The Westworth Kemp Review of 2015

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Introduction

We hope our newsletter finds our readers in good health, refreshed from the holiday season and looking forward to a stimulating 2016. Over the break we took the opportunity to reflect on some of the themes that emerged from our work in 2015. Once again we found ourselves down in Melbourne frequently as many of the audit and accounting related matters seem to be heard there. Given the excellent choice of affordable restaurants, however, it is not a bad spot to spend some time!

Our expert witness practice

Much of our work in 2015 again came from failed companies. In some cases we worked as consulting (or dirty) experts, helping to put the case together; in others we acted as the independent (or clean) expert answering questions put to us by our instructing lawyers. Increasingly we are of the view that this artificial division results in unnecessary duplication of work and contributes to the spiralling costs of commercial litigation. As clean experts, we often have to ask for the underlying primary documentation to make sense of the questions we have been given.

In an ideal world, the facts would be agreed before the independent experts were asked to give their opinion. The establishment of common factual assumptions, an agreed set of questions and good quality experts can remove the risk of bias that the clean/dirty divide was supposed to address. Well run expert conclaves with questions set beforehand facilitate this process – notwithstanding the forensic concerns that instructing lawyers naturally have.

Arbitration and mediation

Early 2015 saw us acquiring new skills in dispute resolution. Chris completed the first part of his arbitration qualification and now has a Diploma from the Chartered Institute of Arbitrators (DipCIArb). Meanwhile, Stephanie completed training with the Australian Disputes Centre to become a mediator. Both these courses gave us new insight into the world of dispute resolution, into which our work on expert reports and opinions draws us.

Auditor cases

Sadly once again our examination of audit files for our litigation work reads like Auditing 101. Many of the audit failures we see come down to very basic auditing: knowledge of the client's business, inadequate appreciation of the risks facing the business, lack of scepticism particularly when the client is a "good client", a tendency to accept what the client says without seeing sufficient appropriate audit evidence. Another pitfall is that the audit team can become so caught up with following the audit methodology that they focus on the detail and ignore the big picture - they do not see the wood for the trees. Similarly, audit teams bring in experts to assist in areas where the accounting standards are complex (think financial instruments and share based payments for example) but skimp on areas which are not as complex in financial reporting terms but have the potential to wreck the business (are the debtors paying their bills?).

Revenue recognition

In technical circles there has been considerable focus on revenue, with the advent of the new AASB 15 *Revenue from Contracts with Customers*, now deferred to 2018. Out in the real world, however, we have seen issues with revenue recognition at a very basic level that a new standard is unlikely to fix.

We have seen lending businesses capitalising interest and recognising it as revenue (and also in some cases as a cash inflow in the statement of cash flows!) without adequate consideration of whether it is probable that the revenue will ever be received. We have seen debtors and work in progress that have been allowed to balloon, again without adequate consideration of the likelihood of their turning into cash.

Impairment

The other side of the revenue recognition issue is of course the valuation of the debtor. Again we are seeing a lack of scepticism when it comes to considering the need for a provision for impairment – a tendency to accept the client's view of which assets are impaired without challenging completeness.

When auditing an impairment calculation it is vital to consider the assumptions that feed into the spreadsheets that calculate the impairment. However beautifully constructed the spreadsheets may be, if the assumptions fed into the maths are invalid, the answer produced will be useless! For example, if the calculation uses sales projections, how were they calculated? What evidence was provided to support the projections? Are the growth assumptions credible for that business in that industry?

Trends in auditing

The new audit reporting standards

The Auditing and Assurance Standards Board's (AUASB) Christmas present to the Australian auditing profession was the issue of one new and 26 revised auditing standards. The revisions focus primarily on communication between the auditor and stakeholders. They introduce the new long form audit report devised by the International Auditing and Assurance Standards Board (IAASB) and move the auditor's opinion to a prominent position at the beginning of the report. The standards form the auditing profession's response to calls for increased transparency of the audit process, following the GFC.

For listed entities, the audit report will contain a description of Key Audit Matters (KAM) and how they were dealt with. KAM are matters taken from the list of significant issues communicated to those charged with governance and form the subject of the new standard, ASA 701 *Communicating Key Audit Matters in the Independent Auditor's Report.* Readers should be aware that listed entities are not limited to those listed on the ASX, but also include entities listed on regional exchanges.

There are a number of publications that contain examples of reports of KAM, for example Chartered Accountants Australia and New Zealand's paper "KAM: The Matters that Matter – Embracing the Spirit of the New Requirements", containing examples of KAM from audit reports already issued in the UK, and the IAASB's paper "Auditor Reporting – Illustrative Key Audit Matters" (you may have to register with IFAC to view this, but registration is free of charge).

A revised ASA 720 *The Auditor's Responsibilities Relating to Other Information in Documents Containing an Audited Financial Report* clarifies the auditor's role in considering other information provided with the financial report to ensure that the entity's audited and unaudited communications within the annual report are consistent.

Other revisions incorporated in the new and revised standards focus the auditor's attention on financial statement disclosures, an issue that is also being looked at by accounting standard setters around the world looking for ways of decluttering the financial report.

Trends in financial reporting

Materiality

For the last few years, communication has been a theme in financial reporting. The pendulum is swinging away from financial reporting as a compliance process and back towards the accounts as a way of communicating with stakeholders.

To this end, accounting standard setters around the world have been working on how to "declutter" the financial report – how to get rid of unnecessary detail that only serves to cloud the overall message. In October 2015, the International Accounting Standards Board (IASB) published a draft practice statement *Application of Materiality to Financial Statements* to provide guidance to assist management in applying the concept of materiality. The paper discusses the characteristics of materiality, how to apply it when making decisions about presenting and disclosing information in the financial statements and how to assess wither omissions and misstatements of information are material to the financial statements. Materiality requires judgment; it needs to be considered within the context of a specific entity and so the draft contains illustrative examples.

We welcome this initiative by the IASB and our submission to them is strongly supportive. Too often materiality is seen as something the auditors think about in deciding how to approach the audit and set testing levels or whether a misstatement should be corrected. Encouraging management to think about materiality at the accounts preparation stage should assist in the reduction of unnecessary detail to focus on the core information that could influence the decisions of users of the financial report.

All (almost) leases on book – the new IFRS 16 *Leases*

IASB has just released the long awaited revision to the leasing standard and it will be considered by AASB at its February meeting. We anticipate that it will be approved for application in Australia from 2019 and there are transitional provisions applying to existing leases.

The intention of the standard is to provide consistent reporting for all forms of financing whether by way of lease or debt. So the old distinction between operating and finance leases has, for accounting purposes, gone and almost all assets held under lease are capitalised with a corresponding lease liability. No one yet knows whether the increase will have an impact on the ATO's thinking about the taxation treatment of leases.

The only exceptions are based on IASB's consideration of two practical issues: rentals of small items and short leases will still be treated as rentals.

The impact for each business will depend on its financing arrangements but the likely impacts are:

- Assets and liabilities will both increase - generally by a roughly similar amount;
- EBITDA will increase by the amount of rental payments;
- EBIT will increase by the amount of the rental payments less depreciation applied to the leased assets now on book;
- Finance charges will increase;
- Overall net profit and net assets should not change materially.

Conversations with the market and the presentation of performance will have to deal with these changes. According to IASB, analysts should understand these changes, as they were seeking them to provide better comparisons between companies with different financing structures. Presently analysts have to make estimates to achieve these alignments.

Businesses will also have to have conversations with their bankers as the changes will alter many of the ratios used in banking covenants. In principle these discussions should not give rise to repricing of debt as the fundamentals of a borrower's business will not have changed. But wrongly timed discussions in an economic downturn could be “uncomfortable”.

Reporting in the not-for-profit world

While reporting has been a little more stable in the for-profit arena in 2015, sweeping changes are taking place for not-for-profits. First was the establishment of the Australian Charities and Not-for-profits Commission (ACNC) in 2012, followed by the Charities Act in 2013, establishing a statutory definition of a charity. In 2015 the Australian Accounting Standards Board (AASB) has turned its attention to the not-for-profit (NFP) sector with the issue of a number of exposure drafts focussing on NFP reporting:

- ED 260 *Income of Not-for-Profit Entities*
- ED 269 *Recoverable Amount of Non-cash-generating Specialised Assets of Not-for-Profit Entities*
- ED 270 *Reporting Service Performance Information*

ED 260 explores the implications of the new Revenue standard, AASB 15 (operative from 1 January 2018) for NFPs and removes the reciprocal/non-reciprocal distinction used to determine the treatment of NFP income under current standards. The new approach questions whether the transferred asset, often money, received by the NFP gives rise to a performance obligation under a contract with a customer. The answer will determine whether the NFP will account for income under AASB 15 *Revenue from Contracts with Customers* or under a new standard, AASB 10xx *Income of Not-for-profit Entities.* AASB 15 will apply to both for profit and NFP organisations alike. An example of a transaction that would fall under AASB 15 would be membership subscriptions received by a professional body providing accreditation, CPE, a journal etc., whereas donations and bequests would fall under the new NFP standard on income. The AASB have prepared a brief summary of the proposed approach with links to papers prepared by the major firms.

While ED 260 is consistent with how many practitioners were interpreting the current standards and could be seen as a clarification of current practices, ED 270 *Reporting Service Performance Information* is more revolutionary. In the NFP arena, fulfilment of the organisation's service performance objectives is as important as its financial result if not more so and the ED has been prepared in response to calls from consumer organizations such as Choice and the findings of a 2008 Senate Standing Committee Report *Disclosure regimes for charities and not-for-profit organisations.* It proposes to require not-for-profit entities to report information about their service performance objectives and the achievement of those objectives – whether the organisation has achieved what it set out to do over its key areas of operation, under four key headings:

- The entity's service performance objectives
- Key outputs and the inputs used to produce those outputs
- Any outcomes the entity is seeking to influence, and
- Its efficiency and effectiveness in achieving its service performance objectives.

Because of the diversity within the NFP sector, the terms used in the ED are generic so that its principles for reporting are flexible enough for entities to report in a way that suits them.

The AASB proposes to issue the ED as an accounting standard applicable to NFPs in the public and private sectors preparing general purpose financial statements and contemplates that regulators might want the information to be audited. This is a key area on which the board is seeking comment. Our preliminary view is that while the information is obviously going to be useful to readers, we question whether it is actually too big a topic for an accounting standard and would be better placed in some sort of conceptual paper like the IASB's paper on Management Commentary. The contrary view, with which we do sympathise, is that unless the AASB makes it mandatory, no one will do it! One answer would be for the ACNC to mandate the provision of this information, using the AASB's paper as guidance, but this solution would require legislation or regulations and be more complex to implement.