
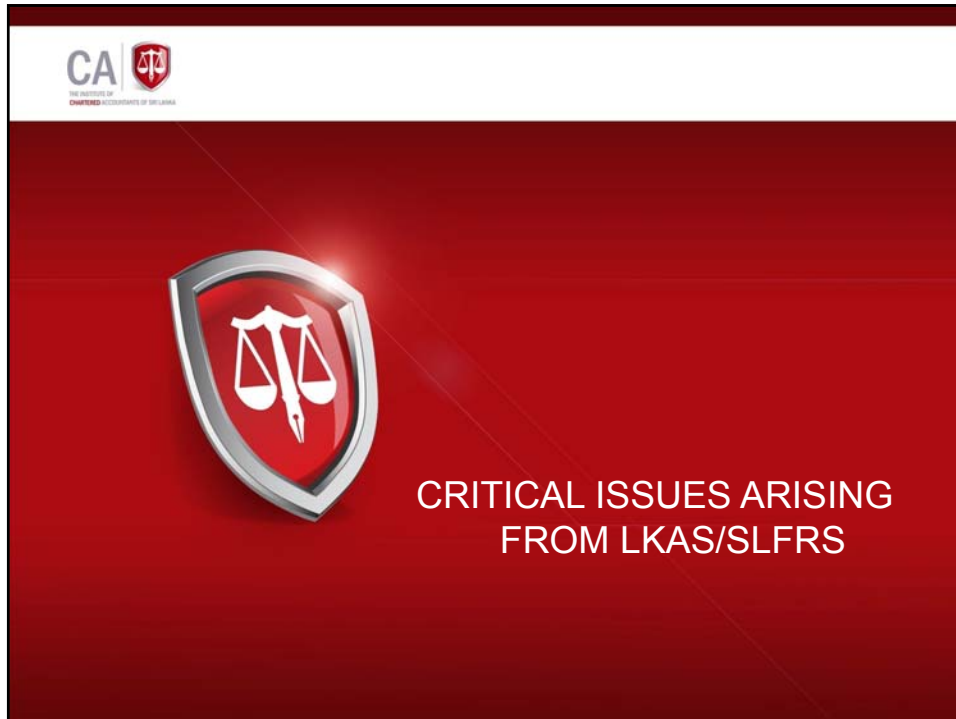

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Critical Issues for Auditors of Finance Companies



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What happened to the Balance Sheet?

Assets	Equity & Liabilities
<ul style="list-style-type: none"> ❖ PPE <ul style="list-style-type: none"> ❖ Land Leases ❖ Fully Depreciated Assets ❖ Component Accounting ❖ Useful Lives ❖ Deemed Cost on transition ❖ Investments (Financial Assets) ❖ Leases <ul style="list-style-type: none"> ❖ Operating Vs Finance (review of contracts and arrangements) ❖ Straightlining of rental ❖ Lease Receivables (Provisioning) ❖ Deferred Tax Asset 	<ul style="list-style-type: none"> ❖ Debt Vs Equity ❖ Financial Liability (Derivatives) ❖ Deferred Tax Liability



What happened to the Income Statement?

- ❖ Revenue
 - ❖ Revenue recognition point for land sales
 - ❖ Lease revenue – Straightline method
- ❖ FV gains and losses from investment in shares
- ❖ Depreciation
- ❖ Deferred Tax
- ❖ OCI
 - ❖ FV changes from AFS securities
 - ❖ Revaluation of land and buildings
 - ❖ Exchange differences on translation of foreign operations
 - ❖ Adjustments arising from hedges
 - ❖ Defined benefit plans



How will your Income Statement Look?

Consolidated income statement
for the year ended 31 December 2011

	Notes	2011 €000	2010 €000
Continuing operations			
Sale of goods		190,599	172,864
Rendering of services		17,131	16,537
Revenue from redemption of GoodPoints	25	1,375	1,125
Rental income	14	1,404	1,377
Revenue		210,809	191,903
Cost of sales		(163,691)	(155,268)
Gross profit		46,818	36,635
Other operating income	9.1	1,585	2,548
Selling and distribution costs		(14,000)	(13,002)
Administrative expenses		(19,746)	(13,482)
Other operating expenses	9.2	(1,153)	(706)
operating profit		13,504	11,993
Finance costs	9.3	(2,868)	(1,223)
Finance income	9.4	1,186	211
Share of profit of an associate	7	83	81
profit before tax from continuing operations		11,908	11,062
Income tax expense	10	(3,693)	(3,432)
profit for the year from continuing operations		8,215	7,630
Discontinued operations			
Profit/(loss) after tax for the year from discontinued operations	11	220	(188)
profit for the year		8,232	7,442
Attributable to:			
Owners of the parent		7,944	7,203
Non-controlling interests		288	239
		8,232	7,442

Consolidated statement of comprehensive income
for the year ended 31 December 2011

	Notes	2011 €000	2010 €000
Profit for the year		8,232	7,442
Other comprehensive income			
Net gain on hedge of a net investment		278	-
Income tax effect		(83)	-
		195	
Exchange differences on translation of foreign operations		(246)	(117)
Net movement on cash flow hedges	9.8	(732)	33
Income tax effect		220	(10)
		(942)	23
Net (loss)/gain on available-for-sale financial assets	9.8	(60)	(20)
Income tax effect		18	5
		(42)	(15)
Actuarial gains and (losses) on defined benefit plans	26	311	(401)
Income tax effect		(194)	120
		117	(281)
Revaluation of land and buildings	13	846	-
Income tax effect		(254)	-
		592	
Other comprehensive income for the year, net of tax		204	(393)
Total comprehensive income for the year, net of tax		8,436	7,051
Attributable to:			
Owners of the parent		6,148	6,612
Non-controlling interests		288	239
		8,436	7,051




Practical Scenarios



Key Areas

- ❖ Auditing the transition entries and the exceptions used under SLFRS 1
- ❖ Focus on the areas of judgments, estimates and the accounting policy changes
- ❖ Specific reference to related parties and the transactions done with them – is it at arms length including terms
- ❖ In the case of estimates, focus on the assumptions, methodology, the independence and the qualification of the managements experts.



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PPE

Fully Depreciated Assets

Scope of PPE (PPE vs Inventory, IP)

Determination of Components

Determination of Useful lives


Applicability of residual values

Use of Deemed cost option on transition

Land Leases – Operating vs Finance

❖ Future

- ❖ - Revisit useful lives
- ❖ - Identification of components
- ❖ - Residual values
- ❖ - Determination of operating lease vs finance lease



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Investments and other placements

Investment in Shares

- ❖ Classification of balances at initial measurement (FVTPL or AFS)
- ❖ FV of balances
- ❖ Identification of Impairment (Significant and prolonged) – AFS portfolio
- ❖ Disclosures

Other Investments	Options	Reason for classification	Future Status
T.Bond Investment	L&R	<ul style="list-style-type: none"> ➢ No active market ➢ Fixed maturity 	<ul style="list-style-type: none"> ▶ Entity should establish a process to classify the investments from the inception (Point of entering in to deal). ▶ Proper process should be in place to verify the ability to hold the security when classifying the portfolio classified as HTM. ▶ Process to be in place to restrict reclassification and premature disposal of HTM portfolio. ▶ Process to determine the fair value changes between the trade date and settlement date if entity opts to adopt settlement date accounting. ▶ Process should be in place to verify the rates used to fair value the financial instruments to reflect actual market conditions.
	HTM	<ul style="list-style-type: none"> ➢ Fixed Maturity ➢ Intention and the ability to hold till the maturity 	
T.Bills Trading	FVTPL	<ul style="list-style-type: none"> ➢ Intention to trade in short to medium term 	
T.Bond Trading	FVTPL	<ul style="list-style-type: none"> ➢ Intention to trade in short to medium term 	

Reclassification and Re-measurement of Balance Sheet as at 31.Dec. 2010



Provision for bad & doubtful debts

- ❖ Specific provision for individually significant balances
 - ❖ Identify impairment indicators
 - ❖ For impaired balances
 - ❖ Obtain expected cashflows
 - ❖ Discount the balances
- ❖ Collective Impairment
 - ❖ Identify and segregate debtor balances based on risk characteristics
 - ❖ Compute historical loss ratio
 - ❖ Evaluate based on judgment, whether historical loss ratios require change

❖ Continuous improvement to judgments! Ex: Gold prices, property prices, etc.
 ❖ Improvements on identification and segregation of risk characteristics based on changes in the business



Judgmental adjustments to historical loss experience : Proposed Model

Step 01: Identify Macro economic factors and portfolio factors that has impact on each and every segment


Step 02: Determine the weight of each factor to the relevant segment of the portfolio.

Step 03: Establish guidelines for ranking the current condition with the historical average conditions.

Step 04: Rank each and every economic and portfolio factors on a 1 to 5 scale and work out weighted average rank for each and every portfolio.

Step 05: Adjust the historical average PD/NFR based on the weighted average rank

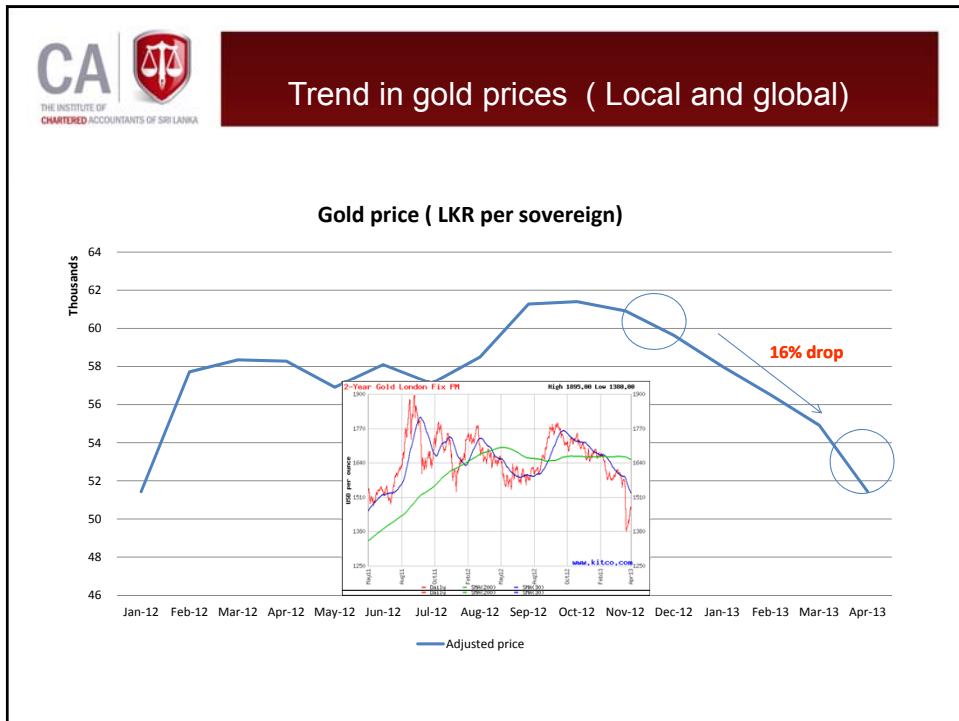
Rank	Comparable Economic/portfolio condition	Adjustment PD
1	Significantly Improved	Significantly Increase
2	Improved	Increase
3	Same	No Change
4	Adverse	Decrease
5	Significantly Adverse	Significantly Decrease

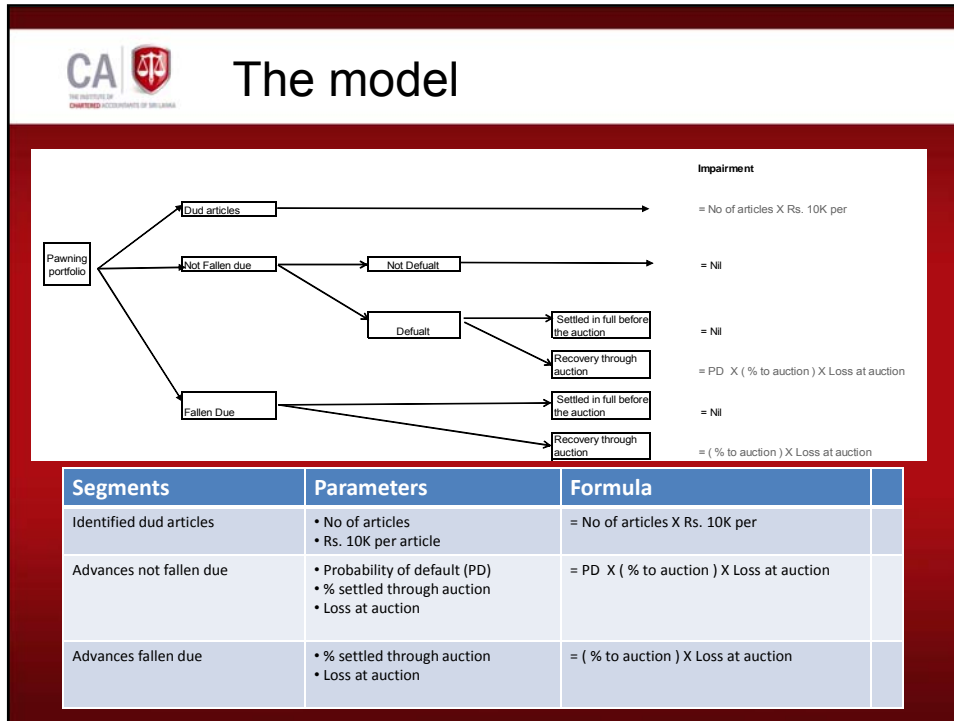


Economic Factors & guidance for scoring

No	Economic factor
[1]	[2]
1	GDP and other Economic Performance indicator (a) = GDP in current year – average GDP in past four year (b) = CPI in current year – average CPI in past four years
2	Economy factors: (a) Changes in Government Policies on the industry compared with past four years (b) Monetary policies (c) Changes in political structures (d) Social issues (e) Demographic
3	Status of industry Business cycle (a) Business cycle of industry (b) Competitiveness in the industry (c) Capital resource invested in the industry (d) Length of investment period and length of return period
4	Maturity Profile of the Portfolio (a) Mix and long term loan balances/ total loan balances (b) Average of (a) in past four years
5	Forecast in Interest Rate Environment (a) = Basic interest rate in current year – average interest rate in past four year (b) = Exchange rate (USD/INR) announced by RBI in current year – average exchange rate in past four years
6	Underwriting Standards (a) Government policies giving limitation on credit granting to specific industries (b) Regulatory environment, macroeconomic policies, Government economic strategies might have impact on specific industry development
7	International economic factors that have impact on national economy and the industry (a) Global economy or regional economy is receding (b) Price of inputs is increasing, basic goods becomes

Factor	Sub-factor	Scoring	1	2	3	4	5
Factor 1	(a)	±2%	2% > a > 0 and (b) < 0	(a) = 0 or 2% > (a) > 0 and (b) > 0	0 > (a) > -3%	(a) < -3% or (b) > 5%	
Factor 2		Being significantly more favorable than past four years	Being more favorable than past four years	Being similar with past four years	Being more unfavorable than past four years	Being significantly more unfavorable than past four years	
Factor 3	(a)	Peak	Expansion	Maturity	Recovery	Recession	
	(b)	Almost nil	Low	Average	High	Very high	
	(c)	Very significant	Significant	Average	Insignificant	Very insignificant	
	(d)	Very short	Short	Average	Long	Very long	
Factor 4	(a)	< (b) ≤ 40%	(b) < (a) ≤ 40%	(a) = (b)	40% < (a) < (b)	40% < (b) < (a)	
Factor 5	(a)/(b)	4 > 0.5	0.5 < (a)/(b) < 1	(a)/(b) = 1	2 > (a)/(b) > 1	(a)/(b) ≥ 2	
Factor 6		Being more favorable than past four years	Being similar with average of past four years	Being similar as average of past four years but less favorable than last year	Being more unfavorable than past four years	Being more significantly unfavorable than past four years	
Factor 7		Being more favorable than past four years	Being similar as past four years	Being similar as past four years but less favorable than last year	Being more unfavorable than past four years	Being more significantly unfavorable than past four years	





Process Improvements


Individual Impairment

- ❖ Re-visit objective evidence that has been determined last year in the light of current market (legal, political, economic) conditions
- ❖ Strengthen the process to capture guarantees obtained on behalf of loans, and the measurement of such guarantees.
- ❖ Detailed instructions and guidelines on estimation of timing and the amount of expected cash flows
- ❖ Operational procedures on :
 - ❖ Segregation of related responsibilities
 - ❖ Target deadline
 - ❖ Appropriate review and authorization level

Collective Impairment

- ❖ Process for on going estimation of LGD
 - ❖ Calculation methods, formulas, assumptions and templates
 - ❖ Appropriate validation levels
 - ❖ Judgmental adjustments based on observable market conditions
- ❖ Review and estimate the historical loss experiences
 - ❖ On time receipt and availability of required data files
- ❖ Appropriate automation of the calculation process
- ❖ Quantify the characteristics of recovery process
- ❖ Eg :Time period between letter of demand to foreclosure
 - ❖ Average recovery cost as a percentage of disposal value
 - ❖ Annual value increase percentage for mortgage property
- ❖ Stability of Loss Given Default (LGD)
 - ❖ In the initial stage of implementation there are many practical issues of estimating loss given default such as
 - ❖ Difficulties to obtain historical data
 - ❖ Inadequate population of realized loss cases to form meaningful statistical conclusion
 - ❖ Less than 3years historical data may distort LGD estimates
 - ❖ Lack of expertise to make proper judgmental estimates

❖ Consideration of Exposure at Default (EAD)




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Leases

- ❖ Leases – Operating vs Finance
 - ❖ Bargain purchase option at the end of the lease period
 - ❖ Lease term is for the entirety of the useful life of the asset

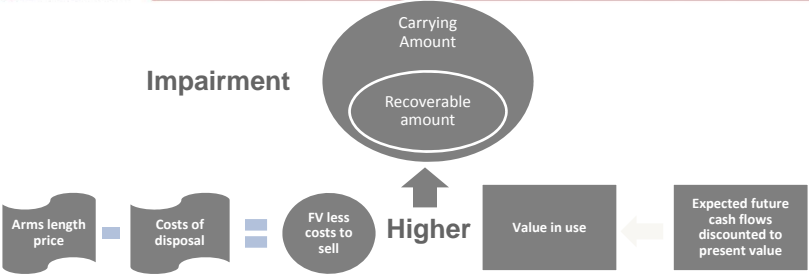
- ❖ Sale and leaseback
 - ❖ Gain/loss on sale
 - ❖ Revenue recognition




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Impairment of Assets


Impairment



When?	Issues
<u>Annual Assessment</u> <ul style="list-style-type: none"> ▶ Intangible assets <ul style="list-style-type: none"> - With indefinite useful life - Not yet available for use ▶ Goodwill through business combination 	Identification of CGU Identification of Impairment indicators
Other assets - when impairment conditions exist	Measurement Disclosures




Disclosures!
Disclosures!
Disclosures!



Disclosures – LKAS 24 – Related Parties

Related parties have the ability to influence transactions!!!

Identification of related parties and the entity	Identification related parties	Entities need to	Disclosures
<ul style="list-style-type: none"> ▶ Identification of related parties and the entity <ul style="list-style-type: none"> ▶ Subsidiaries , joint ventures and associates ▶ Significant owners ▶ KMP's and close family members ▶ Transactions entered into with RP ▶ Companies needs to institute processes to provide these disclosures 	<ul style="list-style-type: none"> <li style="background-color: #F1C40F; padding: 5px;">Subsidiaries, joint ventures and associates <li style="background-color: #F1C40F; padding: 5px;">Significant owners <li style="background-color: #F1C40F; padding: 5px;">KMP's and close family members 	<ul style="list-style-type: none"> <li style="background-color: #F1C40F; padding: 5px;">Institute processes to provide these disclosures <li style="background-color: #34495E; padding: 5px;">Review system capabilities to track information 	<ul style="list-style-type: none"> <li style="background-color: #F1C40F; padding: 5px;">KMP compensation in total and for each category <li style="background-color: #34495E; padding: 5px;">▶ Parent (s) <li style="background-color: #34495E; padding: 5px;">▶ Significant investors <li style="background-color: #34495E; padding: 5px;">▶ Subsidiaries <li style="background-color: #34495E; padding: 5px;">▶ JV/Associates <li style="background-color: #34495E; padding: 5px;">▶ KMP <li style="background-color: #34495E; padding: 5px;">▶ Other RP



Disclosures – SLFRS 8 - Operating Segments

Determination of a Chief Operating Decision Maker (CODM)

Identify reportable segments


- Component which may earn revenue and incur expenses
- Results are regularly reviewed by CODM
- financial information is available


Aggregation is allowed if similar in

- nature of products and services
- nature of production process
- class of customer
- distribution methods

and

- regulatory environment





Disclosures – SLFRS 7 Financial Instruments


▶ **All risks arising from financial instruments to be disclosed.**

Are you ready to disclose?
<p>Risk management policies – Management’s objectives, policies and processes for managing risks</p>
<p>Your credit risk, liquidity risk and market risk</p> <ul style="list-style-type: none"> ▶ Bad debts (Credit Risk) <ul style="list-style-type: none"> ▶ Disclosure of maximum exposure to Bad debt/credit risk ▶ Credit quality – financial assets with credit risk that are neither past due nor impaired ▶ Liquidity Risk <ul style="list-style-type: none"> ▶ Maturity analysis- financial liabilities showing remaining maturities ▶ Market Risk <ul style="list-style-type: none"> ▶ Foreign exchange risk, interest rate risk, etc.
<p>▶ Sensitivity Disclosures</p>
<p>▶ Level of Fair Value (FV Hierarchy)</p>

These will be subject to audit!


Proper process/systems to gather data

Disclosures will be compared by analysts/stakeholders



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FUTURE STATE



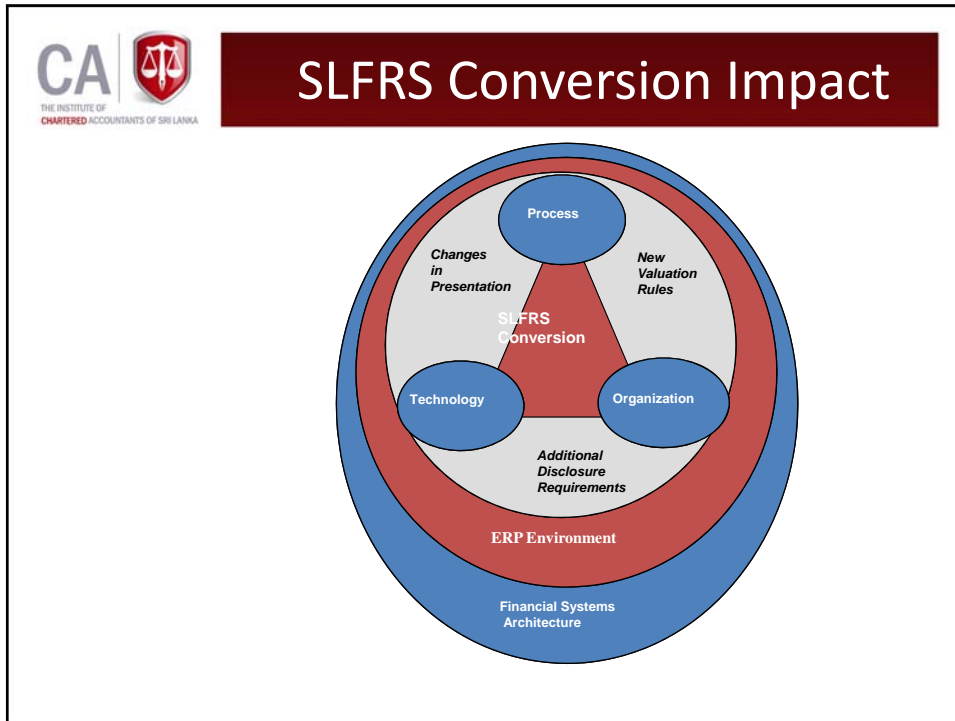
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What reliefs will be out the window

- ❖ Exemption for Share based options vested before transition
- ❖ Formula method for Actuarial valuation of employee benefits
- ❖ Exemption on SLFRS 7 – FV, credit risk, market risk
- ❖ Recasting the comparative quarters for 2013

❖ What is new?

- ❖ New principles for Business combinations



Regulatory requirements

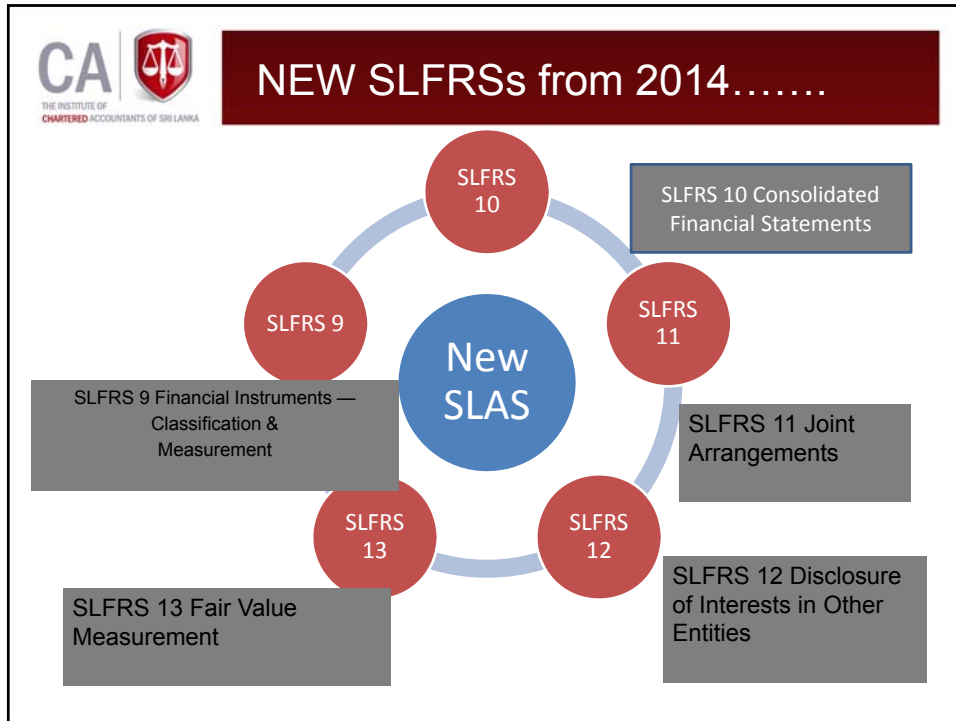


Corporate Governance Direction 3 of 2008

- ❖ Report by the board on the company's internal controls over financial reporting (designed to provide reasonable assurance regarding the reliability of Financial reports)
- ❖ The external auditors certification on the effectiveness of IC mechanism in respect of any statements published after 31/3/2010
- ❖ The external auditors certification of the compliance with the act and rules and directions issued by the monetary board (after 1.1.2011)



What is Next?



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Moving Target



Moving Target.....

- Make sure that the critical areas of judgement has been looked into by experienced staff
- Be aware that the knowledge of the clients staff may be inadequate to prepare financial statements based on LKAS/SLFRS
- The new standards require a lot of input by operations. These inputs may not be adequately controlled
- Different options available in the application of the standards
- The principle based standards require the exercising judgements. This requires to be audited to ensure that the transaction is reflected properly
- The auditors should get the audit comm to understand the key judgements and assumptions and take responsibility for these
- Auditor should be aware of creative reporting. FS should reflect what is practised by the company (SLFRS 7 risk management)
- Extra focus required when auditing Impairment and RPT
- In the case of group audits – make sure the parents policies and consistently applied in the group



Thank You