MODULE 3

Topic 2 – The financial statements and risk

Topic 2.1 – Is going concern appropriate?

Is the client financially viable for a specific period of time?

Remember what going concern is?

- Under the going concern basis of accounting, the financial report is prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. General purpose financial reports are prepared using the going concern basis of accounting, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. … 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 realise its assets and discharge its liabilities in the normal course of business.
    - ASA570.02

Responsibilities

Management

- AASB 101 – management must make an assessment of the entity's ability to continue as a going concern

Auditor

- ASA570 – the auditor must determine whether management's assessment is appropriate

What does GC have to do with ROMMs?

- Clients at risk of NOT continuing as a GC may seek to manipulate their financial statements to appear more financially healthy
  - To attract new shareholders
  - To obtain a new loan

- What sort of accounts do you think are more likely for management to manipulate if they are are facing the possibility of not being a GC?

Events or conditions that ↑ GC risk

ASA570.A3

- Financial
  - Net liability position poor
  - Inability to renew fixed term loans or relying on short term loans
  - Creditors withdrawing support
  - Negative operating cash flow
  - Adverse key financial ratios
  - Substantial operating losses
  - Dividends in arears
  - Unable to pay creditors/loans
- Operating
  - Mgmt intend to liquidate entity
  - Loss of key mgmt.
  - Loss of major market, key customer, key supplier
  - Labour difficulties
  - Shortage of supplies/materials
  - New successful competitor
- Other
  - Non-compliance with legal requirements eg solvency
  - Upcoming changes in regulation
  - Major catastrophes not covered by insurance

Topic 2.2 - Analytical procedures

Besides brain storming – how can the unaudited financial statements of the client give us insight into the ROMMs?

Analytical Procedures (ASA 520)

- Once we have an understanding of the client entity, we have a general idea of how they **should look financially**. **This understanding is then compared to the client's financial statements** to see if the current information presented **corresponds** with our expectations and understanding.

- A key task performed here is **Analytical Procedures** **(ASA 520)** where we **analyse** financial information to identify trends and relationships between accounts **to check that they are consistent (or inconsistent) with our understanding of the entity and the environment** in which it operates.

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Types of Analytical Procedures

Simple Procedures:

- Simple Comparisons to previous year ($)
- Trend Analysis (%)
- Ratio Analysis

Complex Procedures:

- Time Series Modelling
- Regression Analysis
- Financial Modelling

- **Note:** **Analytical Procedures** can be used at **all stages of the audit** including the planning stage, evidence collection stage and/or as part of final review.
- At this stage we concentrate on the use of analytical procedures in **Planning the Audit** to **identify areas of potential risk** which require more audit attention.

Ratio Analysis

- An important task is Ratio Analysis where ratios are calculated on unaudited financial data and compared to:
  - Previous years
  - Budgets or Forecasts
  - Industry Averages.

Liquidity Ratios	
Current Ratio	Current Assets / Current Liabilities
Quick Asset Ratio	Quick Assets / Current Liabilities
Receivables Turnover Ratio	Net Credit Sales / Average Accounts Receivable
Inventory Turnover Ratio	Cost of Good Sold / Average Inventory

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Ratio Analysis

Profitability Ratios	
Gross Profit Ratio	Gross Profit / Net Sales
Net Profit Ratio	Net Profit / Net Sales
Return on Assets Ratio	Net Profit / Average Total Assets
Return on Equity Ratio	Net Profit / Average Total Equity

Solvency Ratios	
Debt to Equity Ratio	Total Liabilities / Total Equity
Debt to Assets Ratio	Total Liabilities / Total Assets
Times Interest Earned Ratio	Net Profit Before Interest and Taxes / Interest Expense

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What is the auditor looking for?

- Combine your financial information with your understanding of the client
- Trends or ratios that are inconsistent with what we know about the entity
- Doesn’t automatically mean a risk – but it is something for the team to investigate

Topic 2.3 - Materiality

We've seen the words "material misstatement" in the auditing standards – but what does that mean?

Remember the purpose of an audit…

- Financial statements are ________ from ____________________

  ____

- We don't need to identify every single misstatement

  Eg ___________________________________

Materiality

- ASA 320.2 states:
  - Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial report;
  - Judgements about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
  - Judgements about matters that are material to users of the financial report are based on a consideration of the common financial information needs of users as a group.[2] The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.
- Therefore a misstatement is deemed to be material where it would influence the user's decision.
- In determining this, the auditor will consider both the amount (quantitative) and the nature (qualitative) of the misstatement.
- Materiality is a relative concept, rather than an absolute concept (i.e. depends on the company size and context).

ASA 320 – different types of materiality?

- The standard refers to “Materiality” and “Performance materiality”

	Materiality	Performance Materiality
When is it used?	Planning the audit. Considers aggregation of misstatements and their overall impact on the financial statements	When planning the procedures to gathering audit evidence.
Over what?	The financial report as a whole	Over the financial report and also sub-levels set for individual accounts or groups of accounts

Steps to calculate materiality

- Select an appropriate benchmark/base for materiality
  - What drives the company?
  - Is the benchmark relevant? Stable? Is data available?
- Choose your % rate
- Calculate materiality
  - Unaudited amount x benchmark %
- This is subject to revision

Base / benchmark	% for calculation
Profit before tax	5%
Total revenue	0.5%
Gross profit	2.0%
Net assets	0.5%
Equity	1.0%

The relationship between materiality and ROMMs

- When the ROMMs is higher – should materiality be higher or lower?

- Materiality should be _____________ - WHY?

Topic 2. 4 – Audit work papers

Why do we have to document our audit work?

What ASA 230.02 says

- Proof that we've done the work

Nature and Purpose of Audit Documentation

2. Audit documentation that meets the requirements of this Auditing Standard and the specific documentation requirements of other relevant Australian Auditing Standards provides:

   (a) Evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the auditor;[1] and

   (b) Evidence that the audit was planned and performed in accordance with Australian Auditing Standards and applicable legal and regulatory requirements.

Benefits of documenting our work

3. Audit documentation serves a number of additional purposes, including the following:

- Assisting the engagement team to plan and perform the audit.
- Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with ASA 220.[2]
- Enabling the engagement team to be accountable for its work.
- Retaining a record of matters of continuing significance to future audits.
- Enabling the conduct of quality control reviews and inspections in accordance with ASQC 1.[3,4]
- Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Documentation

Permanent Audit File: Contains documents relevant to this audit **and** future years.

Examples:

- Key company documents such as the Company Constitution
- Long-term continuing contracts
- Main company policies relating to accounting and the internal control structure
- Previous audited financial reports.

Current Audit File:
Contains documentation applicable to the **current** year under audit.

Examples:

- Audit program and plan
- Working trial balance
- Working Papers
- Evidence gathered for this Audit (e.g. invoices)
- Draft of financial report and audit opinion

What do we need to include?

Form, Content and Extent of Audit Documentation

8. The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: (Ref: Para. A2-A5, A16-A17)

    (a) The nature, timing, and extent of the audit procedures performed to comply with the Australian Auditing Standards and applicable legal and regulatory requirements; (Ref: Para. A6-A7)

    (b) The results of the audit procedures performed, and the audit evidence obtained; and

    (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgements made in reaching those conclusions. (Ref: Para. A8-A11)

9. In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:

    (a) The identifying characteristics of the specific items or matters tested; (Ref: Para. A12)

    (b) Who performed the audit work and the date such work was completed; and

    (c) Who reviewed the audit work performed and the date and extent of such review. (Ref: Para. A13)

10. The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place. (Ref: Para. A14)

11. If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency. (Ref: Para. A15)

Examples of Working Papers

CLIENT Palmwood Ltd
AUDIT PROGRAM FOR Property, plant and equipment
AUDIT PERIOD 30/6/X4

Reviewed by
DRS
Date
5/8/X4

Item no.	Audit procedure	Done by	Working paper reference
1	Obtain or prepare a schedule of property, plant, equipment and accumulated depreciation.	RP	B
2	Vouch additions and retirement from the accounts through records to supporting vouchers and examine support.	RP	B/1, B/2
3	Examine supporting vouchers for repairs and maintenance to ascertain whether such charges should be capitalised or expensed.	RP	B/4
4	Recalculate depreciation calculations.	RP	B/3
5	Trace depreciation to depreciation expense accounts.	RP	B/3
6	Ascertain that depreciation rates and depreciable lives being used appear to be reasonably adequate.	RP	B/3
7	Ascertain that depreciation rates and depreciable lives being used are consistent with previous years.	RP	B/3
8	Recalculate gains or losses on disposals and trace to gain or loss accounts.	RP	B/1, B/2

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Examples of Working Papers

Palmwood Ltd	W.P. No: B/1
Building and accumulated depreciation	Compiled by: RP
Audit 30/6/X4	Date 29/7/X4

		Cost	Accum. dep'n
Balance	30/6/X3	75000 ↘	25000 ↘
15/12/X3	Bolivar Construction Ltd—building addition	15000 *n*	
30/6/X4	JV 19/6 Depreciation provision		4125 B/3
	Balance 30/6/X4 per audit	90000	29125
		B T	B T

↘ per last year's audit working papers
n vouched to original contract and invoice and examined paid cheque
T additions checked OK

Other points to note

- Once we've completed the audit file for the year – documents cannot be deleted or removed. You can make additions in limited circumstances
- How long do we keep documents for? ASQC1 – 5 years, Corporations Act – 7 years
- Document everything!

Topic 2.5 – Using the work of others on the audit

Are auditors know-it-alls? When would we need experts and how should they be used on an audit?

What other parties may be able to contribute to the audit?

Party	Can they contribute?	ASA reference
Other audit firms in the network or group	Yes – very common – all work must be supervised at the audit partner of the parent group is wholly responsible	ASA 600
Internal auditors	In limited circumstances – but they cannot directly work under the auditor's directive	ASA 610
External experts	Yes – where auditors lack the relevant expertise and the expert is properly vetted	ASA 620

Regardless of who assists us

- Are they qualified, knowledgeable and competent?
- We must provide appropriate supervision
- We must be able to understand and explain the work they conducted
- We must ensure their work meets the auditing standards

- Experts – are they objective?

Key takeaways

- Understand how to use the financial information to help us identify any ROMMs
  - Is the company a going concern?
  - What does analysis of the financial statements tell us? Any ROMMs?
- Know how to calculate materiality
- Understand the basics for documentation
  - We'll be documenting on practice work papers
- We don't know it all and will often use experts