جهاز أبوظبي للمحاسبة
ABU DHABI ACCOUNTABILITY AUTHORITY

ADAA IFRS digest

IFRS news, updates from ADAA, IASB and the Accounting Profession **September 2017**

WHAT'S NEW THIS MONTH

ADAA's hot topics

Materiality guidance. Making Materiality Judgements.
ADAA Resolution no 1 of 2017 Effectiveness testing of Internal Control must be included in the scope of audit services.
PWC's IFRS news. In this issue IAS 8, IFRS 13 and 16 and ***EY's*** latest 120 page IFRS 16 leases publication.

Financial statements are not the source of all wisdom for investors. Keep calm and carry on.
KPMG's IFRS Blog focuses on IFRS 15.
Deloitte's IAS Plus website comments real time on a wide range of sources of IFRS related activities August 2017 they report on professional skepticism.
And on the back page ***testing the effectiveness of internal controls*** an insight from ADAA's Hana Al Harati.

WHAT'S NEW FROM IFAC AND THE IASB

The IASB is located in Cannon Street, London

Materiality guidance. In July ADAA published Materiality Matters. In September the IASB publishes Making Materiality Judgements. Singing from the same hymn sheet. The definition of materiality remains largely the same. Emphasis is placed on:

- Not obscuring information.
- Information considered material (even if the amount is immaterial) if it could reasonably be expected to influence.
- Needs of primary users of financial statements, not all.
- Nature and magnitude more relevant than size and nature.

Financial statements are not the source of all wisdom for investors. Tesla, launched in 2010, has burnt USD 7 billion of cash and makes no profits and yet it has a value greater than General Motors even though GM sells more than 100 times more cars than Tesla and does so profitably. This doesn't mean Tesla's financial statements are useless. More likely that the intangibles are not captured in the balance sheet. Financial statements are a reality check based on historic events. It may be Tesla will deliver dividends to shareholders. Current investors do but the information to support that conclusion is not in the financial statements. Is IFRS under threat? No argues Hans Hoogervorst keep calm and carry on IFRS is the best and most comparable source of information for investors.

WHAT'S NEW FROM THE ACCOUNTING PROFESSION

ADAA Effectiveness testing of Internal Control. Resolution No 1 of 2017 published in the Official Gazette requires Subject Entities to ensure that the scope of audit services provided by the Statutory Auditor includes testing the effectiveness of internal control systems. This will be a significant change for some Subject Entities because ISA 330 only requires testing of the effectiveness of internal controls if the auditor is to rely on the controls, or if substantive audit procedures by themselves are not enough.

PWC's IFRS news. In this issue:

- Four new standards come into effect between 2018 and 2021. Investors do not like uncertainty and will try to fill any gaps in information. Companies should ensure they provide the required information and do not let the market guess.
- IFRS 13 gets a health check. Level 3 disclosures are filled with boiler plate generic information. Measuring quoted investments is a unit of account question. Highest and best use might not be current use, so which do you use?
- Leases lab deals with variable lease payments. Variable payments based on an index or rate are remeasured when the index or rate moves. Variable payments not based on an index or rate, are excluded if they are genuinely avoidable. Variable payments that are in substance fixed payments are included because they are, in substance not avoidable from the perspective of the lessee. More here. And EY's 120 page publication here.

KPMG's IFRS Blog focuses on IFRS 15.
"If you have long term contracts or are recognizing revenue over time I strongly advise you to check you have a legally enforceable right for payment for your performance to date. If not, you're likely to need to record your revenue at a point in time rather than over time – most likely only once the contract is completed."
Other issues:

- If you are recognizing profit for services on a blended margin basis you very likely have to separate those services and profit recognition will not be smoothed.
- Business unit heads need to revisit performance measurement KPIs if revenue recognition changes.
- Contract changes with customers may also be required. Read KPMG's ten questions to ask here.

Deloitte's IAS Plus website comments in real time on a wide range of sources of IFRS related activities. In August 2017 they report the IAASB, IAESB and IESBA have come together and published Toward Enhanced Professional Skepticism.pdf. Perhaps as regulators we are a little too skeptical we have read the document and see not very much that is new. For sure if you don't understand the business and are not conscious of the factors that influence you, your professional skepticism will be diminished. It seems ironic the IFAC Boards should publish their views as events unfortunately unravel in South Africa where a lack of professional skepticism is reportedly to blame.

And finally please turn the page for ADAA's monthly accounting insight…

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Testing the effectiveness of internal controls – an insight from ADAA's Hanan Al Harati

It matters not if you are a big company, a small company, a profit orientated entity or a public sector entity, there are only two ways for your auditor to approach their work:

- One is to rely on your system of internal controls.
- The other is to not.

The first approach requires experienced auditors who understand your business and can compare and contrast your system of internal controls with their other clients and advise you how to improve. The second does not. Inexperienced auditors simply substantively test large samples back to source documentation. Otherwise known in the trade as ticking and bashing!

Truth is since the introduction of computer based accounting systems in the last millenium no audit is wholly substantive. The comptometer lady a legend of the past that only the oldest auditor will recall. Today's auditors are millennials, hard wired, cell phone savvy, permanently plugged to social media. Why would a millennial whose daily feeds rely on internal controls of the internet giants and fellow tweeters, not choose to rely on your system of internal controls?

The answer is ISA 315 and ISA 330

ISA 315 requires the auditor to understand the controls relevant to the audit, evaluate the design of those controls assess and perform an audit procedure other than just inquiry on those controls.

ISA 330 only requires the auditor to test internal controls if the auditor intends to rely on them or if substantive testing alone does not provide sufficient and appropriate audit evidence.

ISA 330 is thus a two part test of what to do, and is it enough, both of which the auditor will say are matters of professional judgement.

In the 1970's the then President of the ICAEW (Lord Benson) formed what was a precursor to the International Auditing and Assurance Standards Board, the Board that now sets the ISAs. The reason for Lord Benson's action was because in the 1970s attending the inventory count was a matter of professional judgement. He thought attendance should be mandatory. His intervention led to the mandatory attendance of the auditor at the inventory count being embedded in ISA 501 paragraph 4.

We think assessing and testing the effectiveness of internal controls should be mandatory.

Which requires a framework to compare your internal controls with. While ISA 315 (Revised) is framework neutral, the standard is influenced by the COSO Internal Control–Integrated Framework (1992).

COSO (The Committee of Sponsoring Organizations of the Treadway Commission) was formed in 1985 by the American Accounting Association, the American Institute of CPAs, Financial Executives International, the Institute of Management Accountants, and the Institute of Internal Auditors.

COSO defines internal control as *'a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance of the achievement of objectives in:*

- *Effectiveness and efficiency of operations.*
- *Reliability of financial reporting, and*
- *Compliance with laws and regulations.'*

COSO identifies five components and seventeen steps:

Control Environment

The control environment sets the tone. A weak control environment will inevitably result in weak internal controls.

1) Demonstration of a commitment to integrity and ethical values.

This isn't addressed by communicating a values statement to employees, it requires both words and deeds. Evidence of training and testing and of how unethical actions and integrity breaches have been dealt with in the past.

2) The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control.

Ask does the Board and Audit Committee thoroughly test the assertions of management or are they a rubber stamp? It is not wrong to trust management. It is not wrong to ask them to verify their assertions too. This requires detailed minutes of meetings and retention of documents presented and follow up actions evidenced.

3) Management establishes with Board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.

Assessment requires consideration of roles and responsibilities, levels of authority. Are they appropriate and are they enforced.

4) The organisation demonstrates a commitment to attract, develop and retain competent individuals in alignment with objectives.

Assessment of recruitment activities, performance appraisal systems and rewards may all feature.

5) The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives.

This requires evidence to demonstrate there are processes in place to hold employees accountable for their actions in fulfilling their objectives. What are the consequences of not doing so? What has happened in the past?

Risk Assessment

6) The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives.

These are indirect controls related to the identification of relevant risks to the organization which may lead to an identification of inconsistent or missing objectives. Grouping of objectives into categories supports risk assessment.

7) The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed.

The achievement of step seven depends on the proper execution of step six. In applying step seven, the following questions must be answered:

- What are the risks of achieving the objectives identified in step six across the different levels of the entity?
- What is the likelihood of a specific risk occurring, how severe could it be, how quickly could it affect the entity and for how long?
- In the event of an occurrence, how will management respond? Is it through acceptance, avoidance, reduction or sharing risk?

8) What is the potential for fraud in assessing risks to the achievement of objectives.

Some organizations perform a fraud risk assessment separate and apart from the risk assessment of the business. This is a mistake.

9) The organization identifies and assesses changes that could significantly affect the system of internal control.

Organizations that do not do this formally risk their control environment becoming outdated. Given the nature of the ever-changing business environment, key stakeholders may wonder if the frequency of risk update is appropriate.

Control Activities

10) The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.

Some see control activities as “necessary evils” rather than what they truly are = an effective way to make sure objectives set are achieved or, at the very least, provide an early warning of not achieving, enabling managers to react accordingly.

11) The organization selects and develops general control activities over technology to support the achievement of objectives.

Even though technology works to a high level of accuracy, outputs are based on inputs. Rubbish in results in rubbish out. Therefore there is just as much need to place controls around electronic business processes as there is over the manual/people operated processes. Effective segregation of duties is vital.

12) The organization deploys control activities through policies that establish what is expected and procedures that put policies into action.

This requires developing and documenting clear and accessible policies and procedures. Deploying control activities through business units or functional leaders, and Internal Audit conducting regular and ad hoc assessment and reporting of control activities.

Information & Communication

13) The organization obtains or generates and uses relevant, quality information to support the functioning of internal control.

This requires ongoing training and accumulation of technical knowledge of how to leverage information technology to provide more useful, more comprehensive information to aid the functioning of internal control. Understanding current and developing technologies is part of the toolkit to maintain relevance. It requires ownership and being a catalyst to help your organization leverage compliance.

14) The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control.

Information must be properly communicated and cascaded to the appropriate persons. It has to be carried out in the right manner and at the appropriate time. The use of separate reporting lines is necessary for a Whistle Blowing program to function optimally. Is this happening in your organization? A question that necessities an honest answer.

15) The organization communicates with external parties regarding matters affecting the functioning of internal control.

We only know what we know. Utilising third parties facilitates knowing what they know. Opening up oneself to third party scrutiny increases accountability and identifies areas to improve. Gathering information and not taking appropriate action is worse than not gathering the information at all. Especially if a scandal arises along with the perception that somebody should have known because the information was available.

Monitoring Activities

16) The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.

Why was Sarbanes Oxley such a “tough sell”? Maybe because it forced responsibility and accountability, which many resisted. If internal control activities are important enough to spend the time, why resist formalizing them which improves consistency? Formalizing monitoring controls improves the control environment and provides a more efficient and effective oversight function.

17) The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.

Reporting deficiencies noted in “ongoing evaluations” is an important aspect of a healthy internal control process. This does not apply to a routine mistake but rather a weakness noted in controls design upon review. Deficiencies identified by ongoing evaluations should not be swept away but formally logged, reported and remediated. Reporting level depends on the severity of the issues as dictated by guidelines discussed above.

Concluding thoughts

An effective system of Internal control can prevent poor judgments and poor decisions from being honestly made.

An effective system of internal control can prevent fraud. It can’t prevent all forms of fraud. Collusion can bypass segregation of duty controls. However, monitoring controls should pick this up.

An effective system of internal control will not prevent external events from conspiring to cause an organization to fail. However, it will detect when it is happening and provide time for remediate actions.

Having an effective system of internal control in place is like having a smoke alarm it won’t prevent fire but it will tell you when it is happening so you can do something about it.

Internal Audit, Audit Committees, Non-Executive directors, Executive directors, Heads of business unit functions down to the most junior employees all have a role to play.

Advice on control deficiencies and breakdown in internal controls can come from many sources, internal and external. Suppliers, customers, investors, regulators. Whilstle blowers come from many sources. It makes sense to use them all.

ISA 315 requires the external auditor to make enquiries of internal audit function about their work at the financial statement audit assertion level.

ISA 600 requires the component auditor to communicate to the group engagement team any identified significant deficiencies in internal control at the component level.

ISA 265 requires the external auditor to communicate deficiencies in internal control to management and those charged with governance.

If your auditor is not assessing and testing the effectiveness of your system of internal controls your audit service may provide the right answer (a clean audit opinion) but did you get the best value from it?

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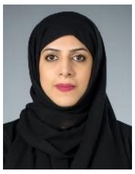
ADAA EDITORIAL TEAM


Sara Al Sajwani


Hasina Al Adawi


Hanan Al Harati


Amna Huwail


Ebrahim Al Shaikhali


Dawood Al Hammadi


Mahmoud Shahin


Ahmed Al Mazrouei


Richard Wright


Steven Ralls
Head of Accounting and Auditing Standards
AASD@adaa.abudhabi.ae

Property of:

Abu Dhabi Accountability Authority Hamdan Street, Falcon Tower, Abu Dhabi,
P.O. Box: 435 - Phone: +971 2 639 2200 Fax: +971 2 633 4122

www.adaa.abudhabi.ae