# KPMG Kundu

## January 2023

## Foreword

Welcome to the first edition of the KPMG Kundu for 2023! As this area becomes increasingly relevant, this month we touch upon the AML/ CTF and its requirements and impact on PNG businesses. Slightly more technical, we reveal in some detail how higher interest rates and inflation may affect the impairment testing of non-financial assets. In terms of compliance, it is noted that the new Investment Promotion (Amendment) Bill 2022 was passed in Parliament on 11 January 2023. In addition, associated with the changes to the IPA's online system, all registered entities are required to re-register by 31 December 2023 or else be struck off.

As a final word, it is recommended to start planning for tax compliance early. While the income tax return deadlines are yet to be confirmed by IRC, these are expected to be 30 June 2023 for 31 December taxable returns and 31 July for 31 December non-taxable returns.

KPMG in PNG has dedicated in-house specialists in all the following areas: internal audit/risk, visa migration, corporate finance, management consulting, IT advisory, fraud investigation as well as tax and assurance. As such we are well placed to provide a truly multi-disciplined approach to business advisory.

Please enjoy this month's Kundu and reach out to us at kmcentee@kpmg.com.au if you would like to see KPMG cover specific topics in future editions.

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## How will higher interest rates and inflation affect the impairment testing of non-financial assets?

### by Terence Mangwiro, Senior Manager, Audit & Assurance Services

**What's the issue?**

In many countries, inflation is at levels not seen in decades driven by persistently high energy costs and rising commodity prices.  This is feeding into rising labour costs and creating expectations of wage inflation.  In response, most central banks are raising interest rates with yields on long-term government bond yields increasing significantly.  Against this macro-economic backdrop, the growth outlook is challenging with slower economic growth negatively impacting earnings forecasts and equity markets.  This outlook raises the prospect for many companies of rising impairments on asset valuations.

For many companies it is highly likely that indicators of impairment exist.  If so, those companies using a discounted cash flow (DCF) model to estimate the recoverable amount of their assets or cash-generating units (CGUs) would need to consider how to reflect the impact of higher inflation and interest rates.  The impacts may be significant e.g. affecting key inputs to the model such as the forecasted revenues, profitability and the discount rate.

**Getting into more detail**

*Valuation – In real or nominal terms?*

Under low inflation conditions, valuations are often performed in nominal terms where the cash flows and discount rate include the effect of inflation. In times of high and unstable inflation (e.g. in hyperinflationary economies), valuations may be performed in real terms where the forecast cash flows and discount rate applied exclude the effect of inflation. The value conclusion should be the same irrespective of whether the valuation is performed in real or in nominal terms. Whichever method is used, the cash flows and the discount rate applied to them need to be determined on a consistent basis. If the cash flows include the effects of general inflation, then the discount rate also includes the effects of inflation and vice versa. This article addresses valuations that are performed in nominal terms.

*Impact on future revenues, costs and profit margins*

When the DCF is prepared on a nominal basis, a good starting point is to consider the impact of inflation on the estimated future costs of materials, services and labour during the forecast period (typically the next five years). The expected level of changes in the costs of materials and services in the forecast period may differ significantly from the general level of inflation in the economy overall. Using inflationary measures such as Consumer Price Index (CPI) and Producer Price Index (PPI) to estimate the change in future costs may not be appropriate.

*Forecasting capital expenditure*

In an inflationary environment, a company's capital expenditure on maintaining property, plant and equipment (PP&E) cannot be assumed to be equal to its depreciation expense. It will exceed depreciation if a company is to maintain its assets in real terms. This is because capital expenditure is based on the current and future prices of PP&E; whereas depreciation expense is based on historical price.

*Impact on the long-term growth rate*

The long-term growth rate is a key input in a DCF calculation as it is used to calculate the terminal value i.e. the value of an asset or a CGU beyond the forecast period. The long-term growth rate comprises the following:

- *Inflationary growth*: In an inflationary economic environment, companies with no real growth should still exhibit growth in cash flows at the rate of the long-term price changes in their products or services and costs.

- *Real growth*: The real long-term growth rate can be positive or negative, depending on the relative strengths or weaknesses and risks associated with the subject asset or CGU.

Distinguishing between real growth and inflationary growth is important when forecasting future cash flows. This is because real growth requires expansionary investment in the business, whereas inflationary growth requires no further cash investment beyond the amount necessary to maintain the company's assets in real terms. When calculating value in use (present value of the future cash flows expected to be derived from an asset or CGU, both from its continuing use and ultimate disposal), IAS 36 *Impairment of Assets* requires a company to use a steady or declining long-term growth rate that is consistent with that of the product, industry or country unless there is clear evidence to suggest another basis. When calculating fair value fewer costs of disposal, the long-term growth rate should reflect a rate that market participants would use in performing the valuation.

*Impact on the discount rate*

DCF calculations are typically very sensitive to even small changes in the discount rate. The current increases in long-term interest rates may have significantly reduced the recoverable amount of assets (e.g. real estate) or CGUs unless cash flow projections have been adjusted upwards. Companies often use the Weighed Average Cost of Capital (WACC) formula as a starting point to estimate the appropriate discount rate when determining enterprise value. The key components of this formula, including the expected long-term future borrowing cost, are affected by changes in the risk-free rate which is generally derived from the yield on government bonds that are in the same currency and have the same or a similar duration as the cash flows of the asset or CGU.

*Disclosure of key assumptions and judgments*

IAS 36 requires disclosure of the key assumptions used to determine the recoverable amount when testing goodwill and intangible assets with an indefinite life for impairment. It also requires sensitivity disclosures if a reasonably possible change in a key assumption would cause the CGU's carrying amount to exceed its recoverable amount. Typically, a DCF calculation is sensitive to small changes in the long-term growth rate and the discount rate. Under IAS 1 *Presentation of Financial Statements*, a company needs to disclose its key assumptions about the future and other major sources of estimation uncertainty at the reporting date that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities in the next financial year. In times of increased economic uncertainty, companies may need to expand their disclosures in the financial statements to include sensitivity disclosures and the key assumptions and judgments made by management. Companies that prepare interim financial statements also need to consider whether to update the IAS 36 disclosures included in their most recent annual financial statements.

**Actions for management**

Accordingly, in times of rising interest rates and heightened uncertainty, management should consider whether:

- there exists any indicators of impairment for the company's non-financial assets or CGUs and, if so, perform the impairment test even if recent impairment tests have shown significant headroom;
- cash flow projections used to calculate recoverable amounts have been updated for the effects of rising inflation and interest rates;
- discount rates and long-term growth rates used in valuations have been updated;
- the assumptions used in projecting cash flows and the discount rate are consistent;
- changes are required to the useful lives and/or residual values of assets tested for impairment (or for which indicators of impairment exist); and
- disclosure of key assumptions and judgments is provided as required under IAS 1 and IAS 36.

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## AML/ CTF - its requirements and impact on PNG businesses
### by Giann Carlo Marquez, Certified Fraud Examiner (CFE), Manager, Advisory

The threat of global money laundering and terrorism remains substantial and has led international organizations and different countries, including Papua New Guinea (PNG), to be more stringent in the application and enforcement of anti-money laundering and counter-terrorist financing (AML/ CTF) framework and regulations in their respective jurisdictions.

Money laundering is the disguise of the existence, nature, source, control, beneficial ownership, location, and disposition of property derived from criminal activity. It is the overall process of making earnings and assets from illegal activities appear legitimate. Terrorist financing refers to aiding terrorist groups through funding such groups to support their activities.

Through the Anti-Money Laundering and Counter-Terrorist Financing Act of 2015 (the Act), PNG introduced a robust regulatory framework consistent with the Financial Action Task Force standards to prevent money laundering and terrorist financing. The Act established the Financial Analysis and Supervision Unit (FASU), an operationally independent financial intelligence unit within the Bank of PNG. Under the Act, FASU collects, analyses, and disseminates financial intelligence for investigative purposes. FASU also supervises Financial Institutions and Designated Non-Financial Businesses and Professions (DNFBP) for compliance with their obligations under the Act.

Financial institutions and DNFBPs that are registered with FASU are expected to have their money laundering, risk assessment, and AML/ CTF Programs in place.

The Act applies to the following:

| Financial Institutions | Designated Non-Financial Business or Professions (DNFBP) |
|---|---|
| 1. Commercial banks | 1. Real estate agents |
| 2. Foreign subsidiaries of banks | 2. Motor vehicle dealerships |
| 3. Savings and loan societies, microbanks, micro-finance companies | 3. Dealers in precious metals |
| 4. Life insurance, general insurance | 4. Dealers in precious stones |
| 5. Superannuation funds | 5. Legal firms |
| 6. Investment banks | 6. Notary public or other independent legal professionals |
| 7. Mortgage companies, finance companies | 7. Trusts or service providers |
| 8. Money remitting services, money changers | 8. Accounting firms |

**AML/ CTF program**

Financial institutions and DNFBPs must develop, adopt, and maintain an AML/ CTF program that reflects their business circumstances. The AML/ CTF program needs to set out how businesses will comply with their AML/ CTF obligations and identify, mitigate, and manage money laundering and terrorist financing risks.

The following are a few of the key requirements within the AML/ CTF Act:

1. Complete a money laundering/terrorist financing risk assessment of the business
2. Design and adopt an AML/CTF risk awareness training program which includes providing relevant and appropriate training to employees on an initial and ongoing basis
3. Design and adopt an employee due diligence program
4. Formally adopt the AML/CTF program and subject it to ongoing oversight by the management and the Board
5. Appoint an AML/CTF compliance officer
6. Subject the AML/CTF program to independent reviews
7. Describe procedures for responding to FASU
8. Describe reporting procedures (threshold transaction reporting, international electronic funds transfer reporting, and Suspicious Matter Reporting)
9. Set out procedures for maintaining FASU registration
10. Set out procedures for ongoing customer due diligence, including transactions monitoring and enhanced customer due diligence program
11. Keeping records in a way that is auditable and retrievable
12. Set out procedures for collecting and verifying know your customer (KYC) information

As FASU does carry out assessments it is important that all entities falling within the activity categories above are proactively complying with the AML/ CTF Act. Failure to comply can have serious consequences.

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## The New IPA Amendment Bill 2022 passed

The new Investment Promotion (Amendment) Bill 2022 was passed in Parliament on 11 January 2023. The new Act reforms the laws relating to foreign investment certification and promotes micro, small and medium enterprises. Key changes include:

- Changing the foreign certification system to process applications quickly and automatically reject applications for reserved activities to support SMEs
- Reviewing the reserved activities list every 3 years
- Introducing more reporting obligations on foreign investors
- Improving IPA's enforcement and compliance and
- Creating a dedicated Registrar of Foreign Investment to oversee the system

The new Act is yet to be certified by the Speaker and a copy is yet to be made available. Also passed was the Association Incorporation Act 2022 which is expected to ensure PNG's compliance with anti-money laundering obligations and effect change in the internal governance and transparency of incorporated associations.

## Companies Office re-registration

As mentioned in previous editions the Registrar of Companies and Investment Promotion Authority have undergone significant amendments to their online filing system. As part of this process, all registered entities are required to re-register by 31 December 2023 or else be struck off. Therefore, these re-registrations must be done in a timely manner to avoid strike off and to ensure lodgments can be done on time.

## IRC income tax returns – why prepare early?

A new year brings with it a new round of income tax return deadlines to be met. While the income tax return deadlines are yet to be confirmed by IRC, these are expected to be 30 June 2023 for 31 December taxable returns and 31 July for 31 December non-taxable returns. We strongly recommend that taxpayers start planning now to meet these deadlines as taxpayers should not expect deadline extensions to be granted by IRC.

There are significant benefits to preparing your tax return early including:

- Early lodgment of refundable returns means quicker access to refund credits.
- Knowing your tax liability in advance means more time to plan for the payment of tax liabilities.
- Early preparation allows more time for detailed review and consideration of tax planning options.
- Less chance of late lodgment and risk of penalties.
- Early lodgment can be particularly helpful where taxable profits are falling as IRC will consequently automatically re-assess the taxpayer's provisional tax downwards meaning less cash outflow during 2023.

Also, with one of the provisional tax deadlines falling in July, some taxpayers have had a nasty surprise in the past when their balance of income tax and provisional tax liabilities fall due together, particularly where taxable profits have increased.

## 13th Prime Minister's Back to Business Breakfast

The 13th Prime Minister's Back to Business Breakfast will be held on 1 February at the Hilton Hotel. Keep an eye out for the update from this event in our next edition.

## Our social media presence

As usual, you may access our regular multi-disciplined thought leadership pieces, newsletters, and updates on our KPMG PNG LinkedIn page. Also, connect via our webpage www.kpmg.com.pg and Facebook https://www.facebook.com/pngkpmg/.

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