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This newsletter has been prepared to provide members with an overview of financial reporting and audit related areas following receipt of members' queries through ICPAC's technical support service on matters concerning IFRS Accounting Standards and International Standards on Auditing (ISAs).

The following areas have been identified as particularly relevant for discussion in relation to recent developments, common findings and queries raised:

IFRS Accounting Standards related section:

- Properties under construction - classification and revenue recognition considerations
- Provisions and contingencies under IAS 37

ISAs related section:

- Auditor's report clarifications
- Going concern and reporting in the auditor's report
- Inventory held by third parties
- Legal and regulatory framework
- Journal entry testing and management override of controls
- Use of GenAI on Audits

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IFRS Accounting Standards related section

Properties under construction – classification and revenue recognition considerations

Introduction

A common issue, particularly in the real estate development and construction sectors relates to how properties under construction should be classified, especially where properties are sold before completion or where management's intended use of the property changes during the development phase.

The accounting treatment depends on the purpose for which the property is held, as well as the specific terms and conditions of any sale arrangements entered with customers.

Classification considerations

Entities should assess the purpose for which properties under construction are held, as this will determine the applicable standard:

- **IAS 2 *Inventories***: applies where properties are held for sale in the ordinary course of business.
- **IAS 40 *Investment Property***: applies where the property is being developed for rental income or capital appreciation and thus it meets the definition of "investment property" under IAS 40.
- **IAS 16 *Property, Plant and Equipment***: applies where the property is constructed for own use.

The classification should reflect management's intended use of the property and should be supported by available evidence.

Where a property under construction meets the definition of an investment property, it continues to be accounted for under IAS 40 throughout the construction period. Similarly, an existing investment property that is being redeveloped for continued future use as an investment property remains within the scope of IAS 40.

Questions may also arise regarding whether a property under construction should be classified as a non-current asset held for sale under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. It should be clarified that inventory is outside the scope of IFRS 5 as IFRS 5 applies to non-current assets and disposal groups. Inventory is a current asset, and it is not reclassified as held for sale under IFRS 5 but rather continues to be accounted for under IAS 2 (lower of cost and net realisable value).

Investment property or property, plant and equipment are classified as held for sale under IFRS 5 where its carrying amount will be recovered principally through a sale transaction rather than continuing use.

Classification as held for sale requires, amongst other criteria, that the property is available for immediate sale in its present condition and that the sale is highly probable. For a sale to be highly probable, management must be committed to a plan to sell the property and have an active programme to locate a buyer and complete the plan. The property must be actively marketed at a price that is reasonable in relation to its current fair value, and the sale should be expected to complete within one year of classification.

A non-current asset held for sale is measured at the lower of its:

- carrying amount; and
- fair value less costs to sell (or costs to distribute).

An impairment loss is recognised on classification as 'held for sale' if the fair value less costs to sell is lower than the carrying value of the non-current asset or disposal group.

For investment property carried at fair value, the measurement provisions of IFRS 5 do not apply. [IFRS 5 para 5(d)]. For investment property under the cost model, measurement under IFRS 5 is at the lower of the carrying amount and fair value less costs to sell. However, for both – investment property under the cost model as well as the fair value model – the presentation and disclosure requirements in IFRS 5 apply.

For property under construction to be classified as a non-current asset held for sale, it is required to be available for immediate sale in its present condition, and the sale should be highly probable and it should occur under normal market conditions. Particular care should be exercised when assessing whether a property under construction is capable of being sold in its current condition. The criterion of marketability should be particularly scrutinised. If the property cannot be sold as property under construction but only following completion, the investment property is not available for immediate sale in its present condition, because completion is required to reach marketability. If there is, in exceptional cases, a possibility to dispose of the property before the construction is completed, meaning that the property is transferable 'as it is', presentation as held for sale is required, provided that all other conditions in IFRS 5 are met.

Measurement of revalued property prior to classification as held for sale – example

An item of property, plant and equipment, within a class that is measured under the revaluation model, should be carried at fair value less accumulated depreciation, in accordance with IAS 16. Entity X has a policy of revaluing its property. Entity X owns an item of property that is stated at EUR7.000 (EUR7.500 revalued amount less EUR500 depreciation since last revaluation) in its most recent annual financial statements. During 20X7, entity X decides to sell the disposal group containing that asset. The asset meets the conditions to be classified as held for sale on 1 July 20X7.

At 30 June 20X7, entity X should charge a further depreciation until that point in time. Entity X does not necessarily have to revalue the asset in accordance with IAS 16 if the carrying amount does not materially differ from the actual fair value at 30 June 20X7. If the fair value at 30 June does not materially differ, the amount as at 1 July 20x7 less costs to sell should be used as the basis for measuring the disposal group under IFRS 5.

In cases where properties are multi-purpose, entities need to consider the guidance of IAS16 *Property, Plant and Equipment* and IAS 40 *Investment Property*. Para 10 of IAS 40 provides that there might be cases where a property could be partly owner-occupied and partly held for rental income or capital appreciation. For example, an entity might own a four-storey block and use the bottom two storeys for its administrative function, whilst renting out the upper two floors. If the entity could sell floors separately or lease them out on a finance lease, it should treat the lower half of the property as owner-occupied property (IAS 16) and the upper half as investment property (IAS 40). However, if the portions cannot be sold or leased out separately on a finance lease, then the entity will need to treat the whole building either as investment property or as owner-occupied property. It is also noted that if an insignificant portion is owner-occupied which in this scenario does not seem to be the case, then the whole-building can be classified as investment property.

<u>Change in use of assets</u>

Transfers into, or out of, investment property are made where there is an evidenced change in use. To conclude that there is a change of use, there should be an assessment of whether or not the definition of investment property is met. This change must be supported by evidence. A change in management's intention, in isolation, does not provide evidence of a change in use. Paragraph 57 of IAS 40 provides a non-exhaustive list of examples when a change in use might be evidenced. This list includes:

(a) commencement of owner-occupation, or of development with a view to owner-occupation, for a transfer from investment property to owner-occupied property;

(b) commencement of development with a view to sale, for a transfer from investment property to inventories;

(c) end of owner-occupation, for a transfer from owner-occupied property to investment property; and

(d) inception of an operating lease to another party, for a transfer from inventories to investment property.

It is noted that changes in use of an existing assets are not changes in accounting policies, and so they are accounted for prospectively [IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, para 16]. This means that no changes in comparatives should be made.

Factors to consider in determining when inventory should be transferred to investment property

An entity involved in the property development sector. develops properties for sale immediately after completion. At this stage, there is uncertainty in the market resulting in fewer buyers/transactions in the market. As a result, the entity decides to rent out a residential property that was supposed to be sold after completion until the market activity improves.

In such a scenario, the entity should carefully assess whether the property should continue to be classified as inventory or be transferred to investment properties in accordance with paragraph 57 (d) of IAS 40. The property should continue to be classified as inventory if this is consistent with the entity's strategy for this property. However, it should be transferred to investment property if there is a change in management's intention to hold the property for future rentals or for capital appreciation (for example, until market prices recover).

Determining the correct classification of such a property requires judgement. The inception of a lease with third parties, in itself, does not automatically require reclassification as investment property, although it might be indicative of a change in management's intention.

The property can, therefore, continue to be classified as inventory to the extent that it is available for immediate sale in its present condition, at a current market price, in the ordinary course of business.

Factors to consider include:

- Is the property actively marketed for sale?
- Is the property available for sale at a price that is reasonable relative to its current market value?
- Does a market exist for properties with sitting tenants, with longer lease terms, such that the property is in a condition to be sold immediately?

- Where there is no market for properties with sitting tenants, are the terms of any leases less than the length of the period that other similar properties take to be sold in the ordinary course of business under current market conditions?

If the entity is unwilling to sell the property at the current depressed market price, it is likely that the property's intended use has changed to meet the definition of an investment property – that is, held to earn rental income and for capital appreciation.

Factors to consider are:

- Has it been decided to postpone the sale of the property until the market price recovers?
- Is there a change in the business plan that takes into account the rental income earned and the necessary future maintenance expenses?
- Has this change in business plan been publicly announced?
- Is the property no longer actively marketed for sale?
- Is there currently no active market for similar properties?
- Is the property available for sale only at a price that is not reasonable relative to its current market value?

Revenue recognition considerations (IFRS 15 *Revenue from Contracts with Customers*)

Entities should follow the guidance of IFRS 15 on how to recognise revenue earned from sales of properties under construction.

Cash receipts do not necessarily indicate that the entity is able to recognise revenue. Revenue is recognised under IFRS 15 when a performance obligation is satisfied, which occurs when control of a good or service transfers to the customer. Control can be transferred either at a point in time or over time, based on a range of criteria. An entity should determine at contract inception whether control of a good or service is transferred over time or at a point in time.

An entity might begin activities on an anticipated contract, prior to the arrangement meeting the criteria of IFRS 15 to be recognised as a contract with a customer. Revenue should be recognised on a cumulative catch-up basis if subsequent reassessment indicates that the criteria are met. This cumulative catch-up should reflect the performance obligation(s) that are partially satisfied, or satisfied on the contract reassessment date. An entity will need to determine the goods or services that the customer controls and, therefore, what portion of the costs are included in any measure of progress, to determine the cumulative revenue recognised.

Revenue is recognised over time when one of the criteria in IFRS 15 is met. In real estate developments, the criterion most frequently considered is whether:

- the property being constructed has no alternative use to the developer; and
- the developer has an enforceable right to payment for performance completed to date if the customer terminates the contract.

Both conditions must be met to support over-time revenue recognition.

Where these conditions are not met, revenue is generally recognised at a point in time, when control of the completed property transfers to the customer.

To determine the point in time at which a customer obtains control of a promised asset and the entity satisfies a performance obligation, the entity shall consider the requirements for control in paragraphs 31–34. In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

(a) The entity has a present right to payment for the asset—if a customer is presently obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.

(b) The customer has legal title to the asset—legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.

(c) The entity has transferred physical possession of the asset—the customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits.

(d) The customer has the significant risks and rewards of ownership of the asset—the transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.

(e) The customer has accepted the asset—the customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the guidance in paragraphs B83–B86.

Multiple promises in a contract

Each distinct good or service that an entity promises to transfer is a performance obligation. Where there are multiple promises in a contract, management will need to determine whether goods or services are distinct, and therefore separate performance obligations. Goods and services that are not distinct are bundled with other goods or services in the contract until a bundle of goods or services that is distinct is identified. The bundle of goods or services, in that case, is a single performance obligation.

A good or service that is promised to a customer is distinct if:

a. the customer can benefit from the good or service, either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct); and

b. the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the contract).

Factors that indicate that a good or service in a contract is not separately identifiable include, but are not limited to:

- The entity provides a significant service of integrating the goods or services promised in the contract into a combined output(s) for which the customer has contracted.
- The good or service does significantly modify or customise another good or service promised in the contract.
- The good or service is highly interdependent on, or highly interrelated with, other promised goods or services.

Therefore, the assessment of whether a good or service is distinct has two elements; the good or service must be both: (a) capable of being distinct; and (b) separately identifiable.

Example

A developer is developing homogeneous units and sells either individual homes constructed on a plot of land, or just the undeveloped plots, to separate customers. The homes/plots are sold with a promise to complete certain amenities (for example, a school, roads, connection to utilities and/or a club house). Sometimes the developer will offer a choice as to whether the customer wants just the plot of land with the promised services (so the customer can use a separate builder to construct the house) or a house on the plot.

Each of the promises in these arrangements (land, amenities and house) is likely to meet the requirement that a customer can benefit from them on their own or in conjunction with other goods or services available in the market. The question is whether they are separately identifiable promises. Whether a bundle of land and services (no house) is one performance obligation may even depend on the location of the land. If the land could not be sold without the promise of services because the location is so remote, there might be one performance obligation. However, a different conclusion could be reached if the land is in a more developed area and the purchaser of a plot could separately arrange for the necessary amenities (e.g. roads, utilities, etc.). It might be more likely that there is only one performance obligation where the developer only sells fully developed plots with a house. This is because the customer is simply contracting for a completed house in a certain setting. Judgement is likely to be required to determine when goods and services are distinct in the context of a contract.

Significant financing component

An entity adjusts the promised amount of consideration where there is a significant financing component. If the contract contains a significant financing component, the transaction price should reflect the time value of money. An entity is not required to consider the time value of money if the period between payment and the transfer of the promised goods or services is one year or less, as a practical expedient.

In assessing whether a contract contains a significant financing component, an entity should consider various factors, including:

- the length of time between when the entity transfers the goods or services to the customer and when the customer pays for them;
- whether the amount of consideration would substantially differ if the customer paid cash when the goods or services were transferred; and

- the interest rate in the contract and prevailing interest rates in the relevant market.

Example

A contractor enters into a contract for the construction of a building on the customer's land. This construction of the building is a single distinct performance obligation. Control passes to the customer over the contract term. The contract terms indicate specific dates on which the customer is required to make certain payments. These payments do not necessarily coincide with the performance by the contractor. The contract is set up in this way so that the contractor has the necessary funds to cover the cost of construction.

The contractor charges the customer in advance. Management will need to consider the time period between payment and the completion of the related performance, where the contractor is performing over time rather than at a specific point in time, to assess whether there is a significant financing component, taking into account the 12-month practical expedient offered by the standard. For example, the contractor might receive payment in month 5 but would perform over the period between month 7 and month 13, and thus there might not be a 12-month period between the date of payment and the associated performance. However, if there is a significant financing component, the contractor will need to assess whether a significant financing transaction exists. If a significant financing transaction does exist, the entity should calculate this finance component.

Costs to fulfil a contract

Entities often incur costs to fulfil their obligations under a contract once it is obtained, but before transferring goods or services to the customer. Some costs could also be incurred in anticipation of winning a contract. The guidance in the revenue standard for costs to fulfil a contract only applies to those costs not addressed by other standards. For example, inventory costs would be covered under IAS 2. An entity cannot recognise an asset under the revenue standard if such costs are required to be expensed in accordance with other standards. Fulfilment costs not addressed by other standards should be capitalised if all of the following criteria are met:

a. the costs relate directly to a contract or an anticipated contract that the entity can specifically identify;

b. the costs generate or enhance resources of the entity that will be used in satisfying or continuing to satisfy performance obligations in the future; and

c. the costs are expected to be recovered.

Example

Entity X incurs costs in connection with winning a bid on a contract to build a bridge. The costs were incurred during the proposal and contract negotiations (for example, legal costs) and include the initial bridge design.

Entity X should cover the costs incurred during the proposal and contract negotiations as incurred. The costs are not incremental, because they would have been incurred even if the contract was not obtained. The costs incurred during contract negotiations could be recognised as an asset if they are explicitly chargeable to the customer regardless of whether the contract is obtained.

Even though the costs incurred for the initial design of the bridge are not incremental costs to obtain a contract, some of the costs might be costs to fulfil a contract and recognised as an asset under that guidance.

Practical considerations

Entities should carefully review contractual arrangements and relevant legal provisions when assessing the timing of revenue recognition.
Judgement is required in assessing:

- whether the customer controls the property as it is being constructed;
- whether the asset has an alternative use to the developer;
- whether the entity has an enforceable right to payment for work performed to date;
- the appropriate measure of progress where revenue is recognised over time; and
- whether contracts satisfy the requirements of IFRS 15 before revenue recognition commences.

Entities should also ensure that disclosures adequately explain significant judgements and estimates applied in determining the classification of properties under construction and the timing of revenue recognition.

Practical example: Right to payment

A property developer signed sales and purchase agreements to sell specific apartments in an apartment block to different customers during the construction phase. Once the contract has been signed, the developer cannot redirect the unit to another customer. All customers are required to pay a 15% non-refundable deposit and pay the remainder of the transaction price based on milestones as determined in the contract. The performance does not create an asset with an alternative use.

If a customer defaults, the property developer will be entitled to 15% of the contract price, and it can retain the work in progress completed to date. Any cash received above 15% will be refunded to the customer.

Analysis

Revenue is recognised over time if the apartment being constructed has no alternative use and the seller has a right to payment for the duration of the contract. While this assessment will need to be made on a contract-by-contract basis, in this example the apartment will meet the 'no alternative use' test, because the specific unit cannot be redirected contractually.

The second criterion is that of a right to payment for performance to date. The entity must be entitled to an amount that at least compensates it for performance completed to date, at all times throughout the duration of the contract, if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised. The right to receive a penalty and the right to retain the work in progress are not considered to provide the developer with a right to payment for work completed to date but are merely a payment of a deposit or a payment to compensate the entity for inconvenience of loss of profit. There is therefore no right to payment for work completed to date established in this contract. The entity should evaluate when control passes to the customer, and it should recognise revenue on this date.

Provisions and contingencies under IAS 37

Introduction

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* continue to be an area of focus, particularly in relation to legal proceedings, regulatory matters, environmental obligations, warranties, guarantees and restructuring activities. A common question that arises is whether a present obligation exists at the reporting date and whether the criteria for recognition of a provision have been met.

Scope

IAS 37 applies to the accounting for provisions, contingent liabilities and contingent assets, except for executory contracts and those arrangements covered by another IFRS Accounting Standard. [IAS 37 para 1]

IAS 37 does not apply to financial instruments, including financial guarantee contracts, that are within the scope of IFRS 9. Some financial guarantee contracts might be within the scope of either IFRS 9 or IFRS 17. Provisions, contingent liabilities and contingent assets that require settlement in cash which does not yet arise from a contract (for example, a contingent payable or receivable for a court judgement) is not a financial instrument. IAS 37 also generally excludes executory contracts, being contracts under which neither party has fully performed its obligations, or both parties have partially performed their obligations to an equal extent. However, where an executory contract becomes onerous, the requirements of IAS 37 apply.

The word 'provision' is sometimes used to describe amounts that are deducted from assets to arrive at their statement of financial position carrying amount. For example, provisions are made for depreciation or amortisation or the impairment of financial or non-financial assets. These are not provisions within the scope of IAS 37. These relate to the measurement of assets, and they are adjustments made to determine the assets' carrying value. [IAS 37 para 7]

Recognition criteria

A provision is recognised only when all of the following conditions are met:

- an entity has a present legal or constructive obligation because of a past event;
- it is probable that an outflow of economic resources will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation.

[IAS 37 para 14]

The past event giving rise to the obligation is referred to as the obligating event. An obligating event creates a situation in which an entity has no realistic alternative but to settle the obligation.

A legal obligation may arise through legislation, contractual arrangements or court judgements. A constructive obligation arises from an entity's actions where it has created a valid expectation among other parties that it will discharge certain responsibilities.

An outflow of resources is considered probable when it is more likely than not to occur.

<u>Provisions versus contingent liabilities</u>

Where one or more of the recognition criteria are not met, a provision is not recognised.

Instead, a contingent liability is disclosed unless the possibility of an outflow of resources is remote.

Judgement is often required in distinguishing between a present obligation requiring recognition and a possible obligation requiring disclosure only.

For obligations arising from a large population of similar items, such as product warranties, the probability assessment should be performed for the population rather than for individual items.

<u>Measurement considerations</u>

Provisions are measured at the best estimate of the expenditure required to settle the present obligation at the reporting date.

In determining the best estimate, entities should consider:

- risks and uncertainties surrounding the obligation;
- the likelihood of different possible outcomes;
- future events expected to affect the settlement amount where there is sufficient objective evidence that such events will occur; and
- the time value of money where the effect of discounting is material.

The amount recognised should reflect management's most realistic assessment based on all available evidence at the reporting date.

<u>Restructuring provisions</u>

Queries frequently arise in relation to restructuring activities. A provision for restructuring is recognised only when an entity has both:

- a detailed formal restructuring plan; and

- raised a valid expectation among affected parties that the restructuring will be carried out.

Future operating losses do not meet the definition of a liability and therefore cannot be recognised as a provision.

Disclosure considerations

IAS 37 requires disclosures that enable users of the financial statements to understand the nature, timing and uncertainty associated with recognised provisions and contingent liabilities.

Entities should ensure that disclosures are sufficiently detailed and entity-specific, particularly where significant judgement has been exercised in determining whether a provision should be recognised or disclosed.

Common deficiencies observed in practice include generic disclosures, insufficient explanation of key assumptions and failure to disclose significant contingent liabilities.

Key areas of judgement

Judgement is often required when:

- assessing whether a present legal or constructive obligation exists;
- determining whether an outflow of resources is probable;
- estimating uncertain outcomes such as litigation and regulatory matters;
- measuring obligations with a wide range of possible outcomes;
- determining appropriate discount rates where discounting is required; and
- assessing the adequacy of disclosures relating to significant judgements and estimation uncertainty.

Entities should ensure that provisions are recognised only when a present obligation exists at the reporting date and that recognised amounts are supported by appropriate evidence and robust estimates. Where recognition criteria are not met, adequate disclosure of contingent liabilities remains important. Given the significant judgement often involved, clear and entity-specific disclosures can help users understand the nature, timing and uncertainty associated with obligations recognised or disclosed in the financial statements.

Applying the recognition criteria to litigation cases

Litigation is often used to illustrate how to apply certain aspects of IAS 37. The litigation process can be long, and the outcome is sometimes unpredictable. Information relating to the litigation cases can be sensitive.

An entity might take legal action against another party, or it might defend an action taken by a third party. Whichever position the entity is in, there will be costs associated with the litigation process (for example, lawyers' fees and fees for expert witnesses) and, finally, costs (or proceeds) either from settling the action out of court or arising from the court's decision. There might also be, for the party losing the action, an insurance claim and potential insurance recoveries if the action was covered by insurance.

The entity will need to consider carefully whether there is a present obligation and a probable outflow for which provision is required. The likelihood of settlement might initially be remote, so a contingent liability is not disclosed. Once an action has been started, the outflow might become possible, requiring disclosure, and then probable, requiring a provision to be recognised. The final outcome might not be concluded until all of the appeals processes have been exhausted. Even then, there might still be uncertainties concerning whether claims against insurers will be successful.

Determining whether a present obligation exists in a legal dispute will require the application of judgement and a consideration of all of the facts and circumstances, including, for example, the opinion of experts. The fact that an entity is planning to appeal an adverse judgment of a lower court, or is in the appeal process, would not mean that the entity can assume that there is no present obligation. In many cases, an adverse lower-court judgment might indicate that a provision should be recognised at the time of the lower court's ruling. However, the entity would need to consider all of the available evidence, including the legal processes in the specific jurisdiction, and judgement would need to be applied.

Proposed amendments to IAS 37

The IASB has proposed targeted improvements to IAS 37. The proposed amendments to IAS 37 are generally applicable to all entities, because most entities have liabilities that are provisions. The amendments are expected to have the greatest impact on entities that are subject to levies or that have significant long-term provisions. Levies can take many forms – for example, as a mechanism for governments to indirectly tax entities, or as an incentive for entities to take specific climate-related actions.

The key proposed amendments are as follows:

- improving one of the criteria for recognising a provision – specifically, the requirement for a present obligation as a result of a past event;

- changes in the guidance for measuring provisions – specifically, clarifying what costs should be included in measuring a provision, and improving the guidance on determining the discount rate used for measuring long-term provisions; and
- updates to the accompanying guidance on implementing IAS 37 to reflect these proposed amendments.

ISAs related section

Auditor's report clarifications

1. Titles of the Primary Financial Statements

The titles of the primary statements referred to in the auditor's reports must be consistent with those used in the body of the financial statements. The ICPAC auditor's report booklet reflects the titles used in the latest version of IAS 1 *Presentation of Financial Statements*. We note that paragraph 10 of IAS 1 permits entities to use alternative titles. Accordingly, the titles included in the ICPAC templates are not mandatory, and the auditor's reports should mirror the titles chosen by management.

2. Reporting on Separate Financial Statements of a Parent Company

When reporting on separate financial statements of a parent company (e.g., ICPAC templates #5, #7, #10, #21), members should ensure that the financial statements clearly state that they are the **separate** financial statements of the Company. A practical way for management to disclose this is by including appropriate wording in the Management Report (where applicable) and in Note 2 – Basis of Preparation.

An example disclosure could be:

"These financial statements are the separate financial statements of the Company. Management clarifies that the terms 'separate financial statements' and 'financial statements' are used interchangeably and with the same meaning throughout these financial statements."

Going concern and reporting in the auditor's report

Introduction

Going concern continues to be a significant area of audit focus, particularly in light of the revised requirements of ISA 570 *Going Concern* and increased regulatory scrutiny. Economic uncertainty, financing challenges, covenant compliance and changing market conditions have heightened the need for robust evaluations of an entity's ability to continue as a going concern.

The auditor's evaluation starts with assessing management's use of the going concern basis of accounting and determining whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern.

It is noted that ISA 570 (Revised 2024) *Going Concern* becomes effective for audits of financial statements for periods beginning on or after December 15, 2026 and the guidance included below is relevant to the revised standard.

Audit considerations

According to ISA 570 (Revised 2024) para 6, auditors are required 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 related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Where events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, auditors, in fulfilling their responsibilities, are required, among other procedures, to:

- assess the reasonableness of significant assumptions used by management;
- evaluate management's plans for future actions; and
- assess whether the related disclosures in the financial statements are adequate.

In relation to management's plans for future actions, ISA 570 (Revised 2024) requires auditors to evaluate both management's intent and ability to carry out the specific courses of action included in those plans.

ISA 570 (Revised 2024) para A7 lists many examples of identified events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, covering financial, operating and other. Some examples of indicators that may require further consideration include:

- recurring operating losses;
- negative operating cash flows;
- net liability or net current liability position;
- significant debt maturities;
- breaches of loan covenants;
- dependence on shareholder or lender support; and
- adverse regulatory, legal or economic developments.

It is noted that ISA 570 (Revised 2024) requires auditors to evaluate management's assessment of going concern, including the significant management judgements on which evaluation is based, regardless of whether events or conditions have been identified.

Common deficiencies identified

Given the significant judgement involved in assessing going concern, this area continues to require careful consideration by auditors. Monitoring reviews continue to identify weaknesses in the following areas:

- insufficient challenge of management's assumptions;
- inadequate testing of cash flow forecasts;
- limited consideration of downside scenarios and sensitivities;
- insufficient assessment of covenant compliance and refinancing assumptions;
- inadequate evaluation of management's mitigating actions; and
- insufficient documentation supporting professional judgement and audit conclusions.

Attention should be given where management's assessment relies on future financing, shareholder support, significant improvements in trading performance or other events that have not yet occurred.

For this reason, the ISA 570 (Revised 2024) includes new and revised requirements and application material to strengthen the auditor’s evaluation of management’s assessment of the entity’s ability to continue as a going concern as well as communication and reporting on matters related to going concern.

Reporting implications

The auditor's reporting responsibilities depend on:

- whether the going concern basis of accounting is appropriate;
- whether a material uncertainty exists; and
- whether the related disclosures in the financial statements are adequate.

ISA 570 (Revised 2024) requires the use of a separate section in the auditor’s report to address certain entity specific going concern matters. Such reporting may be provided either in a section with a heading of “Going Concern” (when no material uncertainty exists) or in a section with a heading of "Material Uncertainty Related to Going Concern” (unless the auditor disclaims an opinion or the going concern basis of accounting in the preparation of the financial statements is inappropriate). These apply to audits of financial statements of all entities, irrespective of their size or complexity and require the auditor to provide specific statements in these sections.

Material uncertainty exists and disclosures are adequate

Where a material uncertainty related to going concern exists and management has provided adequate disclosures in the financial statements, the auditor includes a separate section in the auditor's report entitled:

Material Uncertainty Related to Going Concern

The section draws attention to the relevant disclosures in the financial statements and explains that the events or conditions identified indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern. According to ISA 570 (Revised 570) para 35, the auditor explicitly states that:

- The auditor's opinion is not modified in respect of the matter
- That the management's use of the going concern basis is appropriate and
- That the conclusions are based on the audit evidence obtained up to the date of the auditor's report and are not a guarantee as to the entity's ability to continue as a going concern.

Where such a section is included, the matter is not also reported as a Key Audit Matter.

No material uncertainty exists

Where the auditor concludes that management's use of the going concern basis of accounting is appropriate and no material uncertainty exists, the auditor includes the required "Going Concern" section in the auditor's report in accordance with ISA 570 (Revised 2024) para 34. This is a new section under the Revised Standard where the auditor explicitly states that:

- That the management's use of the going concern basis is appropriate
- That the auditor has not identified a material uncertainty related to events or conditions that may cast significant doubt on the entity' ability to continue as a going concern and;
- That the conclusions are based on the audit evidence obtained up to the date of the auditor's report and are not a guarantee as to the entity's ability to continue as a going concern.

For an audit of financial statements of a listed entity, ISA 570 (Revised 2024) requires a description of how the auditor evaluated management's assessment where significant judgments are made by management in concluding that there is no material uncertainty.

Disclosures are inadequate

Where a material uncertainty exists but the related disclosures are inadequate, the auditor should express a qualified opinion or adverse opinion in accordance with para 36 of ISA 570 (Revised 2024). In the Basis for Qualified (Adverse) Opinion section the auditor must state that a material uncertainty exists that has not been adequately disclosed in the financial statements. A separate section under the heading "Material uncertainty related to going concern" is included in the auditor's report.

Use of Going concern basis is inappropriate

Similarly, where the auditor concludes that the going concern basis of accounting is inappropriate, the implications for the audit opinion should be considered (para 38 of ISA 570 (Revised 2024)).

Insufficient audit evidence

Where sufficient appropriate audit evidence cannot be obtained to conclude on going concern, the auditor should consider whether a qualified opinion or disclaimer of opinion is appropriate, depending on the circumstances.

Emphasis of Matter considerations

Auditors may encounter significant uncertainties that are fundamental to users' understanding of the financial statements but do not constitute a material uncertainty related to going concern.

In such circumstances, an Emphasis of Matter paragraph may be appropriate to draw users' attention to the relevant disclosures in the financial statements.

In addition, an Emphasis of Matter paragraph may be provided when the going concern basis of accounting is not appropriate and management prepares the financial statements on another basis (e.g. liquidation basis) and the auditor determines that the other basis of accounting is acceptable and there is adequate disclosure about the basis of accounting on which the financial statements are prepared (para A96 of ISA 570 (Revised 2024)).

Practical reminders

Auditors should ensure among other things that:

- going concern considerations are addressed early in the audit process;
- management's assessment covers an appropriate assessment period in accordance with the applicable financial reporting framework;
- cash flow forecasts are supported by reasonable and supportable assumptions;

- financing arrangements, covenant compliance and available sources of funding are appropriately evaluated;
- sensitivity analyses are performed where significant uncertainty exists; and
- there is a clear linkage between the audit procedures performed, evidence obtained and the conclusion reached.

Inventory held by third parties

Introduction

Inventory held by third parties presents additional audit challenges, particularly in relation to existence, rights and obligations, and valuation. Such arrangements commonly arise where inventory is stored in third-party warehouses, logistics centres, port facilities, or held by dealers and distributors under consignment arrangements.

The fact that inventory is physically located at a third-party site does not, in itself, affect its classification as inventory. Where an entity continues to own the goods and retains control over them, the inventory generally remains recognised in the entity's financial statements.

Audit considerations

ISA 501 *Audit Evidence* requires auditors to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory if inventory under the custody and control of a third party is material to the financial statements (para 8).

Determine an appropriate approach to obtaining evidence over inventory held at a third party on a timely basis during the planning phase of the audit. As part of planning, obtain an understanding of the arrangement with the third party (e.g., by reading the underlying contract) and consider if obtaining a confirmation from the third party will provide sufficient appropriate evidence, or whether additional or other procedures, such as inspections, may need to be performed.

Where inventory is held by third parties, external confirmations from the third party as to the quantities and condition of inventory held on behalf of the entity are commonly used as a source of audit evidence. However, confirmation responses alone may not always provide sufficient appropriate audit evidence. According to ISA 501 para A15, ISA 505 *External Confirmations* establishes requirements and provides guidance for performing external confirmation procedures.

Depending on the circumstances, for example, where information is obtained that raises doubt about the integrity and objectivity of the third party, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party. Examples of other audit procedures include (ISA 501.A16):

- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
- Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
- Requesting confirmation from other parties when inventory has been pledged as collateral.

Auditors should:

- evaluate the competence, capability and objectivity of the third party holding the inventory;
- maintain control over the confirmation process;
- assess the reliability and completeness of information received;
- consider obtaining information regarding the condition of the inventory; and
- perform additional procedures where necessary.

<u>Common deficiencies identified</u>

Monitoring reviews continue to identify deficiencies where:

- reliance is placed solely on third-party confirmations without performing additional procedures;
- insufficient consideration is given to the reliability of the third party;
- inventory quantities are not adequately reconciled to the accounting records;
- insufficient audit evidence is obtained regarding the condition or valuation of inventory; and
- conclusions reached are not adequately documented.

<u>Practical considerations</u>

Auditors should consider:

- whether site visits to third-party locations are necessary;
- whether alternative procedures are required where physical attendance is not possible;
- risks associated with inventory held in foreign jurisdictions;

- whether inventory is subject to consignment arrangements or restrictions over ownership; and
- the adequacy of documentation supporting the audit conclusion.

Legal and regulatory framework

Introduction

Under ISA 250 (Revised) *Consideration of Laws and Regulations in an Audit of Financial Statements*, entities operate within a legal and regulatory framework that varies by industry and jurisdiction. Some laws and regulations have a direct impact on financial statements because they dictate recognition, measurement, or disclosure requirements. Others govern business operations (e.g., health and safety or employment laws) and do not directly affect financial reporting.

The extent of regulation differs significantly between industries, with sectors such as banking and chemicals typically subject to more extensive regulation. Failure to comply with laws and regulations can lead to consequences such as fines, litigation, or other sanctions, which may in turn have a material impact on an entity's financial statements and therefore be relevant to the audit.
The extent and nature of applicable laws and regulations will vary depending on the entity's size, industry, activities and operating environment.

Common deficiencies identified
Monitoring reviews frequently identify instances where auditors:
- document generic legal and regulatory requirements without considering the specific circumstances of the entity;
- fail to identify industry-specific laws and regulations that could have a significant impact on the financial statements;
- do not adequately assess how management monitors compliance with relevant laws and regulations;
- fail to link identified legal and regulatory risks to the assessed risks of material misstatement and the audit procedures performed; and
- do not sufficiently document the rationale supporting their conclusions.

In some cases, audit documentation includes standardised descriptions of regulatory requirements without demonstrating how those requirements are relevant to the entity's operations and financial reporting.

Impact on audit quality

An inadequate understanding of the legal and regulatory environment can affect:

- the identification and assessment of risks of material misstatement under ISA 315 (Revised 2019) *Identifying and Assessing the Risks of Material Misstatement*;
- the design and performance of responsive audit procedures;
- the evaluation of compliance-related matters affecting the financial statements; and
- the overall audit conclusion.

Failure to appropriately consider relevant laws and regulations increases the risk that material matters affecting the financial statements may not be identified and addressed during the audit.

Audit considerations

Auditors should obtain an understanding of:

- the legal and regulatory framework applicable to the entity and its industry (ISA 250 (Revised) para 13(a));
- how is the entity complying with that framework (i.e. management's processes for identifying, monitoring and addressing compliance obligations) (ISA 250 (Revised) para 13(b));
- the impact of regulatory requirements on financial statement recognition, measurement and disclosure (ISA 250 (Revised) para 6); and
- any known or suspected instances of non-compliance that may require further investigation (ISA 250 (Revised) paras 15-17).

Attention may be required in areas such as anti-money laundering legislation, corporate law requirements, tax compliance obligations, licensing requirements and industry-specific regulations.

Where the entity operates within a regulated environment, auditors should also understand the role of the regulator, the relevant regulatory requirements and the extent to which management's accounting conclusions are supported by the applicable legal framework.

Practical reminders

Best practises include auditors to:

- tailor the documented legal and regulatory framework to the specific entity and industry;
- clearly document the laws and regulations considered relevant to the engagement;
- evaluate how management identifies and addresses compliance obligations;
- link identified regulatory risks to the audit procedures performed;
- maintain professional scepticism when assessing evidence relating to compliance matters; and
- ensure that audit conclusions are supported by adequate and entity-specific documentation.

Journal entry testing and management override of controls

Introduction

Management override of controls is presumed to be a significant risk in every audit engagement and, therefore, cannot be rebutted. Accordingly, auditors are required to design and perform procedures specifically responsive to this risk. Management override should be considered throughout the audit, including during risk assessment, planning, evaluation of audit evidence and assessment of management representations.

Audit requirements

Under ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* para 33, auditors are required to perform procedures addressing the risk of management override of controls, including:

- testing journal entries and other adjustments recorded in the general ledger and financial statements;
- reviewing accounting estimates for indicators of management bias; and
- evaluating the business rationale of significant unusual transactions.

Journal entry testing is a key component of the auditor's response because fraudulent financial reporting often involves inappropriate journal entries, particularly manual adjustments, post-closing entries and other non-routine transactions.

Professional judgement is required in determining the nature, timing and extent of testing.

Journal entry testing considerations

When designing journal entry testing procedures, auditors should obtain an understanding of:

- the entity's financial reporting process;
- controls over journal entries and adjustments;
- the sources of journal entry data; and
- the process for preparing and posting significant adjustments, including top-side entries (these are non-routine adjustments recorded in consolidation systems or directly in the financial statement reporting process and might include consolidation elimination, fair value adjustments, deferred tax adjustments, provisions recognised at year-end etc.).

Audit evidence may be obtained through a combination of:

- substantive testing of account balances;
- testing of consolidation and financial statement adjustments;
- testing of top-side journal entries; and
- targeted procedures designed to address identified fraud risks.

Selection of journal entries

The selection of journal entries should be risk-based and responsive to the assessed fraud risks.

Attention should be given to:

- entries posted at or near period-end;
- post-closing adjustments;
- manual journal entries;
- entries posted by individuals with elevated access rights;
- entries involving unusual accounts or account combinations;
- round-sum or unsupported adjustments; and
- entries associated with significant estimates and judgements.

Because fraud can occur at any point during the reporting period, auditors should not focus exclusively on year-end journals. Consideration should also be given to journal entries recorded throughout the period where risk factors are present.

Common deficiencies identified

Monitoring reviews frequently identify issues such as:

- insufficient testing of journal entries and other adjustments;
- failure to obtain and validate a complete population of journal entries;
- overreliance on monetary thresholds when selecting entries for testing;
- inadequate identification of high-risk journal entries;
- lack of unpredictability in audit procedures;
- insufficient procedures over top-side entries and consolidation adjustments; and
- inadequate documentation of the rationale for selecting journal entries for testing.

In some cases, audit files do not clearly demonstrate how the testing performed responds to the assessed risk of management override of controls.

Documentation considerations

Audit documentation should clearly demonstrate:

- the understanding obtained of the journal entry process and related controls;
- the population of journal entries subject to testing and how completeness was assessed;
- the risk criteria used to select journal entries for testing;
- the rationale for the selection made;
- the procedures performed; and
- the conclusions reached.

Where monetary thresholds are applied, auditors should document their consideration of the remaining untested population.

For journal entries selected for testing, auditors should obtain and examine appropriate supporting documentation. Inquiry of management alone, or the existence of a sign-off or approval, is generally not sufficient audit evidence regarding the appropriateness of an entry.

Unpredictability procedures

Teams should consider performing unpredictable procedures by incorporating an element of unpredictability in the nature, timing and extent of audit procedures in order to respond to an assessed risk of material misstatement due to fraud at the financial statement level, and/or the assertion level if a specific fraud risk at the assertion level has been identified. Examples include: conduct meetings with entity staff with whom we have not had much previous contact (e.g. sales staff responsible for handling major customer accounts), change nature of substantive analytical procedures (e.g. use different basis for disaggregating revenue), extend cut-off testing beyond the periods normally covered, including sales and sales returns, test areas of expense not previously tested in detail, where there are large numbers of bank accounts and selective testing of bank reconciliations is performed, change the basis of selection etc.

Use of GenAI on Audits

A GenAI technology is an automated tool or technique (e.g. ChatGPT) that assists the user by performing a task more efficiently by generating an output to be used as a starting point or suggestion for the user, for example by creating a list of questions for potential inclusion in an agenda used in meetings with clients. The starting point or suggestion does not replace the procedures performed, evidence obtained, or conclusions reached.

The use of GenAI can increase both the efficiency and effectiveness of our work through activities such as tailoring meeting agendas, summarization of information or assistance with administrative tasks. When GenAI is used in performing tasks that are related to an audit procedure, engagement teams need to continue to fulfill the requirements of professional standards, including their responsibility for considering the relevance and reliability of information to be used as audit evidence. Although the outputs from GenAI may appear plausible, they may not be accurate or complete, and, without an understanding of the source of the output information, engagement teams may not be able to satisfactorily conclude that it is reliable for the purposes of the audit. Therefore, it is important to remember that while GenAI offers numerous benefits, it cannot replace human judgment and expertise.

GenAI is appropriate for supporting audit procedures when it is used with relevant, reliable, and unrestricted source information, and when the prompt is specifically designed to align with the audit procedure and remain within the scope of that source information. In all cases, the preparer must perform an independent review to verify that the GenAI output is complete and accurate relative to the inputs before relying on it.

Documentation objectives

When technological resources are used in an audit, documentation should support:

- ISA 230 *Audit Documentation* compliance – sufficient audit documentation to support the work performed and conclusions reached.

- ISA 220 (Revised) *Quality Management for an Audit of Financial Statements* supervision and review requirements – enabling reviewers to understand, supervise and evaluate the work performed.

These objectives should be considered together when determining the nature and extent of documentation required.

A more experienced team member should direct those using the technology by covering:
- Whether the technology is appropriate for the audit procedure.
- How the technology contributes to the audit objective.
- The capabilities and limitations of the technology.
- Whether team members are sufficiently skilled to use it.
- The team's responsibilities for:
    - testing inputs,
    - assessing reliability,
    - evaluating completeness and accuracy of outputs.
- Required supporting documentation and guidance.

For engagement-specific technology solutions, reviewers must:
- Review outputs in the context of the audit objective.
- Verify inputs, including source data and parameters used.
- Assess procedures performed over the completeness and accuracy of source data.
- Understand how the technology supports the audit objective.

The depth of review depends on:
- Complexity of the technology.
- Nature of the audit procedure.
- Availability of supporting evidence.

Practical Examples of Review

Simple Technology (e.g., Excel)- a reviewer may:
- Check formulas.
- Recalculate selected calculations independently.
- Verify filters and assumptions.

More Advanced Technology - A reviewer may:
- Walk through the workflow with the preparer.
- Review explanatory documentation.
- Reperform selected steps independently.
- Confirm that data, filters and logic used are appropriate.

Visualisations - A reviewer may:
- Drill into charts and dashboards.
- Agree selected results back to source data.

- Confirm that the visualisation reflects the complete population.

Kind reminders:

- *All queries to ICPAC's technical support services shall be accompanied by the member's ICPAC membership number, therefore in the query senders are kindly requested to include their membership number.*
- *From 1 January 2023 onwards, the Advisor is able to provide guidance and interpretation on the International Standard on Review Engagements (ISRE) 2400 (Revised) Engagements to Review Historical Financial Statements.*
- *All support queries relating IFRS Accounting Standards, ISA and ISRE 2400 matters should be addressed to technicalsupport@icpac.org.cy.*