FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

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Financial reporting – review findings and guidance for entities in light of COVID-19

The FMA regulates compliance with the financial reporting requirements for FMC reporting entities. Last year we published a statement on our financial reporting reviews, outlining our approach and highlighting the following areas of interest for our 2019 reviews:

- significant accounting judgements and sources of estimation uncertainty
- impact of the new accounting standards[1]
- non-GAAP financial information.

We also focused on entities' accounting records supporting accounting judgements and implementation of the new accounting standards.

This document summarises our key findings in these areas, and provides guidance and expectations for future reporting, particularly given the rapidly changing COVID-19 environment.

What we have seen

During 2019, we reviewed and made inquiries with approximately 30 NZX listed entities with balance dates ranging between February 2019 and August 2019. These reviews highlighted a number important areas set out below where entities did not comply with accounting standards, guidance or other laws and regulations.

Failure to maintain proper accounting records

- There was a lack of documentation within management papers to set out clearly and sufficiently how the entity undertook its assessments. This includes considering all necessary requirements of the accounting standards in areas involving significant judgement and/or estimation uncertainty. There was an absence of key documentation that supported how, and why, management made particular judgements such as:
  - rationale for applying the same discount rate to different cash-generating units when performing goodwill or other intangibles impairment testing
  - sufficient rationale and documentation that supported the decision to not perform impairment testing for certain assets (a particular area of weakness noted was impairment testing of investments in associates)
  - support for the assumptions applied for forward-looking information used for impairment testing purposes (such as growth rates and costs reductions)
  - determining whether subsequent events were adjusting or non-adjusting events
  - support for specific accounting treatments applied based on consideration of the recognition requirements as set out in the accounting standards.
- Lack of detail within Board minutes documenting the discussions between Board members and

1: Application of NZ IFRS 15 Revenue from Contracts with Customers (NZ IFRS 15), Application of NZ IFRS 9 Financial Instruments (NZ IFRS 9) and Disclosure of the expected impact of implementation of NZ IFRS 16 Leases (NZ IFRS 16) management in concluding on areas involving significant judgement and/or complex accounting estimates. An example of this would be the lack of documentation to demonstrate the discussion, and consideration of, various scenarios in the assessment of whether impairment was required for certain assets, and the rationale for the chosen scenarios.

- Insufficient accounting records supporting the completeness of identified related parties, related party transactions and disclosures of these in the financial statements. This includes the entity having insufficient systems, controls and processes in place to ensure compliance with the accounting standards.
- Lack of accounting records supporting the materiality considerations (both quantitative and qualitative), including the materiality considerations made to the level of disclosures in the notes to the financial statements.

Inadequate disclosure of significant accounting estimates and judgements

Inadequate disclosures in the financial statements continues to be an area where significant improvements are required in order to meet the requirements of the accounting standards. Examples of inadequate disclosures include not disclosing:

- uncertainties and assumptions applied in determining significant estimates, and the sensitivity of these assumptions and the impact on the valuation
- information about the inputs and assumptions used in the impairment testing of non-financial assets including the sensitivity analysis and disclosures of the relevant risks
- recognition and recoverability of deferred tax assets
- significant and judgemental accounting principles in the financial statements.

Inadequate disclosures relating to new accounting standard requirements

In relation to the new accounting standards, in particular NZ IFRS 15 Revenue from Contracts with Customers, we noticed:

- inadequate and incomplete disclosures, for example relating to the disaggregation of revenue, performance obligations, measurement of the transaction price, and timing of the revenue
- lack of explanation relating to significant judgements used in applying the accounting standard, in particular relating to determination of the transaction price and timing of the revenue
- lack of documentation supporting management's materiality considerations relating to application of NZ IFRS 15, including the level of disclosures. For example no explanation and information of the revenue classified as "other" even though its components were determined qualitatively and/or quantitatively to be material.

Failure to follow FMA's guidelines in relation to non-GAAP financial information

We noted several examples of annual reports, market announcements, management commentary, investor presentations and other communications to market participants and shareholders containing non-GAAP financial information that failed to comply with our guidelines. Examples include:

- lack of disclosures explaining why presented non-GAAP financial information provides useful information to the investor and how it is used internally by management. We also identified instances where information on usefulness of the non-GAAP financial information is provided in a boilerplate manner without clearly explaining the reason for disclosing such information
- not providing reconciliations (directly or by reference) to the directly comparable GAAP measures

- presenting non-GAAP financial information with greater prominence than the directly comparable GAAP information
- labelling adjustments as either one-off, non-recurring or abnormal when they have occurred in the past or are reasonably likely to occur in that business again in the future
- inaccurate labelling of non-GAAP financial information measures used, in particular 'EBITDA' and 'EBIDAF' when the adjustments do not correspond to the abbreviation.

Impact of COVID-19

Entities are facing high levels of uncertainty about their immediate prospects and the impact of COVID-19. The entity's structure, industry and measures taken by governments around the world can significantly affect business operations. As a result, entities and directors should consider the impact of COVID-19 on:

- the entity's ability to continue as a going concern, including considering all the relevant information about the entity's prospects and forward-looking information supporting its conclusions. Depending on the uncertainties pertaining to the going concern assumption, entities may need to consider a range of scenarios in a number of key assumptions supporting the going concern assumption
- providing clear and transparent disclosures on the entity's going concern position. This will require increased disclosures where there are material uncertainties and/or significant judgement involved in the going concern assessment
- sufficient level of disclosure for other significant judgements applied in the preparation of the financial statements, for example the sources of estimation uncertainty and other key assumptions made. This includes having complete and comprehensive records supporting judgements and assumptions made together with the materiality assessment of the level of disclosure
- valuations of non-financial assets prepared by third parties. These may contain additional levels of judgements and uncertainty because of COVID-19. Entities should disclose how valuers have factored these uncertainties into the valuations used for financial reporting purposes, including disclosing where valuers considered a reliable fair value measurement could not be provided
- understanding the nature and level of information the users of financial statements, including investors, need and ensuring such information is disclosed in the financial statements or outside of the financial statements (as appropriate) in a complete and understandable way
- judgements required in determining whether events subsequent to the end of the reporting period affect the reported assets, liabilities and performance for that period and, depending on that, the appropriate level of disclosures for these events including both qualitative or quantitative information
- the entity's ability to obtain secure, reliable and relevant information, on an ongoing basis, in order to manage future operations, including the flow of financial information from significant subsidiary, joint venture and associate entities
- current management and governance processes. These may need to change to allow for reliable, timely and accurate information for management, directors and the auditor during this period of increased business disruption and uncertainty
- the need for additional reporting in the annual report or financial statements. These may need to include further detail on the impact of COVID-19 on financial statements specific to the entity, and forward-looking information to provide insights into the Board's assessment and plans relating to the entity's prospects going forward.
- finalising the financial statements process and your engagement with your auditor in a timely manner.

Because of COVID-19, we expect to see more frequent engagement with your auditor, as the complexity of financial reporting matters is likely to increase. The increased complexity of issues may affect audit procedures and reporting timelines.

Our expectations

Allowing enough time to consider, assess and document the impact of COVID-19 on your annual report is critical. This includes ensuring compliance with the applicable accounting standards, and providing an adequate and meaningful level of disclosures, in particular relating to the areas of significant estimates and judgements.

Entities should focus on providing information that is material and communicating this in a clear, concise and effective way so that material information is not lost in lengthy explanations of the circumstances and the impact on numbers. More guidance about clear, concise and effective disclosure is available in our 2014 report Quality Financial Reporting –How to Improve Financial Statements and 2018 report Improving financial statements.

We expect entities to focus on the following:

- Preparation of high-quality technical papers for all material accounting areas, with a particular focus on the areas significantly impacted by COVID-19. This includes detailed materiality assessments and accounting considerations of decisions made to support compliance with generally accepted accounting principles in New Zealand. Examples include:
    - debtor impairment allowance and recoverability assessment, considering the ability of each debtor to make full payment
    - assessing the measurement of financial instruments, including expected credit losses
    - consideration of revenue from contracts with customers that may have been impacted due the circumstances of COVID-19
    - going concern assumption of the entity, especially due to the current uncertainty regarding future demand of products, borrowing capacity, ability of any entity being relied upon for financial support, and adverse market conditions etc. This also includes management and the Board discussing and documenting various scenarios related to the current uncertainty
    - non-financial assets valuation and impairment testing, together with reassessing and adjusting the current models. This includes considering relevant contingent factors surrounding these calculations, including assessments regarding future events and assumptions that may not have been key in the past, but that may now be critical and highly sensitive to a variety of changes and variables
    - reassessing non-financial assets measured at fair value, such as property plant and equipment, that may have historically only needed to be revalued on a periodic basis
    - subsequent events considerations
    - inventory provisioning and write-offs
    - new and impending provisions such as restructuring, failure to comply with debt covenants etc
    - accounting for lease arrangement modifications in accordance with IFRS 16.
- Disclosure of the significant accounting estimates in financial statements should be clear, concise and effective. Key material information should not be lost in unnecessary detail. We also expect more disclosure of the impact of COVID-19 and the various scenarios the entity is facing to be disclosed, along with relevant and appropriate sensitivity and probability analysis. Our 2018 report Disclosure of significant accounting estimates provides useful guidance on this area.
- Adequate documentation in minutes of Board and audit committee meetings that includes

discussions, analysis and conclusions for material accounting areas, or areas significantly impacted by COVID-19. Due to the quickly changing circumstances, these documents will be critical to support the entity in maintaining proper accounting records. Further, where decisions are made that items are immaterial to disclose, these decisions should be included in the documentation.

- More timely engagement with your auditor. In 2019, we issued Audit quality – a director's guide, guidance for directors and management on how to effectively engage with your auditor.
- Entities should be mindful of adjusting existing non-GAAP financial information with specific COVID-19 impacts together with introducing new alternative performance measures. In cases when management considers this appropriate and useful to investors, non-GAAP financial information should be presented in a way that is not false or misleading. In addition, entities should continue to comply with all the principles (including consistency) in the FMA 2017 guidance note Disclosing non-GAAP financial information. Entities therefore should consider if COVID-19 references in alternative performance measures are appropriate and could be better explained by narrative disclosures.

  When disclosing non-GAAP financial information, management and directors should:

  - clearly explain why they consider it useful to present non-GAAP information adjusted by the impact of COVID-19. If not all adjustments are COVID-19 related, clearly explain and label appropriately
  - not be biased and not 'cherry-pick' when disclosing non-GAAP information
  - not present pre-COVID-19 results with greater prominence than the most comparable GAAP information or forward outlook of the entity
  - not treat items as 'one-off' for the current year if they occur from time to time in the particular business, or are likely to reoccur going forward due to the current global and economic conditions
  - consider items or disclosures that are better suited to be disclosed to investors outside of the financial statements
  - check the accuracy of statements being made regarding the impact of COVID-19 and not use COVID-19 as a 'blanket' rationale for certain matters, for example where impairments would have been required regardless of COVID-19
  - provide sufficient information, but do not overcomplicate disclosures with too much detail or provide 'what-if' scenarios for if COVID-19 had not impacted the entity.
- While interim financial statements for listed entities are not a requirement of the Financial Markets Conduct Act 2013, we note that these half-year reports may be the first financial report released post COVID-19, and therefore will be the first place where investors are provided information on its impact. These reports, along with accompanying reports such as Chair and Director reports, should follow the same guidance as above. For material and relevant matters (such as estimation uncertainties, key assumptions, business impact, underlying drivers of performance, strategies, risks and future prospects) we expect the interim financial statements to include the same level of disclosure that would be required for the full financial statements.

ASIC'S COVID-19 implications for financial reporting and audit: Frequently asked questions is a useful reference for entities when preparing their financial statements.

FMA's focus

Our focus in the current environment is to ensure that entities provide meaningful disclosures around COVID-19, significant accounting estimates, and complex and judgemental areas. We also want entities to maintain appropriate accounting records, including ensuring that all the key assumptions underpinning those estimates and judgements have been considered, and fully documented to ensure compliance with accounting standards, guidance documents and other laws and regulations.

We understand that entities would like to provide insights on the impact of COVID-19 in non-GAAP financial information, and we will monitor this information and whether it is relevant, not misleading and meets the requirements and expectations we have set.

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