MODULE 6

Topic 2 – Audit opinions

In this topic

1. Collating our audit findings
2. Negotiating adjustments with the client
3. Preparing the audit opinion
4. Determining the Key Audit Matters
5. Preparing the Management Letter

Context

2.1 Collating our audit findings

Summary of misstatements

ASA 450 Evaluation of misstatements identified during the audit

- What are included in “misstatements”?
  - “Misstatement means a difference between the ___________ amount, classification, presentation, or disclosure of a financial report item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework” (para 4a)
- During the audit, we must:
  - “accumulate misstatements identified during the audit, other than those that are clearly trivial.” (para 5)
- We must evaluate the misstatements individually and in aggregate form

Summary list of misstatements

- A record of all misstatements identified during the audit
- Many names, depending on the audit firm
  - Summary of unadjusted misstatements
  - Schedule of audit differences
- Individual firms have their own classification systems for misstatements – options include
  - Type – factual, judgement or projected
  - Type – amount, classification, presentation/disclosure
  - Material – quantitatively material, qualitatively material

2.2 Negotiating audit adjustments with the client

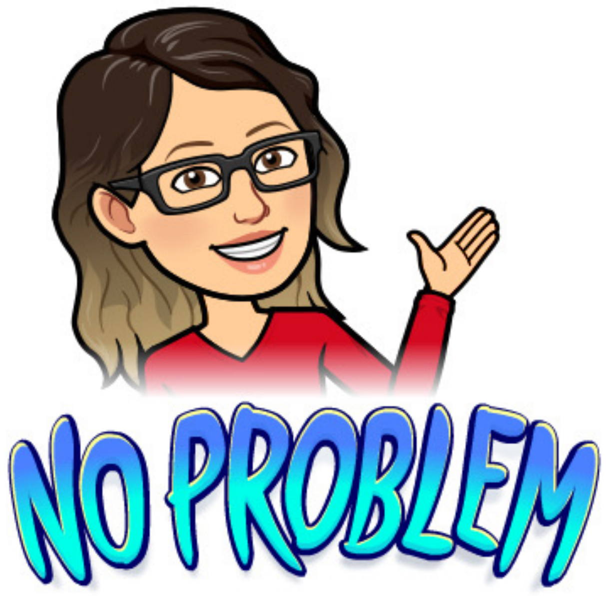
Auditors cannot change the financial statements

ASA 450 instructs the auditor to

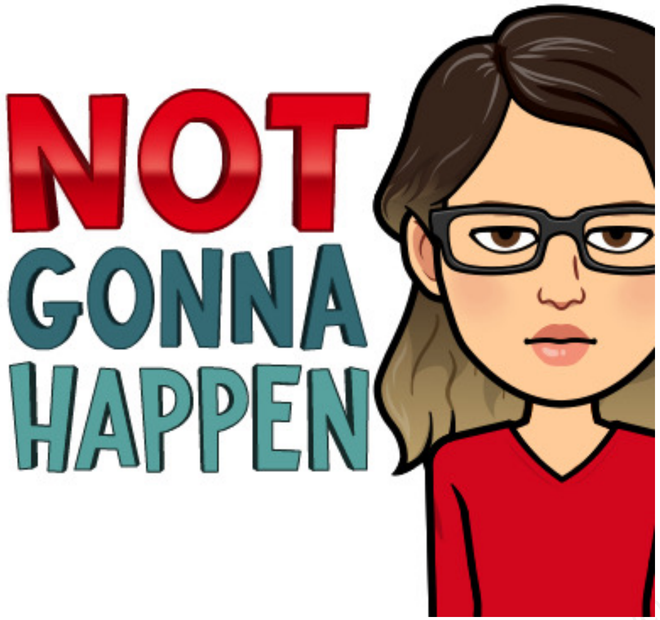
- Request management correct the misstatements (450.8)
- If they refuse – consider this when preparing their opinion (450.9)

Textbooks vs real life

Client in the textbooks:



Client in real life:



The audit negotiation process

Adjustments will be more easily accepted by the client when:

- They are based on clear mistakes / errors
- They are based on projections with large samples
- An independent expert verifies the auditor's judgement or opinion about an issue
- Where the audit committee is effective in providing oversight
- Whether a similar misstatement was made in previous years

Adjustments are more likely to be argued over when

- They are based on projections with small samples
- They are based on a difference of opinion in an accounting estimate
- They are for disclosures that require judgement on how much to disclose
- There is a dominant CEO/CFO

Factors that affect the auditor-client negotiation process

- Why is an audit needed?
- Does the CFO or FC support the auditor’s judgement?
- The negotiation tactics used
- Whether the auditor is at the beginning or end of their 5 year rotation
- Whether it is the first year a firm audits a client
- The quality of the auditor-client relationship
- Whether non-audit services are also provided by the auditor
- The experience of both the audit partner and the client’s main negotiator
- Whether anyone on the audit committee used to work at the audit firm

Carrot or the stick?

- The auditor must issue an opinion

2.3 Preparing the audit opinion

ASA 700, 705 and 706

Organisation of the standards

ASA 700

- We must form an opinion (para 10)
- The information we must use to prepare our opinion (para 10-13)
    - Do we have sufficient appropriate evidence? (ASA ______)
    - Are any uncorrected misstatements material?
    - Is the financial report overall free from material misstatement?
    - Are disclosures appropriate?

The opinion clients want

- "The auditor shall express an ____________ opinion when the auditor concludes that the financial report is prepared, in all material respects, in accordance with the applicable financial reporting framework." (ASA700.16)
  - ❑Sufficient appropriate evidence
  - ❑Uncorrected misstatements are immaterial
  - ❑Prepared within the AASBs

Modified audit opinions - ASA 705

Nature of Matter Giving Rise to the Modification	Auditor's Judgement about the Pervasiveness of the Effects or Possible Effects on the Financial Report	
	Material but Not Pervasive	Material and Pervasive
The financial report is materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

What exactly does pervasive mean?

- ASA705.5

5. For the purposes of this Auditing Standard, the following terms have the meanings attributed below:

   (a) Pervasive – A term used, in the context of misstatements, to describe the effects on the financial report of misstatements or the possible effects on the financial report of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial report are those that, in the auditor's judgement:

      (i) Are not confined to specific elements, accounts or items of the financial report;

      (ii) If so confined, represent or could represent a substantial proportion of the financial report; or

      (iii) In relation to disclosures, are fundamental to users' understanding of the financial report.

ASA 706 – EoM and OM paragraphs

- When the auditor wants to draw attention to some matter that is outside of a modification
- The matter is either
  - Already presented/disclosed in the financial statements but the auditor wants to add additional emphasis, or
  - We think it is relevant to the user's understanding of the audit, auditor's responsibilities or the report itself
- ASA706.6
- Neither of these "modify" the auditor's opinion

Emphasis of Matter vs Other Matter para

- For matters already disclosed in the financial report
- Important to help users understand the financial report
- Mostly for subsequent events disclosures

- For matters not in the financial report
- Important to help users understand what the audit is, and the auditor's responsibilities
- Where other information is contradictory

What about when there is a going concern issue?

- Where management make appropriate disclosures
- Where management do not make appropriate disclosures
- A material uncertainty paragraph in the opinion
- Modify the opinion

Material uncertainty related to going concern

We draw attention to Note 2 in the financial statements, which indicates that the Group incurred a net loss of $1,089,254 during the year ended 30 June 2019 and had net operating cash outflows of $958,034. As stated in Note 2, these events or conditions, along with other matters as set forth in Note 2, indicate that a material uncertainty exists that may cast doubt on the Group's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

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Another Material Uncertainty paragraph

Material uncertainty related to going concern

We draw attention to note 2(b) in the consolidated financial statements, which discloses that the Group has incurred a loss of $9.3 million and net cash outflows from operating activities of $9.4 million for the year ended 31 March 2019. At the current run rate the Group only has sufficient cash for a further four months from the date of signing these financial statements. In order to generate sufficient cash for at least the next 12 months the Group will need to secure the deal with the North American bank and other smaller scale customers, or raise additional capital. As stated in note 2(b), these events or conditions, along with other matters as set forth in note 2(b), indicate that a material uncertainty exists that may cast significant doubt on the Group's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

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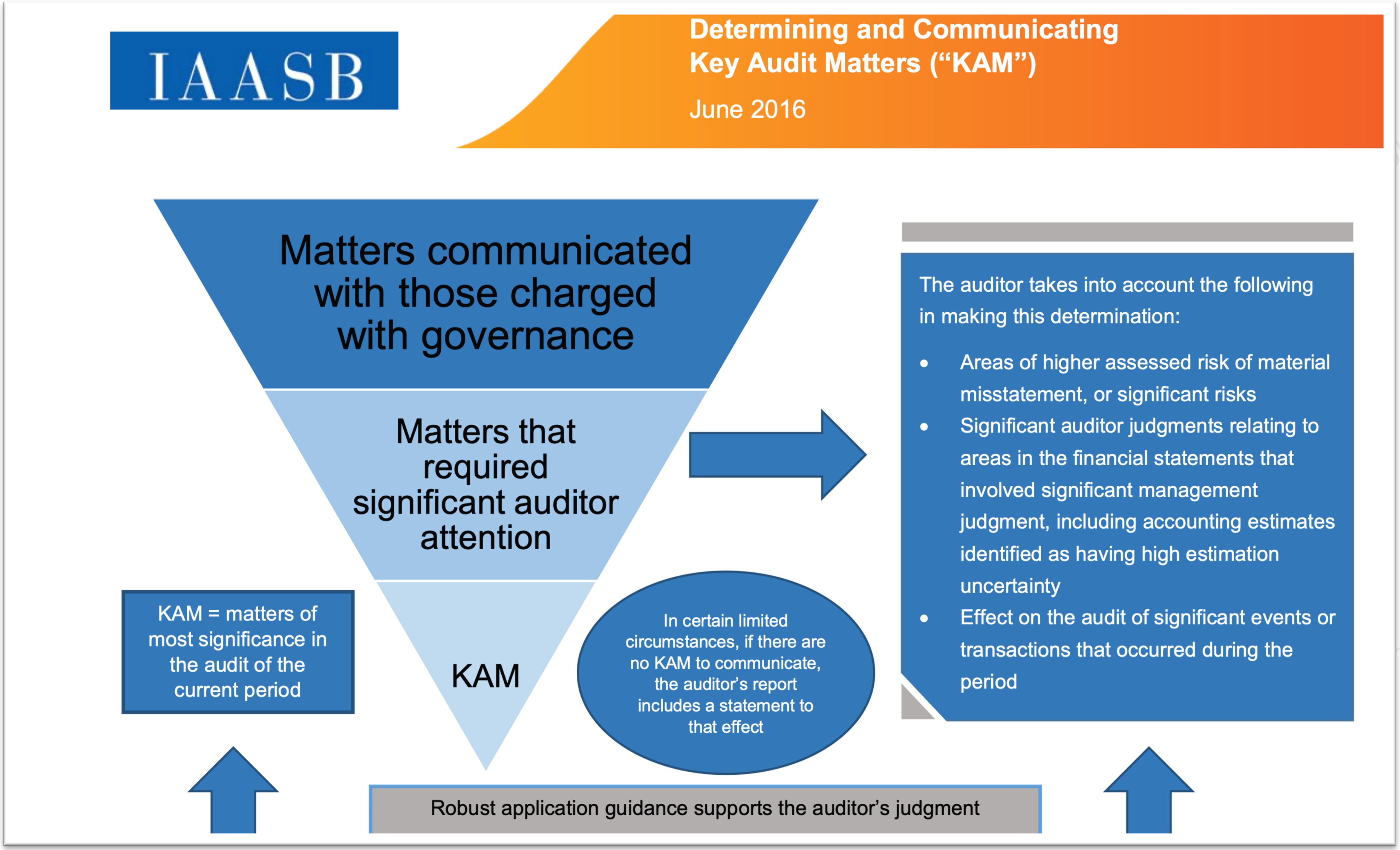
2.4 Determining the Key Audit Matters

ASA 701

A relatively new standard

- Came into effect in Australia in 2019, but the International Standard was produced in 2015.
- The UK was an early adopter of Key Audit Matters.
- The US has a similar standard but use the term Critical Audit Matters
- Why?
  - “The purpose of communicating key audit matters is to enhance the communicative value of the auditor’s report by providing greater transparency about the audit that was performed.” (ASA701.2)



https://www.ifac.org/system/files/publications/files/IAASB-KAM-Overview-Diagram.pdf

Woolworths Ltd
2019 annual report

Key Audit Matter	How the scope of our audit responded to the Key Audit Matter
Onerous lease provisions and asset impairment in the BIG W business BIG W incurred a loss before interest, tax and significant items of $85 million as disclosed in Note 2.2 and continues to operate under a multi-year turnaround plan. As described in Note 1.4, during the financial period the Group concluded the review of the BIG W network. This will result in the closure of 30 BIG W stores over the next three years and the closure of two distribution centres. The result of the review, together with the revised three-year strategic plan for BIG W which reflects a more conservative margin recovery, has resulted in a decrease in the recoverable amount of the cash-generating units and consequently the recognition of an impairment charge of $166 million as disclosed in Note 3.5. Additional onerous leases have been identified and provided for as disclosed in Note 3.8. Significant judgement is involved in the determination of the recoverable amount of property, plant and equipment and the onerous lease provisions. ***Impairment*** – As disclosed in Note 3.5 the recoverable amount and carrying value of BIG W is $404 million. The Group determined the recoverable amount using a value-in-use model, based on discounted future cash flow forecasts derived from the three-year strategic plan. The cash flow forecast is an area of focus given the significance of the loss incurred by the business and the level of inherent judgement in relation to the assumptions applied to future trading results, particularly gross margins, to determine the recoverable amount. ***Onerous lease obligations*** – Where the expected future benefits from a leased store are less than the future contractual lease payments for that store, the Group has recognised, in accordance with accounting standards, an onerous lease provision. The determination of this provision involves significant judgement in determining the expected timing of store closures; estimated future cash inflows (most significantly sub-lease income) and where applicable, expected termination payments to landlords.	Our procedures included but were not limited to: • Updating our understanding of the Group's processes and controls over the assessment of the recoverable amount of property, plant and equipment and the assessment of onerous lease provisions. • Ensuring that the methodologies applied are consistent with the relevant accounting standards. • Evaluating the key assumptions used in the future cash flow forecasts derived from the three-year strategic plan with reference to historical performance and observable external trends. • Evaluating historical accuracy of forecast cash flows. • Involving internal specialists in our assessment of management's impairment models and discount rates used. • Performing sensitivity analysis in relation to the key assumptions used to estimate future cash flows. • Testing, on a sample basis, the mathematical accuracy of the value-in-use models and the onerous lease calculations. • In addition, for the onerous lease calculations we: – evaluated assumptions in relation to the timing and amount of sub-lease income with reference to market benchmarking reports; and – agreed the store cash flows to the value-in-use models and the lease cost and lease expiry dates to lease contracts. • Assessing the appropriateness of the disclosures included at Notes 1.4, 3.5 and 3.8.

Woolworths Ltd
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AASB 16 *Leases* disclosure	Our procedures included but were not limited to:
As described in Note 1.2.6, AASB 16 *Leases* (AASB 16) will be effective for the financial period commencing 1 July 2019 and will hatve a significant impact on the Group's Financial report. The Group has completed its assessment of the estimated impact of AASB 16. This results in an increase in the Group's lease assets and lease liabilities of $12.2 billion and $14.7 billion respectively as at 1 July 2019. The impact of the adoption of AASB 16 on the Group is dependent on a number of key judgements and estimates, primarily the determination of the lease term, non-lease components and appropriate discount rate for each lease.	• Understanding the Group's processes and controls to determine the impact of AASB 16. • Understanding the Group's accounting policy and confirming compliance with the requirements of AASB 16. • Leveraging our understanding of the Group and global retailers to identify key risks and judgements that may impact on management's estimate. • Evaluating and challenging the key assumptions used in determining the impact of AASB 16 which included: – determining lease terms including options that are reasonably certain to be exercised; – assessing the appropriateness and consistency of the discount rate used (i.e. incremental borrowing rate) by using our internal specialists to benchmark the Group's rate curves to market curves; and – identification and valuation of non-lease components by using external data to benchmark the Group's assumptions. • Agreeing a sample of leases to the original lease contract terms or other supporting documentation. Recalculating the expected lease assets and lease liabilities for each of those leases included in our sample to assess the accuracy of management's AASB 16 calculation. • Testing the completeness of management's calculation by: – reconciling the Group's existing lease commitments to the AASB 16 calculation; – confirming the inclusion of a sample of leases selected from management's lease agreement records and rent expense general ledger accounts; and – attendance at lease sessions held across the Group to identify any other arrangements that may contain a lease. • Assessing the appropriateness of the disclosures included in Note 1.2.6.

2.5 The management letter

Not to be confused with the Management Representation Letter!

What is the management letter?

- ASA 260 Communication with those charged with governance (TCWG) – para 16

Significant Findings from the Audit

16. The auditor shall communicate with those charged with governance: (Ref: Para. A17–A18)

    (a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial reporting disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity; (Ref: Para. A19–A20)

    (b) Significant difficulties, if any, encountered during the audit; (Ref: Para. A21)

    (c) Unless all of those charged with governance are involved in managing the entity:

        (i) Significant matters arising during the audit that were discussed, or subject to correspondence, with management; and (Ref: Para. A22)

        (ii) Written representations the auditor is requesting;

    (d) Circumstances that affect the form and content of the auditor's report, if any; and (Ref: Para. A23–A25)

    (e) Any other significant matters arising during the audit that, in the auditor's professional judgement, are relevant to the oversight of the financial reporting process. (Ref: Para. A26–A28)

• ASA 265 also requires this communication

8. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies. (Ref: Para. A5-A11)

9. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. (Ref: Para. A12-A18, A27)

11. The auditor shall include in the written communication of significant deficiencies in internal control:

(a) A description of the deficiencies and an explanation of their potential effects; and (Ref: Para. A28)

(b) Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that: (Ref: Para. A29-A30)

(i) The purpose of the audit was for the auditor to express an opinion on the financial report;

(ii) The audit included consideration of internal control relevant to the preparation of the financial report in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; or

Is this a real letter?

- Yes – but more lengthy – often a report
- Many auditors will also give a presentation to TCWG – the audit committee, members of the executive
- The last chance to clear up any confusion about the audit and the audit report
- What do we hope to achieve with this communication?
  - Improvement in internal controls
  - Better understanding of the audit process and what the auditor is asking for
  - Smoother audit next year

To sum up

- We need to understand what misstatements require adjustment and how to approach management about making those adjustments
- We need to know how to determine which opinion to give and whether an emphasis of matter, other matter or material uncertainty paragraph is required
- Communicating our audit findings is important to the current audit and future audits

We've reached the end!!!