Perspective

This is one of a series of articles where experts in assurance, reporting and regulatory matters discuss recent technical and policy developments in these areas.

The triple threat to Prospectuses

Wayne Basford, FCA, Partner, Asia Pacific Leaders IFRS, BDO
Susan Oldmeadow-Hall, FCA, Associate Director, IFRS Advisory, BDO

May 2018

In our October 2017 Perspective Article, we considered the impact of the three new accounting standards on deals and how they result in a changing reporting landscape. ASIC's February 2018 *Report 567: 'ASIC Regulation of Corporate Finance: July to December 2017'* highlighted ASIC's expectation that financial information provided in prospectuses and offer documents will provide financial information that incorporates the effect of the new standards. This effectively pushes forward the measurement of the impacts of these standards for any entity issuing a prospectus.

When presenting financial information in prospectuses a 'stable financial reporting platform' needs to be determined, with both historical and prospective results reconciled to the restated information presented.

At BDO we are seeing a 10 year high in corporate finance activity in Australia. Coupled with significant complexity in adopting these new standards, it is a challenging time for practitioners working in corporate finance or preparing prospectuses.

According to Sherif Andrawes, Corporate Finance Partner and International Leader of BDO's Natural Resources Group:

"The requirement to disclose up to three years' historical financial information in prospectuses has improved the supply of information for investors but has also increased the requirements for companies and investigating accountants. Based on the number of IPOs we are currently working on, in addition to the number I know of in the pipeline, I expect 2018 to be the most active year for IPO's experienced since 2007. Add to this the requirement to show the impact of these new Accounting Standards, for up to three years of historical financial information, companies will need to plan ahead should they be contemplating an IPO in the near future."

Over the next three years the financial reporting landscape will change

The new standards are being phased in on a staggered basis. Judgement is required in determining what reconciliations will be required in prospectuses. The period of transition to these standards is likely to cause confusion in relation to financial information presented.

Standard	Standards Applicable 2017	Standards Applicable 2018	Standards Applicable 2019
Financial instruments	AASB 132 & 139 - comparatives may be restated for AASB 9	AASB 9	AASB 9
Revenue	AASB 118 - comparatives may be restated for AASB 15	AASB 15	AASB 15
Leases	AASB 117	AASB 117 - comparatives may be restated for AASB 16	AASB 16

The changes introduced by the new standards are far reaching. Impacting how bad debt provisions are calculated, causing more financial assets to be measured at fair value, introducing very complex rules as to when revenue can be recognised and effectively scrapping the operating lease classification, bringing all leases, together with the lease liability onto an entity's balance sheet.

In the period of transition, there is a very real risk that if revenues are deferred on adoption of AASB 15, that this will result in certain revenues being recognised twice in the statutory financial report, hence improving post transition results. The introduction of AASB 16 will improve EBITDA.

ASIC's guidance

Paragraph 29 of Report 567 ASIC states:

We will be closely reviewing disclosure practices for historical and prospective financial information. We suggest that companies and their advisers should consider:

- *a) Providing appropriate disclosure of the future effect of the new accounting standards*
- *b) The prominence given to financial information presented under the pre-existing standards and the new standards, taking into account the size and extent of the effect of applying the new standards*
- *c) Presenting historical and prospective financial information on a consistent basis, or presenting information on both bases for an overlap period*
- *d) Ensuring the effects on historical financial information are presented clearly by a general discussion, reconciliation of key items (such as profit and net assets), and/or line-by-line reconciliations for one or more years*
- *e) Disclosing key assumptions made when applying the new standards to forecast information and*
- *f) Clearly identifying whether the pre-existing or new standards have been applied to particular information.*

In November 2016, ASIC introduced guidance on the disclosure in prospectuses in *Regulatory Guide 228: 'Prospectuses: Effective disclosure for retail investors'*. This guidance requires disclosure of at least the three most recent financial years or two years of audited information and a half-year of reviewed information, depending on the date of the prospectus.

As historical and prospective financial information is to be prepared on a consistent basis, companies will be required to restate their annual results and balance sheets to comply with the new standards, not just for the current year, but going back up to three years.

Obtaining information to retrospectively apply these standards to historical data, such as the financial year ended 2015, 2016 and 2017 will prove to be challenging for many entities, with restatement for these years not required by the accounting standards.

Perspective

There is no one size fits all approach, and the impacts of transition vary greatly depending upon the industry and operations of the company. Because the introduction of the new standards is occurring in a staggered way, it is not just a case of moving from the old standards to the new standards.

Understanding the impact on historical and forecast information, in order to determine what results will be reported for a particular period, is likely to be a complicated exercise for many companies looking to issue a prospectus.

A common misconception is that the new accounting standards are just a financial reporting compliance issue. However, the new standards have the potential to have far-reaching implications on a business.

Once you overlay the need to account for items at a contract level, the potential for change and the need for robust systems and process reviews, it is more than likely to take considerable time to assess, develop and implement the changes necessary to comply with the new standards. For companies that have delayed their adoption of the new standards, preparing this information at the time of developing a Prospectus is likely to be a daunting task, as the impacts of these standards are far reaching on key performance rations, profit, EBIT, EBITDA, net assets, net current assets etc.

AASB 9 Financial Instruments

AASB 9 significantly changes the financial reporting landscape for how entities account for financial instruments with this standard applying to all reporting entities, not just the financial services sector.

Entities will need to determine which of the four AASB 9 categories their financial assets fit into. In a number of instances, the use of amortised cost will be restricted, resulting in both difficulties in measuring an asset's fair value and increased earnings volatility.

AASB 9 requires that unlisted equity investments be valued at fair value. Determination of fair value is likely to be difficult to establish given there is no active market for the underlying securities.

Financial assets (including trade receivables, intercompany loans, other investments etc.) will also be subject to a new 'expected loss' impairment model, which means entities could be recognising impairment losses earlier than under AASB 139. This will likely result in additional losses, recognised in retained earnings on transition, with a positive impact on post adoption reported earnings.

New hedging rules also make it easier for many entities to qualify for hedge accounting, reducing volatility in profit or loss movements from period to period. The relaxed rules could well see entities revisiting their treasury policies, entering into hedging transactions with derivatives and options.

AASB 15 Revenue from Contracts with Customers

This standard will change the pattern of revenue recognition for many entities. In a significant number of cases, adoption of AASB 15 will result in the recognition of revenue in a pattern that does not correspond to the amount invoiced to the customer.

Changes to processes and systems may be required so that the accounting system can recognise revenue in accordance with AASB 15, rather than when invoiced to the customer. Sales contracts and any modifications to these contracts will need to be analysed in detail to ensure they reflect the recognition of revenue as contemplated by this new standard.

This standard is also likely to affect a company's remuneration structures, earn-out clauses, covenant compliance calculations and income tax.

AASB 16 Leases

The accounting headlines of applying AASB 16 are as follows:

- There is no such thing as rental expense
- All leases come on to the balance sheet
- An entity's net current assets will decrease
- An entity's EBITDA will improve
- An entity's operating cash flows will improve.

One area of complexity is determining which contracts contain leases, as the requirements are pervasive and require a review of service contracts to see if they contain assets which fall within the scope of AASB 16. This is particularly relevant for entities that enter into long-term service contracts that also require the use of equipment, such as wet hire contracts in the mining industry and transportation agreements.

For contracts that contain leases, companies are required to set up a right-of-use asset register and calculate the lease liability for each leased asset. Systems and processes are required to calculate asset amortisation and the finance costs arising from leased assets.

Without doubt, the impact of the new standards has added an extra level of complexity and for those preparing prospectuses, implementation has effectively been pushed forward, with the date of transition being as early as 2015, given the requirement to restate historical financial information presented. Should actual results be materially impacted by application of the new standards and this is not properly disclosed in the prospectus, those involved may be exposed to actions by the regulator and investors. With the right resources and planning, transition and reporting of relevant financial information can be managed effectively. However, for many entities, adoption of the new standards is indeed a triple threat and will be a headache for members of due diligence committees and all those involved with fund raising and prospectuses.