THE BOTTOM LINE

Issue 15

Welcome to the latest edition of our financial reporting publication that aims to keep you in the loop with all the latest accounting and financial reporting developments, and the potential impact they may have on your business.

In this issue we look at the recent interest rate increases and its impact on financial statement balances, transactions and disclosures. We address some areas which should be considered in the lead up to the June 2023 reporting period. We outline why auditors will be asking more questions this year due to changes to ASA 315 – *Identifying and Assessing the Risks of Material Misstatement*. We close out the issue with a reminder of AASB's recent Discussion Paper that sets out its initial thoughts on what a third tier of reporting for smaller NFP private sector entities might look like.

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FEATURE ARTICLE

Rising interest rates: How they may impact June reporting?

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In recent times due to action taken by central banks to curb higher inflation, official interest rates have rapidly increased in Australia and in many economies across the world. In Australia, the RBA official cash rate has increased from 0.1% in April 2022 to 3.6% in April 2023. From a financial reporting perspective, rising interest rates are likely to impact a number of financial statement balances, transactions and disclosures. As we get closer to the June 2023 reporting season it is important to consider how these impacts may present challenges for financial statement preparers. Below we look at some areas which should be considered in the lead up to the June 2023 reporting period.

Impairment of assets

Accounting Standards require annual impairment testing on goodwill and certain intangible assets and otherwise on other assets such as property, plant and equipment, right-of-use assets and investment properties where impairment indicators are identified at the end of a reporting period.

Impairment testing involves determining the recoverable amount of an asset or the cash generating unit ("CGU") to which the asset belongs to. The recoverable amount is the higher of an asset's or CGU's fair value less costs of disposal and its value in use. Where an asset's or CGU's recoverable amount is less than an its carrying amount, an impairment loss equal to this difference is required to be recognised.

A key input in the determination of the value in use of an asset or CGU is the discount rate which is used to discount future cash flows assumed in the value in use model to present value. Practically, many financial statement preparers will reference an entity's weighted average cost of capital (WACC) as a starting point to estimate a discount rate for this purpose. The WACC comprises of the cost of equity and cost of debt which both rely on or are influenced by movements in risk-free interest rates (as well as other elements). All things being constant, an increase in the discount rate will reduce the present value of future cashflows of an asset or CGU in a value in use model and therefore may increase the possibility of impairment losses being recognised, especially in the case of those assets or CGU's that had little headroom in prior period impairment tests.

Furthermore, rising interest rates and inflation may also indicate impairment indicators now exist which could trigger the need for more detailed impairment testing across a wider range of assets compared to prior periods.

Fair value

Many assets and liabilities are required or are otherwise permitted to be measured at fair value under Accounting Standards. Where an asset or liability does not have an observable quoted price in an active market (such as a quoted price on a stock exchange) generally a valuation technique involving the use of observable (market-based) and unobservable inputs will be used to measure fair value.

Key inputs in some valuation techniques (either directly or indirectly) are inputs that reflect or are otherwise impacted by market-based interest rates. Rising interest rates as a result will likely impact asset and liability fair values and in some circumstances force financial statement preparers to perform or revise fair value measurements that were historically only prepared periodically due to the fact that inputs used in valuation techniques had not changed significantly period to period.

Lease liabilities and right-of-use assets

Lease liabilities represent the present value of future lease payments. The present value of future lease payments are estimated using a discount rate which is determined based on either the interest rate implicit in the lease or if that rate cannot be readily determined, the lessee's incremental borrowing rate. Right-of-use assets are correlated to lease liabilities and represent the value of the lease liability adjusted for various items such as lease incentives received, initial direct costs and other restoration and dismantling costs.

In previous reporting periods, discount rates applied to leases (either implicit in the lease or based on the lessee's incremental borrowing rate) were likely lower given the lower interest rate environment which existed, which led to higher lease liabilities and right-of-use assets (assuming all things constant) given lower discount rates yielded higher present value estimates of future lease payments.

For new leases, or in certain circumstances where existing lease liabilities are reassessed or lease modifications occur, new discount rates estimated using current market interest rates (including the effect of credit risk) will need to be determined (where an incremental borrowing rate is used). Discount rates used on similar leases in prior periods are likely to be no longer relevant and the degree of estimation required to determine new discount rates may be greater in a rising interest rate environment.

Higher discount rates will also lead to lower lease liabilities (and right-of-use assets) and over time will change the portions of interest expense and depreciation expense recognised on leases (interest expense will increase and depreciation expense will decrease) compared to prior periods.

Provisions

Accounting Standards require provisions to be discounted where the effect of the time value of money is material. In addition to the specific risks of the provision in question, discount rates applied to provisions must reflect current market assessments of the time value of money and therefore are substantially based on market interest rates that exist at the end of a reporting period.

In prior periods, the impact of time value of money discounts may have not been material but with recent rising interest rates it is likely that this may no longer be the case especially for long-term provisions. The effect of discounting will reduce the carrying amount of a provision and result in additional interest expense being recognised in profit or loss.

Finance facility covenants and going concern

Higher interest rates have a direct impact on the cost of borrowings for many entities. The effects of higher financing costs alone could impact directly on an organisation's available cash flows as it services these higher borrowing costs. Higher financing costs may also impact borrowing covenants, especially covenant ratios that are based on interest expense, such as an interest cover ratio.

In some areas of the economy, we are observing significant increases to supply chain input costs which are impacting gross margins if organisations are not able to pass on increased costs to their customers. We are also observing indications of increased financial distress in some sectors which increases potential counter party risks if a significant customer or supplier was to fail. The impact of these risks, along with the impact of higher borrowing costs need to be considered in forecasts and cash flow modelling, as they may impact on an entity's ability to continue as a going concern.

While these matters have a commercial impact, they also may lead to additional disclosures and potentially affect the classification of borrowings in financial statements.

Rising interest rates will likely impact a number of financial statement balances, transactions and disclosures for the June 2023 reporting period. Asset values and impairment are also expected to continue to be significant focus areas for Boards, finance teams, auditors and regulators.

Financial statement preparers should closely analyse and understand the impacts higher interest rates will have on their financial statements and year end close processes both for the upcoming June 2023 reporting period and future reporting periods.

Please reach out to us if you would like to discuss how these impacts can be identified and addressed in a timely manner.

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Why you should expect your auditor to be asking more questions this year

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Audits are performed in accordance with Australian Standards on Auditing (ASA). For 31 December 2022 year-ends onwards, a significantly revised auditing standard comes into effect that will almost certainly lead to your auditor asking more questions and/or requesting additional audit evidence.

The revised ASA in question is ASA 315 – *Identifying and Assessing the Risks of Material Misstatement*. The Auditing and Assurance Standards Board (AUASB) describes the revised ASA 315 as being "significantly enhanced to require a more robust risk assessment process and to promote consistency in application".

At a very high level, some of the additional audit requirements coming from the standard include:

More detailed requirements around understanding and documenting:

- the entity;
  - its environment;
  - internal controls;
  - the applicable financial reporting framework; and
  - IT systems.
- A multi-dimensional approach required to assessing risks of material misstatement.
- A new definition of Significant Risk.
- Specific requirements to exercise and document professional scepticism.
- New 'stand-back' requirements to evaluate the completeness of the significant classes of transactions, account balances and disclosures at the end of the risk assessment process.

Changes to the requirements in respect of understanding and evaluating an entity's IT environment (including general IT controls, application controls, etc.) are perhaps those that will be most obvious to entities subject to an audit. Questions, requests and procedures in respect of an entity's IT environment and related controls are likely to be noticeably greater than in previous years. Other changes (such as those in respect of the multi-dimensional risk assessment) will require greater auditor effort but may be less obvious to the entity being audited.

The changes are significant and will undoubtedly lead to increased audit effort. Whilst audit teams will continue to make use of the latest technological tools to increase audit efficiency (analytics, automation, artificial intelligence, etc.), this is unlikely to outweigh the additional audit effort introduced from the revised ASA 315.

Although more time and effort will need to be expended by both auditors and entities subject to audit, it's not necessarily bad news, benefits of the new requirements will include:

- A more robust risk assessment, leading to a more focused and risk targeted audit;
- Gaining a deeper understanding of an entity's business, allowing for a more insightful and value-added audit process; and
- A greater understanding and analysis of an entity's IT environment and associated controls, allowing for specific recommendations and observations in this increasingly critical business area.

Ultimately the changes are designed to lead to a higher level of audit quality, with a by-product of this being an opportunity for auditors to add greater value to entities through their observations and recommendations.

Contact your auditor should you have any questions or wish to learn more about the revised ASA 315 standard.

SPFS

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Submissions for comment on the Australian Accounting Standards Board discussion paper - Development of Simplified Accounting Requirements (Tier 3 Not-For-Profit private sector entities) closed 31 March 2023.

The proposed Tier 3 reporting simplifies recognition and measurement, and presentation requirements for Not-for-Profits (NFP) in comparison to the current financial reporting requirements. The discussion paper seeked views on proposed changes to the reporting requirements for smaller not-for-profit entities.

Significant changes many NFPs could face include, but are not limited to:

Income recognition – under the current standards, many types of income received by NFPs are recognised on receipt. The effect of this has been that the matching of income and expenditure is not always possible, meaning the financial performance for the year may be distorted as a result. The proposed change could see the deferral of income recognition until expenditure outflows occur.

Financial assets – many NFPs have significant asset portfolios to generate greater returns to support their mission, often consisting of a mix of different types of assets in their portfolio. Depending on this mix, the current accounting standard requires some financial assets to be classified as at 'fair value through profit or loss' whereby fair value movements are to be presented 'above the line' which impacts the surplus/deficit before other comprehensive income. On the other hand, fair value movements in equity instruments (upon initial election) can be classified as measured at fair value through other comprehensive income whereby fair value movements are to be presented 'below the line'. This mix of presentation, apart from being overly complex for a NFP can also be confusing for the reader of the financial statements. The proposed standard will require all financial assets held to generate income and capital gains to be 'at fair value through other comprehensive income', which moves all fair value movements to 'below the line', simplifying the reporting and making it more useful to the reader.

Lease accounting – under the proposed standard, a simplified approach will be taken and will remain off-balance sheet.

Consolidation – preparers will have the option to choose to prepare either consolidated financial statements or parent only financial statements with additional disclosures around the parent's significant relationships with the group.

The full list of changes is summarised in the 12-page summary from the AASB (https://aasb.gov.au/media/qzlbchnp/tier-3-snapshot_sep-22.pdf).

While the proposed changes may somewhat alleviate cost pressures, changing the rules for some organisations and not others in the NFP space presents the potential risk of disparity. Users of financial reports will need to gain a full understanding of the basis of preparation for the accounts and take this into account when comparing to other NFPs. For this discussion paper, the AASB have taken into consideration those NFPs with revenue between $500,000 and $3 million when applying Tier 3 reporting, consistent with a medium-sized charity registered with the Australian Charities and Not-for-profits Commission. Arguably, changing some of these requirements for future Tier 3 reporters, such as income recognition and the classification of financial assets, could be relevant to many large NFPs.

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