ADAA IFRS digest

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

January 2019

WHAT’S NEW THIS MONTH

ADAA’s hot topics

Are we ready for the next crisis? Hans addresses Washington DC.

ESMA’s enforcement priorities. Changes in IFRS expected to be embedded within companies’ 2018 annual reports.

What to expect during the new year? News from the IASB and FASB.

New lease accounting is now effective; who is ready?

Correcting the audit market; the need for major change.

IASB amends definition of business in IFRS 3. Current guidance is too complex.

Board Matters Quarterly.

Financial Analysis. Unlocking real value.

And on the back page Accounting Estimates, an insight from ADAA’s Richard Wright.

WHAT’S NEW FROM IFAC AND THE IASB

Are we ready for the next crisis? Chair of the IASB Hans Hoogervorst is concerned at the growth in global debt - 269% at the outbreak of the financial crisis, to 318% now. The main drivers being public and corporate debt. Is the global economy in a classic debt trap? Debt is high because interest rates are low and interest rates are low because debt is high. Hans does not foresee an orderly repayment and wonders if the new expected loss model in IFRS 9 could make matters worse if overly pessimistic economic expectations are applied during a recession. He thinks not. His impression is IFRS 9 has contributed to overly optimistic economic expectations.

ESMA’s enforcement priorities. The enforcement priorities for IFRS financial statements are:

• IFRS 15 – Identification and satisfaction of performance obligations, disaggregation of revenue and the disclosure of significant judgements related to recognition of revenue. For credit institutions the application of the new credit loss model (ECL) and in particular careful consideration and disclosure of significant inputs used in the assessment of a significant increase in credit and in the determination of ECL.

• IFRS 16 – the publication of financial statements will happen after the entry into effect of IFRS 16 and issuers should be to disclose the expected impact. More here.

IASB amends definition of business in IFRS 3. Current guidance considered too complex, resulting in too many transactions deemed business combinations. The definition ‘outputs’ is narrowed to focus on goods and services provided to customers, generating investment income, and other income, and excludes returns in the form of lower costs, and other economic benefits. The changes will likely result in more transactions being deemed asset acquisitions particularly in real estate, pharmaceutical, and oil and gas industries. Differences in accounting between business combinations and asset acquisitions include, goodwill, contingent consideration, transaction costs, and deferred taxes. More here.

WHAT’S NEW FROM THE ACCOUNTING PROFESSION

What to expect during the new year? New amendment proposals from the IASB and the FASB are on the way.

1. IAS 37: costs to fulfill a contract are those “directly related” to a contract, which excludes G&A. Illustrative examples here.

2. Goodwill: amortize over 10 years, or test for impairment? In addition to new items to be included in goodwill.

New lease accounting is now effective; who is ready? Survey shows an increase in companies’ implementation costs over the last year. 42% of companies in the Americas and EMEA were in the process of implementing a new lease accounting system, a project that will take 6 months. The most challenging part is ensuring completeness of the leases population, especially significant ones that reside inside larger service, or supply contracts. More here.

Correcting the audit market. A study by the UK Competition and Markets Authority thinks audit market is diluted because:

• Although reporting is to shareholders, companies select and pay their own auditors. This must affect cost and quality for some.

• The selection of the auditor is an audit committee role, however the tender criteria for the audit is set by management.

• Introducing the mandatory tendering of the audit after 10 years has increased a change of auditor more frequently. However, the change has been within the large four audit firms and has not increased competition.

• The audit market is perceived to be and maybe is inefficient because competition and regulation are not aligned to achieve high quality audits. Remedies suggested include:

  1. Regulatory scrutiny of auditor appointment and management.

  2. Mandatory joint audits with challenger audit firms (outside the big four) to increase competition.

  3. A structural split between audit and advisory services.

  4. Peer reviews to keep quality levels more visible. More including comment letters from the audit firms here and the Kingman report here pdf.

Board Matters Quarterly. Topics considered:

• The board’s role in confronting crisis. What provides effective oversight?

• Cybersecurity disclosure benchmarking. More focus on corporate disclosure due to complexity of the interconnected business ecosystem.

• Improving board performance through effective evaluation. To enhance their effectiveness and address stakeholder interests.

• Today’s independent board leadership landscape. Views on best practice vary. See EU’s publication here.

Financial Analysis. Unlocking real value. To present real value to the shareholders, their motives for investing need to be understood. Real value comes from the ability to assess information beyond the numbers, from the answers revealed from questioning and analyzing the statements, benchmarking and peer review. Read GT’s whitepaper in collaboration with ACCA here.
ACCOUNTING ESTIMATES, AN INSIGHT FROM ADAA’S RICHARD WRIGHT

BACKGROUND

The IASB receives all the glory and accolades in the accounting world. And whilst the focus in 2019 is naturally on implementing the new shiny accounting standards: IFRS 15 and 16, there standing in the background, quietly, and unnoticed, are the wall flowers, the IAASB.

The International Auditing & Assurance Standards Board (IAASB) doesn’t receive the global interest and attention that the IASB does. Which is a shame, because the work it does, is just as important, if not more, than the work of the IASB. Because although accounting standards tell the bean counters what to do, the standards are by their nature subjective. They will invariably be wrong. They are imprecise. The application of judgement introduces the possibility of bias.

It is a few years since the IAASB kicked off their project on quality improvements and although much of it is still work in progress, the IAASB issued a new ISA effective for 2019 on Accounting Estimates. It sounds boring but it is not. Estimates are by their nature subjective. They will invariably be wrong. They are imprecise. The application of judgement introduces the possibility of bias.

We have in the office Ferrari fans and Mercedes fans and the championship has swung between the two during the season with Louis Hamilton eventually topping out the 2018 Formula 1 as a five-time world champion with 408 points compared to Sebastian Vettel’s 320 points. During the season various predictions of points and winner have been proposed, each backed up with historic data overlaid, sensibly onto current performance. However, a difference of 88 points, or more than three race wins or DNFs, was never one of the estimations made.

Old ISA 540 was issued in 2008 as part of the IAASB’s clarity project. It was designed to enhance the rigor applied to auditing accounting estimates, including fair values, and required the auditor to focus attention on areas of higher risk, accounting judgment, and possible bias, thereby assisting the auditor to form appropriate conclusions about the reasonableness of such estimates.

SO WHY CHANGE?

Because accounting estimates and related disclosures have become much more complex and can have a material impact on financial statements and dividends:

- Valuation of financial instruments
- Intangibles
- Investment Property
- Environmental clauses requiring provisions
- Litigation provisions

New ISA 540 is also a response to new provisions in: IFRS 9 to report expected credit losses. IFRS 17 Insurance Contracts for IBNR. IFRS 15 for estimates in achieving revenue over time. And IFRS 16 in estimating lease term and payments.

The latest IIFIAR inspection survey continues to indicate the most pervasive inspection finding for audits, relates to auditing accounting estimates.

Auditors sometimes have to make choices when assessing the reasonableness of assumptions, performing risk assessment procedures, testing the accuracy of data used, or taking relevant variables into account.

Other factors such as confirmation bias - the fundamental human urge to “search for, interpret, favor, and recall information in a way that confirms one’s pre-existing beliefs or hypotheses” 

Or it may also be due to a lack of professional skepticism. In an audit with tight reporting deadlines it is subconsciously easier to rationalize and accept management’s position, than chase down empty rabbit holes looking for evidence that may not exist that challenges management’s position.

Lastly, the new Key Audit Matters reporting for listed entities has increased the interest in audit procedures applied and their results and the disclosure of estimates in financial statements.

WHAT ARE THE KEY ENHANCEMENTS TO ISA 540?

- Explicitly recognized the spectrum of inherent risk, building on existing concepts in ISA 200, 315, 330 to drive scalability. Emphasis on doing less when risks are low and doing more when risks are high.
- The higher the assessed risk of material misstatement the more persuasive the audit evidence needs to be.
- Introduced the concept of inherent risk factors, including not only estimation uncertainty, but also complexity and subjectivity.
- Complexity refers to the complexity inherent in the process of making an accounting estimate, such as when multiple data sets or assumptions are required.
- Subjectivity arises from inherent limitations in the knowledge or data reasonably available about valuation attributes.
- Enhanced risk assessment procedures relating to obtaining an understanding of the entity and its environment, including the entity’s internal control.
- Requires a separate assessment of inherent risk, from control risk.
- Emphasizes the importance of the auditor’s decisions about controls relating to accounting estimates by highlighting relevant requirements in ISA 315 and 330.
- Introduces objectives-based work effort requirements directed to methods, data and assumptions specifically when complex modelling is involved.
- Enhanced the ‘stand back’ requirement by adding evaluation of corroborating and contrary audit evidence.
- Enhanced requirements to obtain audit evidence about whether the disclosures are reasonable.
- Use of stronger language such as challenge, question and reconsider.

WHAT NEXT?

Old ISA 540 required estimates to be reasonable, and disclosures to be adequate. New ISA 540 requires estimates and disclosures to be reasonable.

The new auditing standard indicates the IAASB has listened to the concerns of IIFIAR and users of IFRS financial statements and requires:

- Preparers of financial statements to improve the quality and understandability of the accounting estimate disclosures they provide, and
- Auditors of financial statements to improve the quality of their audit procedures with a robust challenge and application of professional skepticism to management’s assumptions in searching for audit evidence that both corroborates and contradicts management’s judgements.

We suggest Audit Committee members inquire of management and the Statutory Auditor what will be different in 2019 as a result of new ISA 540.
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