

## **ASIC's review of 30 June 2010 financial reports and focuses for 31 December 2010**

### **1. Reporting performance and business drivers**

#### **1.1 Operating and financial review**

ASIC reviewed the quality of the Operating and Financial Reviews (OFRs) contained in the annual reports of 50 of the top 200 listed entities. Section 299A of the *Corporations Act 2001* (Corporations Act) requires listed companies to present OFRs (also known as 'management commentary' or 'management discussion and analysis') that contain information that members of the company would reasonably require to make an informed assessment of:

- (a) the operations of the entity;
- (b) the financial position of the entity; and
- (c) the entity's business strategies and its prospects for future years (unless disclosure is likely to result in unreasonable prejudice to the company or a controlled entity and that fact is disclosed).

The OFR enables directors to explain the drivers underlying the statutory performance and financial position to users of the financial report. The OFR should provide users of the financial report with meaningful information about the matters in (a) to (c) above.

We found that there were significant opportunities to improve the quality of the OFR in that:

- (i) Most of the companies reviewed appear to have provided what they considered to be minimum disclosures, but which would not appear to comply with the obligation to provide information members would reasonably require.
- (ii) The OFR often lacked information and explanations that would provide users with an understanding of the drivers of an entity's performance. Instead, general descriptive comments that repeated movements evident from the financial report (e.g. revenue increased by 3%) were given, that provided users with little or no information about the specific activities, transactions and events that gave rise to the results.
- (iii) Most entities did not provide key performance indicators, production statistics or similar information.
- (iv) Most entities did not present the OFR information in a single section of the financial report. This could increase the focus of the company and its directors on the completeness and quality of the OFR information, and assist users of the annual report in locating the information.
- (v) Most entities provided more analysis in investor presentations or analyst briefings lodged with ASX. Directors should consider giving more detail in the OFR, which is part of the annual report. However, undue prominence should not be given to an alternative profit measure compared to the statutory profit.

About half of the entities reviewed did not disclose business strategies and prospects for future financial years to a level we might ordinarily expect. We note that this information is not required if disclosure is likely to result in unreasonable prejudice to

the company or its controlled entities. ASIC intends to review the reasons for not disclosing information in future reviews.

Directors could also give consideration to providing a discussion of their business model and about risks specific to the entity, so as to better inform the market.

Entities may also wish to have regard to the guidance in the International Accounting Standards Board's Practice Statement 'Management Commentary: A Framework for Presentation' (issued December 2010) and the Group of 100's 'Guide to Review of Operations and Financial Condition' (issued 2003).

ASIC will focus on the quality of the OFR again for financial years ending 31 December 2010.

## 1.2 Alternative profits

The legislation and accounting standards restrict the use of alternative financial statements and profit measures in financial reports. There is more flexibility in market announcements but there is a statutory requirement to ensure that these disclosures are not misleading. In this regard, important considerations include:

- (a) the measures should not be given undue prominence compared to the statutory profit;
- (b) the measures should be understandable and reconciled to the statutory profit;
- (c) the measures should be calculated consistently from period to period; and
- (d) the measures should be unbiased and not be utilised to remove 'bad news'.

ASIC reviewed the financial reports, market announcements, investor and analyst presentations and related media releases for 50 of the top 200 listed entities in relation to alternative profit disclosures.

The financial report should not include alternative financial statements in additional columns. Disclosure of alternative profit measures in profit announcements and other documents should not be misleading and should not be given undue prominence compared to the statutory profit. There should be a reconciliation of any alternative profit to the statutory profit, with explanations of adjustments. Both positive and negative adjustments should be included and should be consistent from period to period.

Of the 31 entities (62%) that disclosed alternative profits, ASIC noted that:

- (a) 15 entities did not provide a reconciliation between their alternative profit figure and statutory profit in documents in which the alternative profit figure was disclosed, which would have enabled users to understand the basis of calculation;
- (b) 21 entities gave the alternative profit figure more prominence than the statutory profit;
- (c) 8 entities did not include both positive and negative adjustments to their statutory profit in calculating their alternative profit figure, and a number of entities appeared to focus on removing the 'bad news';
- (d) 8 entities focused on a profit figure different from the prior year (2 changing to statutory profit) and 5 other entities made adjustments in deriving the alternative profit that were not consistent with the prior year;

- (e) 6 entities used alternative profit figures different from the profit measures used internally by management and disclosed in their operating segment note. It is unclear why different measures were considered appropriate; and
- (f) one entity used planned returns for a significant element of their alternative profit, without adequate explanation of the basis used.

Statutory profit in accordance with accounting standards enables users of financial reports to make comparisons between entities and over time. Alternative profits disclosed were not determined on a consistent basis between entities and, as noted above, some entities changed the basis of calculation from the prior year.

The alternative profits for 3 entities excluded the impact of fair value of hedging instruments and foreign exchange rates or unrealised gains on financial instruments, but not realised amounts. Many entities excluded 'non-recurring' items such as impairment losses and restructuring costs, even where those items appeared in previous years.

Because different users can require different information, directors should provide sufficient information on the components of the statutory profit of an entity and its other comprehensive income within the financial report to enable users of the financial report to better understand the performance of a company. Users can use this information to derive the performance measure that they consider appropriate for their purposes. As noted in 1.1 above, the operating and financial review should be used to present meaningful information on the underlying drivers of the business.

### **1.3 Segment reporting**

Most entities did not identify additional operating segments that potentially should have been identified following the adoption of AASB 8 'Operating Segments'. Entities must identify and report on segments having regard to components of their business for which there is regular internal reporting of operating results to the entity's chief operating decision maker for the purpose of making decisions about resources allocated to the component and assessing its performance.

Importantly, directors must also have regard to the core principle in the standard that requires entities to disclose information enabling users to evaluate the nature and financial effects of the business activities in which the entities engage and the economic environments in which they operate.

Entities should review whether to reconsider whether the segments they are proposing to disclose in their upcoming financial reports meet the requirements of the new standard.

## **2. Control and significant influence**

Our reviews identified a number of instances where an entity holds more than a 50% interest in another entity but does not consolidate the investee. In some cases the entity has an economic interest greater than 80% but claims that it does not have control. ASIC is currently reviewing these cases, but is concerned that there are some cases where non-consolidation seems to be based on the ability of another party to make one type of decision that would not seem to impact on control.

Directors and audit committees should continue to monitor off-balance sheet investments to ensure the treatment is appropriate. Where arrangements remain off

balance sheet, the details of the arrangements should be disclosed, together with the reasons why they are not on balance sheet.

We are also making enquiries of some entities that hold an ownership interest of between 20% and 50% in another entity but have not equity accounted their investment, claiming that there is no significant influence over the investee. The substance of all investor/investee relationships needs to be considered in determining whether significant influence exists.

### **3. Current market conditions**

#### **3.1 Going concern**

Of the 30 June 2010 reviews undertaken by ASIC, 10 per cent of audit reports contained an emphasis of matter paragraph drawing attention to uncertainty surrounding the entity's ability to continue as a going concern. This compares to 18 per cent of the entities reviewed for years ended 30 June 2009.

While the proportion of audit reports containing a going concern emphasis of matter paragraph has fallen, the question of whether the going concern assumption is appropriate remains an important issue. Entities should continue to focus on their financing arrangements, particularly their compliance with lending covenants and their ability to refinance debt due for repayment.

#### **3.2 Asset impairment**

For the financial reports reviewed, ASIC found that write-downs were 6 per cent of the total value of indefinite life intangible assets (including goodwill) for the 12 months to 30 June 2010. For the 12 months to 30 June 2009, the write-downs were 11%.

Different entities are affected differently by the current uncertainty in the global economy. Directors should continue to focus on asset values at 31 December 2010.

Impairment testing continues to be a troublesome area for entities and their directors. Common issues identified in our reviews this period were:

- (a) the use of unrealistically optimistic discount and growth rates. In a number of cases, risk-free rates were used to discount the projected cash flows, whereas the discount rate is required to reflect the risks and uncertainties associated with the assets being tested;
- (b) flawed discounted cash flow (DCF) methodology, including terminal values incorrectly calculated;
- (c) the failure to disclose carrying amounts allocated to each CGU and the basis for determining recoverable amount;
- (d) a lack of disclosure of assumptions used in DCF calculations, particularly growth rates and discount rates; and
- (e) no sensitivity analysis disclosed for changes in key assumptions.

It is important that directors ensure that the assumptions used in impairment testing are reasonable and supportable, and the correct methodology is applied. If necessary expertise is not available internally, directors should ensure that appropriate external resources are utilised to meet the impairment testing requirements. Given their

knowledge of the business, directors should play a key role in reviewing assumptions and cash flows used in significant impairment calculations.

The disclosures referred to in (c) to (e) above are required by accounting standards and are critical for users of the financial report to understand the judgements and risks associated with the values of the entity's assets.

#### *Assets denominated in foreign currencies*

In testing for impairment of non-monetary assets that are measured in a foreign currency, the carrying amount of the asset translated at the historical exchange rate is compared to the net realisable value or recoverable amount, as appropriate, translated at the closing spot rate. Given the recent strong appreciation of the Australian dollar against most major currencies, it is possible that an impairment loss will result.

#### *Reversal of impairments*

Although many industries in Australia and overseas continue to be adversely affected by current global economic conditions, other industries and companies are showing signs of recovery. AASB136 'Impairment of Assets' requires entities to assess at each reporting date whether there is any indication that an impairment loss recognised under that standard in prior periods no longer exists or may have decreased (other than in relation to goodwill). If there is an indication, the entity is required to determine whether a write back of the impairment loss is required to the extent that the recoverable amount has now increased for the relevant cash generating unit.

### **3.3 Fair value of assets**

#### *Investment properties*

A number of entities carrying investment properties at fair value failed to appropriately disclose the methods and significant assumptions applied in determining the fair values. Again, the disclosure of this information enable users to understand the judgements associated with the values of the entity's assets.

#### *Financial Assets*

Financial assets at fair value should be valued by reference to quoted prices in active markets, including most ASX-listed securities. A careful assessment should be made as to whether or not there is an active market. In those instances where there is an inactive market, fair values should be determined with the maximum use of market inputs, and key assumptions should be disclosed.

AASB 7 'Financial Instruments: Disclosures' requires entities to ensure that fair value measurements of financial assets are classified using a three level 'fair value hierarchy', reflecting the extent to which quoted prices or observable and non-observable market data are used in the measurement.

### **3.4 Financial instrument disclosures**

Entities should make adequate disclosures to enable users of financial reports to understand and evaluate the nature and extent of the specific market, credit and liquidity risks associated with its use of financial instruments. Disclosures should be meaningful to users, and specific disclosures should be made rather than boilerplate disclosures.

### **3.5 Current vs non-current classifications**

The correct classification of liabilities and assets between current and non-current is important to an understanding of the financial position of an entity. Directors and audit committees should ensure that there are appropriate processes to ensure the correct classification and should review the classification having regard to their knowledge of the business and its funding.

### **3.6 Disclosures for estimates and accounting policy judgements**

AASB 101 'Presentation of Financial Statements' requires entities to disclose significant judgements in applying accounting policies and sources of estimation uncertainty. These disclosures should be specific to the entity and its assets, liabilities, equity, income and expenses. This information is often material information for users of financial reports.

## **4. Other matters**

### **4.1 Business combinations**

With a recent increase in the number of acquisitions, and relatively new business combination and consolidation accounting standards, directors and auditors should focus on the accounting for these transactions, including appropriate treatments of reverse acquisitions and common control transactions.

At 30 June 2010, some entities capitalised acquisition-related costs in the cost of acquisitions, rather than expensing them as is now required under AASB 3 'Business Combinations'.

### **4.2 Debt vs equity**

Directors and auditors should ensure that financial instruments classified as equity are correctly classified when there are indications the substance of the transaction might be debt.

### **4.3 Other comprehensive income**

Directors and auditors should ensure the correct classification of items between profit and loss and other comprehensive income.

### **4.4 Providing information, explanations and assistance to auditors**

Information was withheld from the auditors of two separate entities on the basis that the information was confidential. Confidentiality agreements or concerns do not override the requirements of the Corporations Act for officers to provide the auditors with the information, explanations or other assistance they require for the purposes of an audit or review. Where auditors become aware that information has not been provided, they should consider how that affects their audit opinion and whether there is a need to report a suspected contravention of the Corporations Act to ASIC.