance that can arise. And so, it's really a matter of ah, Directors and preparers again focusing on the information needs of users.

So part of this goes to how you communicate information as well, not just the content, but clarity, um you know the sorts of things that have been talked about around complexity of financial reporting using plain English, the order in which information is presented, so that you know, more important information comes first, you're linking things together and so forth.

But it goes ah beyond the financial report as well, to think about, yes the financial report is an incredibly important document in terms of the historical information it presents, but in addition it's accompanied by the offering a financial review, which is intended to fill out the picture, you know, what's driving those results, but also the business strategy and prospects, are we ahead of the risks and so forth and how that links in with the financial report. Ah, and even um, I'll throw it in, the use of non-interest financial information making sure that's used in an appropriate way and it's not misleading. But it really is thinking about, um yes making sure we're covering the nuts and bolts and the things that we're required to do, but thinking about are we getting the right message across? Are we giving the information the right way that users, investors and others, um will understand what's happening with the company? And making a much more useful document.

Ram Subramanian: Thanks Doug. Um, the other headline item is about the new accounting requirements, which um, as highlighted in the media release is probably going to have the greatest impact on financial reporting since the adoption of international financial standards back in 2005. And, these accounting standards will be on financial instruments, revenue, lease accounting, and further down the line, insurance as well.

There is obviously a requirement to disclose the impact of new accounting standards before they become effective. But perhaps more importantly entities should already be preparing for these significant accounting changes well in advance of the standards coming into force.

Is ASIC seeing evidence that entities are actually getting ready for these new standards? Are entities devoting adequate time and resources to get ready.

Doug Niven: You've introduced it very well and, ah I think the bottom line is, is there is definitely more to be done. There is, um certainly if you look at the financial reports where there's already a requirement for note disclosure around the impact of the new standards, um, where no seeing, ah a lot there and we're certainly not seeing quantification. And, remember when we're coming up to 31 December year ends, particularly for the revenue and financial instrument standards, well actually they're live for the December 2018 year. So you've already passed through one comparative period, hopefully you would have the numbers for the comparative period, um and you really need a starting number for the live year as well.

So, the fact that we're not seeing quantification does raise questions and from discussions with um, various players in the reporting chain, and in the markets, yes there's some work that's being done, some companies are more advanced than others. I suspect it's also the case that some haven't really embraced it and really thought about it, ah, tendency perhaps sometimes to leave things to the last minute, because we've got other things to worry about.

Perhaps an assumption, that these standards might not affect them, when in fact ah they can have very significant impacts. The revenue standard it could actually change the earnings pattern quite significantly. Financial instruments, some people think that might be just for banks, well everyone's got financial instruments. And it can have quite a significant impact again. Ah, leases a little bit harder, sorry a little bit easier for people to get their minds around in that um, it involves more leases being on balance sheet. But even then it's about the calculation, disclosures and everything else, so there's work to be done there. Um, insurance is a little bit further off and it effects particular companies, but again um, quite significant changes for those companies that are affected. So, you're right we've been focusing people on, what are the real business impacts from these new standards as it can affect capital requirements, dividend policies, remuneration, all sorts of things.

Similarly, having systems and processes in place for the standards, and that's not something you can do at the last minute. Um, and of course, as you touched on the disclosure to market not just through the financial report, continuous disclosure obligations, and what you might need to disclose in a transaction document now because you've got forecasts running into the period you'll be reporting under the new standards.

Ram Subramanian: The media release highlights the fact that Directors are primarily responsible for the quality of the financial report. And of course, under the Corporations Act, Directors do have that primary responsibility for the financial reports of the entity, um ASIC has long pushed for improvements in Director's financial literacy and so have other stake holders including CPA Australia. And this is to do with ah, um, ah, financial literacy that will assist Directors fulfil their obligations regarding financial reports.

Are you seeing improvements in this aspect of Directors responsibilities?

Doug Niven: Um, it links back to, in part to the answer I gave to your first question about what we're finding in our financial reporting surveillance. And we are continuing to have findings which indicates that there is more that Directors and preparers need to do, and that can reflect upon the level of knowledge of Directors.

We're very conscious that we have a large number of ah, companies even just in the listed space, more than 2000 companies and Directors, it's a very diverse population and you do want Directors with different skills, industry knowledge and so forth. But each Director needs to have an understanding of the financial reporting requirements. They do have obligations in terms of the financial report. And you may recall the Centro case, while it didn't actually change the law it did highlight the fact that Directors need to read the financial report, um, they need to bring to bear ah, what they know, what they should know by the way, ah to the financial report. Ask the right questions, ah, see whether the financial report is reflecting what they know um, if there's something that looks unusual in terms of an accounting treatment, ask questions they might not know, uh they might not know the technical accounting as themselves.

So the knowledge of financial reporting is very important. I think it is fair to say that there's more that needs to be done in this space, and it's reflecting in our results, but even just discussions more generally uh, with, uh Directors, companies and so forth.

The other thing I mentioned is that, um we did develop up a course, a quiz around Director's knowledge of financial reporting with CPA Australia, a couple of the other accounting bodies and the ARCD. There's a link to that quiz on our website asic.gov.au and it's worthwhile Directors completing that quiz, it's only 10 multiple choice questions, um and at the end of the quiz it might direct you to appropriate resources where you ah, you can ah, obtain more information and ah, develop your knowledge if that's, that's appropriate. Including some resources on the CPA Australia website.

Ram Subramanian: Thanks Doug.

One of the key documents um that forms part of the financial report under the Corporations Act is the operating and financial review. Ah, there are some new areas such as the impact of Brexit, climate change and some cyber security that are highlighted as matters to be considered for inclusion in the UFR.

Could you share your views on what ASIC sees as the major national and international developments which shape disclosure in the UFR particularly from the stand point of climate change risk.

Doug Niven: Hmmm, ah there are a few things that are happening and perhaps, just by way of background, in terms of the operating of financial review we do have a regulatory guide which provides um, some further information on how to apply the legislative requirement. Um, there are three limbs to the legislative requirement, the third one is probably the one that's of most focus here which is around business strategies and prospects of a company, which includes talking about forward looking information. Not necessarily quantified of course, um and that involves risks, um so you have the base of the historical financial report, you have an explanation of what's driving that and then you go into the business strategies and prospects.

So, before I get to climate, it's sort of interlinked also with um, integrated reporting, sustainability reporting’s as well. And the approach in Australia has been not to mandate integrative reporting, it's really voluntary, it's up to companies whether ah, they prepared an integrative report. Ah, the idea being that it allows companies to innovate and, ah you know decide what's appropriate for their business. So there's no requirement. Having said that it can be worthwhile companies thinking about whether something under integrative reporting that's not already required and covered in the operated financial review, so ah that's perhaps something to think about.

If we move to climate though, your specific question, um yes, it's one of a number of risks and that's probably something to bare in mind ah, you touched on some of them Brexit for example, cyber security, you know digital disruption, technology itself, you know there's a range of risks and they will vary from company to company.

So it's important that companies in the operating financial review do think about the range of risks and the balance and making sure they're giving appropriate prominence to appropriate risk. Um, it can also, by the way, flow through to asset values, ah these risks can affect the um value of assets. So, um in terms of climate change, there's a few things that have been happening, um one is the Senate economic references committee made some recommendations in March of 2017 around um, this area. A couple of them did relate to ah financial reporting, specifically under the Corporations Act. One about the Corporations Act and one about guidance by ASIC in this area. Ah, the Government hasn't yet responded ah to this ah, reports and the recommendations. So that's one piece of background.

There's also a fair bit happening internationally, and this partly flows from the financial stability board which is um, an international group. Which um is interested obviously in financial institutions but ah, they set up a taskforce, the TCFD, which reported in June and made some recommendations round disclosure on climate change. Um, and I won't go through the whole report, but it includes things like scenario analysis, what's your impact of a two degree increase in ah, in temperature.

So um, following on from that the international organisations of securities commissions has been thinking about is there guidance for something that needs to be done in that space that hasn't been concluded either. So, that's to pain the picture that there's still things happening and evolving internationally of course, where always interested in, as far as possible, and where appropriate, being in step ah, in the interest of our capital markets and companies with what's happening internationally.

So that's a bit of background. In terms of climate ah, disclosures in Australia, well we sort of touched on, in that last release, think about it for the operating financial review as one of the risks. Think about it for impairment as one of the risks. Um, in terms of scenario analysis that one is a little bit more complicated, because ah, we say, um disclosures ah shouldn't be hypothetical, and we'll give some more thought to what that means in terms of scenario analysis.

I think one of the challenges is what is the effect of a two degree increase in climate? Uh, on a company and you know, there could be a range of impacts, you know legislative change, incentives or you know disincentives um, will there be a two degree increase, um you know, what does that mean you need a scientist to figure out some of these things and they've probably got a range of views so it's a fair bit of uncertainty and you could end up with companies making these disclosures coming up with quite different answers, so it's going to be quite important they disclose how they got to them, what the assumptions were, but it raises some interesting questions as to how readers of that make comparisons as well. So I think there's probably more thinking to, to go in this space.

Ram Subramanian: Thanks Doug. One of the issues highlighted in the media release is enhanced auditor reports and of course it's a, a new regime that has come in which has a significant impact on the audit profession. What is the role of financial report preparers, which is effectively the focus of this media release? Ah, with enhanced audit reports which are relatively new addition to the financial reporting process.

Doug Niven: Yes, it's probably quite true that sometimes Directors or preparers might think well, that's the auditor’s report, I don't need to worry too much about that. And it the auditor’s report. It is useful for Directors generally, and audit committees, they would normally have good communications with auditors and so to be aware of the matters before the audit report is finalised and a lot of firms had been doing dry runs, but of course now we're talking about December 2017, this is actually the second live version of the enhanced audit reports.

What we're particularly interested in though is there is the potential for these key audit matters, which are the areas where the auditors spent the most time and effort effectively, um, to reflect on information that should be in the financial report, or the operating and financial review itself. A good example would be, there's a requirement under standards to disclose, you know significant accounting policy judgements and sources of estimation of uncertainty, and you can imagine if the auditors talking about some of those things that they were key audit matters, well the question would arise, well, if there is nothing in the financial report, why? Because those are the sorts of things that should've been spoken about there.

Similarly, if there are risks that the auditor is talking about in the key audit matters, well why aren't those actually highlighted and talked about in the operating and financial review for example. So it is important that preparers do think about these sorts of matters, we'd hope they get the disclosures right by the way, before engaging with key audit matters, but nevertheless I think that's an important part of the process. So, um it, it is really pointing to some areas that Directors and preparers need to focus on.

I should just add by the way, also the key audit matters might also point to areas where the auditor had to put in more effort because there were problems with the companies own you know, reporting systems and processes. The judgments they've reached and so forth, and that might indicate things that the Directors, management need to focus on going forward to improve controls or, ah, there processes to reach judgements on accounting policies or whatever.

Ram Subramanian: If I could perhaps now turn to the actual focus areas themselves, um it appears that all the seven topics highlighted as focus areas have appeared in previous iterations of this publication. Could you provide some insights into these focus areas and the fact that they're appearing again and again.

Doug Niven: Yes. I often say when, it'd be nice to come back next year and not have to talk about impairment of assets, and unfortunately, I always come back and talk about it. (laughs) And I think this is pointing to the underlying question which goes back to a couple of your previous questions in fact, that we keep having findings in these areas and significant adjustments to financial reporting. And, that's why we're continuing to highlight some of these areas. And I won't go into all the detail, but when you think about impairment, it's an area where Directors might for example sometimes say well very complex calculations involved, but even Directors can bring to bare their knowledge of the business. Do, do the sorts of forecasts, that for example built into a discount cashflow analysis to support the assets values, make sense in terms of their knowledge of the business and where they think things are heading. That's a simple example, but it's about Directors of course probing, asking the right questions and being aware of the things that are highlighted in terms of adjustments by other companies as well.

Similar issues, we actually have revenue recognition in there as a separate item, not because of the new accounting standard I mentioned earlier, ah that's important as well, but because we do find companies um, not having appropriate policies in terms of revenue recognition, when control of the goods has passed, and you know, services have been provided and so forth. And, ah, it can be quite complex because you need to think about it carefully, whether a multiple deliverables, with multiple elements and so forth.

So, I could go through a whole list, but obviously the other areas were about expense deferral, off balance sheet arrangements, consolidation and the like, tax accounting is still there, um and that by the way, should mention brings out some similar issues to asset valuation. Do you have potentially gaps between the accounting people who know the numbers and what's behind them and the tax people or the valuers, depending upon which area you're looking at who have a lot of technical expertise but don't necessarily know a lot of the other side and that can cause problems.

Um we did call out, the accounting policy disclosures also estimation of uncertainty and needless to say, the new accounting standards that are going to have quite significant impacts on companies going forward.

Ram Subramanian: Doug, thank you very much for coming today and talking to us about ASIC's latest financial reporting focus areas.

Doug Niven: Thank you very much Ram.

Ram Subramanian: The transcript of this podcast recording and also links to various useful information that relates to the conversation we've had today is available on the podcast page.

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