Endunamoo BCTA Support Course (BCTA2018)

AUE3702: Evaluating, Concluding and Reporting

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Introduction

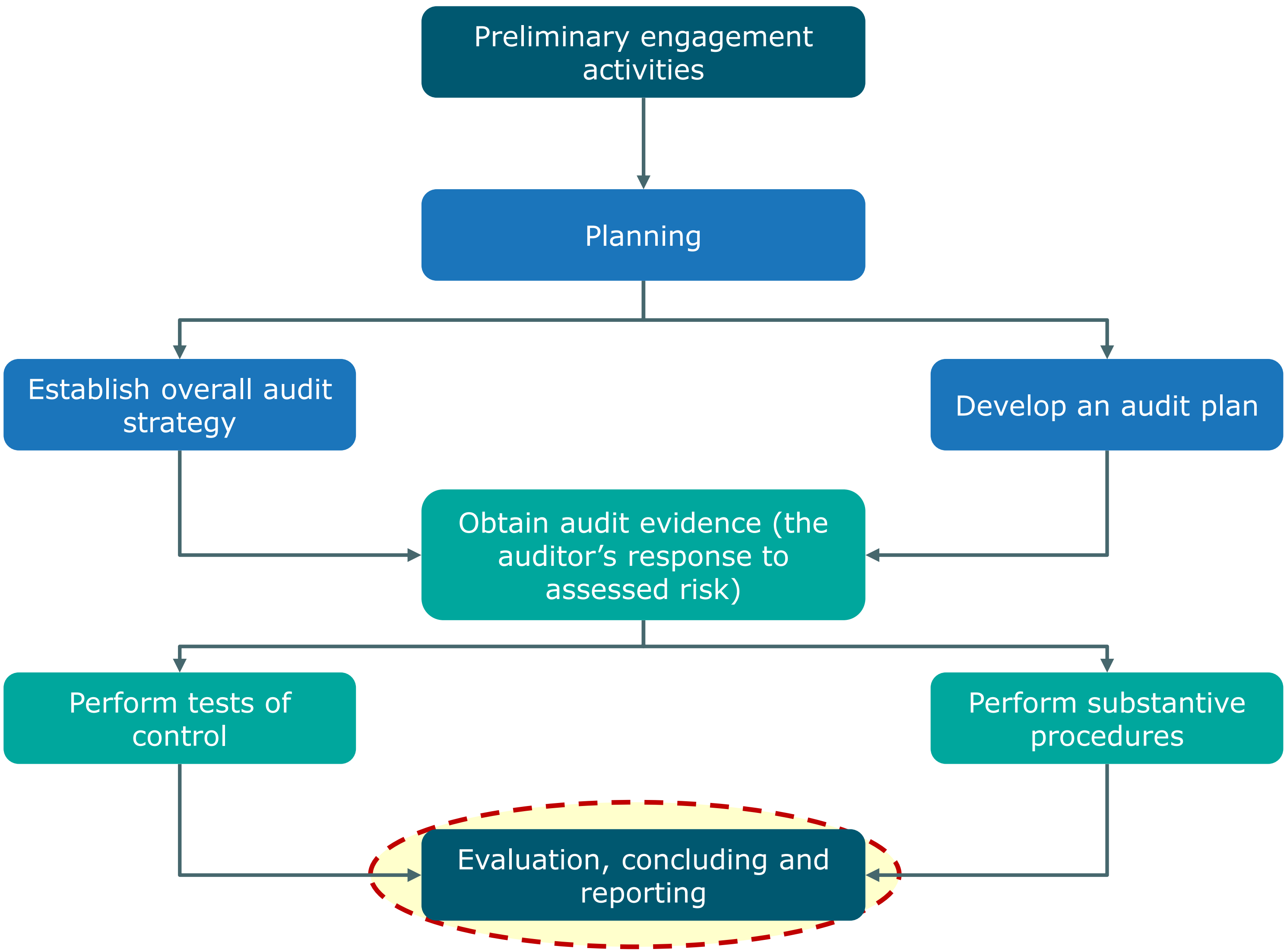
The Audit Process

The Companies Act (2008)

The Auditing Profession Act (IRBA)

King IV

The Code of Professional Conduct, By-Laws and rules regarding improper conduct



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ISA 450: Evaluation of misstatements identified during the audit

ISA 450

The objective of the auditor is to evaluate:

(a) The effect of identified misstatements on the audit; and

(b) The effect of uncorrected misstatements, if any, on the financial statements

Misstatement – A difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. (Ref: Para. A1)

ISA 450

When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

Uncorrected misstatements – Misstatements that the auditor has accumulated during the audit and that have not been corrected.

ISA 450

Steps to follow when we identify a misstatement are as follows:

1. Accumulation of Identified Misstatements

- The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial

2. Consideration of Identified Misstatements as the Audit Progresses

- The auditor shall determine whether the overall audit strategy and audit plan need to be revised if

❖ Nature of identified misstatements

❖ The aggregate of misstatements accumulated during the audit approaches materiality

ISA 450

3. Communication and Correction of Misstatements

- The auditor shall communicate, unless prohibited by law or regulation, on a timely basis all misstatements accumulated during the audit with the appropriate level of management
- The auditor shall request management to correct those misstatements

4. Evaluating the Effect of Uncorrected Misstatements

- Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with ISA 320 to confirm whether it remains appropriate in the context of the entity's actual financial results.
- The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate

ISA 450

5. Written Representations

- The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole

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ISA 550: Related Parties

ISA 550

Related party – A party that is either: (Ref: Para. A4-A7)

(i) A related party as defined in the applicable financial reporting framework; or

(ii) Where the applicable financial reporting framework establishes minimal or no related party requirements:

a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;

b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or

ISA 550

c. Another entity that is under common control with the reporting entity through having:

i. Common controlling ownership;

ii. Owners who are close family members; or

iii. Common key management.

ISA 550

1. Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions.

- Fraud Risk Factors Associated with a Related Party with Dominant Influence

a) Transactions involving the related party are rarely independently reviewed and approved

b) Significant transactions are referred to the related party for final approval.

c) There is little or no debate among management and those charged with governance regarding business proposals initiated by the related party

ISA 550

2. Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions

a) Confirming or discussing specific aspects of the transactions with intermediaries such as banks, law firms, guarantors, or agents, where practicable and not prohibited by law, regulation or ethical rules.

b) Confirming the purposes, specific terms or amounts of the transactions with the related parties

c) Where applicable, reading the financial statements or other relevant financial information, if available, of the related parties for evidence of the accounting of the transactions in the related parties' accounting records.

ISA 550

Another thing to consider when doing related party is the accounting standard IAS 24

When doing your substantive procedures make sure that you incorporate the measurement and recognition criteria used in IAS 24

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Subsequent events

ISA 560: Subsequent Event

Definitions

Date of the financial statement (AFS): The date of the end of the latest period covered by the financial statements, normally the financial year-end date.

Date of Approval of the AFS: Date those with authority assert that they have taken responsibility for the AFS

Date of auditors report: Date auditors select to date the audit report on the AFS

Date the AFS are issued: Date auditors report and audited financial statements are made available to 3rd parties

ISA 560: Subsequent Event

Subsequent events: events occurring between the dates of the AFS and the date of the auditors report and facts that become known to the auditors after the date of the auditors report.

Please study: Chapter 17 of Jackson and Stents

Please refer to: IAS 10 Events after reporting period

Please refer to: ISA 560 Subsequent events

ISA 560: Subsequent Event

Types of subsequent events:

- **Adjusting events:**

Events requiring adjustment in the AFS. Adjustments must be made where the subsequent events provides evidence of conditions that exited at the reporting period.

- **Non-adjusting events:**

Events that are indicative of conditions that arose after the reporting period. If non-adjusting events after reporting the reporting period are material

- **Dividends**

If a company declares a dividend after the reporting period, the entity shall not recognise those dividends as a liability at the date of AFS as they are approved at the AGM.

ISA 560: Subsequent Event

- Going concern

If management determines after the reporting period that either : it intends to liquidate the company or to cease trading or that they no alternative but to do so, the AFS may not be prepared on the going concern basis

ISA 560: Subsequent Event

ACTIVITY 4.3.1

The following events took place at various audit clients of your audit firm:

(1) A final judgment was given by the court (after the client’s reporting period) in a case in which the audit client was successfully sued for damages amounting to R4 million. The case commenced during the client’s previous financial year end. At the date of the financial statements the client had provided R2 million in respect of this claim.

(2) A fire at the audit client’s factory (after the financial year end) resulted in the directors announcing a plan to discontinue that specific manufacturing operation.

(3) The company declared a dividend of 30 cents per share to its ordinary shareholders after the date of the financial statements.

ISA 560: Subsequent Event

(4) The collapse of the audit client company's market in Japan after the date of the financial statements has resulted in the going concern assumption no longer being appropriate.

Required:

Classify each of the above cases as either an adjusting or a non adjusting event.

You should also justify your reasoning.

ISA 560: Subsequent Event

Classification and justification
(1) Adjusting • Increase of R2 million required – known obligation at date of financial statements relating to circumstances that existed at year end.
(2) Non-adjusting • Discontinuation did not "exist" at the date of financial statements; disclosure should be made as it is a material matter.
(3) Non-adjusting • No liability at year end; no adjustment, but disclosure is required.
(4) Adjusting • Although collapse took place after financial year end, the financial statements should be adjusted so as not to be presented on the going concern basis.

ISA 560: Subsequent Event

ACTIVITY 4.3.2

15 May 201X: An explosion in the new warehouse destroyed inventory with a cost price of R100 000. While investigating this matter, the auditor discovers an error in the allocation of overheads to inventory resulting in other inventory (other than inventory lost in the explosion) being overstated by R350 000. The company's year-end is 31 March 201X and as at 15 May 201X the auditor has not yet issued the audit report. Materiality was set at R250 000.

Required:

Identify the events and state how they should be treated in the financial statements at 31 March 201X. Give reasons for your answer.

ISA 560: Subsequent Event

FEEDBACK ON ACTIVITY 4.3.2

As you gathered, there are two events, namely the explosion and the overstatement of the inventory.

The explosion would seem to be a non-adjusting event.

This event occurred after the date of financial statements and concerns conditions which did not exist at the date of financial statements. This would appear therefore to be an item that should not be disclosed and should also not be treated as an adjusting event.

The discovery of the fact that inventory was overvalued by R350 000, as a result of the misallocation of overheads, is an adjusting event, because it gives more information about a condition that existed at the date of financial statements (misallocation of overheads during the year). It is certainly quantitatively material in relation to the set materiality (R350 000 versus R250 000).

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Provisions and Contingent Liabilities

Provisions and Contingent Liabilities

DEFINITIONS

Provisions

A liability of uncertain timing or amount.

Liability

A present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow of resources from the entity.

Contingent liability

A possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of an uncertain future event not wholly in the control of the entity.

Provisions and Contingent Liabilities

RECOGNITION

Provision

A provision must be recognised when the following has been met

- Company has a present obligation as a result of a past event
- It is probable that an outflow of resources will be required to settle the obligation.
- A reliable estimate can be made of the amount of the obligation

Contingent liabilities

Contingent liabilities are not recognised but must be disclosed

Provisions and Contingent Liabilities

If asked to create substantive procedures for provisions and contingent liabilities, it is essential that you consider the definition and recognition criteria discussed above

Please study also IAS 37 for this topic

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Going Concern and Factual Insolvency

Going Concern and Factual Insolvency

- Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future.

- When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

Going Concern and Factual Insolvency

The auditor's **objectives** regarding the going concern assumption:

(a) 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;

(b) 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; and

(c) To report in accordance with this ISA.

Going Concern and Factual Insolvency

Examples of events or conditions which may cast doubt about the entity's ability to continue as a going concern are as follows:

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.

Going Concern and Factual Insolvency

- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments
- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labour difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Going Concern and Factual Insolvency

There are two categories of insolvency to consider:

1. Commercial insolvency

- Arises when an undertaking is unable to pay its debts as they fall due as a result of illiquidity, even though its assets may exceed its liabilities.
- It is clearly indicates going concern problems and would be taken into consideration by management and auditors in assessing the appropriateness of presenting the AFS on the going concern basis

2. Factual insolvency

- Arises when the liabilities of an undertaking exceed its assets, fairly valued.
- It is clearly indicates going concern problems, but in addition, has far more serious implications for the auditor

Going Concern and Factual Insolvency

- If an entity continues to trade while tis liabilities exceeds its assets, fairly valued, a situation is created where certain irregularities may be taking place.
- If such irregularities are taking place, a duty on the part of the auditor to report a reportable irregularity may arise.

Reportable Irregularity

- An unlawful act or omission
- Committed by management
- Have caused or be likely to cause financial loss **or**
- Be fraudulent or amount to theft **or**
- Represent a material breach of fiduciary duty by the person committing the unlawful act

Going Concern and Factual Insolvency

ACTIVITY 4.5.3

During the audit of Hiki (Pty) Ltd for the year ending 31 December 201X you discovered that Hiki (Pty) Ltd is factually insolvent (i.e. liabilities exceed assets, fairly valued). The managing director is confident that the company will return to profitability in the new financial year as certain large new contracts have been secured. Management is unable to satisfy you (as the auditor) that Hiki (Pty) Ltd will restore its solvency in the foreseeable future.

Required:

State, giving reasons, what actions you would take given the circumstances that management is unable to satisfy you that Hiki (Pty) (Ltd) will restore its solvency in the foreseeable future. Your answer should include a discussion of:

Going Concern and Factual Insolvency

- Sections 1 and 45 of the Auditing Profession Act 2005
- Section 22 of the Companies Act 2008
- Common law fraud
- The considerations to formulate an audit opinion on the company's financial statements

FEEDBACK ON ACTIVITY 4.5.3

1. Continuation of operations in the present circumstances may be considered to be a reportable irregularity in terms of section 1 of the Audit Profession Act as the company will be trading while factually insolvent.

2. This is because in terms of section 22 of the Companies Act a company must not carry on its business recklessly, with gross negligence, with the intent to defraud creditors or for any other

Going Concern and Factual Insolvency

fraudulent purpose, or trade under insolvent circumstances.

2.1 Because the management accounts reflect the factual insolvency, and the directors have not taken appropriate remedial action, an unlawful act has been committed by persons responsible for the management of the entity.

2.2 Trading while factually insolvent, with no concrete strategy to restore solvency, is fraudulent and will give rise to material financial losses on the part of the company's creditors.

3. I would therefore, without delay, send a written report to the IRBA, giving particulars of the reportable irregularity in terms of section 45 of the Auditing Profession Act.

4. Within three days of sending the report to the Regulatory Board, I would notify the members of the board of Hiki (Pty) Ltd in writing of the sending of the report to the IRBA and the provisions of this section.

Going Concern and Factual Insolvency

5. As soon as reasonably possible but no later than 30 days from the date on which the report was sent to the IRBA, I would ...

(a) take all reasonable measures to discuss the report with the members of the management board of the entity

(b) afford the members of the management board of the entity an opportunity to make representations in respect of the report

(c) send another report to the IRBA, including a statement, with supporting information, that I am of the opinion that no reportable irregularity has taken place or is taking place, or the suspected reportable irregularity is no longer taking place and that adequate steps have been taken for the prevention or recovery of any loss as a result thereof, if relevant, or the reportable irregularity is continuing

Going Concern and Factual Insolvency

6. I would further advise the directors that, in terms of case law, they could be found guilty of common law fraud for incurring debts the company may not be able to pay.

7. At year end, the effect of the deficit will have to be considered in formulating an audit opinion on the company's financial statements.

8. Use of the going concern assumption in these circumstances would appear to be inappropriate; the annual financial statements should be prepared on the liquidation basis, with full disclosure.

9. Should this not be done, an adverse audit opinion should be expressed, as the matter is material and pervasive (as the financial statements are rendered meaningless and/or misleading).

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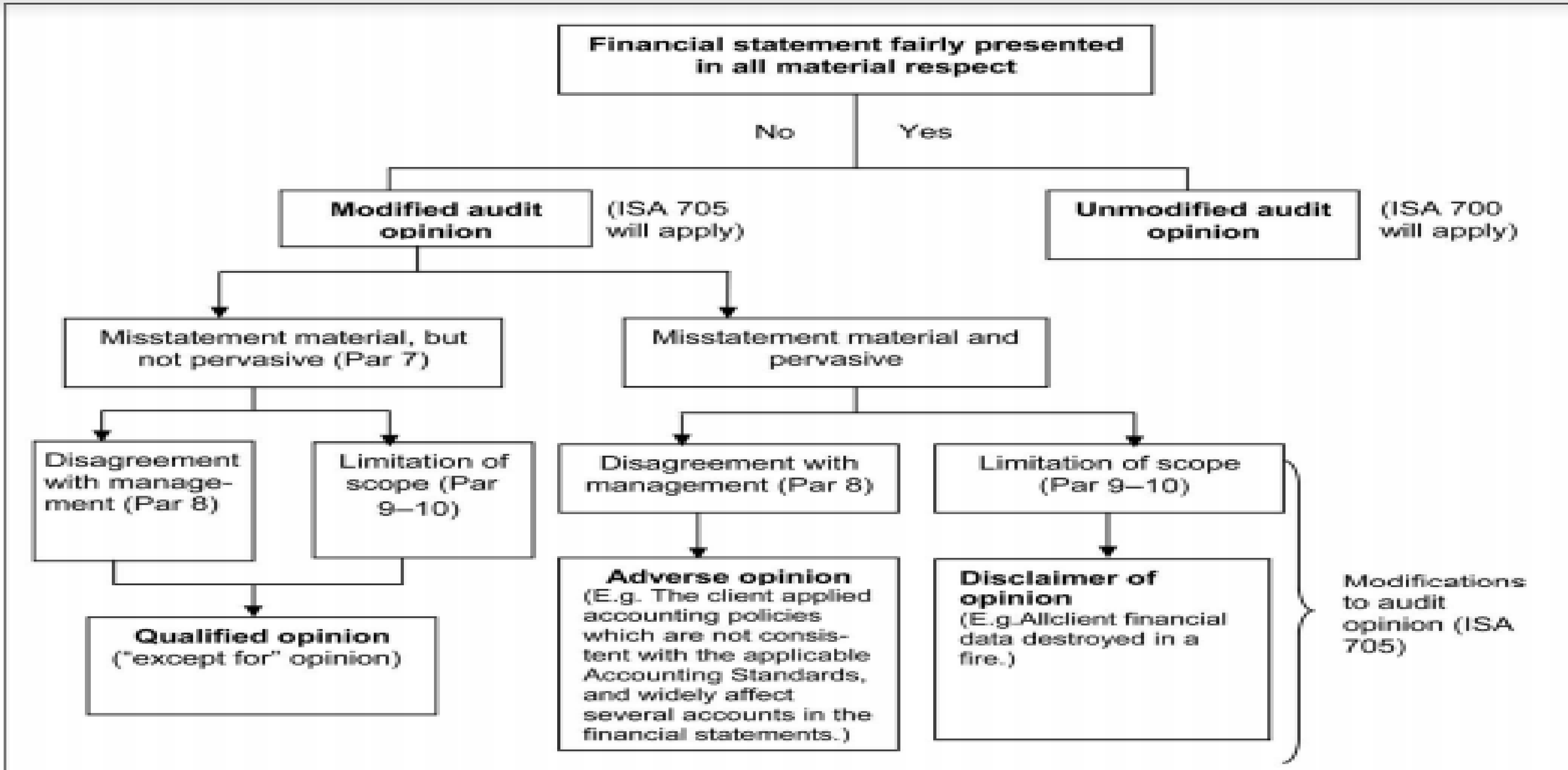
Audit Report

Audit Report



For modified opinions, refer to ISA 705, paragraph A1, to help you determine an appropriate modification.

Audit Report

ACTIVITY 4.6.3

Imagine that during the audit of CRI Limited you found the inventory to be overvalued by a material amount (R3 million) and the directors refuse to correct the error.

Required

Write down the two paragraphs applicable to the facts in this activity.

FEEDBACK ON ACTIVITY 4.6.3

(1) Qualified opinion: In our opinion, except for the effects of the matter described in the paragraph on basis for qualified opinion section of our report, the accompanying financial statements present fairly, in all material respects, the financial position of CRI Limited as at 31 January 201X, and its financial performance and

Audit Report

cash flows for the year then ended, in accordance with the International Financial Reporting Standards (IFRSs).

(2) Basis for qualified opinion: The Company's inventories are carried in the statement of financial position at xxx. Management have overvalued inventory to the value of R3 million, thereby materially overstating assets. Cost of sales has been undervalued with the same amount resulting in an overstatement of profit for the year.

Audit Report

ACTIVITY 4.6.5

For this activity, assume that in addition to the information in Activity 4.6.3, almost all of the accounting records of CRI Limited were destroyed in a flood. As a result, you could not perform adequate audit procedures to arrive at any meaningful opinion.

Required:

Write down the two paragraphs, applicable to the facts in this activity.

FEEDBACK ON ACTIVITY 4.6.5

(1) **Disclaimer of opinion:** We do not express an opinion on the accompanying financial statements. Because of the significance of the matter described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient.

Audit Report

appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

(2) **Basis for disclaimer of opinion**: As indicated in the directors' report, the accounting records were destroyed during a flood and no other documentation was obtainable to substantiate the amounts presented in the financial statements

End of the lecture

Any questions?

Thank you

Presenter's details

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AUDITING