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NANGIA & CO LLP

CHARTERED ACCOUNTANTS

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Foreword

We are delighted to present the **October 2024** edition of the **Assurance Gazette.** This edition explores NFRA's proposed revisions to SA 600, aiming to align with international standards and enhance group audit quality in India. Prompted by audit failures like DHFL and IL&FS, these revisions address key issues, such as improved coordination between principal and component auditors, stricter documentation, and increased professional skepticism. As NFRA seeks public feedback, understanding these changes is crucial for all professionals, ensuring a smooth adaptation when the standards are finalized. This issue also highlights IFRS 18, issued by the IASB, which aims to enhance the presentation and disclosure of financial statements, improving transparency and comparability across entities. The standard seeks to raise the quality of financial reporting by enforcing consistent categorization, allowing users to easily track and better understand financial performance across businesses.

IFRS 18 - Presentation and Disclosure in Financial Statements

It was issued by the International Accounting Standards Board (IASB) on April 9, 2024, with an effective date for periods beginning on or after January 1, 2027. The standard focuses on enhancing the presentation and disclosure of financial information, aiming to increase transparency, improve comparability across entities, and give users a clearer understanding of companies' financial performance.

Key Features of IFRS 18

1. Classification of Income and Expenses

IFRS 18 requires companies to classify their income and expenses into five major categories:

- **Operating**: Reflects the core activities of the business. For banks and insurers, income and expenses that might traditionally fall into investing or financing categories will be included here due to the nature of their business models.
- **Investing**: Pertains to activities that generate returns from investments not tied to the core operations.
- **Financing**: Includes interest and other costs related to funding the business.
- **Income Taxes**: Captures the tax expenses associated with operating profit and other categories.
- **Discontinued Operations**: Focuses on the results from parts of the business that are no longer operational.

Example: A retail company would classify its revenue from product sales under *Operating*, while a bank would classify income from loans, interest, and fee-based services under *Operating* due to its core business of providing financing.

2. Management-Defined Performance Measures (MPMs)

IFRS 18 introduces a requirement for companies to disclose MPMs. These are non-GAAP performance measures that management uses to communicate financial performance outside of the standard IFRS measures. MPMs must be reconciled with the most comparable IFRS totals or subtotals, ensuring that users can understand the differences between management's perspective and standard financial measures.

Example: If a company reports Adjusted Operating Profit as an MPM in its investor presentations, it must disclose how this measure differs from the standard Operating Profit calculated under IFRS, providing transparency into the adjustments made (e.g., excluding non-recurring costs).

3. Sector-Specific Guidance

Certain industries like banks and insurers receive additional guidance under IFRS 18. For example:

- **Banks**: Interest revenue, interest expenses, fee, and commission income, which may traditionally be part of the financing category, are classified under the *Operating* category as they form the core part of the business.
- **Insurers:** Income from investments and insurance-related financial income is classified under *Operating,* despite this normally being treated as investing or financing in other sectors

4. Aggregation and Disaggregation

Companies must aggregate similar items and disaggregate unlike items to provide a clear view of material information without obscuring critical details. This improves the clarity of financial statements and ensures that users can distinguish between key components of income and expenses.

Example: A company that generates income from multiple sources (e.g., product sales, service fees, and investments) must separate these into distinct categories, rather than lumping them together as "other income." This enables users to see how much revenue comes from core vs. ancillary activities.

5. Comparative Information

Entities are required to provide comparative data for previous periods, ensuring that users can see changes in financial performance over time. If any classifications change from one period to another, the entity must explain and adjust comparative figures accordingly.

Example: If a company reclassifies certain expenses (e.g., moving marketing costs from *Administrative* to *Operating*), it must present and adjust prior-year figures to reflect this change, providing users with a consistent basis for comparison.

Illustrative Example of a Financial Statement under IFRS 18

A sample income statement under IFRS 18 for a company might look like this:

ABC Corp Income Statement (FY 2027)

Categories	Amount (in $ million)
Operating Revenue	800
Operating Expenses	(600)
Operating Profit	200
Investing Income	50
Investing Expenses	(20)
Financing Costs	(30)
Profit Before Income Taxes	200
Income Taxes	(40)
Profit from Continuing Operations	160
Discontinued Operations	(10)
Net Profit	150

In this example:

- Operating revenue and expenses reflect the core activities of the company (sales and related costs).
- Investing and financing items are separately disclosed to reflect non-core activities.
- Taxes and discontinued operations are also distinctly categorized, allowing users to easily track which activities contribute to overall profitability.

Nangia's Take

IFRS 18 aims to reduce the discretion entities previously had in classifying income and expenses, leading to better comparability across companies and industries. By standardizing the presentation, particularly with respect to non-core activities (like investing and financing), users can now directly compare financial performance across businesses with different structures.

In conclusion, IFRS 18 strengthens the quality of financial reporting by enforcing consistent categorization, enhancing transparency through MPM disclosures, and ensuring that users of financial statements are well-informed about how companies perform and view their operations. The new rules are especially beneficial for investors and analysts seeking clarity on financial performance across different entities and industries.

Decoding NFRA's Proposed Changes to SA 600 and it's Implications on Group Audits

The National Financial Reporting Authority (NFRA) has proposed significant revisions to the Standard on Auditing (SA) 600 to better align it with the International Standards on Auditing (ISA) 600. These changes aim to address key shortcomings in group audits that have led to financial misstatements, insufficient diligence, and even fraud, as seen in cases like DHFL, IL&FS, and Coffee Day Enterprises. Failures in these cases were tied to the improper use of SA 600.

NFRA identified issues such as weak coordination between principal and component auditors, as well as an over-reliance on component auditors without proper oversight. The revised standards aim to improve audit quality and better protect stakeholders, with NFRA seeking public feedback to ensure the changes are comprehensive and effective.

Proposed Changes:

1. **Enhanced Role of Principal Auditor:** The principal auditor will bear increased responsibility for evaluating and reviewing the work performed by component auditors to ensure sufficiency & reliability of work done by component auditor.
2. **Assessment of Component Auditors:** Principal auditors must evaluate the technical expertise, experience, and adherence to ethical standards of the CA and not merely on the fact that the person is CA.
3. **Stricter Documentation Requirements:** Principal auditors will now need to maintain detailed and thorough documentation concerning the work performed by component auditors. Further, the decision-making process and justification for reliance on component auditors must be clearly documented.
4. **Increased Professional Skepticism:** The revisions call for a higher degree of professional skepticism, especially for audits involving large multinational corporations or complex conglomerates. Auditors will be expected to scrutinize related-party transactions, unusual financial dealings, and any signs of potential fraud with more rigor.
5. **Clarified Materiality and Risk Aggregation:** The revised standard includes more precise definitions of materiality and aggregation risk in group audits, addressing the risk that misstatements at the component level could lead to material misstatements at the group level. For this, Component auditors must define materiality for each component and ensure it aligns with the overall group audit.

6. **Review and Sharing of Work Papers:** Principal auditors will now have the right to review the work papers of component auditors to assess the adequacy of their audit procedures.
7. **Mitigation of Audit Concentration Risk:** While some concerns have been raised about potential audit concentration risks with larger firms dominating group audits, the revisions focus on ensuring that audit quality standards remain high across the board without compromising on competition.
8. **International Convergence:** The proposed revisions aim to align SA 600 with global best practices as outlined in ISA 600, ensuring that Indian auditing standards are on par with international standards.

Implications of the Changes:

1. **Increased Accountability for Principal Auditors:** Principal auditors will bear greater responsibility for group financial statements, ensuring stronger coordination and consistency in audits.
2. **Improved Audit Quality & Reduced Misstatement Risk:** The revisions are expected to improve audit quality and reduce the risk of misstatements and fraud, especially in complex group structures.
3. **Enhanced Fraud Detection:** Greater scrutiny of financial transactions and dealings will improve the detection of fraud, as demonstrated in cases like IL&FS and Coffee Day.
4. **Better Public Interest Protection:** These changes will enhance the protection of investors and creditors by ensuring the integrity and reliability of financial statements.
5. **Increased Compliance Burden:** Smaller audit firms may face higher compliance costs due to stricter documentation and review requirements.
6. **Stronger Investor Confidence:** Improved auditing standards will likely increase investor confidence and enhance market credibility.
7. **Challenges for Smaller Firms:** Stricter competence requirements for component auditors could limit opportunities for smaller firms, although this is expected to primarily affect audits of large public interest entities.
8. **Global Competitiveness:** Aligning with ISA 600 will facilitate cross-border audits, enhancing the global competitiveness of Indian firms and attracting foreign investment.

Nangia's Take

The proposed revisions to SA 600 seek to improve group audit quality in India by enhancing the principal auditor's oversight, improving coordination with component auditors, and aligning with international standards like ISA 600. These changes are designed to strengthen financial reporting integrity and boost investor confidence. However, concerns have been raised regarding the potential impact on smaller audit firms and the additional compliance burden these revisions may introduce. Issues like audit concentration risk and stricter competence requirements for component auditors could affect the inclusivity and competitiveness of the audit market, particularly for smaller firms.

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