GAAP ALERT

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#13/2016 2016 REFLECTIONS

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Introduction

Following the very positive feedback from many sources after my inaugural *2015 Reflections*, I have repeated the dose, compiling in *2016 Reflections* the commentaries and reports that I considered to be the issues of the month in *GAAP Alert* newsletters.

The *GAAP Consulting* team has addressed several of these issues in greater detail at our GAAPinars and in face-to-face training programs during the year.

My commentaries should continue to resonate with governance, preparers, auditors and users in 2017.

I trust that you will find them helpful.

Please feel free to share my *2016 Reflections* with your colleagues and contacts.

Financial reporting

Revenue recognition – a key problem

ASIC's financial-reporting surveillance program has been focusing on revenue recognition for several years.

Recently, there have been several corporate restatements where companies have been named and shamed as result of the ASIC's enquires.

Restatements reflect poorly on boards, management and auditors. Reputation damage and class action can result.

Can it be as simple as directors and management failing to understand the 31 pages of AASB 118 *Revenue*, don't have a detailed accounting policy that applies AASB 118 and fail to have internal quality-assurance procedures to confirm compliance with standards? Or is there something more sinister at play?

It appears that many entities are not learning from restatements. How long will ASIC permit slaps on wrists?

Some 'restaters' have responded to ASIC's concerns by early adoption of AASB 15 *Revenue from Customer Contracts*. Simple? Well, not really.

AASB 15 is a 42-page standard. But there are more than 200 pages of supportive material. And there is a specific Australian not-for-profits appendix released in December as well as further amendments to the standard itself.

Many entities have yet to take a good look at it.

If you have a contract with a customer, the new AASB 15 affects you. The more contracts you have and the more they vary – you might have some with locals and some with overseas customers – the harder AASB 15 *Revenue from Customer Contracts* is to implement.

There is now a complex five-step process to recognise and measure revenue. In many cases, AASB 15 will result in increased revenue deferral, recognition of some new assets, and impairment considerations.

AASB 15 replaces the well-worn AASB 118 *Revenue*, AASB 111 *Construction Contracts* and the much disliked AASB 1004 *Contributions*. AASB 15 applies to all reporting entities with contracts – profit-seeking and not-for-profits operating in private and public sectors – and it will also apply to some special-purpose financial statements.

It will be introduced on 1 January next year, but much should be done now to prepare for implementation.

My colleague Carmen Ridley, our team leader corporate reporting (and a member of the AASB) takes you through the essentials of AASB 15 in a *Special GAAP Report – AASB 15 The effective date approaches – don't stick your head in the sand* (www.gaap.com.au). There are also specific insights into legal aspects of contracts by Stephen Newman, a commercial lawyer at Hope Earle.

AASB 15 is not easy to understand or implement. Our 'to do' list will help get you started.

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AASB 15 a priority for December balancers

Entities with a 31 December reporting date should begin implementing considerations of AASB 15 *Revenue from Customer Contracts* – its effective date is 1 January.

AASB 15 is likely to result in changes to reported results, customer contracts, bonus schemes, bank covenants, budgets, IT systems, accounting manuals and disclosure templates.

Implementation of AASB 15 will be the responsibility of not only the finance team. Various staff will need to be involved to ensure that the transition is accurate, seamless and minimises stakeholders' surprises.

The time needed to determine the impact of AASB 15 on an entity will be significant. Each aspect of the contract and revenue process will need to be scrutinised, and a plan for implementation developed.

Most will require a 3rd balance sheet as at that date and comparatives at the end of the 2017. But to get there, there is five-step process:

Step 1: Identify the contract

Step 2: Identify performance obligations in the contract

Step 3: Determine the transaction price

Step 4: Allocation of transaction price to performance obligations, and

Step 5: Recognise revenue when performance obligations are met.

Simple, well no. So to get you started, here is our 10 point plan:

1. Find time to consider AASB 15 – we are all busy but this can't be ignored
2. Understand existing revenue-recognition practices, including reviewing existing contracts with customers
3. Read AASB 15 in the context of your organisation and existing contracts – identify areas of potential change
4. Apply the requirements of AASB 15 to your existing contracts and understand their impact
5. Form an implementation committee with representatives from relevant divisions or external advisors (legal, finance, sales, contract management, project management)
6. Identify deficiencies in existing systems that will prevent your capturing relevant AASB 15 information
7. Determine whether changes to existing contracts are needed
8. Formulate a communications strategy for key stakeholders, for instance, banks, shareholders and most importantly customers
9. Develop a project, plan and
10. Seek expert assistance.

Remember your obligations under AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* to disclose the effect of standards issued that are not yet effective (an ASIC focus for 31 December 2016). As we move towards AASB 15 effective date, an entity should be able to quantify its affect.

We held our masterclasses on AASB 15 for CFOs and auditors, conducted briefings and GAAPinars, and a have undertaken a number of AASB 15 implementation engagements. We are ready. Are you?

Over-coming financial-reporting shortcomings

On the eve of the reporting date, let's talk about the errors some people make in the hope that others can avoid them.

My review is based on our pre-issuance reviews of draft financial reports, technical queries put to *GAAP Consulting*, and important lessons gained from litigation briefs.

Financial information in directors' reports is often disconnected from its effects. Financial reports need consistent narratives. New transactions are often not well understood as financial statements are prepared, business combinations and new financial instruments especially.

The complexity of rules governing remuneration reports provides a fertile ground for errors.

Accounting policies specific to an entity are critical to users' understanding of financial statements, yet many preparers apply generic ones. Only significant accounting policies that are relevant to an entity in the current period should be disclosed. Bin the rest.

It still continues to surprise me that some preparers cannot evidence compliance with their summary of accounting policies by a detailed accounting policy that explain how an individual significant accounting policy is applied in the entity circumstances, and what judgements have been made. Instances come to mind of revenue recognition and measurement, as well as impairment (especially goodwill).

Accounting standards require disclosure of significant judgements in applying an entity's policies and also sources of estimated uncertainties about carrying amounts of assets and liabilities. Not enough consideration is given to the depth and breadth of these disclosures. They are critical judgements.

Issued but not-yet operative accounting policies are important disclosures, particularly in light of significant new standards such as AASB 15 *Revenue from Customer Contracts* and AASB 9 *Financial Instruments*, which have an effective date of 1 January. Entities should be well advanced towards quantifying their financial effects and required disclosures. Disappointingly, many are not; and will see more boilerplate disclosures.

The recently released AASB 16 *Leases* is effective from 1 January 2019, and businesses should have at least started to consider its impact.

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We are seeing instances of reference to the old consolidation and joint-venture standards in the summary of significant policies, which leads us to question whether the suite of AASBs 10-12 have been applied. They have been in force since 1 January 2013.

Many accounting standards contain fair-value requirements, AASB 13 *Fair Value Measurement* requiring description of methodology and disclosures. Instances of preparers still struggling with its requirements are several.

AASB 139 *Financial Instruments: Recognition and Measurement* requires specific and collective provisioning. Seems that some preparers have missed the collective provision requirements.

Directors, preparers and auditors should refer to the financial-reporting findings of Australian Securities and Investments Commission and the Australian Charities and Not-for-profits Commission as they provide a great resource for identifying shortcomings. The challenge is to improve financial reporting and its processes consistently.

But people often write them up in a rush, using last year's financial statements (with their legacy issues) and new transactions ill-considered. Financial reporting requires preparers to think about the needs of those who use them.

Let's not repeat the errors, but commit to continuous improvement.

The financial-reporting challenges ahead

No blockbuster accounting standards will spoil the reporting season this year. What a relief! But are preparers going to relax and ignore the challenges ahead? Unfortunately, many will for a while – until certain tasks turn around and bite them.

The operative date of AASB 15 *Revenue from Customer Contracts* and AASB 9 *Financial Instruments* is from 1 January 2018. They require addressing comparatives and expedient transitional arrangements. Oh, yes … There's also the requirement for a third statement of financial position when an entity applies an accounting policy retrospectively. And that is due on 1 January next year.

Both standards have been around since December 2014. Yet many entities have failed to assess their effects or undertake any implementation processes. Canny directors will ask, *Where are we at with these?*

ASIC has stated that it will look at disclosures about issued but not yet operative accounting standards. Given that these two standards have been around for a while, one would expect that listed entities in particular would have quantified their financial effects by now.

It will be interesting to see if ASIC starts asking why these disclosures have not been quantified and what actions it might take if they aren't. Is the market informed?

What about AASB 16 *Leases*? Just recently issued with an effective date of 1 January 2019, preparers have a little more time with this one. It would be my number-three priority, unless an entity wanted to implement a big-bang approach and apply all three standards together.

ASIC has identified its seven focus areas for the 31 December reporting period, and it is likely that the same topics will apply to 30 June. So let's improve reporting around them.

While on the commission, there have been several ASIC-inspired corporate re-statements of financials of late. Let's learn the lessons they provide and have a good look over the detail of accounting policies on revenue and impairment and how we handle business combinations.

How did directors, management and auditors get it wrong? We don't know, is the short answer, because ASIC didn't tell us. ASIC's press media releases skinny, really helpful. By comparison, ASIC will deal with the detail of what auditors did wrong in their auditor-surveillance program and undertakings entered into.

Those are some of the technical considerations. Now, what about looking at how preparers communicate to users. Let's remove the clutter from financial statements and reports for a start by implementing a more considered assessment of what is material. Easy?

Let's be more advantageous and streamline financial reporting by providing more relevant information and grouping together financial information that reflects the individuality of a business. Now, there's a challenge.

Here is an idea – hardly a new one. Let's use plain English and enhanced communication graphics in our reports. Perhaps accountants are not the world's best communicators and need assistance. No end of trained professional communicators are waiting for work, having lost their jobs in journalism.

By the way – and in case your auditors have failed to tell you – there are enhanced audit reporting standards taking effect from 15 December. It would be a good idea to see how these affect your financial-reporting processes so that you are prepared.

Surprisingly, there is much to do, not just from a mere compliance perspective but to benefit all stakeholders. I hope my ideas help.

'Leases' – all 340 pages of it

AASB 16 *Leases* (IFRS 16) sets out the principles for the recognition, measurement, presentation and disclosure of leases. The standard is effective for annual periods beginning on or after 1 January 2019.

The IASB is replacing 30-year-old IAS 17's 18 pages with more than 340 pages of authoritative material. There are 90 pages on the standard itself, 57 pages of examples, 90 of bases of conclusions and 103 of effects analyses. To say the least, this presents a significant challenge for CFOs and auditors.

The sheer volume of material is yet another example of the IASB's contributing to the increased complexity of standards, which disengages many in the financial-reporting supply chain. Understanding and applying standards is increasingly confined to us accounting technicians – a sad outcome.

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Simply, AASB 16 eliminates the classification of leases as either 'operating' or 'finance'. There is now a single lessee model, which requires a lessee to recognise on statements of financial positions assets and liabilities for leases with terms of more than 12 months unless the underlying asset is of low value. Such exceptions are poor standard-setting.

AASB 16 will have no effect on the total amount of cash flows reported, but it is expected to have an effect on their presentation. This is because cash flows relating to operating leases are presented as cash flows from operating activities; applying the new standard will result in the presentation within financial activities of cash flows relating to the repayment of principal on lease liabilities.

The accounting requirements for lessors are substantially the same as those in AASB 117. A lessor, therefore, continues to classify its leases as 'operating' or 'finance' leases, and accounts for them differently.

Don't forget that the implementation of IFRS 16 will also interact with AASB 12 *Incomes Taxes*, adding complexity.

AASB 16 does provides much-improved transparency and comparability of companies' lease assets and lease liabilities for investors and other users of general-purpose financial statements. But it could have been done sooner and with less complexity.

While much will be written about IFRS 16, to me it ranks as number three in importance behind the recently issued standards AASB 15 *Revenue from Customer Contracts* and IFRS 9 *Financial Instruments* (in particular, impairment). CFOs will need to start their journey on understanding these standards and prepare their implementation plans. Some may default to relying on their auditors, risking audit independence.

My colleagues Sonya Sinclair and Carmen Ridley take you through the essentials of AASB 16 in a *Special GAAP Report – AASB 16 Look before you lease* (www.gaap.com.au).

A final thought. Locally, isn't it time to move 'IFRS for SMEs' and leave big GAAP to listed and other public-accountable entities? What about it, AASB and stakeholders?

We need to rethink the AASB's agenda

The Australian Accounting Standards Board (AASB) has released invitation to comment 34 *AASB Agenda Consultation 2017-2019* and has been underwhelmed by responses.

What would I like to see?

1. A significant redirection from international projects to domestic standard-setting and coordination.
2. The board take a more direct role as pre-eminent standard-setter for reporting financial and non-financial information in Australia. For example, there is no need for other parties such as the Australian Securities and Investments Commission to set accounting rules or make exceptions to those set by the AASB. ASIC accounting class orders (and like guidance) should be reviewed and where appropriate included as 'Aus' paragraphs in AASB standards.
3. Financial statements alone do not provide a complete picture of an entity's financial performance. Completeness comes with appropriate management discussion and analysis (MDA). A standard should be developed on MDA based on an IFRS practice statement and ASIC regulatory guide 247.
4. Arguably the primary information provided to investors is no longer the annual report but profit announcements (preliminary final reports) provided to markets. Existing guidance in this area should be enhanced and the AASB should work with market regulators to provide measurement and content consistency.
5. The AASB exposure draft on *Reporting Service Information* is ground-breaking and appropriate but why stop there? The AASB should take the lead in such areas as integrated reporting and the reporting of forward-looking statements.
6. The AASB 1053 *Application of Tiers of Australian Accounting Standards* definition of public accountability should specifically address not-for-profits (NFPs). Aren't all NFPs publicly accountable?
7. SMSF users are dependent users – general-purpose financial reporting is relevant; a specific standard is needed.
8. Foreign entities' requirements to prepare and lodge general-purpose financial reports should be pursued in the public interest and for the sake of transparency.
9. The reduced-disclosure reporting framework should be abandoned and primacy given to materiality to determine disclosure.
10. The diversity in practice in the use of crucial performance measures such as net interest margin and comparable store sales should be addressed and should provide guidance on using such measures similarly to earnings per share.
11. *IFRS for SMEs* must have a place in the Australian regulatory framework, perhaps as benchmark for special-purpose financial reporting.
12. AASB tag for profit-seeking entities should cease. It should simply be IFRS.
13. The causes of alternative profit reporting need to be analysed and understood. Accounting standards should incorporate revised performance measures (if required) or primacy given to statutory numbers as performance measures. Entities should not be permitted to pick and choose their reported profits.

If the AASB does not respond to the needs of its Australian constituents it might as well just shut-up shop, leaving us to apply international profit-seeking and NFP standards.

While you might not agree with my comments, let the AASB know your views. It's time for fundamental reform.

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Ethics

NOCLAR rules affect us all

The responsibilities of every Australian accountant and auditor over non-compliance with laws and regulations are about to increase significantly.

Substantial revisions of APES 110 *Code of Ethics for Professional Accountants* are on their way. Proposals were released as a Christmas present by the Accounting Professional and Ethical Standards Board (APESB). Revised ethical and auditing standards have been released internationally and are the basis for our local requirements.

The proposals address breaches of laws and regulations dealing with matters such as fraud, corruption and bribery, money laundering, tax payments, financial products and services, environmental protection, and public health and safety.

Non-compliance with laws and regulations comprises acts of omission or commission, intentional or unintentional, committed by a client, or by those charged with governance, by management or by individuals working for or under the direction of a client that are contrary to prevailing laws and regulations. In shorthand, it's known as NOCLAR.

Proposed new ethical requirements apply to all categories of professional accountants, including auditors, professional accountants in public practice and in entities, including those in businesses, government, education, and the not-for-profit sector.

The proposals set out a framework to guide accountants in what actions to take in the public interest when they become aware of a potential illegal act committed by a client or employer.

Confidentiality requirements in the code have been revised to require an accountant to determine whether non-compliance needs to be disclosed to an appropriate regulatory authority.

It will no longer be appropriate to ignore non-compliance or just to resign.

Responsibilities under the code differ depending on whether you are:

- A professional accountant in public practice providing professional services other than audits of financial statements
- An auditor undertaking an audit of financial statements
- A professional accountant employed by an entity, and
- A 'senior professional accountant'.

A senior professional accountant is described as a director, officer, or senior employee able to exert significant influence over, and make decisions regarding the acquisition, deployment and control of, an entity's human, financial, technological, physical and intangible resources.

Because of their roles, positions and spheres of influence, there is a greater expectation for them to take whatever action is appropriate in the public interest to respond to non-compliance or suspected non-compliance.

Their responsibilities require them to:

- Obtain an understanding of the matter
- Address the matter
- Determine whether further action is required
- Determine whether to disclose the matter to an appropriate authority.
- Documentation of these steps is encouraged.
- Responsibilities of other professional accountants are not so extensive but still quite onerous.

The revisions flow from a revision of the *Code of Ethics for Professional Accountants* that has been released by the International Ethics Standards Board with two new sections and consequential amendments. The new sections are 225 *Responding to Non-compliance with Laws and Regulations*, which applies to members in public practices, and 360 of the same title, which applies to members in business.

It is proposed that the changes become operative from 15 July (the same date as the international standard). The domestic operative date is totally unrealistic, given that the proposals were issued in December and comments were sought by 31 March. Expect significant pushback from stakeholders.

As the new requirements have been finalised internationally, don't expect any changes to result from the local exposure process. It is policy to comply with the international ethical and auditing rules.

The Auditing and Assurance Standards Board (AUASB) also believes in Christmas presents and has issued ASA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements*, which reflects auditing amendments stemming from the NOCLAR proposals. It will be effective for audits of financial statements for periods beginning on or after 15 December 2017.

Changes to ASA 250 will prompt auditors to think about whether to report identified or suspected NOCLAR to an appropriate authority outside their businesses, taking into consideration the provisions of laws, regulations and relevant ethical requirements in their jurisdiction, as well as the impact of NOCLAR on their audits.

Every accountant and auditor needs to know about their new NOCLAR responsibilities. Entities will need to consider their internal policies and procedures regarding compliance with laws and regulations and the implications of reporting non-compliance. The time to start thinking about it is now.

Audit

Enhanced audit reporting – Fifteen things to do before 15 December

The suite of enhanced auditing standards apply from 15 December, affecting reports on each and every financial-statement – general purpose, special purpose and self-managed superannuation funds.

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Significant changes are in store for the way auditors communicate with users, boards and management.

The new reporting rules are not just about issuing a new form of audit reporting. There is much more.

Auditors will have to understand new requirements and their implications. Audit teams will have to be trained. Current and potential clients as well as statement users will need to be familiar with the new rules and how they affect them. And we need also to take into account risks to audit firms of non-compliance once standards become operative.

The suite of enhanced reporting standards are:

- *ASA 700 Forming an Opinion and Reporting on a Report*
- *ASA 701 Communicating Key Audit Matters in the Independent Auditor's Report*
- *ASA 705 Modifications to the Opinion in the Independent Auditor's Report*
- *ASA 706 Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*
- *ASA 720 The Auditor's Responsibilities Relating to Other information*
- *ASA 805 Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statements*
- *ASA 810 Engagements to Report on Summary Financial Statements*
- *ASA 570 Going Concern,* and
- *ASA 260 Communicating with Those Charged with Governance.*

Conforming amendments resulting from the changes affect the following standards: ASAs 210 (engagement terms), 220 (quality control), 230 (audit documentation), 510 (initial engagements), 540 (accounting estimates), 580 (representations), 600 (audit of groups) and 710 (comparatives).

Here's my list of things to do before 15 December. It's all about being – like good Boy Scouts – prepared.

1. Appoint an internal 'product' champion and develop an implementation plan.
2. Ensure that your key audit people are familiar with the broad principles of the new regime.
3. Discuss the general principles with audit clients as part of 30 June close-out reporting (and have standards developed to include in such reports).
4. Consider each firm's branding approach to the new audit reports.
5. Provide examples of new audit reports to clients (particularly where key audit matters [KAMs] are concerned).
6. Re-issue all audit-engagement letters in plain English with illustrative audit reports.
7. Update audit-tender templates and firm websites to reflect new responsibilities.
8. Develop internal policies and procedures on implementing the new requirements.
9. Develop a specific policy on KAMs.
10. Consider legal implications (such as professional-indemnity insurance)
11. Set up a library of audit reports (and have them quality assured).
12. Ensure that auditing templates are revised, taking into account the changes.
13. Develop a data-base of precedents (including audit reports of competitors).
14. Conduct a pre-15-December internal training with a client-base focus.
15. Answer a crucial pre-15-December decision. Are we ready for 31 December year-ends?

Enhanced audit reporting – going concern

While reporting of key audit matters by listed entities has grabbed much recent attention, several other new changes will affect financial statements.

They are new audit-report formatting and content, considering 'other information' to be presented with audited statements, disclosures, and the going-concern basis.

Going-concern considerations can be among the most challenging and judgmental aspects of auditing. The enhanced standards:

- Give more prominence to the going-concern basis by a paragraph in the report (and in an auditor's description of management's responsibilities)
- Replace 'Emphasis of Matter' with 'Material Uncertainty – Going Concern Basis'
- Address the relationship between a material uncertainty and a key audit matter, and
- Push further disclosure considerations when events and conditions have been identified but no material uncertainty exists (the so-called 'near miss').

There is now an explicit going-concern statement in audit reports. To refresh your memory, it is:

'As part of an audit in accordance with the Australian Auditing Standards, we exercise professional judgement and maintain professional scepticism throughout the audit. We also: Conclude on the appropriateness of the directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial report or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.'

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This statement and related changes to ASA 570 *Going Concern* require an auditor to have a thoughtful approach to the risk associated with using the going-concern basis generally and, in particular, where there is a related material uncertainty.

In the latter case, an 'Emphasis of Matter' paragraph no longer applies. Instead, there is a new paragraph headed 'Material Uncertainty Related to Going Concern', which in part states: 'As stated in Note X, these events or conditions, along with other matters as set forth in Note X, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter'.

Audit reports reference relevant note(s) in financial statements (general-purpose or special-purpose) that need to comply with relevant accounting standards. In general-purpose statements, appropriate disclosure of a material uncertainty requires various considerations to tell the going-concern story.

They include such matters as:

- The disclosure of material uncertainties (AASB 101 *Presentation of Financial Statements*)
- The concept of fair presentation, the judgements made in applying accounting policies, and capital management (AASB 101)
- Liquidity risk disclosure (AASB 7 *Financial Instruments: Disclosure*), and
- Subsequent events (AASB 110 *Subsequent Events*).

The auditor needs to be satisfied that appropriate disclosures are made, otherwise a modified opinion will need to be issued concerning inadequate disclosure.

An auditor must consider whether there is adequate disclosure of the following:

- The principal events or conditions that might cast significant doubt on the entity's ability to continue as a going concern
- Management's plans to deal with these events or conditions, and
- That there is a material uncertainty related to events or conditions that might cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it might be unable to realise its assets and discharge its liabilities in the normal course of business.
- ASA 570 now addresses what is becoming known as a 'near miss': 'If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty exists, the auditor must evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial report provides adequate disclosures about these events or conditions'.

The 'near miss' rule should result in the auditor's prompting the preparer to revisit the adequacy of disclosures around going concern. Near-miss disclosures revert back to the reporting framework being applied.

Perplexingly, a 'near miss' can give to a key audit matter, but a material uncertainty related to going concern does not. The key-audit-matter section contains only a cross-reference to the material-uncertainty paragraph.

Preparers need to take a good look at what the new audit reporting says about your responsibilities regarding going concern.

Its application can be difficult. Preparers and auditors needs to be on top of their game, particularly where there are near misses or material uncertainties.

Auditing disclosures rules – don't forget them

Much of the focus on enhanced audit reporting has centred on key audit matters (KAMs), but they apply only to listed entities. Other changes will affect all financial-statement audits. Let's look at the new rules on auditing disclosures.

Auditing standard-setters have decided to embed the new rules in several standards, so it's easy to overlook them.

As governance is responsible for the preparation and disclosures in statements, they should be made aware that, from now on, auditors will have to apply *specific* procedures to disclosures of financial information.

Some preparers have been a bit lazy with disclosures – recycling previous years', cut-and-paste from a model set of financial statements. There has been a lack of tailoring them to circumstances.

Information in notes accompanying financials is both quantitative and qualitative. Preparers need to ensure that they have the policies and procedures in place to be confident about information reported *before* an auditor's involvement. Experience has shown that many disclosure processes and considerations are ad-hoc.

The new audit rules can act as prompts for preparers to revisit their disclosure practices and policies to ensure that only relevant and compliant disclosures are made and that notes are supported by reliable information.

Preparers should be encouraged to have a pre-issuance reviews of their financial statements as well as to reassess their underlying detailed accounting policies and information sources. This will facilitate the auditor involvement in financial statements auditing disclosures – a saving to governance and management.

Auditors' responsibilities are described in ASA 2015-1 *Amendments to Australian Auditing Standards* (December 2015). The auditing disclosure amendments are a combination of mandatory requirements and to application guidance; these also flow through to new formats of the auditor's report.

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Specifically auditors will need to:

- Revise audit-engagement letters to address management's responsibilities regarding disclosures and the auditor's access to information (ASA 210)
- Consider disclosure as part of audit planning in the same way that consideration is given to classes of transactions, events and balances. This may give rise to need for the use of auditor's expert or identify matters that may need to be discussed with governance, for example, disclosures in new accounting standards (ASA 300)
- Understand information from outside the general ledger that affects the disclosures, discuss the risks of misstatement of financial statements disclosures with the audit team, and consider the controls over disclosure determination. Financial-statement assertions that auditors target have been revised to place more emphasis on disclosure (ASA 315)
- Consider the nature of potential misstatements in disclosures as part of the design of audit procedures to address risks of material misstatement (ASA 320)
- Evaluate the overall presentation of financial reports by considering classification and description, presentation structure and content (ASA 330), and
- Evaluate whether disclosures may lead to misstatements (ASA 450).

ASA 2015-1 is operative for financial reporting periods ending on or after 15 December. Please focus on the amendments and manage your audit risks.

'Other information' – more onerous responsibilities for auditors

The enhanced audit-reporting standards contain significant changes to how an auditor approaches 'other information' (financial or non-financial information in an annual report).

ASA 720 *The Auditor's Responsibility Relating to Other Information* replaces ASA 720 *The Auditor's Responsibility Relating to Other Information in Documents Containing an Audited Financial Report*. Both preparers and auditors need to understand their new responsibilities.

Let's get started by defining an annual report. It's a document or combination of documents prepared typically on an annual basis by management or governance in accordance with laws, regulations or customs. Its purpose is to provide owners (or other stakeholders) with information on the entity's operations, its financial results and position as indicated in the financial report (general-purpose or special-purpose statements).

An annual report contains or accompanies the financial report and the auditor's report and usually includes information about an entity's developments, its outlook, risks and uncertainties, a statement by the entity's governing body, and reports covering governance matters.

It may be a single document referred to as the 'annual report' or by some other title, or two or more separate documents that together serve the same purpose. It might include a management report, management commentary, operating and financial reviews or similar reports by governance (for example, a director's report), a chairman's statement, corporate-governance statement as well as internal control and risk-assessment reports.

It may be printed or digital, and can appear on companies' websites. A document (or combination of documents) may meet the definition of an annual report irrespective of how it's made available to users.

So determining what constitutes the annual report – what goes in it – is fundamental.

Under the revised ASA 720, an auditor needs to *consider* 'other information', not just read it. Specific requirements and procedures are identified.

He or she needs to consider whether there is a material inconsistency between other information and the financial report but also whether there is a material inconsistency between the information and what he or she learned doing the audit. If there is an inconsistency, the auditor needs to respond appropriately. Again, more detail is provided.

A material inconsistency might indicate a misstatement of the financial report or of other information, either of which may undermine the credibility of the financial report and the auditor's report.

Importantly, ASA 720 now states: 'This Auditing Standard may also assist the auditor in complying with relevant ethical requirements that require the auditor to avoid being knowingly associated with information that the auditor believes contains a materially false or misleading statement, statements or information furnished recklessly, or omits or obscures information required to be included where such omission or obscurity would be misleading.' It's a clear warning of a potential exposure.

Through discussions with management, an auditor needs to determine what document or documents make up an annual report, when they are issued, and make appropriate arrangements to obtain final versions of them in a timely manner and, if possible, before the auditor's report is written. The former obviously informs the latter. The results of these discussions should be documented as part of audit planning.

If documents are available only after the date of the auditor's report, management should be asked to provide a written statement that they will be provided to the auditor before their public release. Obviously, the auditor needs to read and consider them.

There are now specific requirements for auditors in responding to material inconsistencies. Auditors will need to become very familiar with these rules and their implications for additional audit work.

Audit reports are changing, and the requirements for listed-entities differ from their non-listed counterparts.

Where an auditor has obtained or expects to obtain other information from a listed entity, or has received some or all of the other information from a non-listed entity, his or her report must include a separate section headed 'Other Information'.

This section must include

- A statement that management is responsible for the other information
- An identification of the other information received before the date of the auditor's report and for a listed entity other information expected to be obtained after the report's date
- A statement that the auditor's opinion does not cover the other information and, accordingly, that he or she does not express (or will not express) an opinion or any form of assurance conclusion
- A description of the auditor's responsibilities relating to reading, considering and reporting on other information, and
- When other information has been obtained before the date of the auditor's report, either a statement that the auditor has nothing to report or, if the auditor has concluded that there is an uncorrected material misstatement of other information, a statement that describes it.

As far as documentation goes, reference is made to general requirements in ASA 230 *Audit Documentation* as well as new requirements to document the procedures performed under ASA 720, including work performed on the final version of the other information.

In implementing the suite of enhanced standards, auditors should pay particular attention to ASA 720 and work with management and governance on the new requirements.

ASIC's audit-communication proposals have big implications

ASIC's new consultation paper 265 *Communicating audit findings to directors, audit committees or senior managers* has profound implications for the auditor-client relationship and audit firms' risk-management processes.

You may recall that the ASIC Act was amended in 2012 to allow the commission to communicate specific financial-reporting and audit findings identified from reviews of audit files to directors, audit committees and senior managers of companies, responsible entities and disclosing entities.

The amendment aimed to help businesses properly manage their affairs. Despite having had for four years the licence to divulge findings, ASIC has not yet used it.

The commission's audit inspections and financial-reporting surveillances:

- Predominantly focus on recognition and measurement issues involving potential material misstatements of profits and net assets arising from accounting policy choices and estimates (for example, asset values) rather than disclosure issues
- Exclude matters that are within a range of reasonable judgement, and
- Exclude genuine issues relating to the interpretation of accounting and auditing standards, which may be matters for international standards-setting bodies.

The paper sets out ASIC's proposed criteria for determining which findings it would communicate and those that it wouldn't. The commission has also outlined proposals to notify an audited entity's board that it will be reviewing files as part of its routine inspections.

The proposed criteria for communicating financial-reporting and audit findings are:

- That the communication of a material misstatement will assist in timely resolution of a matter
- That a finding from a previous year has not been addressed
- A planned enforcement action
- That independence requirements have not been met, and
- There was a failure to obtain reasonable assurance that a financial report was free of material misstatement across several key audit areas.

ASIC proposes to apply these criteria to the audit files it reviews rather than reporting all findings.

The commission contends that information from its reviews of audit files may assist directors to:

- Take action to address deficiencies in an entity's financial report
- Improve systems and processes supporting financial reporting, and
- Discuss with auditors actions to improve audit quality.

If an auditor does not address deficiencies, directors can seek the firm's resignation or removal.

ASIC's proposal to notify directors of a review are intended to enable them to go direct to auditors about any issues and concerns that might arise. The commission believes that this would enable directors to ask auditors about the steps they are taking to:

- Address any issues and concerns
- Improve audit quality, and
- Support investor and market confidence in the quality of financial reports.

ASIC will also consider whether its review findings should be communicated to other regulators, such as the Australian Prudential Regulation Authority and the Australian Taxation Office.

Comments on the paper closed on 30 September.

2016 REFLECTIONS

And please …

Remember that, even when you aren't working face-to-face with the *GAAP Consulting* team, you can stay up-to-date with financial-reporting developments.

GAAP Alert is a free monthly emailed newsletter that alerts you to the latest Australian and international developments in GAAP, GAAS, ethics and regulations. We reported over 200 items during the year. Now, I call that keeping you informed. You can subscribe to *GAAP Alert* at www.gaap.com.au.

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We're on LinkedIn and Twitter.

Questions or assistance required? Please contact me, Colin.

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