ADAA digest

IFRS news, updates from ADAA, IASB and the Accounting Profession

February 2018

WHAT'S NEW THIS MONTH

ADAA's hot topics

Transparency, accountability, efficiency. Why IFRS must not be played with.

Must know US Tax reform – accounting under IFRS.
IFRS IC decision on interest and penalties related to tax.
IFRS Blog: Accounting for Crytocurrency.

ESMA issued MIFID ii why you should be interested.

And on the back page ***The second of the COSO five - Risk assessment*** an insight from ADAA's Mahmoud shahin

WHAT'S NEW FROM IFAC AND THE IASB

The IASB is located in Cannon Street, London

Transparency, accountability, efficiency. Why IFRS must not be played with.

- IFRS brings transparency by enhancing the international comparability and quality of financial information enabling investors to make informed economic decisions.
- IFRS strengthens accountability by reducing the information gap between capital providers and the people to whom they have entrusted their money.
- IFRS contributes to economic efficiency by helping investors to identify opportunities and risks across the world. *"Accounting is as much of an art as a science, there is obviously a lot of room for differences of opinion on what is economic reality and how best to reflect in accounting. Consequently, accounting is subject to a lot of genuine, healthy intellectual debate. However, there are also less noble motives for debate. There is big interest at stake in accounting. Remuneration and reputations are often closely linked to profit so there is incentive for standards that help to manage earnings…"*

Transparency, accountability and efficiency foster trust, growth and long-term financial stability in the global economy. Even for people who never look at financial reports, it is important that accounting standards lead to financial reporting that is both informative and trustworthy. Yes, there will always be charlatans that come and go (eventually to be locked up) who will play games with the evidence to support their desired accounting outcome. To reward themselves with bonuses, dividends, and grandeur they should not. There will be real economic booms and busts as capital flows to the most attractive markets and technology disrupts. This is natural and to be expected. IFRS (and IPSAS) brings transparency and enables prudential regulators to know when to intervene. Problems buried deeply within a company's balance sheet are made visible by high quality accounting. In the long run cash is king. If a profit does not become cash, maybe it was never a profit at all. More here. And here.

WHAT'S NEW FROM THE ACCOUNTING PROFESSION

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

Must know US Tax reform – accounting under IFRS. US federal tax rate reduced from 35% to 21% effective 1 January 2018 has an immediate impact of deferred tax assets and liabilities that will reverse. Alternative Minimum Tax (AMT) repealed – previously unrecognized deferred tax assets may now be recognised. Net Operating Losses (NOLs) can be carried forward indefinitely. 100% deduction for certain capex placed in service after 27 September 2017. Territorial tax regime change provides 100% dividend relieve when repatriating foreign earnings, and that's not all!
IFRS IC decision on interest and penalties related to tax. Do you apply IAS 37 or IAS 12 when accounting for interest and penalties as part an overall settlement with the tax authority?
IFRS Blog: Accounting for Crytocurrency. It's not legal tender, it's not a cash equivalent, it's not a contractual right to receive cash. No it's a Bitcoin! Maybe its inventory so held at cost. But its value moves with the market. So maybe it's an intangible asset, but then changes in value go through OCI. Accounting for Bitcoins at fair value with changes in value through the P&L would provide the most useful information but current accounting rules prevent. More on these three PWC IFRS news.

ESMA issued MIFID ii why you should be interested.

Markets in Financial Instruments Directives (MIFID ii) will bring about fundamental changes to distribution of wealth and asset management products and services in the EU. The MIFID ii has 5 core measures:

1. External controls/reporting
2. Internal controls/governance
3. Investor protection
4. Market structure
5. Market transparency

The impacts investors might feel will come from increased regulatory and client reporting requirements for all asset classes and a potential ban or limitation of marketing to retail customers. So some bonds previously sold to retail could be sold again.

The above measures will be applied to all financial instruments transacted on EU trading venues with new pre & post trade transparency rules. It should lead firms to be more systematic in obtaining the best possible results for customers. With enhancedd record keeping & audit/reference trail requirements.

More here Bloomberg and EY showing effect on governance of stakeholders regarding compliance, diversity, and effect on access by third country firms.

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The second of the COSO five - Risk assessment, an insight from ADAA's Mahmoud Shahin

ADAA IFRS Digest September 2017 reports the importance of testing effectiveness of internal controls in an audit of financial statements.

Decree number 1 of 2017 requires ADAA Subject Entities to obtain as part of the audit services a separate report on the effectiveness of their system of internal control. This involves assessing design and testing the application of the internal control system. To assess the design, it has to be assessed against something. ISA 315.14 onwards includes something. It includes a framework, based on COSO. In ADAA IFRS Digest December 2017 we reported on the Control Environment. In this publication we report on Risk Assessment.

Although the auditor is required to report it should not be forgotten that management is responsible for their financial statements and management is responsible for the design and effectiveness of their system of internal control.

Internal Audit is a key tool for management in assessing internal controls. COSO has many useful tools and publications available on their website, some of which are utilized in preparing this publication.

The five components of Internal Control:

- Control Environment
- **Risk Assessment**
- Control Activities
- Information and Communication
- Monitoring Activities

Component Two – Risk Assessment

Risk assessment is about prioritizing and measuring risk within predefined parameters so that risks are not over or under managed. There are four principles (of seventeen COSO principles) for the risk assessment component starting at six:

6) Specify organizational objectives with sufficient clarity to enable identification and assessment of risk relating to objectives.

It may seem obvious to assess the risk of not achieving performance, one has to identify what performance is expected. However, how often do you agree objectives for your performance?

Financial outcomes do not emanate from the Finance department, that is where they end up. Financial outcomes emanate from Operations. It doesn't matter whether you are a Public Sector Entity (PSE) delivering roads and parking services, or a Government Business Enterprise (GBE) delivering water, electricity, oil, aircraft passenger services, or a Sovereign Wealth Fund investing to achieve capital growth. All entities have a raison d'etre and they want to be the best at it.

Let's start with parking services.

Is the objective to have parking spaces available when a person wishes to park? Or to maximize revenue from parking spaces? Two competing performance objectives which drive different behaviour. Both require measurement of utility and quantity but then drive different operational decisions.

To maximize availability, increase the number of spaces and keep increasing spaces until there are spaces available. It's a nice idea but in a city where space is limited so are parking spaces.

To maximize revenue, limit the number of spaces and increase prices and keep increasing prices until there is no space available.

But then increasing prices causes people not to pay, so then ticket inspectors will be required. The number of which requires consideration of the price of a ticket compared to a fine and any inconvenience factor in paying the fine, which requires assessment of collectability and of enforcing collectability, and it includes assessment of the cost of a ticket inspector and their efficiency, which includes assessment of the technology used from camera's to ticket machines, to transport.

So was it better when there was no paid parking? No it was much worse, there were cars parked everywhere!

What we have highlighted is that clarity on the entity's objectives drives objective decisions in operations, performance of which needs to be measured and assessed to improve operational decisions to improve the likelihood of achieving the entity's objectives.

In COSO speak Operations objectives:

- Reflect management's choices
- Considers tolerance for risk
- Includes operations and financial performance and goals
- Forms a basis for committing resources

Operational objectives drive internal, external, financial, non-financial and compliance reporting objectives.

7) Identify risks to achievement of objectives across the entity and analyze as a basis for determining how the risks should be managed.

The risks of not maximizing revenue include:

- Customers not being able to purchase tickets. Response multiple payment options that work; phones, ticket machines. Regular maintenance of machines. Exception and trend reporting.
- Not knowing when spaces are used. Response: data gathering of times and locations. It's easy in a carpark that has a green light that turns red when occupied. It's a lot less easy on the street when people pay by phone and location is not known.
- Not knowing if ticket inspectors are being effective. What to do? Measure number of tickets inspected, or number of steps walked per inspector, or number of fines issued?
- Government changes which reduces cars on roads. E.g. toll stations, congestion charging, clean air legislation. Each risk requires a response - accept, avoid, reduce, share.

The 2013 Framework, with its emphasis on organizational objectives, puts a greater weight on entity-level risk.

8) Consider potential of fraud in assessing risks to achievement of objectives

There are two type of fraud: loss or leakage of cash (or other assets) and fraudulent reporting.

It is unlikely given the relative insignificance of parking charges a material loss of cash could occur from the revenue side. However, revenue is not normally where cash fraud is found. Revenue is much more susceptible to fraudulent reporting. Deloitte sample listing of fraud schemes.pdf It may be a 2009 publication but it is still relevant today. It is quite easy to book a sale early or wrap up a discount as an expense. It is quite simple to bounce debts around the sales ledger and re-age them, or hide them between subsidiaries in a consolidation.

Cash fraud is more difficult, often it requires collusion and it is likely found in payments, to a supplier not on an approved list, or to a supplier with a side agreement.

Fraud requires three things: Pressure, opportunity and rationalization. Normal people do not normally commit fraud. But if pressure comes from the top, to make the results look as good as possible (and there are too many examples to state) and there is opportunity to stretch assumptions, to push a valuation, or not book a provision, stretch the audit evidence, to keep my job, to do what the leadership wants, they know so why not. Then you have conditions for fraud.

What surprises the most is with hindsight spotting fraud is easy. So why was it not discovered at the time? The most often cited reason is because thinking it, was not thinkable.

9) Identify and assess changes that could significantly impact the system of internal control.

Change is inevitable. Stroll down the Corniche. Abu Dhabi is the change management capital of the world.

Change comes from three areas:

The external environment – from changes in the economy, changes in regulation, changes in the physical environment.

The internal environment – changes in people, processes and systems. New people bring new approaches. New processes and systems bring new ways of working. When either one of these three changes happen there is propensity for things to go wrong.

Leadership – A change in leadership brings change. A new business model. A new approach to acquisitions or divestments. A new approach to technology.

Final thoughts

Some say: the requirement for an assessment of internal control is a new thing.

Some say: the requirement for an internal control framework is a new thing.

Some say: a substantive audit approach is most cost effective.

ISA 315 only requires the auditor to *"identify and assess the risks of material misstatement…through understanding the entity and its environment, including the entity's internal control"* What constitutes an 'understanding' can be a very nebulous thing.

ISA 330 only requires the auditor to "*design and perform tests of controls to obtain sufficient, appropriate audit evidence as to the operating effectiveness of relevant controls if the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively…or substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level."*

Management do not rely on a third party valuation in making a keep, sell or purchase decision. Management do not rely on a customer confirmation in assessing credit risk. Management do not rely on the audit report of a subsidiary auditor to tell them what is wrong. Management do not rely on substantive audit procedures.

Management relies on management information to make management decisions. Management relies on high quality accurate budgeting and forecasts based on historical and market trends. Management relies on informed, careful management and an ongoing analysis of actual incomes and spends. Management relies on a full and detailed assessment of risks and thought through responses that they could apply.

Management relies on:

- Setting the right Control Environment including tone from the top.
- Performing an insightful Risk Assessment and developing appropriate responses to risk.
- Implementing appropriate control activities.
- Gathering appropriate information and communicating it.
- Applying appropriate monitoring activities.

Management relies on the Socratic approach of COSO of asking what's not right and could be better. Should your auditor not do so too?

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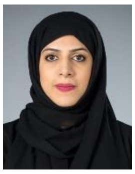

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