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Audit & IFRS Newsletter

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Audit & IFRS Newsletter

ABOUT US

Zampa Debattista is a boutique accounting and assurance firm primarily focused on international business. Its main areas of specialization are VAT, Audit and Assurance, and financial reporting. Zampa Debattista is in a position to offer its clients quality professional services whilst at the same time retaining a high level of partner involvement.

IMPACT OF COVID-19 – IFRS VERSUS GAPSME

GOING CONCERN MATTERS AND EVENTS AFTER THE REPORTING DATE

Following the advent of COVID-19, preparers of financial statements need to assess whether the entity is a going concern at the date of the authorisation of the financial statements.

If the entity is not a going concern, IAS 10 'Events After The Reporting Period' requires a fundamental change in the basis of accounting, such as a break-up basis.

If the entity is a going concern, there may still be material uncertainties about the entity's ability to continue as a going concern. Such uncertainties would need to be disclosed.

Also, preparers need to assess whether events after the reporting date are adjusting or non-adjusting events. If the impact of COVID-19 happens after the reporting period, and does not reflect conditions existing at the balance sheet date (like in almost all cases, for 31 December 2019 periods), it would be a non-adjusting event. In such case, the following is disclosed for each material category:

1. The nature of the event.

2. An estimate of its financial effect, or a statement that such estimate cannot be made.

On the other hand, if the conditions did exist at the balance sheet date (such as government measures already in place, causing impairments of assets), balances presented need to be adjusted, for impairments, onerous contracts, and other items as discussed in the following section.

SPECIFIC ACCOUNTING IMPLICATIONS OF COVID-19

Non-Current Assets

· Depreciable assets are still depreciated during periods of inactivity.

· COVID-19 may indicate the impairment of non-current assets within the scope of IAS 36 'Impairment Of Assets'. Few assets require annual impairment testing; the majority require testing only in the existence of an impairment indicator. COVID-19 will trigger numerous impairment tests, and possibly impairment adjustments.

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· If long term projects are stopped for a prolonged period of time, finance costs on qualifying assets cannot be capitalised during such period, but will be expensed in line with IAS 23 'Borrowing Costs'. Under GAPSME, the capitalisation of borrowing costs related to qualifying assets is optional. If the Company opts to capitalise them, the Company will also expense them during suspension periods.

Inventories

If the cost of inventories exceeds the net realisable value, the carrying amount of the inventories is reduced to the net realisable value.

Financial Instruments

· For financial assets within the scope of the expected credit loss (ECL) model prescribed by IFRS 9 'Financial Instruments', COVID-19 could potentially impact the computation of the impairment of financial instruments. COVID-19 could possibly:

o Require recognising lifetime ECL rather than 12-month ECL due to a significant increase in credit risk between the recognition date and the reporting date.

o Cause higher loss rates to cater for forward-looking information.

o Cause a loss in time value of money when payments are delayed.

o Cause assets to be no longer classified as low credit risk.

Preparers following GAPSME need to apply an incurred loss model instead of an expected credit loss model. Under GAPSME, an impairment is recognised only when a loss event that will impact future cash flows occurs.

· Contract modification provisions in IFRS 9 'Financial Instruments' will need to be considered for any changes in terms on loan agreements.

Revenue

· IFRS 15 'Revenue From Contracts With Customers' contains extensive guidance for the timing of revenue, and for the amount of revenue recognition in instances where there is variable consideration. Contracts with customers including an element of variable consideration might cause lower recognition of revenue, since the amount of revenue that, it is highly probable, will not be reversed in future periods, may be lower. GAPSME lacks guidance in relation to variable consideration, meaning possibly a simpler assessment of revenue.

· The advent of COVID-19 might also trigger contract modifications to contracts with customers. IFRS 15 also includes extensive guidance in this respect, contrary to GAPSME.

Provisions

COVID-19 may have significant implications on accounting matters regulated by IAS 37 'Provisions, Contingent Assets and Contingent Liabilities':

· Provisions for future operating losses are never booked, irrespective of how gloomy the future looks. Changes in future economic prospects are catered for by the assessment of the going concern assumption.

· Restructuring costs are provided for only when there is a detailed plan and it has been communicated to those concerned.

· Onerous contracts need to be recognised as a liability – an onerous contract is defined in IAS 37 as "a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it".

· Any termination benefits incurred for laying off workers need to be accounted for as provisions.

· Any insurance recoveries that an entity may have are only recognised when the entity is virtually certain of receiving the benefits. If they are probable' they're disclosed as contingent assets.

Leases

Careful considerations need to be made in relation to changes in lease terms following the advent of COVID-19:

· IFRS 16 includes detailed provisions in relation to contract modifications. One needs to see whether the lease contracts relate to changes in scope (in terms of the lease term, or of the size of the physical asset being leased) or changes in payment terms.

· The original terms and conditions of the lease, such as the 'force majeure' section of the contract, also need to be considered.

Right-of-use assets for lessees, and items of property, plant and equipment subject to an operating lease are within the scope of IAS 36 'Impairment Of Assets'.

Lessors will also need to consider the applicable requirements of IFRS 9 'Financial Instruments', for instance when accounting for any impairment of lease receivables.

CHANGES EFFECTIVE FROM 1 JANUARY 2020

THE IBOR REFORM AND IFRS

IBOR stands for 'Interbank Offered Rates'. These are the benchmark interest rates that underpin the measurement of numerous financial instruments. Examples include LIBOR (London Interbank Offered Rates), EURIBOR (Euro Interbank Offered Rate) and others.

Many companies have contracts with floating interest rates based on LIBOR or EURIBOR. For instance, a company might have a loan receivable whereby interest is charged at 1% + LIBOR. Other companies might use an IBOR as a basis to determine a discount rate. Reliable discount rates are useful in various circumstances, such as when initially measuring a financial liability, or when determining the value-in-use of a cash generating unit under IAS 36.

Beyond the financial reporting world, the process by which such benchmark rates are being calculated, is being reformed.

In spite of COVID-19, the indication is that the original transition target date is unchanged. From 2022, banks will no longer be required to submit the rates that they have used, which, as per current practice, are used to calculate LIBOR. Other IBORs, such as EURIBOR, are also being reformed.

Amongst a number of future uncertainties in this respect is the impact on financial reporting. This is currently being tackled by IASB, who are undergoing a two-phase project.

'Phase 1 amendments' are effective from 1 January 2020. These amendments consist of reliefs to hedge accounting in the period before the reform: it has been in fact decided that the IBOR reform shall not impact hedge accounting. The relief will end when the uncertainty from the reforms shall no longer be present.

‘Phase 2 amendments’ are not effective from 1 January 2020, and amendments are expected for Q3 2020. The objective of Phase 2 amendments is to assist entities in providing useful information to users of financial statements and to support preparers in applying IFRS standards when changes are made to contractual cash flows or hedging relationships, as a consequence of the transition.

AMENDMENTS TO IFRS 3 ‘BUSINESS COMBINATIONS’

If the IFRS annual reporting period starts on or after 1 January 2020, business combinations happening during that period need to consider the following amendment (in other words a 30 June year-end company would need apply the amendment to business combinations happening on or after 1 July 2020). Any earlier adoption is to be disclosed.

The amendment addresses – as follows – the difficulties that may arise when deciding whether the purchase was of a business or of a group of assets:

1. For the purchase to be considered that of a business, an integrated set of activities and assets must include at least an input and a substantive process that together, significantly contribute to the ability to create an output.

2. Acquired assets shall be assessed in their current condition, rather than on the market participant’s ability to continue producing output.

3. It has been clarified that the existence of output already provides evidence of a business. Conversely, the absence of outputs requires more persuasive evidence in order to conclude that a business has been purchased.

4. The definition of ‘output’ has been narrowed, because it now includes goods and services to customers, investment income, or other income from ordinary activities.

REVISED ‘MATERIALITY’ DEFINITION

The IASB has amended its definition of ‘material’ with effect from 1 January 2020, with early adoption permitted – thus impacting IAS 1 ‘Presentation of Financial Statements’ and IAS 8 ‘Accounting Policies, Changes In Accounting Estimates And Errors’.

‘Materiality’ is meant to guide entities in their decision about what to include and what not to include in the financial statements. Some stakeholders highlighted that the old definition encouraged the disclosure of immaterial information.

Old definition: “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”.

New definition: “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 reporting entity”.

Note the following differences:

1. The word ‘obscuring’ highlights that immaterial information could obscure material information.

2. ‘Could [...] influence’ has been replaced by ‘could reasonably be expected to influence’. Previously, too much information resulted, since any information has at least remote potential to influence some users’ decisions.

3. ‘Users’ have been replaced by ‘primary users’. As a result, the targets of financial statements have been restricted to existing and potential investors, lenders and creditors.

THE NEW CONCEPTUAL FRAMEWORK

The revised Conceptual Framework was issued in March 2018, and is effective for financial periods beginning on or after 1 January 2020.

The Conceptual Framework is meant to assist the IASB by identifying concepts that the IASB will use for future standard-setting. Key changes include:

· Management’s stewardship has more prominence.

· Prudence concept was reinstated.

· A reporting entity has been defined (it can be a legal entity or a portion thereof).

· The definition of an asset was revised – “an asset is a present economic resource controlled by the entity as a result of past events”.

· The definition of a liability has been revised – “a liability is a present obligation of the entity to transfer an economic resource as a result of past events”.

· The probability threshold for recognition has been removed; guidance on derecognition has been added.

· Further guidance on measurement bases has been added.

· It has been stated that profit or loss is the primary performance indicator, and that, in principle, income and expenses in OCI should be recycled where the relevance or faithful representation of the financial statements would be enhanced.

CHANGE EFFECTIVE FROM 1 JUNE 2020

COVID-19 AND RENT CONCESSIONS

Rent concessions include, for instance, rent holidays, and temporary rent reductions – a reality following the advent of COVID-19.

A simplification is now available to IFRS preparers accounting for COVID-19-related rent concessions given that a number of criteria are met:

· Criteria 1: The change in lease payments results in revised consideration for the lease that is substantially the same as, or less than, the consideration for the lease immediately preceding the change.

· Criteria 2: Any reduction in lease payments affects only payments originally due on or before 30 June 2021 (this means that if a rent concession is reducing lease payments on or before 30 June 2021, and increasing those beyond 30 June 2021, the criteria is still met).

· Criteria 3: There is no substantive change to other terms and conditions of the lease.

Lessees are exempt from having to assess individual lease contracts to determine whether rent concessions within scope of the amendment are lease modifications. Therefore, lessees are allowed to account for such rent concessions as if they were not lease modifications.

The amendment is effective for reporting periods starting on or after 1 June 2020, but to ensure the relief is available when needed most, lessees can apply the amendment immediately in any financial statements – interim or annual – not authorised for issue at 28 May 2020.

It needs to be pointed out that at the date of writing, the EU has not yet endorsed this amendment.

CHANGES EFFECTIVE FROM 1 JANUARY 2022

AMENDMENTS TO IAS 16 'PROPERTY, PLANT AND EQUIPMENT'

Companies shall be prohibited from deducting from the cost of property, plant and equipment, amounts received from selling items produced while the company is preparing the asset for its intended use. Such sales proceeds and related cost should be included in profit or loss.

The amendments are applied retrospectively, but only to items of property, plant and equipment that are brought to the location and condition necessary for them to be capable of operating in the manner intended by management on or after the beginning of the earliest period presented in the financial statements in which the entity first applies the amendments. The entity shall recognise the cumulative effect of initially applying the amendments as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the beginning of that earliest period presented.

AMENDMENTS TO IAS 37 'PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS'

The amendments specify which costs are included in onerous contracts. The cost of fulfilling a contract includes the costs that relate directly to the contract. Costs that relate directly to a contract consist of both of:

· The incremental costs of fulfilling that contract, such as direct labour and materials.

· An allocation of other costs that relate directly to fulfilling contracts, such as an allocation of depreciation for an item of property, plant and equipment used in fulfilling that contract.

The date of application is the first day of the first financial period in which the amendments are applied. The amendments are applied to all contracts for which the entity hasn't fulfilled all its obligations by the date of the initial application.

OTHER AMENDMENTS

Other minor amendments include amendments to:

· IFRS 1 'First Time Adoption Of IFRS' – including an update in relation to subsidiaries as first-time adopters of IFRS.

· IFRS 3 'Business Combinations' – updating a reference to the Conceptual Framework.

· IFRS 9 'Financial Instruments' – including an update in relation to the consideration of fees in the 10% test for de-recognition of financial liabilities.

· IFRS 16 'Leases' – including an update to an illustrative example about lease incentives.

· IAS 41 'Agriculture' – including an update in relation to tax in fair value measurements.

CHANGES EFFECTIVE FROM 1 JANUARY 2023

CURRENT AND NON-CURRENT LIABILITIES

Amendments to IAS 1 'Presentation Of Financial Statements' have been issued to clarify how to classify debt and other liabilities as current or non-current – these amendments were initially targeted to be effective for reporting periods starting on or after 1 January 2022, however, in July 2020, the IASB is expected to issue an amendment for the deferral of the effective date to periods starting on or after 1 January 2023.

Salient amendments:

- If the entity has a substantive right to defer settlement for at least 12 months after the reporting period, it is non-current. The term 'unconditional' currently existing in IAS 1 has been wiped out.

- In relation to the term 'substantive right', it just needs to be considered whether the right exists. On the other hand, expectation of the exercise of the right is irrelevant.

- The right to defer settlement exists only conditional to the entity not breaching conditions at reporting date.

- If a condition is breached at or before the reporting date, and a waiver is obtained after the reporting date, the liability is current.

- If a condition is breached after the reporting date, the liability is non-current.

'Settlement' is defined as the extinguishment of a liability with cash, other economic resources or an entity's own equity instruments. There is an exception for convertible instruments that might be converted into equity, but only for those instruments where the conversion option is classified as an equity instrument as a separate component of a compound financial instrument.

Application is retrospective in line with IAS 8, but early application is permitted.

IFRS 17 'INSURANCE CONTRACTS'

The IASB has deferred IFRS 17 'Insurance Contracts' by two years – the new effective date is for financial reporting periods beginning on or after 1 January 2023. This will enable insurers worldwide to implement the new Standard at the same time.

Preparers applying IFRS 17 should also consider amendments issued by the IASB on 25 June 2020.

Section B Audit

COVID-19 & AUDITING IMPLICATIONS

The coronavirus pandemic continues to spread, and its economic effects have a profound impact on financial reporting and auditing of financial statements. The impact on companies will differ and both companies and the auditors, must consider how COVID-19 affects their operations. In order to be compliant with International Standards on Auditing (ISAs), the external auditors need to address particular audit challenges that COVID-19 causes for companies and their reporting. Some factors are highlighted hereunder:

RISK ASSESSMENT PROCEDURES

As the current COVID-19 situation is very fluid, the auditor's risk assessment needs to be constantly reconsidered throughout the audit. For example, a company's liquidity may deteriorate abruptly in the current situation and therefore, because of new significant risks, the auditor's risk assessment would need to be revised accordingly in line with ISA 315 Identifying and assessing risks of material misstatements.

GATHERING AUDIT EVIDENCE AND RESPONDING TO ASSESSED RISKS

ISA 500 Audit Evidence states that the objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. Under the current circumstances, auditors may need to change their audit approach and carry out alternative procedures if access to information is restricted. The auditor should consider the greater use of technology in sharing data, gathering evidence, and hosting virtual meetings.

ASSESSMENT OF GOING CONCERN

Given the uncertainty brought about by the pandemic, the going concern assessment will surely be a key focus of many current and forthcoming audits. The auditor needs to be compliant with ISA 570 Going Concern which states that 'The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.'

This will be challenging for auditors, because management's assessment of going concern may include updating forecasts and sensitiveness as considered appropriate, changing management's plans for future actions amongst other factors. Having said this, the current uncertainty and unpredictability decreases forecasting accuracy and hence makes auditing accounting estimates very challenging. (Refer to the section ISA 540 (Revised) | Auditing Accounting Estimates)

MANAGEMENT'S DISCLOSURES ABOUT COVID-19'S IMPACT

In line with ISA 720 The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements, the auditor needs to ensure that disclosures appropriately disclose the company's prospects in view of the high degree of uncertainty and how financial statements' users might be affected. Furthermore, to be compliant with ISA 560 The auditor's responsibilities relating to subsequent events, the auditor needs to identify any material subsequent events related to COVID-19, and check whether these have been appropriately addressed or disclosed in the financial statements in accordance with the financial reporting framework.

AUDIT REPORT

COVID-19 implications may include:

- Key Audit Matters for PIEs covering additional work in relation to COVID-19
- An 'emphasis of matter' paragraph, for example to highlight a significant subsequent event disclosed in the financial statements
- Material Uncertainty on going concern paragraph
- A qualified opinion, or adverse opinion, for example in respect of inadequate disclosures, or going concern uncertainties, in the financial statements
- A qualified opinion, or a disclaimer of opinion, because of scope limitation when unable to obtain sufficient appropriate audit evidence

More than ever, it is extremely important that auditors exercise professional scepticism in performing audit procedures and arriving at the audit opinion.

ISA 540 (REVISED) | AUDITING ACCOUNTING ESTIMATES AND RELATED DISCLOSURES

ISA 540 (Revised) was published in 2019 and is applicable for current accounting periods which began on or after 15 December 2019. Auditing accounting estimates has never been easy and this has never been so relevant, then in today's uncertain environment as a result of COVID-19. Estimates are very difficult to measure, can be based on complex models and often involve management's judgement, making them by their nature difficult to audit. The revised standard introduces a number of changes that auditors will need to understand and implement.

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RISK ASSESSMENT

The IAASB introduced stronger requirements and guidance in respect of the auditor's risk assessment for estimates. The revised standard requires auditors to perform separate inherent risk and control risk assessments at the assertion level to form the basis for designing and performing further audit procedures to respond to the risks of material misstatement. ISA 540 (Revised) also introduces scalability i.e. determining where the assessed risk falls on the spectrum and by doing so determining what further audit procedures needs to be performed. For example, for low inherent risk estimates the auditor may look at subsequent event, test management processes and/or develop own estimate. These procedures are similar to those done in practice to date. However, for non-low inherent risk estimates the auditor shall design and perform further audit procedures to obtain audit evidence about their complexity, judgment by management and estimation uncertainty.

These risk assessments will be based on auditors' understanding of the entity, its environment and internal control. Auditors are also required to assess the outcome of previous accounting estimates to be able to identify and assess the risk of material misstatement in the current period. ISA 540 Revised addresses inherent risk factors such as:

(i) Estimation uncertainty (inherent lack of measurement precision)

(ii) Subjectivity (inherent limitations in the data or knowledge that is reasonably available about valuation attributes) and

(iii) Complexity

(iv) Susceptibility to misstatement due to management bias or fraud

The auditor needs to exercise professional scepticism to determine if and how these risk factors affect the likelihood or magnitude of misstatements to the Financial Statements.

PROFESSIONAL SCEPTICISM

As highlighted above, auditors need to be more sceptical in view of the extent of complexity, uncertainty and judgment involved in making some accounting estimates. The revised standard introduced a number of provisions to enhance professional scepticism. This is also introduced through a stand-back requirement whereby the auditor evaluates, based on the audit procedures carried out, the appropriateness of the risk assessments and whether they have obtained unbiased sufficient appropriate audit evidence.

DOCUMENTATION

ISA 540 (Revised) specifically requires audit documentation to include:

- The key elements of the auditor's understanding of the entity and its environment, including internal control relating to accounting estimates;
- The linkage of further audit procedures with the assessed risk of material misstatement at the assertion level;
- The response to situations where management has not taken appropriate steps to understand and address estimation uncertainty;
- Indicators of possible management bias, if any, and the auditor's evaluation of the implications for the audit; and
- Significant judgments made in the determination of whether the accounting estimates and related disclosures are reasonable, or are misstated, in the context of the applicable financial reporting framework.

In November 2019 the ISA 540 (Revised) Implementation Working Group prepared an Audit Client Briefing intended to make CFOs, other senior management responsible for financial statement preparation, and staff directly involved in determining accounting estimates aware of matters to consider in preparing for the auditor's requests pertaining to the revised ISA 540.

ISA 315 (REVISED 2019) | IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT

In December 2019 the IAASB released this revised standard for identifying and assessing risks of material misstatement with the aim to improve audit quality globally. Identifying and assessing the risks of material misstatement is fundamental to the audit. The IAASB made enhancements and clarifications to encourage a more consistent and robust risk assessment. The changes are intended to:

- Promote consistency in application of procedures for risk identification and assessment.
- Make the standard more scalable through revised principles-based requirements.
- Reduce the complexity and make the standard more usable by auditors of all entities, whatever the nature or complexity.
- Encourage a more robust risk assessment thereby more focused responses to those identified risks.
- Support auditors using the standard by incorporating guidance material that recognises the evolving environment, including in relation to information technology.

ISA 315 (Revised 2019) becomes effective for financial statement audits for periods beginning on or after December 15, 2021. More information will be provided in the next Newsletter.

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AUDITORS' FIRST ENCOUNTER WITH MANDATORY APPLICATION OF IFRS 16 'LEASES'

Auditors auditing companies preparing IFRS financial statements need to be aware of IFRS 16, mandatory for financial periods commencing on or after 1 January 2019. This includes all IFRS companies preparing financial statements for the year ended 31 December 2019.

IFRS 16 changes the accounting of lessees who classified leases as operating leases under IAS 17.

The classification of leases as 'operating leases' and 'finance leases' is not relevant for lessees. Under IFRS 16, lessees are meant to capitalise all leases, unless the leases are deemed short term or low value, in which cases the lessee may avail itself of an exemption.

Previously, lessees expensed operating leases; under IFRS 16, the capitalisation of a lease means that a right-of-use asset and a lease liability are recognised. The lease liability is measured as the present value of future cash outflows arising from the contract, whilst the right-of-use asset is the sum of the lease liability, lease payments made on or before the commencement date of the lease, any direct costs incremental to the lease agreement, and an estimate of any removal expenses.

Auditors need to also be on the lookout for correct transition to IFRS 16, and for adequate supporting disclosures.