OWNERSHIP MATTERS
GOVERNANCE ADVISORS

Eight Key Audit Matter disclosures of note

Jessica Wallace
James Samson, CFA
6 February 2018

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Summary

For financial periods ending after 15 December 2016 the auditor has a responsibility to communicate key audit matters (KAM) in the audit report

This disclosure for listed companies has now been a requirement for a year, so all companies have at least one set of accounts with KAMs specified

OM analysed 290 KAM disclosures for ASX 300 companies during 2017 to observe trends and identify any companies where the audit matter may provide insight for investors

KAMs can provide users of financial statements with hints as to areas of disclosure that may warrant further investigation or seem otherwise innocuously disclosed. Examples include:

1. **Austal (ASB)**
2. **Graincorp (GNC)**
3. **Steadfast (SDF)**
4. **Sky Network Television (SKT)**
5. **Blue Sky Alternatives (BLA)**
6. **Domino's Pizza (DMP)**
7. **Fairfax (FXJ) / Nine Entertainment (NEC)**
8. **Myer Limited (MYR)**

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Auditing Standard ASA 701 sets out the requirement that auditors shall determine and disclose key audit matters in audit reports, defined as 'those matters that required significant attention in performing the audit.'[1]

[1] (see: http://www.auasb.gov.au/admin/file/content102/c3/ASA_701_Compiled_2017_1503299611435.pdf)

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In 2017, 827 KAMs were identified in the ASX 300 for an average of 2.86 KAMs per audit. Of the 290 companies analysed, 30 audit reports disclosed only one KAM, with CBA's auditor disclosing the most at six KAMs.

Many audit matters appear routine with the following being the most commonly observed across the sample:

1. Goodwill and intangibles impairment testing – 150 (18%)
2. Property, plant & equipment / investment property valuation – 96 (12%)
3. Revenue recognition – 89 (11%)
4. Business combinations / demergers – 73 (9%)
5. Taxation and deferred tax matters – 63 (8%)

While these appear to be the matters most routine to audit, it is likely that these are areas of accounting judgment that warrant attention when considering the interpretation of financial statements generally.

Across the ASX 300 16 different audit firms were used, with eight conducting one audit. PwC was most prevalent with almost 30% of all audits, followed by EY, KPMG and Deloitte (25%, 23% and 14% respectively).

Of the big four, PwC averaged 3.35 KAMs per audit, followed by EY at 2.8, KPMG at 2.5 and Deloitte at 2.4.

The quality of information enclosed in audit reports has been greatly enhanced as a result of the inclusion of KAMs. The following are a selection of examples where investors could take hints from the auditor when considering investments.

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Austal Limited (ASB) – KAM on 'Taxation'

The KAM from EY reveals amended tax assessments have been issued by the ATO following an audit undertaken during the year. This is not disclosed to investors anywhere else in the 2017 annual report (generally this would be found in the income tax note or listed as a contingent liability) and aside from the commentary provided in the KAM, no other details concerning the size or nature of the dispute are provided. Investors were first alerted to the company being in dispute with the ATO in 1H17 accounts over "differing interpretations of technical items" as part of an ongoing tax audit, noting that these matters are "currently undergoing an independent ATO review process".

Based on OM's review of the 2017 accounts this dispute appears related to losses recognised in Australia and inter-company royalties, as the income tax reconciliation note introduces two new line items explaining why ASB's tax rate was higher than 30%: Australian tax group losses not recognised and transfer pricing adjustments. ASB's tax rate increased from 37% in 1H17 to 76% in 2H17.

Excerpt 1: ASB KAM, 2017 annual report, p. 124

Why significant	How our audit addressed the key audit matter
The Group's geographic operations results in significant income tax expense, across two main jurisdictions, being USA and Australia. In addition, significant deferred tax assets and liabilities are recognised by the Group. During the year an audit was completed by the Australian Taxation Office ('ATO'). Amended tax assessments have been issued by the ATO in respect of the matters and the tax years that the audit focused on. The Group has provided for any additional tax or penalties arising from the ATO audit. The Group's disclosures relating to taxation are included in Note 9 – *Income and other taxes* to the financial report.	Together with our tax specialists we assessed the Group's tax-related balances and the underlying assumptions and calculations on which these were derived. We examined correspondence from the Group's tax advisers in both Australia and the USA and correspondence between the Group and the ATO. We also assessed the independence and competence of the Group's tax advisers. We involved our tax specialists to assist in evaluating the potential exposure to additional tax or penalties that may become payable as a result of the tax audit, and the Group's provision for additional tax or penalties. We assessed the adequacy of the Group's disclosures relating to taxation.

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Save for this audit matter disclosure, the tax rate was not discussed extensively, and the cause was not disclosed.

Excerpt 2: ASB disclosure regarding tax rate, 2017 annual report, p. 4

- NPAT was suppressed by a high effective tax rate as a result of double taxation on inter-company royalties imposed by the Australian Tax Office and no recognition of carry forward tax losses from Australia. This tax treatment is explained in Note 9.

<u>Graincorp Limited (GNC) – KAM on 'Sufficiency for the provision for customer claims'</u>

In FY17, GNC's customer claims provision continued to decline. The provision was last materially replenished in FY14 (through a 'below the line' addition) and has since been run down. In FY15, FY16 and FY17 GNC has utilised $41.9mn from the customer claims provision, protecting earnings, and added just $2.2mn in new provisions (net of reversals).

The sufficiency of the claims provision was considered as a KAM by GNC's auditor PwC in the FY17 audit report. The KAM disclosed that the auditor considers this a KAM because there is 'significant judgment in estimating the provision'.

Given the provision now stands at its lowest point in a number of years, the potential for either the need to add to the provision, or begin expensing customer claims as they occur has the potential to impact GNC's profitability going forward.

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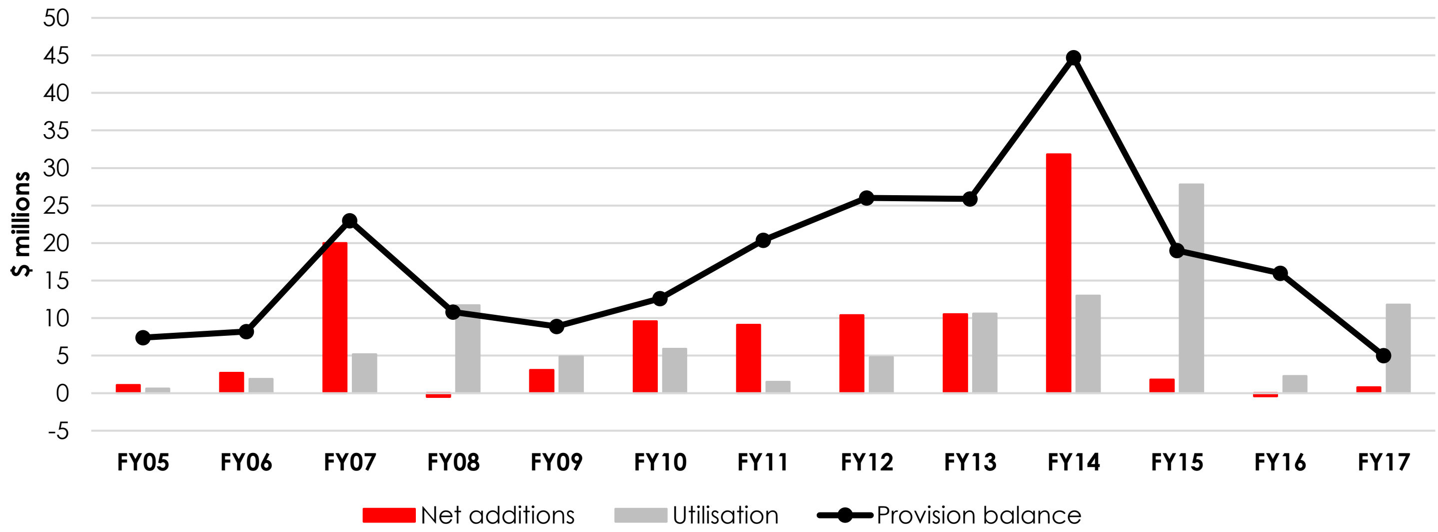
Graph 1: Customer claims provision at GNC FY05 – FY17



<u>Steadfast Limited (SDF) – KAM on 'Decentralised Operations'</u>

The accounts for FY17 disclose the company's complex structure and numerous subsidiaries and associates are such that 66% of revenue and 56% of PBT was subject to 'full scope audit', with 12% of revenue and 17% PBT subject to a 'specific risk-focused audit'; and 22% of revenue and 27% of PBT subject to head office audit procedure.

This disclosure provides investors with insight into the complexity of SDF's operations and accounts. The complexity of the corporate structure makes the accounting equally complex with the changes in ownership of equity accounted investments from period to period impacting statutory numbers.

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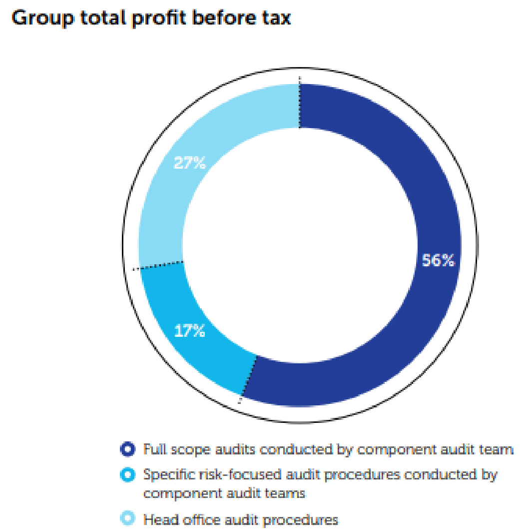
Excerpt 3: Audit scope for Steadfast, 2017 annual report, pp. 117-118



Given this complexity, it is also interesting for investors to understand that there are material parts of SDF's reuslts not subject to a full scope audit.

<u>Sky Network Television (SKT) – KAM on 'carrying value of goodwill'</u>

In FY17, SKT changed its basis for impairment testing goodwill from a measure that expected a 'net gain in subscriber numbers' to a measure that afforded a 10% decline in satellite subscriber numbers before impairment.

The disclosure was such that the company moved from 'value in use' in FY16 to 'fair value less cost to dispose' in FY17' for the purposes of impairment testing.

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Excerpt 4: Sensitivity of key assumptions in SKT 16AR, p. 47

Sensitivity of recoverable amounts

The assessment of value-in-use is most sensitive to the assumptions made for the net gain in subscriber numbers and the USD/NZD exchange rate. Based on the sensitivity analysis carried out, directors believe that no reasonable change in any of the key assumptions would cause the carrying value of goodwill to exceed its recoverable amount.

Excerpt 5: Goodwill assumptions disclosure in SKT FY17 results, p. 29

The following changes in key assumptions or combinations of these factors would cause the fair value less cost of disposal calculation to be less than the carrying amount.

- A decrease in satellite subscriber numbers of more than 10% over five years
- A decrease in satellite ARPU by more than 5.0% over five years
- A terminal growth rate assumption of lower than -1.0%
- A decline in operating costs of less than 14% over five years
- An increase in the after tax discount rate above 1.0%

PwC as SKT's auditor outlines in its key audit matter that this change allows SKT management to factor in expected **future** cost savings in relation to both changes in SKT's business as well as the marketplace. In addition to this PwC states that the market capitalisation was factored into its assessment of the value of goodwill with a control premium as at 30 June 2017. Since 30 June 2017 the share price has fallen ~17.4%.

Blue Sky Alternatives Limited (BLA) – KAM on 'Valuation of Investments'

OM has written in previous notes to clients about the accounting complexity at BLA. Specifically, the company provides its own version of the company's accounts for the purposes or performance measurement and market information.

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GOVERNANCE ADVISORS

Eight Key Audit Matter disclosures of note

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In addition to this it is worth noting the auditor's view, with four KAMs highlighted by EY: 'Revenues from management services', 'control / significant influence over funds', 'valuation of investments' and 'valuation of investment properties'.

Given BLA's significant exposure to both the equity investments and the fees derived from the valuation of level three investments, the auditor's discussion of this highlights for investors the potential complexity in the BLA accounts.

Specifically, the discussion of internal and external valuation specialists, and the point that these usually result in a range of values is worth noting.

Excerpt 6: 'Valuation of investments' KAM, BLA 2017 annual report, p. 92

Why significant	How our audit addressed the key audit matter
The Group holds investments in certain funds that are equity accounted. Some of the underlying investments that these funds have invested in are recorded at fair value. The valuation process involves significant judgement as these investments are classified as "level three" securities in accordance with Australian Accounting Standard - AASB 13 *Fair Value Measurement*, as there are no observable market inputs for valuation. The Group uses internal and external valuation specialists to assist in determining the appropriateness of fair value, as explained in note 3 of the financial report. Due to the significant judgement involved, the valuers generally provide a range of estimated values.	For a sample of underlying investments that are fair valued we performed the following: ▸ Examined underlying financial reports of the investments where available ▸ Examined the internal valuations and the work of the external valuation experts engaged by the Group ▸ Assessed the competence and independence (where applicable) of the Group's internal and external valuation experts ▸ Where relevant, we involved our valuation specialists to assess the valuation methodology and key assumptions used in the valuation of the underlying investments including discount rates and multiples ▸ Agreed the forecasted and actual earnings used in the valuation to Board approved forecasts and actual results and checked the clerical accuracy of the calculation ▸ Assessed the reasonableness of forecasted earnings including review of key assumptions and evaluated accuracy of forecasting by comparing previous forecasts to actuals.

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Domino's Pizza Enterprises Limited (DMP) – KAMs on 'Put options' and 'Accounting for guarantees, contingencies and claims related to the group'

Deloitte disclosed in the FY17 DMP audit report that the valuation of put options relating to the non-controlling interests of DMP's German operations was $81.4mn. The auditor points out that this valuation is subject to significant management judgment on inputs.

In addition, the auditor also pointed out that the company's operations are complex and require compliance with differing legal and regulatory requirements.

Given recent press and issues in the franchising sector, investors should take note of the need for the auditor to point out that a key consideration in its FY17 audit was assessing the status of new and existing claims and contingencies.

Excerpt 7: DMP KAM on accounting for guarantees, contingencies and claims, 2017 annual report, p.40

Accounting for guarantees, contingencies and claims related to the Group The Group operates in a number of jurisdictions with different regulatory and legal requirements. Given this complexity, management is at times required to exercise judgement in evaluating compliance with relevant laws and regulations, as disclosed in note 4.1.10 and 41.2.	Our audit procedures included, but were not limited to: • Evaluating management's process of recording guarantees, contingencies and claims; and • Assessing the status of new and existing claims and contingencies through: - Inquiring of management and the Group's legal advisors; - Obtaining confirmation from the legal advisors; - Inspecting minutes of board meetings and relevant information presented to the directors; and - Inspecting selected correspondence from regulatory authorities. We also assessed the appropriateness of the related disclosures included in note 4.1.10 and 41.2 to the financial statements.

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Fairfax (FXJ) / Nine Entertainment (NEC) – KAM on 'Recoverability and classification of Stan loan receivable'

FXJ and NEC each hold loan assets to Stan, the JV structured streaming service, valued at $93mn. Each company uses EY as their auditor and in 2017 EY mentioned the recoverability and classification of these loans as KAMs for each entity's audit report. This shows some consistency in the approach taken by two EY auditors.

At both NEC and FXJ the loan is carried at amortised cost and is unimpaired. The impairment testing for the loan (or its recoverability) is however called out as a KAM.

Specifically, EY's testing of the loan appears to have been conducted against different accounting standards at NEC and FXJ. This may be a distinction without a difference, but the disclosure of the KAM at both, and the slightly different accounting treatment is of interest.

Excerpt 8 & 9: FXJ annual report (p.136) & NEC annual report (p.104) - KAM on Stan loan receivable respectively

3. Impairment of related party loan receivable

Why significant	How our audit addressed the key audit matter
As at 25 June 2017 the Group's statement of financial position includes a non-current related party loan receivable of $93.0 million due from the equity accounted investee Stan Entertainment Pty Ltd. Given the start-up nature of the debtor, assessing the recoverability of the loan requires the directors to scrutinize the business plan, performance and forecasts to consider the value of the business of the investee. This is an inherently uncertain process. As disclosed in Note 24 to the financial statements, the directors have assessed the recoverability of the loan receivable by obtaining an independent valuation of the investee.	Our audit procedures included the following: ▸ assessed whether the loan receivable met the recognition criteria of Australian Accounting Standard - *AASB 139 Financial Instruments: Recognition and Measurement*; ▸ evaluated the directors assessment of the recoverability of the related party loan receivable with reference to an independent third party valuation of the investee; ▸ considered the appropriateness of the valuation methodology applied and the competence of the independent valuer utilised; ▸ assessed the basis of the cash flow forecasts in light of current business performance and future expectations;

3. Recoverability and classification of Stan loan receivable

Why significant	How our audit addressed the key audit matter
At 30 June 2017, a non-current loan receivable from the Stan joint venture of $93.0m is recorded at amortised cost in the consolidated statement of financial position. The loan classification is assessed in accordance with AASB 9 *Financial Instruments* and AASB 128 *Investments in Associates and Joint Ventures*, as disclosed in Note 1(j) to the financial statements. Note 1(e) refers to the judgement exercised by the Directors in assessing whether any indicators of impairment of the receivable were present at 30 June 2017.	Our audit procedures included the following: • Assessed whether the requirements of Australian Accounting Standard AASB 9 *Financial Instruments* and AASB 128 *Investments in Associates and Joint Ventures* have been satisfied, which includes the classification of the receivable as a financial asset carried at amortised cost. • Evaluated the Directors' assessment of indicators of impairment of the loan and their determination that repayments continue to be planned and likely. These procedures included assessment of forecast performance of Stan

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This slightly different accounting approach is unlikely to have any material implications, the auditors are indicating that the Stan receivable is an asset, the recoverability of which is subject to director assumptions and an area of subjective judgement based on forecasting by the respective companies.

Myer Limited (MYR) – KAM on 'accounting estimates and disclosures relating to the New Myer strategy implementation'

This KAM stood out under analysis for its peculiarity: It is included as the auditor deems that the strategy created significant restructuring, redundancy, store exit and onerous leases which were expensed in FY17. However, the implementation of the strategy was incomplete at period end, and further estimates on the cost of implementation are anticipated in future.

This KAM, excerpted below on p.12, provides a link between the actions of the board and executive team and the expenses and provision balances in the accounts. It also raises the question of the sufficiency of the provisions taken and their reliance upon management assumptions for the successful implementation of the new strategy.

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Excerpt 10: Myer 'New Strategy' KAM, FY17 annual report, p.111

Accounting estimates and disclosures relating to the New Myer strategy implementation
(refer note A3 and C3)

In September 2015 the Group implemented the "New Myer" strategy which involved the execution of a five-year transformation agenda. During FY2017 the execution of the New Myer strategy involved the closure of stores, changes to store sizes following various landlord negotiations, voluntary redundancies and cost reduction within the Group's support office in Melbourne.

The FY2017 strategic decisions resulted in restructuring, redundancy, store exits and onerous lease costs of $20 million which were recognised in the period to 29 July 2017 in accordance with Australian Accounting Standards. The restructuring activity was incomplete at period end, with further judgements and assumptions made by the Group regarding the nature and quantum of restructuring activity anticipated in future periods; this activity required the recognition of estimated restructuring and onerous lease provisions of $26 million at 29 July 2017.

We considered this a key audit matter because of the judgements and assumptions applied by the Group in estimating the level of provisioning required to be recognised at 29 July 2017.

To assess the Group's accounting policies for calculating the New Myer related provisions we performed the following procedures amongst others:

- Considered the judgements and assumptions applied by the Group to determine the recognition of provisions based on the status of committed and Board approved strategic action plans.
- Compared the Group's judgements and assumptions used to calculate the New Myer provision to:
  - Board minutes
  - landlord agreements
  - historic data, including prior store closures and restructuring experience
  - other supporting audit evidence.

We assessed whether there were other provisions which met the Group's recognition criteria, and if they had been recognised at 29 July 2017, by making inquiries of management responsible for the New Myer strategy and by reading minutes of Board meetings for the full financial period.

We considered the disclosures made in note A3 and C3, in light of the requirements of Australian Accounting Standards.

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