ZAMPA DEBATTISTA

AUDIT & IFRS NEWSLETTER

EXCELLENCE IS OUR AIM.
PRO-ACTIVENESS IS KEY TO OUR SUCCESS.

Q4/2020

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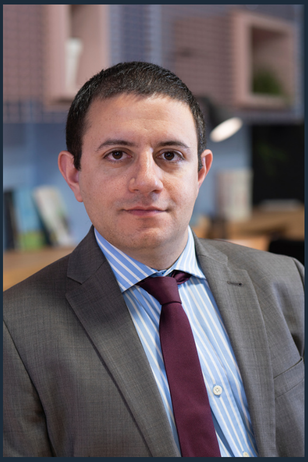
ABOUT US

Zampa Debattista is an advisory firm with strong values of integrity and excellence which help us keep high levels of customer satisfaction. We have built our reputation by offering specialised services in the Indirect Taxation and Financial Reporting areas, but offer services in Direct Taxation and Assurance areas through dedicated teams.

Should you require any further information please contact:



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IFRS CHANGES FOR 2020

IFRS Changes For 2020 Financial Statements

In contrast with 2018 and 2019, there are no new standards coming into effect for periods beginning in 2020. It needs to be mentioned however that the revised Conceptual Framework is effective for annual periods beginning on or after 1 January 2020.

Despite the absence of overhauled standards, preparers should be aware of some minor amendments effective from 2020.

Amendments to IFRS 16 'Leases' – COVID-19-Related rent concessions

The undesirable, surprising turn that 2020 took has impacted everyone, including preparers. COVID-19 has potentially massive accounting and disclosure implications. Over and above this, one of the amendments to IFRS was triggered by COVID-19 itself.

IFRS 16 'Leases' was amended, following government measures that forced many buildings to be shut, and consequential negotiation of cheaper lease payments when compared to the original contract.

This amendment applies to annual periods beginning on or after 1 June 2020. However, earlier application is permitted for financials not yet authorised for issue at 28 May 2020. IFRS 16's general provision is that a rent concession needs to be accounted for as a lease modification by the lessee. This requires potentially complex adjustments to balance sheet items, including the remeasurement of the lease liability. The relaxation is that, when a number of criteria are met (including for instance, that the rent concession is a direct consequence of the COVID-19 reality), preparers of lessee accounts need not treat the change as a lease modification (i.e., high inputs).

Amendments to various financial instruments standards – 'Interest Rate Benchmark Reform – Phase 1'

Many interest rate benchmarks are in the process of being replaced. This process of replacement is known as the IBOR reform. The impact on financial reporting will also happen before the reforms are finalised since hedge accounting is based on future expectations.

The amendments are split into Phases 1 and 2. The Phase 1 amendment is now effective and permits preparers to ignore the future IBOR reforms in their assessment of future forecast cash flows, for instance in relation to floating rate bonds (for which the cash flows can be tied to the existing interest rate benchmark).

Amendments to IFRS 3 'Business Combinations' – 'Definition of a Business'

The old definition of a business under IFRS 3 was as follows:

A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to other owners, members or participants.

The new definition is as follows:

An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities.

The new definition applies if the acquisition that happens at the earliest on the first day of the first annual period beginning on or after 1 January 2020, with earlier application permitted.

The change was made to address the struggles in preparers distinguishing between the purchase of a group of assets versus that of a business – a distinction with important accounting implications.

The amendment introduces an optional concentration test: if substantially all of the fair value of the gross assets is concentrated in a single identifiable asset or group of similar identifiable assets, the concentration test is met and the set of activities and assets is determined not to be a business. If the concentration test is not met, further assessment needs to be made.

The new definition focuses on the requirement of a business to have at least an input and substantive process that together significantly contribute to the ability to create outputs, removes the requirement of market participants being able to replace any missing inputs or processes and continuing to produce outputs, and narrows towards the provision of goods and services to customers.

Amendments to IAS 1 'Presentation of Financial Statements' and IAS 8 'Accounting Policies, Changes In Accounting Estimates And Errors' – 'Definition of Material'

The old definition of material was as follows:

Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

The new definition of material is as follows:

Information is material if omitting, misstating, or obscuring it could reasonably be expected to influence the decisions that the primary users of general-purpose financial statements make on the basis of those financial statements, which provide financial information about a specific entity.

The above definition has three main new elements:
The concept that important information should not be obscured by excessive disclosure of immaterial information, or excessive disaggregation.
The threshold of whether the information is material is increased from 'could influence' to 'could reasonably be expected to influence'.
The focus on primary users, that is lenders to the company and current or prospective investors.

IFRS LATEST NEWS

Amendments to IFRS 4 ‘Insurance Contracts’

The temporary exemption from applying IFRS 9 ‘Financial Instruments’ for instance entities has been extended. Insurance entities are permitted to apply IAS 39 ‘Financial Instruments: Recognition And Measurement’ instead of IFRS 9. This extension applies up to periods beginning before 1 January 2023, at which point IFRS 4 will be replaced by IFRS 17 ‘Insurance Contracts’.

Latest News

The IASB has commenced the post-implementation review of IFRS 9 ‘Financial Instruments’. This review will be split into three phases, the first of which will be the review of the classification and measurement requirements. This will be followed by a review of impairment requirements, and hedge accounting requirements.

The IASB is proposing to amend IFRS 16 ‘Leases’, specifically to clarify how the seller-lessee accounts for the lease liability both at the date of the transaction and after it.

The IASB launched a public consultation related to potential requirements for merger and acquisitions involving group companies, that is, business combinations under common control. The general idea is to clarify the treatment with a view to harmonisation between preparers. The IASB is leaned toward fair-value information provided when shareholders external to the group are affected, and book-value information for other cases.

The post-implementation review of IFRS 10 ‘Consolidated Financial Statements’, IFRS 11 ‘Joint Arrangements’ and IFRS 12 ‘Disclosure Of Interest In Other Entities’ has reached the feedback stage. Comments may be submitted by 10 May 2021.

On 28 January 2021, the IASB has published a proposal for a new accounting standard that would replace IFRS 14 ‘Regulatory Deferral Accounts’. Comments can be submitted by 30 June 2021. The new standard will oblige companies subject to rate regulation to give investors enhanced performance information. The amount and timing of a company’s charge to customers may be subject to rate regulation, in some industries such as utilities. A company might supply a service in 2018, but will be in a position to charge the customer in 2019 based on rate regulations. This causes timing differences which, so far, companies are not required to report. The proposal is that companies will start giving users information about regulatory assets, liabilities, income and expense.

IAASB FRAUD AND GOING CONCERN ROUNDTABLES

During September 2020, the IAASB published a discussion paper on fraud and going concern. This discussion paper sets out the issues and challenges related to the 'expectation gap' and possible actions that the IAASB could undertake to help narrow the expectation gap. In addition, the IAASB held 3 roundtables during the months of September and October 2020 to discuss specific aspects related to fraud and going concern, specifically:

1. Technology, and how this facilitates the perpetration of fraud. Technology can also be used in financial audits and forensic audits.
2. The Expectation Gap, with an emphasis on what is expected of auditors in relation to fraud and going concern in audits of financial statements.
3. Fraud and Going Concern in Less Complex Entities ('LCEs').

Technology

Artificial intelligence and other forms of advanced technology play a dual role vis-à-vis fraud: they can help detect fraud but can also be used by fraudsters to perpetrate fraud. Technological tools used by fraudsters may be specifically designed to evade detection. In this regard, cybersecurity and data security are very important in today's environment due to the rise in cybercrime.

With the COVID-19 pandemic, new opportunities to commit fraud have arisen. Remote work and working in a virtual environment were contributing factors to the increased risk of cybercrime. Today, financial statements' auditors use data extraction and analytics to perform fraud-related procedures in financial statements audits, in particular, those relating to testing of journal entries in accordance with International Standard on Auditing ('ISA') 240. The auditor benefits from such advanced technologies since large sets of client data can be analysed faster and more effectively. In addition, obtaining data provided from an entity can be challenging at times and it may be difficult to reconcile and verify the completeness and accuracy of such data. However, using such complex tools may not always be relevant for less complex audits.

Forensic auditors also use similar technologies as financial statement auditors to carry out a quantitative and qualitative analysis of data.

The main take away of this roundtable is that while technology offers useful tools to identify anomalies and 'red flags', it cannot replace professional judgement and professional scepticism.

Expectation gap

The expectation gap is the difference between the expectation of the users of financial statements and the financial statement audit. This gap can be narrowed through certain changes in the auditing standards and the tandem effort of audit committees, those charged with governance, management, internal audit, regulators, governments, investors and others.

The expectation gap related to fraud and going concern, respectively, can be attributed to various elements of a knowledge gap, a performance gap, and an evolution gap. There is an opportunity for auditors to do more related to fraud. Incremental procedures may include the auditors exercising enhanced professional scepticism when undertaking procedures on fraud and going concern. Auditors could also 'stand-bank' and consider cumulative audit evidence obtained when formulating their conclusions. It may also be beneficial to incorporate forensic-type procedures in various stages of the audit.

Robust two-way communication between the auditor and those charged with governance is of utmost importance in relation to the topics of fraud and going concern. In this regard, accounting standard setters and other stakeholders should drive transparency in management's disclosures in respect of going concern.

Fraud and going concern in less complex entities

Misappropriation of assets is more common in LCEs than financial reporting fraud. There is greater opportunity to commit fraud in less complex entities since These types of entities tend to have less anti-fraud controls (e.g. internal audit function) and less segregation of duties.

Owner-managers of LCEs may at times feel pressure to understate revenue in order to reduce tax liabilities and other times overstate revenue to demonstrate profitability in order to obtain additional funding. Owners also may rationalise the perpetration of fraud to help their company survive.

Certain fraud risk factors, such as journal entries posted outside normal business hours, maybe less prevalent in LCEs as compared to more complex entities. However, given the limited segregation of duties within LCEs, fraud may be perpetrated by trusted employees and may take years to uncover.

The minimum requirements in ISA 240 may not be appropriate in all circumstances for LCEs. For example, additional journal entry testing may not be the most effective way to respond to the risk of management override of controls. LCEs tend to have few journal entries throughout the year which could possibly have already been captured by other audit procedures.

An effective measure could be for auditors of LCEs to utilise forensic type interview skills when performing inquiries of management. Additional guidance focused on less complex circumstances in the area of fraud as applicable to LCEs may be useful.

LCEs tend to operate with less formality and regularity than more complex entities. In fact, formal forecasts or going concern assessments are often not prepared by the management of LCEs. LCEs also tend to depend heavily on the skills of certain individuals. These factors present the auditor with challenges when performing audit procedures vis-a-vis going concern. Auditors often place reliance on the knowledge of the owner-managers and on management representations. It is particularly challenging to obtain evidence on the ability of the owner to provide ongoing or future financial support to the company.

Disclosures regarding material uncertainty ongoing concern may be resisted by management since these are at times perceived by stakeholders as 'red flags'. It may be useful if there is a 'middle ground' that can be disclosed in the auditors' report to explain particular circumstances without raising serious concerns as to the entity's ability as a going concern.

Way forward

The results from the IAASB's roundtables highlighted above will be considered together with input from the IAASB's Discussion Paper *'Fraud and Going Concern in an Audit of Financial Statements: Exploring Differences between the Public Perceptions about the Role of the Auditor and the Auditor's responsibilities in a Financial Statement Audit'* to determine possible future actions to address the challenges and issues that have been identified.

IAASB COMMUNIQUE DETAILS PLANS TO DEVELOP SEPARATE STANDARD FOR AUDITS OF LESS COMPLEX ENTITIES

In December 2020, the IAASB held its first public discussions on the draft of a separate standard being developed for audits of LCEs and the official project proposal to complete and publish the draft standard for public consultation in 2021. The IAASB approved the project proposal and early draft.

Two specific issues relating to the initial working draft were discussed, specifically as to how the separate standard will look like and who will be allowed to use the separate standard.

The standard for audits of LCEs will be based on similar concepts and principles as the ISAs while containing all requirements relevant to an audit of an LCE. Such requirements will be based on 'core' requirements from the applicable ISAs i.e., those requirements that the IAASB considers to be critical to any audit. The IAASB's plan is to construct the standard into sections that will mirror the flow of an audit while setting out the relevant requirements for the various components within.

It is not yet clear on who will be able to use the separate standard as the applicability is still under discussion by the IAASB. However, at the December meeting, the IAASB reaffirmed its position that this standard will not be applicable for audits of listed entities. It was also recognized by the IAASB that each jurisdiction will need to decide whether the application of such standard is appropriate for use within their local environment.

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AUDIT NEWS

AUDIT QUALITY MANAGEMENT STANDARDS

On 17th December 2020, IAASB released 3 quality management standards which will become effective on 15th December 2022:

I. International Standard on Quality Management (ISQM) 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements;*
II. International Standard on Quality Management (ISQM) 2, *Engagement Quality Reviews*; and
III. International Standard on Auditing 220 (Revised), *Quality Management for an Audit of Financial Statements.*

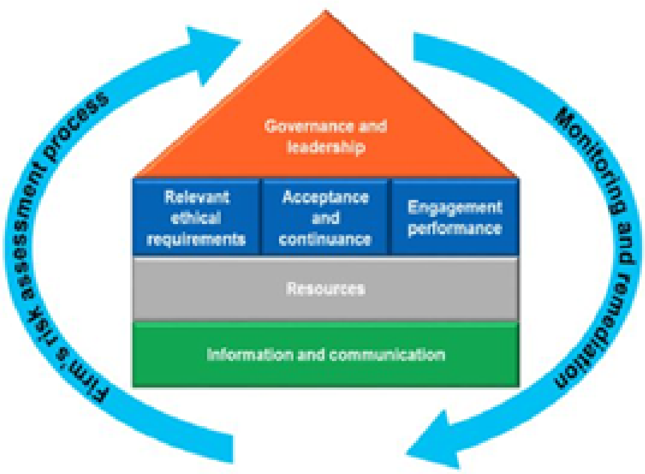
The standards promote a robust, proactive, scalable and effective approach to quality 'management', rather than 'control', and enhances audit quality.

IAASB summarized the key changes as follows:

- Increases firm leadership responsibilities and accountability
- A risk-based approach focused on achieving quality objectives
- Modernizes standards to address technology and the use of external service providers
- Increases focus on the continual flow of information and appropriate communication
- Proactive monitoring of quality management systems and timely and effective remediation of deficiencies
- Enhances engagement partner's responsibility for audit engagement leadership and audit quality
- Clarifies and strengthens requirements for a more robust engagement quality review

International Standard on Quality Management (ISQM) 1

ISQM 1 replaces ISQC 1 and encourages firms to design a system of quality management that is tailored to the nature and circumstances of the firm and engagements it performs. Firms are required to have their system of quality management designed and implemented by 15 December 2022. ISQM 1 consists of 8 components operating in an integrated manner as shown below:



ISQM 1 addresses the roles, responsibilities and accountability of **leadership** and demonstrates a commitment to quality through the firm’s culture. It introduces a risk-based approach:
I. Establish quality objectives.
II. Identify and assess quality risks.
III. Design and implement responses.

The standard also addresses proactive monitoring of the system as a whole and timely and effective remediation. An evaluation is required at least on an annual basis. *International Standard on Quality Management (ISQM) 2*

ISQM 2 deals with the appointment and eligibility of the engagement quality reviewer, and the reviewer’s responsibilities relating to the performance and documentation of an engagement quality review (‘EQR’). This is effective for audits and reviews of financial statements for periods beginning on or after 15 December 2022. An EQR is a specified response designed and implemented by the firm to address quality risks. ISQM 2 clarifies and strengthens aspects of the relevant requirements for a more robust EQR. The revised requirements focus on the objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon.

Under ISQM 2, engagements subject to EQRs are:
- Audits of financial statements of listed entities.
- Audits or other engagements for which an EQR is required by law or regulation.
- Audits or other engagements for which the firm determines that an EQR is an appropriate response to address quality risks.

The standards strengthened the eligibility criteria for an individual to be appointed as an engagement quality (‘EQ’) reviewer and a cooling-off period of 2 years is required before the engagement partner can assume the role of an EQ reviewer. Furthermore, it precludes the engagement partner from dating the engagement report until notification has been received from the EQ reviewer that the EQ review is complete.

International Standard on Auditing 220 (Revised)
ISA 220 Revised is also effective for audits of financial statements for periods beginning on or after 15 December 2022 and deals with the engagement partner and engagement team’s responsibilities for quality management for an audit of financial statements.

The changes to the standard are intended to encourage proactive management of quality at the engagement level, emphasize the importance of professional scepticism and enhance the documentation of the auditor’s judgments.

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