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ACCOUNTING NEWS

THE 'BLIND FREDDY' PROPOSITION – PART TWO

The 'Blind Freddy' proposition continued

Judging from the response to last month's article of Justice Middleton's ruling against the Centro directors, his proposition that Australian boardrooms would not empty overnight may have been over optimistic.

We have received numerous calls from directors asking how they can possibly comply with the obligations Justice Middleton appears to have placed on them.

In this article we consider steps, and particularly questions, that non-executive directors should be asking management, their accountants and their auditors in order to fulfil their director's duties under the Corporations Act.

Sources of information that should alert directors of errors in, and omissions from, the financial report they are reviewing include:

1. Tailored aspects of the auditor's representation letter
2. Checking changes/omissions vs. the prior year financial report
3. Checking financial reports against competitors' financial reports.

IN THIS EDITION

In this month's newsletter, we look at questions boards should ask as a result of the 'Blind Freddy' proposition put forward by Justice Middleton in the Centro case. We also look at standards issued by the AASB during the past month, the exposure draft on investment entities, and how fair value should be applied to Greek debt. We finish off with some Corporations Act reminders about new rules for voting on remuneration resolutions at AGMs and the ban on hedging performance risk for key management personnel.

Reviewing the auditor's representation letter

As a matter of course, as required by Australian Auditing Standards, the entity's auditors will request from management a 'management representation letter', setting out key areas of judgement and items where they have specifically relied on management's representations in order to form their opinion. This letter will typically include 'key judgements' in the financial report or potential contentious areas. It is also a useful 'checklist' for disclosure of contingent liabilities, subsequent events, etc.

Checking accounts vs. prior year

It is sometimes worthwhile checking the current year's financial report against the prior year report, the purpose being:

1. To identify deleted disclosure, which may still be appropriate
2. If the accounts are exactly the same, but the business has changed significantly, perhaps the disclosures should change.

Checking against competitors' financial reports

It is good practice to familiarise yourself with the facts and disclosures of other entities operating in the same sector, that have been audited by different audit firms to identify potential omitted disclosures or better presentation.

The 'Blind Freddy' proposition, questions to be raised

The key principle behind the 'Blind Freddy' proposition is that when the board is fully aware of a transaction, or is fully aware of disclosable situations facing the entity for which they approve the accounts, they should be able to spot if this is not properly disclosed or accounted for in the financial report.

We now consider potential issues that all directors should be fully aware of that could be erroneously disclosed or accounted for in an entity's financial report. Having knowledge of these issues, directors should reasonably be expected to make enquiries about:

- Going concern
- Impairment
- Provisions / accruals
- Litigation
- Contingencies
- Subsequent events
- Related party transactions
- Other key judgements / estimates.

The remainder of this article looks at further questions directors should be asking about impairment, contingent liabilities and related party transactions.

Questions to be asked on impairment

Impairment covers a whole range of disclosure items in a financial report, including:

- Carrying value of assets
- Goodwill
- Debtors
- Inventory
- Fixed assets
- Intangibles
- Investments.

Disclosure is required about the key assumptions in measuring impairment and ultimately the impact on reported earnings and earnings per share.

As a matter of course, boards are given detailed information about material assets that are not performing, and which may be subject to sale, abandonment, closure or restructuring.

It therefore follows that such knowledge should lead directors to review the accounts to ensure impairment details are properly represented in the financial report and to explicitly question executive management as to how impairment has been dealt with.

Questions directors may reasonably ask include:

- 'Have we provided for x line of slow moving inventory?'
- 'Have we provided for all raw materials and WIP used in the production of product X which we have just decided to delete?'
- 'Have we written off 'XYZ' brand given that we have elected to re-brand all of our stores?'
- 'Have we written off any intangibles associated with our decision to get out of 'XYZ' business?'
- 'Have we provided for fixed asset write downs following the decision to close/replace the facility?'
- 'Have we written down our investment in 'XYZ' given its underperformance?'
- 'Based on market intelligence that our competitors will launch a very competitive new product, have we impaired PPE and inventory?'
- 'Based on us finding out that we have been unsuccessful in tendering to retain the 'XYZ' contract, have we written off PPE and inventory? Also how have we disclosed this?'
- 'Based on the latest clinical trial results, have we impaired capitalised development costs in respect of this project?'
- 'Based on our inability to raise adequate funds, or to find a suitable partner, have we impaired capitalised development costs/work in progress?'

Contingent liabilities – legal cases

A financial report can only fail to give a true and fair view of an entity's financial position if the error/omission is material. If a board has adequate reporting to it, it should be aware of all major claims, contingencies, or other liabilities which the entity is subject to. So questions directors may reasonably ask include:

- 'How have we disclosed the 'XYZ' claim/case?'
- 'What have we provided for legal costs in respect of the 'XYZ' case?'
- 'In light of the large warranty claims on 'XYZ' product, have we accounted for future warranty costs?'
- 'Given the latest environmental report on site 'XYZ', what have we provided for site restoration?'

Boards would be expected to be aware of planned closures, selective cessation of product lines and specific business lines. This knowledge should not only prompt board members to ask questions as to potential impairment issues discussed above, but also questions around provisions and onerous contracts, for example:

- 'Has the planned cessation of 'XYZ' left us exposed to supply contracts for goods we will not use? How has this been accounted for?'
- 'In respect of our plan to exit the 'XYZ' premises early, how have we accounted for the cost of the remaining lease?'
- 'How have we accounted for the redundancy arrangements?'
- 'In respect of our plan to exit 'XYZ' site, how have we accounted for the costs of restoring the site?'

Related party transactions

Boards are very well placed to be the key persons to identify errors in related party disclosures and remuneration expenses. It is not uncommon for senior management to have very confidential remuneration arrangements, particularly in respect of sign-on arrangements, bonus arrangements and exit arrangements. These arrangements may involve share options or share plans. It is not uncommon that these very confidential arrangements are withheld from executive management, including the CFO.

Questions the board should ask if they are unsure of related party disclosures include:

- 'How have we treated Mr 'XYZ's' remuneration/bonus/exit arrangement?'
- 'How have we accounted for Ms 'XYZ's' share options?'
- 'Why isn't 'XYZ Ltd' listed as a related entity?'
- 'How have we accrued for the CEO's bonuses?'

The above questions are by no means exhaustive, but hopefully they show that directors do not have to be Chartered Accountants to raise common sense questions, based upon their knowledge of the business, which will present the potential for 'Blind Freddy' errors.

AASB ISSUES NEW CONSOLIDATION, JOINT ARRANGEMENTS, FAIR VALUE AND OTHER STANDARDS

CONSOLIDATIONS AND JOINT ARRANGEMENTS

On 31 August 2011, the Australian Accounting Standards Board (AASB) issued a suite of six new accounting standards (equivalents to IFRS standards with same names) which include some significant changes to consolidation accounting and accounting for joint arrangements. These standards apply to annual periods beginning on or after 1 January 2013 and may be adopted early, provided that all standards in the suite are adopted at the same time, namely:

- AASB 10 *Consolidated Financial Statements*
- AASB 11 *Joint Arrangements*
- AASB 12 *Disclosure of Interests in Other Entities*
- AASB 127 *Separate Financial Statements*
- AASB 128 *Investments in Associates and Joint Ventures*
- AASB 2011-7 *Amendments to Australian Accounting Standards arising from the Consolidation and Joint Arrangements Standards*.

The fact that these have been issued as Australian Accounting Standards makes early adoption now possible for entities applying Australian Accounting Standards. However, we do not expect to see many entities early adopting given that some of the new requirements are fairly complex, and that early adoption is unlikely to be an advantage for many entities. However, some entities/groups may use the new de facto control principles as a reason to consolidate and others may use the removal of the 'risk and reward' test to justify no longer consolidating SPEs or securitisation vehicles.

For more information on IFRS 11 *Joint Arrangements*, please refer to Accounting News, June 2011, and for more information on IFRS 10 *Consolidated Financial Statements*, please refer to Accounting News, July 2011.

Fair value measurement

On 5 September 2011, the AASB issued AASB 13 *Fair Value Measurement* and AASB 2011-8 *Amendments to Australian Accounting Standards arising from AASB 13* as local equivalents to IFRS 13. These standards also apply to annual periods beginning on or after 1 January 2013 and may be adopted early. However, due to the significant amount of additional disclosure required, particularly for 'level three' non-financial items such as investment property and owner-occupied land and buildings, we do not anticipate that many entities will early adopt the new standards.

For more information on IFRS 13 *Fair Value Measurement*, please refer to Accounting News, June 2011.

Other changes

On 6 September 2011 the AASB issued a revised version of AASB 119 *Employee Benefits* (equivalent to IAS 19 (2011)) which applies to annual periods beginning on or after 1 January 2013, with early adoption permitted. Changes relate mainly to:

- Prohibiting the 'corridor' approach for recognising actuarial gains and losses
- Requiring actuarial gains/losses to be recognised in other comprehensive income, rather than in profit or loss.

The AASB also issued on 6 September 2011, AASB 2011-9 *Amendments to Australian Accounting Standards – Presentation of Items of Other Comprehensive Income* which applies to annual periods beginning on or after 1 July 2012 and may be adopted early. The main change requires entities to group items presented in other comprehensive income on the basis of whether they can be reclassified to profit or loss in future.

For more information about these changes, please refer to Accounting News, July 2011.

AASB ISSUES EXPOSURE DRAFT FOR INVESTMENT ENTITIES

THE INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB) LAST MONTH ISSUED ED/2011/4 *INVESTMENT ENTITIES* (ED 220 IN AUSTRALIA) WHICH EXEMPTS 'INVESTMENT ENTITIES' FROM HAVING TO CONSOLIDATE THEIR CONTROLLED ENTITIES.

The exposure draft proposes that investment entities measure all their investments in controlled entities at fair value through profit or loss under AASB 9 *Financial Instruments*, instead of consolidating them under AASB 10.

The exposure draft proposes that an 'investment entity' must meet all of the following criteria:

- Entity's only substantive activities are investing in multiple investments for capital appreciation, investment income, or both
- Entity makes an explicit commitment to its investors that the purpose of the entity is to invest to earn capital appreciation, investment income, or both
- Ownership of the entity is represented by units of investments, such as shares or partnership interests (or units in a trust/fund), to which proportionate shares of net assets are attributed
- Funds of the entity's investors are pooled so that investors can benefit from professional investment management. Investors are unrelated to the parent (if any), and in aggregate hold a significant ownership interest in the entity
- Substantially all of the investments are managed, and their performance evaluated, on a fair value basis
- Entity provides financial information about its investment activities to its investors. The entity can be, but does not need to be, a legal entity.

Investments in controlled entities of an investment entity will be measured at fair value through profit or loss, except when:

- The parent of an investment entity is not itself an investment entity
- The investment entity controls an investee that provides services that relate only to the entity's own investment activities
- The investment entity takes control of collateral as a result of defaults related to its investments.

The exposure draft also proposes additional disclosures for investment entities.

The AASB is seeking comments on this exposure draft by 30 November 2011. We encourage any interested parties to make a submission, or to contact Wayne Basford so that we can include your comments as part of our submission.

WHAT IS FAIR VALUE? HOW SHOULD IT BE APPLIED TO GREEK DEBT?

THE NEW CHAIR OF THE IASB, HANS HOOGERVORST, RECENTLY WROTE TO THE CHAIR OF THE EUROPEAN SECURITIES AND MARKETS AUTHORITY, EXPRESSING CONCERN ABOUT THE FACT THAT HOLDERS OF DISTRESSED SOVEREIGN DEBT, INCLUDING GREEK GOVERNMENT BONDS, HAVE BEEN APPLYING THE ACCOUNTING REQUIREMENTS FOR FAIR VALUE AND IMPAIRMENT LOSSES IN A WAY THAT DIFFERS FROM THE OBJECTIVE OF IAS 39 *FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT*.

Where holders have classified distressed debt instruments as available-for-sale, they must be recognised at fair value at the end of each reporting period. Where there is objective evidence that these instruments are impaired (i.e. fair value has dropped below original cost), impairment losses are recognised in profit or loss. So impairment losses for available-for-sale debt instruments should be based on fair value.

The letter highlights that some investors holding government bonds are not following the IAS 39 requirements when assessing whether the bonds are impaired. Instead, they are using a present value technique that includes cash flows arising from a proposed restructure of the bonds, rather than using current market prices, as required by IAS 39.

The letter also highlights that some holders of Greek government bonds classified as available-for-sale are relying on internal valuation methodologies to measure fair value rather than market prices (which IAS 39 requires), the reason being given that the market for Greek government bonds is currently inactive and therefore does not provide reliable pricing information. The IASB are saying that IAS 39 prioritises the use of quoted prices in active markets over the use of valuation methodologies developed using internal assumptions, and that whilst market activity for Greek government bonds may have decreased, transactions are still taking place and should therefore be used to determine fair value.

Although the IASB does not have the authority to ensure compliance with IFRS, the exposure that this letter received in the UK's Financial Times could result in increased compliance enquiries from securities regulators around the world to entities holding distressed debt.

BAN ON HEDGING PERFORMANCE RISK FOR KMPS

JUST A REMINDER THAT THE CORPORATIONS AMENDMENT (IMPROVING ACCOUNTABILITY ON DIRECTOR AND EXECUTIVE REMUNERATION) ACT 2011 INTRODUCED A NEW SECTION 206J WHICH PREVENTS HEDGING OF REMUNERATION OF KEY MANAGEMENT PERSONNEL OF COMPANIES THAT ARE DISCLOSING ENTITIES.

Key management personnel, and their closely related parties, must not enter into arrangements which would have the effect of limiting their exposure to risk relating to an element of their remuneration that:

- Has not vested
- Has vested but remains subject to a holding lock.

These new rules apply to arrangements entered into on or after 1 July 2011, irrespective of whether the remuneration was for services rendered before, on, or after 1 July 2011.

VOTING ON REMUNERATION RESOLUTIONS AT AGMS

THE CORPORATIONS AMENDMENT (IMPROVING ACCOUNTABILITY ON DIRECTOR AND EXECUTIVE REMUNERATION) ACT 2011 INTRODUCED REQUIREMENTS ABOUT VOTING RESTRICTIONS ON KEY MANAGEMENT PERSONNEL OR THEIR CLOSELY RELATED PARTIES WHEN VOTING ON THE ADVISORY RESOLUTION FOR ADOPTING THE REMUNERATION REPORT (NEW SECTION 250R(4) TO (10)).

As currently written, the sections refer to directed proxies but do not describe whether the chairperson is able to vote if they are holding undirected proxies.

The Government is proposing to change the law sometime during 2011 to clarify that the chairperson is allowed to vote undirected proxies in relation to remuneration reports if shareholders expressly authorise them to vote such undirected proxies. Until the law is changed (these new rules already apply to AGMs being held for the 30 June 2011 reporting season), ASIC has released an Information Sheet called 'Annual general meetings: Voting on the remuneration report resolution' to assist companies through their upcoming AGM process.

Companies have various choices about how to deal with this situation:

Option 1 – The Chairperson will not vote on any undirected proxies on the remuneration report. If companies do not wish to change their current processes for holding AGMs, they should inform their shareholders that their votes will not be counted if they provide an undirected proxy on the remuneration report. This will minimise the number of uncounted votes.

Option 2 – Amend the proxy form so that shareholders can give an express 'for' or 'against' specifically on the remuneration report.

Option 3 – Companies may suggest that shareholders nominate a proxy for the remuneration report resolution who is not a member of the key management personnel (or their closely related party).

Option 4 – Include clear and prominent wording in the proxy form to the effect that unless the shareholder ticks the 'for' or 'against' box for the remuneration resolution, they will be directing the chairperson to vote in accordance with the chairperson's clearly stated voting opinion. The voting intention would be disclosed in the notice of meeting and proxy appointment form.

Option 5 – Company to apply for relief for the chairperson to cast undirected proxies on a specific remuneration report resolution. ASIC must be satisfied that by granting relief there will be no unfair prejudice to interests of any member of the company. Refer to the Information Sheet for more information about how to go about applying for relief.

COMMENTS SOUGHT ON EXPOSURE DRAFTS

At BDO, we provide comments locally to the AASB and internationally to the IASB. We welcome any client comments. If you like to provide any comments please contact Wayne Basford.

DOCUMENT	PROPOSALS	COMMENTS DUE TO AASB BY	COMMENTS DUE TO IASB BY
ED 213 *Improvements to IFRSs*	Proposes various amendments to standards as a result of the IASB's annual improvements project.	6 September 2011	21 October 2011
Tier 2 Supplement to ED 201 Insurance Contracts	The AASB considers there to be no need for Tier 2 disclosure relief for entities with material insurance contracts as such entities are expected to be publicly accountable.	30 September 2011	NA
ED 215 *Mandatory Effective* Date of IFRS 9 [proposed amendment to AASB 9 (December 2009) and AASB 9 (December 2010)]	Proposes deferral of date when IFRS 9 would be mandatory from 1 January 2013 to 1 January 2015.	7 October 2011	21 October 2011
ED 212 *Not-for-Profit Entities within the General Government Sector* (proposed AASB 10XX, including proposals relating to Tier 2 disclosure requirements)	Proposes to change the financial reporting requirements for not-for-profit entities, including government departments and statutory authorities, within the General Government Sector of the State, Territory and Federal Governments.	31 October 2011	NA
ED 216 *AASB 12 Disclosure of Interests in Other Entities: Tier 2 Proposals*	For Tier 2 entities applying the Reduced Disclosure Requirements - proposes various disclosure exemptions relating to interests in subsidiaries, joint ventures and associates, as well as interests in consolidated and unconsolidated structured entities.	30 November 2011	NA
ED 217 *AASB 127 Separate Financial Statements: Tier 2 Proposals*	For Tier 2 entities applying the Reduced Disclosure Requirements - proposes various disclosure exemptions relating to interests in subsidiaries, joint ventures and associates when an entity elects not to prepare consolidated financial statements.	30 November 2011	NA
ED 218 *Presentation of Items of Other Comprehensive Income: Tier 2 Proposals*	The AASB considers there to be no need for Tier 2 disclosure relief for additional disclosures introduced by AASB 2011-9.	5 December 2011	NA
ED 219 *AASB 13 Fair Value Measurement and AASB 2011-8 Amendments to Australian Accounting Standards arising from AASB 13: Tier 2 Proposals*	For Tier 2 entities applying the Reduced Disclosure Requirements - proposes various disclosure exemptions relating to fair value measurement.	5 December 2011	NA
ED 220 *Investment Entities*	Proposes that 'investment entities' be required to measure all their investments in controlled entities at fair value through profit or loss under AASB 9 *Financial Instruments* instead of consolidating them under AASB 10. Also proposes additional disclosures for investment entities.	30 November 2011	5 January 2012
ED 214 *Extending Related Party Disclosures to the Not-for Profit Public Sector*	Proposes to extend application of AASB 124 to not-for-profit public sector entities and to permit Tier 2 not-for-profit public sector entities to apply the reduced disclosure requirements of AASB 124.	31 January 2012	NA

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