Essential Guidance for the June 2014 reporting season

Our Essential Guidance series continues with this June 2014 edition. This paper assists finance professionals, auditors and directors in planning for the business issues to consider for the June 2014 reporting season.

1. Domestic Economic Conditions

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<td>The Reserve Bank of Australia (RBA), in its most recent statement on domestic and international monetary policy and economic conditions(^1), reports that Australian economic activity picked up over the last six months (i.e. from the latter part of 2013), largely off the back of strong growth in resource exports and some signs of better conditions in the non-mining economy, including slightly stronger consumption growth in late 2013 continuing into the March quarter 2014. This is evidenced by an increase in GDP for the year ended 31 December 2013 of 2.8% compared with the estimated increase in GDP for the year ended 30 June 2014 of 3.0%.</td>
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<td>With the economy beginning to strengthen, preparers should reassess the assumptions used in areas of significant judgement such as going concern, fair value and asset impairments. If improved economic conditions appear to be sustainable for a particular business, there may be a need to revise assumptions. If these result in reversals of asset impairments, provision estimates or contingent liabilities, such matters will need to be correctly accounted for.</td>
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<td>Consistent with these signs, firms have reported over the past six months a pick-up in trading conditions, profitability, employment and forward orders. Banks have generally reported declines in bad debt charges owing to improved asset quality and increased income due to balance sheet growth.</td>
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<td>A number of factors can be observed in the economy linked to an increase in GDP, as follows:</td>
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<td><strong>Dwelling investment</strong> is beginning to pick up after being weak for a number of years, increasing by 1% in the December 2013 quarter to be 1.5% higher over 2013. Housing price growth, low lending rates, government assistance for first home buyers and strong population growth are expected to support a substantial increase in new dwelling construction over the period ahead.</td>
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<td>Revenue may increase for entities that service the housing industry such as real estate, construction, retail, legal and financial services as a result of the improvement in the housing market. These entities should review the assumptions in their cash flow forecasts, particularly those used in fair value determinations, impairment calculations and going concern. Exporters should also review their cash flow forecasts in view of increasing sales and assess the impact of changes.</td>
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<td><strong>Exports rose</strong> by 6.5% over 2013, adding nearly 1.5% to GDP growth over the period. This was due largely to expansions to capacity for iron ore and coal, our largest exports by value, though there has also been some growth in manufactured and services exports over 2013. In March 2014 indications are that there was further strong growth in iron ore and coal export volumes and rural exports overall.</td>
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\(^1\) Unless otherwise referenced, information in this paper has been sourced from the Reserve Bank of Australia Statement on Monetary Policy, May 2014.
Despite some positive signs, the RBA has highlighted a number of uncertainties regarding the outlook for the domestic economy over the next few years. This includes the reluctance of business to commit to major new investment until sustained increases in demand are seen.

There are also uncertainties surrounding the timing and magnitude of the decline in mining investment, and similarly the timing and magnitude of the projected increase in non-mining investment. Higher aggregate demand could see a stronger recovery in non-mining investment than expected, but on the other hand firms may remain reluctant to undertake significant new investment due to spare capacity.

The exchange rate also presents significant uncertainty. With resource prices and hence our terms of trade expected to decline further, historical relationships suggest that the exchange rate could move lower over time. The rate of pass through of an exchange rate depreciation to consumer prices (which typically occurs over the course of several years) is another area of uncertainty with opposing factors affecting the rate of pass through at work.

While some industries are experiencing improved conditions, this is not universal and conditions remain uncertain. Preparers should be considering the specific conditions in their industry and market when determining the assumptions and inputs into accounting estimates.

Cashflow forecasts need to remain realistic and careful consideration of the impact of economic outlooks on assumptions is important.

Entities should continue to focus on their foreign exchange risk management policies and ensure that they remain appropriate in the current environment and are minimising the impact of foreign exchange exposure.

2. Global Economic Conditions

Growth of Australia’s major trading partners over 2013 was close to its long run average (which over the past 30 years has been a little over 4%). Indicators are that this remains the case in early 2014.

In March, the Chinese Government announced a range of growth targets for 2014, which were largely unchanged from last year. The GDP growth target is unchanged at 7.5%. The RBA also observed the increasing importance of China as a destination for Australia’s exports.

Japan’s recovery has progressed but demand there is expected to weaken following the increase in Japan’s consumption tax in April.

Other east Asian economies have continued to grow at around their decade-average pace.

In the US, the economy is showing moderate signs of growth supported by stimulatory monetary policy.

Growth in the year to December 2013 across the euro area was positive for the first time since 2011. Growth has largely been driven by exports and investment, with private consumption increasing only slightly.

Preparers need to evaluate the economic conditions in countries where they have overseas operations, investments and other exposures as these will often be exposed to greater risks.

Where countries are experiencing economic recovery, prior period impairments should be reviewed and the assumptions updated in impairment calculations.

Going concern and asset impairment continue to be issues for entities which have investments or assets in underperforming economies and these should also be reviewed carefully to ensure the assumptions used reflect the current conditions.
3. Regulator Focus

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<td><strong>ATO</strong></td>
<td>Preparers and directors can access the <a href="#">December 2013 version</a> of Essential Guidance to refresh themselves on the major focus areas.</td>
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<tr>
<td><strong>ASIC</strong></td>
<td>Preparers and directors can access the <a href="#">December 2013 version</a> of Essential Guidance to refresh themselves on these issues.</td>
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**New standards**

For many for-profit companies June is the first year where AASB 10 Consolidated Financial Statements, AASB 11 Joint Arrangements, AASB 12 Disclosure of Interests in Other Entities and AASB 13 Fair Value Measurement are mandatory.

Assessing the impact of the new accounting standards should be a key priority. The impact will depend on the structure and operations of the organisation, which industry it operates in and any contractual agreements in place. For entities that are required to apply consolidations for the first time, it may be worth considering, if applicable, the early adoption of the investment entity exemption. This is an exemption from consolidation and is contained in AASB 2013-5 Amendments to Australian Accounting Standards – Investment Entities, and is mandatory from 1 January 2014.

These standards are very judgemental and have significant disclosure obligations, particularly around judgements and estimates. These should be reviewed as early as possible in the financial reporting process, to ensure the information required is readily obtainable.

**Disclosures**

Complexity of disclosures is becoming an area of focus for financial reporting. The AASB issued a staff paper [To Disclose or Not to Disclose: Materiality is the Question](#) in February 2014. This paper encourages materiality to be applied more robustly when making disclosures in financial reports.

ASIC are still concerned with disclosures in areas of significant judgement such as estimates, going concern and fair values and will continue to review the disclosures of non-IFRS financial information.

Directors and preparers should consider the issues raised in the AASB staff paper and examine the disclosures in the financial report carefully. It is important that there is sufficient disclosure for complex issues but reducing disclosures in non-essential areas can also positively impact the value of the financial report for users. This will take time and given the judgements involved should be undertaken by senior staff.

Given the new accounting standards identified above contain significant judgements, these will be an important focus for ASIC in the upcoming reporting season. This will be in addition to the other more traditional areas of judgement and estimates which include going concern and impairment.

**Guidance on directors’ responsibilities**

In March 2014, ASIC released [INFO Sheet 196 Audit quality: The role of directors and audit committees](#). The INFO Sheet reflects the importance of the role directors and audit committees have in the audit process, how they can evaluate external auditors and the impact a company’s internal processes may have on audit quality.

ASIC also revised [INFO Sheet 183 Directors and Financial Reporting](#) in March 2014 to further clarify directors’ responsibilities and activities in relation to financial reporting.

It is likely that ASIC will look at this area in the course of its financial reporting and audit inspection programs.

Directors need to be aware of their responsibilities in relation to financial reporting and the quality of the audit process and how their corporate governance processes are supporting the application of these responsibilities.