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# WHAT KEEPS YOUR AUDITOR AWAKE AT NIGHT?

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Malaysian Approved Standards on Auditing comply with International Standards on Auditing (ISA), similar to the way in which Malaysian Financial Reporting Standards (MFRS) comply with International Financial Reporting Standards (IFRS).

When undertaking the audit of Malaysian companies, auditors in Malaysia are required to conduct their audit in conformity with ISA.

Since December 2016, ISA 701 “Communicating Key Audit Matters in the Independent Auditor’s Report” has required auditors to determine Key Audit Matters (KAMs) when forming their audit opinion and communicate those matters by describing them in their audit report for listed entities.

With financial reports for the year ending 31 December 2021 due to be prepared in a few months’ time, and in the light of the experience gained by auditors over some five years since the introduction of ISA 701, it is timely to review common KAMs communicated by auditors in their 2020 reports. This article aims to assist directors in identifying aspects of their company’s 2021 financial statements which might require additional review, particularly in light of the economic impacts of COVID-19.

## What are KAMs?

ISA 701 defines KAMs as matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. KAMs are selected from matters communicated to those charged with governance which required significant auditor attention in performing the audit, taking into account the following:

- areas of higher assessed risk of material misstatement or significant risk identified such as:
  - past misstatements and whether they were corrected on a timely basis,
  - the nature of the entity and its environment including deficiencies in internal control,
  - significant changes that the entity or its operations may have undergone since the prior financial period, and
  - particular types of transactions and other events or account balances (and related disclosures) where the auditor experienced difficulty in performing the necessary audit procedures, for example, due to their complexity
- areas in the financial statements that involved significant auditor and management judgement including accounting estimates identified as having higher estimation uncertainty
- the effect on the audit of significant events or transactions that occurred during the period.

## Most commonly occurring KAMs

An analysis of KAMs referred to in the audit reports on 2020 financial statements for a sample of approximately 5% of companies listed on the main market of Bursa Malaysia across a variety of sectors, weighted towards those sectors with the most companies, indicated that KAMs mainly related to:

- impairment assessment of non-current assets
- impairment assessment of goodwill
- impairment of receivables, loans, financing and advances and other credit exposures
- revenue recognition

## Reliance on management judgement and accounting estimates

The common theme amongst these items is the extent to which they involve judgement concerning accounting estimates identified as having higher estimation uncertainty. This uncertainty with estimates is likely to be further exacerbated by the impact of COVID-19 in the 2021 financial year and hence it is opportune to review the requirements and guidance of MFRS relating to these matters.



## MFRS 136 *Impairment of Assets*



MFRS 136 covers the impairment of most assets with notable exceptions, which included among others, inventories, investment property measured at fair value, biological assets related to agricultural activity measured at fair value less costs to sell and deferred tax assets, all of which are covered by other MFRS, and financial assets coming within the scope of MFRS 9 *Financial Instruments*.

The Standard requires an entity **to assess** at the end of each reporting period **whether there is any indication that an asset may be impaired and if so, estimate the recoverable amount of the asset** and immediately reduce the carrying value to the recoverable amount by way of an impairment loss in profit or loss, unless the asset has been previously revalued, in which case the impairment loss is first applied against any previous revaluation surplus for that asset. In addition, the Standard also requires an entity to test an intangible asset with indefinite useful life or an intangible asset not yet available for use and goodwill for impairment annually, irrespective of whether there is any indication of impairment.

In assessing whether there is any indication that an asset may be impaired, an entity is required to consider both external and internal sources of information such as:

- significant changes with an adverse effect on the entity's technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated

- increases in interest rates which may impact discount rates used in calculating value in use
- the carrying amount of the net assets of the entity exceeds its market capitalisation
- evidence of obsolescence or changes in the expected utilisation or useful life

**The recoverable amount of an asset or cash-generating unit is the higher of its fair value**, being the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, **less costs of disposal, and its value in use.**

**Value in use** is defined as the present value of the future cash flows expected to be derived from the asset or cash-generating unit. The elements that shall be reflected in the calculation of an asset's value in use which include, among others, an estimate of the future cash flows the entity expects to derive from the asset, expectations about possible variations in the amount or timing of those future cash flows, and time value of money, represented by the current market risk-free rate of interest. Estimating the value in use of an asset involves estimating the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal and applying the appropriate discount rate to those future cash flows.

In measuring value in use, an entity shall base cash flow projections on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset; and the most recent financial budgets/forecasts approved by management, but shall exclude any estimated future cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance; as well as estimate cash flow projections beyond the period covered by the most recent budgets/forecasts by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified.

## **MFRS 13 Fair Value Measurement**

In considering fair value, reference needs to be made to MFRS 13 which categorises the inputs used in valuation techniques used to measure fair value into three levels with the highest priority given to quoted prices (unadjusted) in an active market for identical assets or liabilities that the entity can assess at the measurement date (Level 1). This is followed by inputs other than quoted prices which are observable for the assets or liabilities either directly or indirectly (Level 2), and next with unobservable inputs used to measure fair value having the lowest priority (Level 3).

## **MFRS 138 Intangible Assets**

After initial recognition, MFRS 138 permits an intangible asset to be carried at either its cost or revalued amount (but only if its fair value can be determined by reference to an active market) less any accumulated amortisation and accumulated impairment loss.

The amortisation period and the amortisation method for an intangible asset with a finite useful life is required to be reviewed at least at each financial year-end. If the expected useful life of the asset is different from previous estimates, or if there has been a change in the expected pattern of consumption of the future economic benefits embodied in the asset, the amortisation period or the amortisation method should be changed respectively and such changes shall be accounted for as changes in accounting estimates in accordance with MFRS 108 *Accounting Policies, Changes in Accounting Estimates and Errors*.

The useful life of an intangible asset that is not being amortised is also to be reviewed each year to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite is accounted for as a change in an accounting estimate in accordance with MFRS 108.

## **MFRS 108 Accounting Policies, Changes in Accounting Estimates and Errors**

In March 2021, the MASB issued an Amendment to MFRS 108, effective from 1 January 2023, to replace the definition of a “change in accounting estimates” with the term “accounting estimates” defined as “monetary amounts in financial statements that are subject to measurement uncertainty”.

The Amendment was made to align with an amendment to the corresponding International Financial Reporting Standard (IAS 8) as a result of feedback received by the International Accounting Standards Board (IASB) concerning some confusion arising between what constituted a change in an accounting policy, as opposed to a change in an accounting estimate or correction of an error.

The IASB indicated that in issuing the amendment, it sought to clarify that the effects on an accounting estimate of a change in an input or a change in a measurement technique are changes in accounting estimates unless they result from the correction of prior period errors. As a result, the effect of the change relating to the current period is recognised as income or expense in the current period with any effect on future periods being recognised as income or expense in those future periods.



## Impairment of Trade Receivables, Loans, Financing and Advances and other Credit Exposures

Impairment of Trade Receivables, Loans, Financing and Advances and other Credit Exposures comes within the scope of MFRS 9 which requires expected credit losses to be measured in a way that reflects an unbiased, probability-weighted amount determined by evaluating a range of possible outcomes, the time value of money, as well as reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

*In their KAMs in which trade receivables or loans, financing and advances were listed as an area of focus, auditors made reference to this being due to the assessment of impairment involving management judgements in ascertaining the probability of default, loss given default and macro-economic forward-looking adjustment.*

Whilst a normal part of management's judgement would, in accordance with MFRS 9, involve consideration of past experience with collections and recovery actions, the unprecedented economic impact of COVID-19 suggests that management may need to reconsider the probability of possible outcomes used previously, particularly in the light of current and forecast economic conditions.

## MFRS 15 Revenue from Contracts with Customers

There are three key aspects to the Standard, namely **recognition, measurement and disclosure**.

**Revenue recognition** arises when (or as) the entity satisfies a performance obligation by transferring a promised good or service (i.e., an asset) to a customer which occurs when (or as) the customer obtains control of that asset.

*A number of KAMs referred to judgement being required to ascertain the satisfaction of the performance obligation with respect to measuring progress when performance obligation is satisfied over time, such as for some construction contracts.*

*Complexity arising in recognising revenue on transactions, such as bundled contracts with multiple performance obligations or reliance on systems and controls in multiple transaction environments, was also the subject of KAMs.*

**Measurement** is based on the transaction price (which excludes estimates of variable consideration that are constrained) being the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes) that is allocated to that performance obligation after considering the terms of the contract and its customary business practices.





***The uncertainties around determining the consideration under some contracts, and the need to rely on management's judgement when recognising revenue from variations and additional claims, was noted in a number of KAMs.*** Reference was also made to ***disclosure*** of sufficient information as required by MFRS 15 to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. This includes the judgements, and changes in the judgements, that significantly affect the determination of the amount and timing of revenue from contracts with customers. In particular, those judgements and changes in judgements impacting:

- (a) the timing of satisfaction of performance obligations; and
- (b) the transaction price and the amounts allocated to performance obligations.

## Sleeping well

Throughout 2021, the uncertainty of the impact of COVID-19 on economic outcomes, and the extent to which this affects the carrying value of assets and the recognition of revenue, has been exacerbated with the mutation of the virus from the Alfa strain to the more infectious Delta strain and the mitigating effects from government relief measures.

Because MFRS are principle-based standards rather than prescriptive standards, they are designed to facilitate reasonableness, consistency and comparability of financial reporting in response to changing circumstances<sup>1</sup>.

As a result, it is very important for directors to fully consider the requirements and guidance of the standards discussed above in light of current circumstances when reviewing their company's 2021 financial reports which hopefully will enable both directors and their auditors to sleep well at night!

<sup>1</sup> MASB staff had published a series of Q&As to help constituents understand and respond to COVID-19 financial reporting implication. The Q&As are available here: [https://www.masb.org.my/pdf.php?pdf=QandA\\_COVID\\_19\\_impacts\\_v4-website.pdf&file\\_path=pdf\\_file](https://www.masb.org.my/pdf.php?pdf=QandA_COVID_19_impacts_v4-website.pdf&file_path=pdf_file)