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The Forensic Lens

Accounting and reporting in 2023: Challenges and questions

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- We think reporting season 2023 will, yet again, present accountants and users of accounts with challenges
- Uncertainties lead to accounting surprises; we set out areas we think most at risk that people may not have thought about
- In the full note, we answer the five most common accounting questions we have received from investors and analysts

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2023 will be different (yet again)

It may be tempting to think that we are now "back to normal" in accounting and reporting following the pandemic. Previous years' issues may have abated, but the macro uncertainties that began in 2022 and continue into 2023 will, we think, present accountants, auditors and the users of financial statements (investors and analysts) with yet another set of unique challenges as we head into the 2023 reporting season.

Uncertain times lead to uncertain accountants

As we have discussed in previous issues of *The Forensic Lens* that modern accounting standards require accountants to have a view of the future, rather than just reporting historical cost. This adds to the subjectivity and judgement within reported numbers. Understanding the areas affected will help investors differentiate between the benign and concerning consequences. We explore the accounting areas that we think are most sensitive to current macro issues, particularly items that may have been overlooked. These include: asset write-downs, capitalised interest, revenue/profit recognition, hedge effectiveness, going concern, and government grants.

In the full report, we answer five common questions and a set out a reminder of our approach to identify issues and risk, along with potential opportunities

We try to answer the five most common questions we have received from investors and analysts recently:

1. Are there lingering accounting issues for defined benefit (DB) pensions following the liability-driven investment (LDI) issues?
2. Are we past the peak of exceptional items?
3. If a company thought that its cash position was likely to be below expectations how might that be manipulated at year end?
4. Will any non-cash write-downs affect dividends?
5. How do increasing interest rates affect lease accounting under IFRS 16?

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Another set of new reporting challenges

- The 2023 reporting season is likely to provide another new set of challenges
- We think there are a number of accounting issues that may lead to surprises
- In the full note, we answer the five most common accounting questions from investors analysts that we have received recently

The 2023 reporting season will (again) be challenging

We are, again, facing a unique year in financial reporting

In recent years each reporting season has presented accountants, auditors and the users of financial statements (investors and analysts) with a unique set of challenges. We think it is inevitable that the continuing economic and geopolitical uncertainties will, again lead to yet another new set of challenges in the 2023 reporting season. As companies with December 2022 year ends begin to report, we think, therefore, that users and investors need to be mindful of those challenges, and be alert for some accounting issues that may arise as a result.

Although it is not possible to provide an exhaustive list, in this report we set out the key areas that we think either may not have occurred to users of financial statements and/or may need particular consideration by investors. The full note, also looks at five common questions that we have received from investors and analysts in relation to the accounting issues given the current macro environment.

Uncertainty may lead to surprises

Accountants have to have a view of the future…

As we discussed in our previous edition of *The Forensic Lens (3 August 2022)*, modern accounting standards increasingly require accountants to have a view of the future, rather than simply reporting on a historical cost basis. This inevitably adds to the amount of subjectivity and judgement required to present certain numbers within financial statements.

…views of the future that might have been sensible 12 months ago may need to change which would change the accounting

In our previous note we also set out a long list of the individual accounting and financial reporting areas that, we think, investors should be mindful of (or monitor) when considering the impact of the current conditions on company accounting. Below we set out the areas we think are emerging as either the most relevant (or where people may not realise that there is a potential impact), and/or where we have had specific questions.

The key points from our August 2022 report were:

Understand what numbers rely on the future – that's where to start looking for issues

- understanding what numbers rely on a view of the future may point one to areas where one might have to re-examine assumptions;
- identifying whether subjective judgement has been used by management, even subtly, to move numbers closer to the narrative that management wishes to present; and
- selective accounting, even if small, or immaterial, may indicate potential balance sheet stress, or bring forward "bad news" in order to provide a lower starting point for growth and performance metrics.

Dig a little deeper in 2023: reporting areas that may not be fully appreciated

Rising interest and inflation rates

Areas which may have been overlooked

Much has been written about the effect of inflation and interest rates on companies and their financial reporting, enough to run to many technical volumes (including one of our reports). However, from a users' perspective, when attempting to identify issues, we think it more helpful to first consider which numbers in a set of financial statements (and resulting metrics) are likely to rely on a view of the future, rather than getting bogged down in technical detail. However, this is not always straightforward and, based upon our recent conversations, we think that people have either not considered (or not fully considered) certain areas of potential impact, including:

- **Potential write-downs/impairments of long-term assets**;
- **Capitalised interest increases may lead to unforeseen accounting of long-term assets;**
- **Cost of lease obligations may increase**;
- **Revenue and profit recognition**;
- **Asset or liabilities subject to fair value assessment**;
- **Hedges effectiveness** which may be influenced by either interest or inflation rates;
- **Unexpected increases in borrowing costs;**
- We have discussed **DB pension scheme valuations** in detail before but it remains an area where we receive frequent questions. We therefore discuss this further in our questions section in the full note.
- **Provisions may go up or down…**

Going concern assumption and additional audit work

With increased economic uncertainty, we think that there will be enhanced scrutiny by auditors on companies' going concern assessments, liquidity and solvency. In addition, we think that auditors may be particularly sensitive to the subject area as it is probable their work in this area will be subjected to high levels of scrutiny if their audit file is subsequently chosen for review by their regulator (who frequently comment on this audit area as requiring more robust work).

Work on going concern by both companies and auditors tends to be finalised quite late in the audit process (by its nature a company and auditor has to have a view at the signing date). Consequently, any audit issues encountered in this area usually carries with it a risk of delay to results. Where delays do happen, it is often difficult to discern from company releases whether the delay is just procedural or whether there are underlying issues. We think investors should consider planning for what a response to a delay might be, and be in a position to quickly challenge management to fully explain the nature of the delay. We have discussed this, including what audit opinions might be available to an auditor in the event an issue arises in a previous note. Contact your HSBC representative for more details.

Post balance sheet events

As discussed above, accounting may now require a view of the future in some areas, but often the accounting for "post balance sheet events" is often misunderstood. Generally, events after the balance sheet date are not included in the numbers **unless** the event provides more information on something that was already present at the balance sheet date. If a company is pointing to post balance sheet events to explain numbers, we think it wise to consider whether the events referenced meet the criteria to effect the 2022 numbers, or rather should sit in 2023.

Government grants

Several governments have put in place support schemes to assist with the rising costs of energy. Depending upon the nature of the scheme these may be accounted for as government grants (which may require a new accounting policy if a company has not previously received government support). We think that investors should understand how these have been accounted for (i.e. as an income or reduction in expense), whether they have been classified as exceptional/one-off in adjusted earnings and what effect these may have on metrics and reported performance.

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The full note contains a further look at the reporting areas that may not be fully appreciated, answer common questions we received on accounting in 2023 and reiterate our forensic accountant's approach to identifying issues.

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