SLAuS – 560 - Subsequent events

Subsequent events are events occurring between the period-end and the date of the auditor's report and include facts discovered after the auditor's report has been issued. Auditors shall consider the effect of such events on the financial statements and on their audit opinion.

LKAS 10 *Events after the reporting period*

LKAS 10 Events after the reporting period deals with the treatment in the financial statements of events, both favorable and unfavorable, occurring after the period end. There are two types of event defined by LKAS 10:

- Those that provide evidence of conditions that existed at the year-end date (adjusting events)
- Those that are indicative of conditions that arose after the year-end date (non-adjusting events)

Table 17.3: Adjusting and non-adjusting events

Adjusting events	Non-adjusting events
Settlement of a court case	Dividends declared after the year-end
Sale of inventory after year-end providing evidence of its NRV at year-end	Fire causing destruction of major plant
Fraud or error showing the accounts are incorrect	Announcement of a major restructuring

SLAuS 560 *Subsequent events* provides guidance to auditors in this area. The objectives of the auditor are:

- To obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that need adjustment or disclosure in the financial statements are properly reflected in the financial statements
- To respond appropriately to facts that become known to the auditor after the date of the auditor's report that may have caused the auditor to amend the auditor's report, had they been known to the auditor at the date of the report

Procedures

Auditors have a **responsibility** to **review subsequent events** before they sign the auditor's report, and may have to take action if they become aware of subsequent events between the date they sign the auditor's report and the date the financial statements are issued.

The following timeline is helpful when considering subsequent events and the auditor's responsibilities concerning them.

Figure 17.2: Timeline of events and auditor's responsibilities

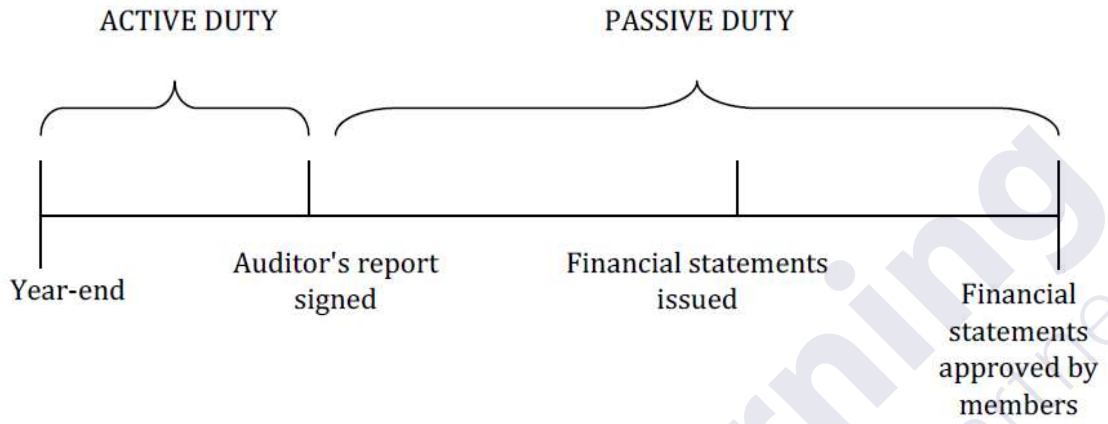


Table 17.4: Audit procedures - subsequent events

Audit procedures to test subsequent events	
Enquiries of management	Status of items involving **subjective judgement** Status of items accounted for using **preliminary or inconclusive** data Whether there are any new **commitments, borrowings or guarantees** Whether there have been any: • **Sales** or destruction of **assets** • **Issues** of **shares/debentures** or changes in business structure • **Developments** involving **risk areas, provisions** and **contingencies** • **Unusual accounting adjustments** • **Major events** (eg going concern problems) affecting appropriateness of accounting policies for estimates • Litigations or claims

Other procedures	**Review** management procedures for identifying subsequent events to ensure that such events are identified. **Read minutes** of general board/committee meetings and enquire about unusual items. **Review latest available interim financial statements** and budgets, cash flow forecasts and other management reports. **Obtain evidence** concerning any litigation or claims from the company's solicitors (only with client permission). Obtain **written representation** that all events occurring subsequent to the period-end which need adjustment or disclosure have been adjusted or disclosed.

Facts discovered after the date of the auditor's report but before the financial statements are issued

The financial statements are the management's responsibility. They should therefore inform the auditors of any material subsequent events between the date of the auditors' report and the date the financial statements are issued. The auditor does not have any obligation to perform procedures, or make enquires regarding the financial statements, after the date of the report.

However, if the auditor becomes aware of a fact that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- Discuss the matter with management and those charged with governance.
- Determine whether the financial statements need amendment.
- If amendment is required, inquire how management intends to address the matter in the financial statements.

If amendment is required to the financial statements and management makes the necessary changes, the auditor must carry out a number of procedures:

- Undertake any necessary audit procedures on the changes made.
- Extend audit procedures for identifying subsequent events that may require adjustment of, or disclosure, in the financial statements to the date of the new auditor's report.
- Provide a new auditor's report on the amended financial statements.

If management does not amend the financial statements:

- If the auditor's report has not yet been provided to the entity, the auditor shall modify the opinion and then provide the auditor's report.
- If the auditor's report has already been provided to the entity, the auditor shall notify management and those charged with governance not to issue the financial statements before

the amendments are made; but if the financial statements are issued anyway, the auditor shall take action to seek to prevent reliance on the auditor's report.

Facts discovered after the financial statements have been issued

Auditors have no obligations to perform procedures or make enquiries regarding the financial statements after they have been issued.

However, if the auditor becomes aware of a fact that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- Discuss the matter with management and those charged with governance.
- Determine whether the financial statements need amendment.
- If amendment is required, enquire how management intends to address the matter in the financial statements.

If management amends the financial statements, the auditor shall carry out any necessary procedures on the amendment and review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements is informed.

The auditor shall also issue a new or amended auditor's report, which will include an explanatory paragraph (known as an emphasis of matter paragraph or other matter paragraph – we discuss these further in Chapter 18) that refers to a note in the financial statements that discusses the reason for the amendment. Audit procedures will be extended up to the date of the new report.

If management does not take the necessary steps, the auditor shall notify management and those charged with governance that the auditor will seek to prevent future reliance on the report. If management still does not act, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report.

SLAuS 570 – Going Concern

01. What is Going Concern Assumption

An entity is viewed as continuing in business operations for the foreseeable future.

Examples

- An oil and gas firm operating in Nigeria is stopped by a Nigerian court from carrying out operations in Nigeria.
  - ✓ The firm is not a going concern in Nigeria, because it has to shut down.

- A bank is in serious financial troubles and the government is not willing to bail it out.

  The Board of Directors has passed a resolution to liquidate the business.

  - ✓ The bank is not a going concern.

- A merchandising company has a current ratio below 0.5. A creditor $1,000,000 demanded payment which the company could not make. The creditor requested the court to liquidate the business and recover his debts and the court grants the order.
  - ✓ The company is no longer a going concern.

02. Accounting Standards perspective

LKAS 1 – Presentation of Financial Statements

- When preparing financial Statements, management shall make an assessment of the entity's ability to continue as going concern (section 25 – LKAS 1)
- An entity shall prepare Financial Statements on going concern basis unless management either intend to liquidate the entity or to cease the trading or has no realistic alternative but to do so

03. Objectives of SLAuS 570

- To obtain sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern assumption in the preparation of the financial statements

- 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

- To determine the implications for the auditor's report.

04. Management's responsibilities for going concern

Management has specific responsibilities relating to going concern that may be set out in law or regulation and in the financial reporting framework. LKAS 1 *Presentation of financial statements* contains a specific requirement that management makes an assessment of an entity's ability to continue as a going concern.

Since general purpose financial statements are prepared on a going concern basis, the going concern basis is a **fundamental principle** in the preparation of financial statements. Therefore management's responsibility for the preparation and presentation of the financial statements also encompasses a responsibility to assess the entity's ability to continue as a going concern, even if there is no explicit requirement to do so in the financial reporting framework.

Management's assessment involves making a **judgement** about inherently uncertain future outcomes of events or conditions. This judgement is affected by the following:

- **Degree of uncertainty,** which increases the further into the future an event/condition/outcome occurs
- **Size and complexity** of the entity
- **Nature and condition** of the business
- Judgement about the future is based on **information available** at the time the judgement is made, but **subsequent events** may result in **inconsistent outcomes**

05. Auditor's responsibilities in relation to management's assessment

The auditor must **remain alert** throughout the audit for evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. However, the auditor also has specific responsibilities in relation to management's assessment.

The auditor shall **evaluate** management's assessment of the entity's ability to continue as a going concern. However, if this assessment covers less than 12 months from the date of the financial statements, the auditor shall ask management to extend its assessment period to **at least 12 months** from that date. The auditor shall also enquire of management its knowledge of events or conditions beyond the period of the assessment that may cast significant doubt on the entity's ability to continue as a going concern.

06. Events and Conditions that may cast doubt about Going Concern Assumption

<u>Financial</u>

- 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.
    - Change from credit to cash-on-delivery transactions with suppliers.
    - Inability to obtain financing for essential new product development or other essential investments

<u>Operating</u>

- 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).
- Labor difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

<u>Other</u>

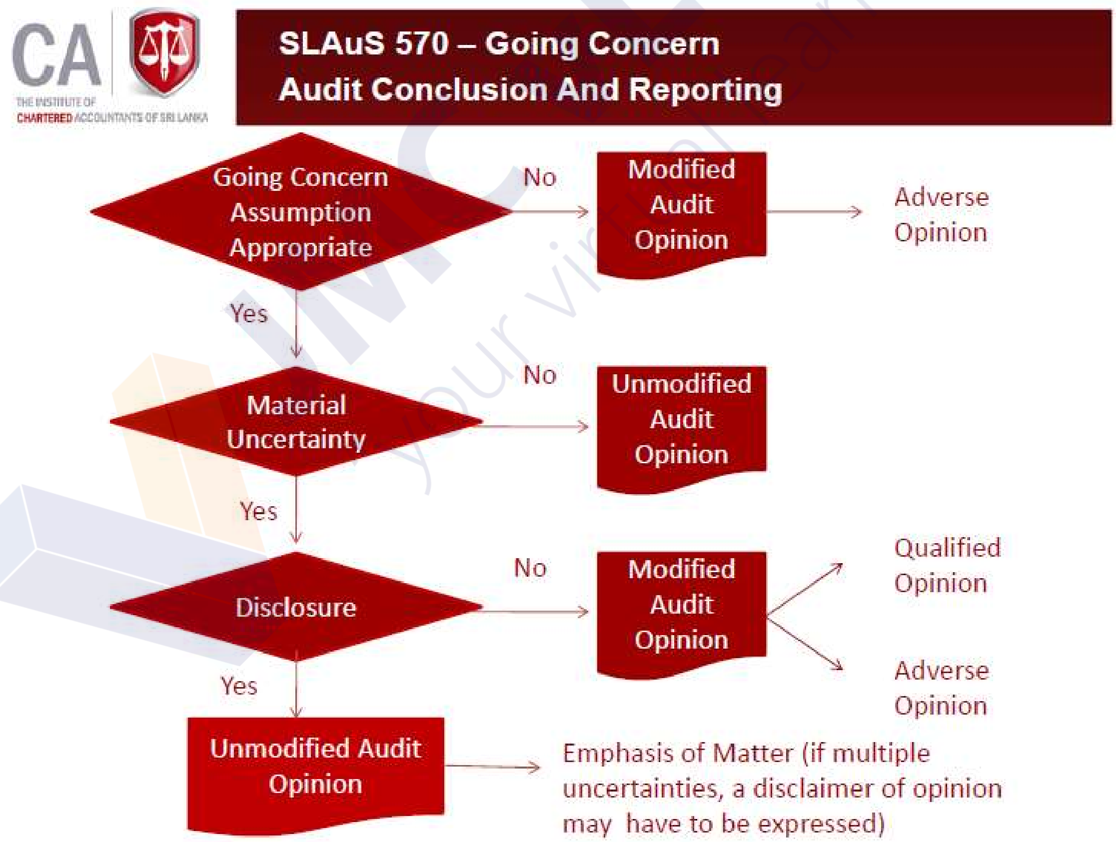
- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

07. **Events or conditions identified**

If events or conditions are identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether a material uncertainty exists by:

- Requesting management to make its assessment, where this has not been done
- Evaluating management's plans for future action
- Evaluating the **reliability of underlying data** used to prepare a cash flow forecast and considering the **assumptions** used to make the forecast
- Considering whether any **additional facts or information** have become available since the date that management made its assessment
- Requesting **written representations** from management and those charged with governance about plans for future action and the feasibility of these plans

08. Audit Conclusion and Reporting



Specific audit procedures the auditor might carry out could include the following:

- **Analyse and discuss cash flow**, profit and other relevant forecasts with management
- **Analyse and discuss** the entity's latest available **interim financial statements** (or management accounts)
- **Review the terms of debentures and loan agreements** and determine whether they have been breached
- **Read minutes** of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties
- Enquire of the entity's lawyer regarding litigation and claims
- Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties
- Assess the financial ability of such parties to provide additional funds
- Consider the entity's position concerning unfulfilled customer orders
- Review events after the period-end for items affecting the entity's ability to continue as a going concern
- Confirm the existence, terms and adequacy of borrowing facilities
- Obtaining and reviewing reports of regulatory actions
- Determining the adequacy of support for any planned disposals of assets

SLAuS 540 *Auditing accounting estimates, including fair value accounting estimates, and related disclosures*

SLAuS 540 Auditing accounting estimates, including fair value accounting estimates, and related disclosures provides guidance on the audit of accounting estimates contained in financial statements. The auditor's objective is to obtain sufficient appropriate audit evidence about whether accounting estimates are reasonable and related disclosures are adequate.

An **accounting estimate** is an approximation of a monetary amount in the absence of a precise means of measurement.
Estimation uncertainty is the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.
Management's point estimate is the amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.
Auditor's point estimate or **auditor's range** is the amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate.

Examples of accounting estimates include:

• Allowance for doubtful accounts
• Inventory obsolescence
• Warranty obligations
• Depreciation method or asset useful life
• Outcome of long-term contracts
• Costs arising from litigation settlements and judgements

• Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability

Risk assessment procedures

SLAuS 540 states that the auditor shall obtain an understanding of the following to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:

- The requirements of the applicable financial reporting framework
- How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates
- How management makes the accounting estimates and an understanding of the data on which they are based, including:
  – Method
  – Relevant controls
  – Assumptions
  – Whether change from prior period in method used
  – Whether management has assessed the effect of estimation uncertainty

The SLAuS also states that the auditor shall review the **outcome** of accounting estimates included in the **prior period**.

Risk identification and assessment

The auditor shall also evaluate the degree of **estimation uncertainty** associated with an accounting estimate. Where estimation uncertainty is assessed as high, the auditor shall determine whether these give rise to **significant risks**.

Responding to the assessed risks

The SLAuS requires the auditor to perform one or more of the following:

- Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.
- Test how management made the accounting estimate and the data on which it is based.
- Test the operating effectiveness of controls over how the accounting estimate was made.
- Develop a point estimate or a range to evaluate management's point estimate.

Substantive procedures in response to significant risks

Where the auditor judges that the accounting estimate gives rise to a significant risk, he shall evaluate the following in accordance with SLAuS 540:

- How management has considered alternative assumptions and why these have been rejected
- Whether the assumptions used are reasonable
- Management's intent to carry out specific courses of action and its ability to do so

If the auditor considers that management has not adequately addressed the effects of estimation uncertainty on accounting estimates that give rise to significant risks, he shall, if necessary, develop a range with which to evaluate the reasonableness of the accounting estimate.

Other audit procedures
SLAuS 540 requires the auditor to do the following:

- Evaluate whether the accounting estimates are either **reasonable or misstated**.
- Obtain sufficient appropriate audit evidence about whether **disclosures** are correct.
- For accounting estimates that give rise to significant risks, evaluate the adequacy of **disclosure of their estimation uncertainty**.
- Review the judgements and decisions of management in making the accounting estimates to identify if there are indications of **possible management bias**.
- Obtain **written representations** from management whether management believes significant assumptions used are reasonable.

SLAuS 402 *Audit considerations relating to an entity using a service organization* provides guidance to auditors whose clients use such an organisation.

A **service organisation** provides services to user entities. There may be special considerations for the auditor of a user entity when that entity makes use of a service organisation.

A **service organisation** is a third-party organisation that provides services to user entities that are part of those entities' information systems relevant to financial reporting.

A **user entity** is an entity that uses a service organisation and whose financial statements are being audited.
A **user auditor** is an auditor who audits and reports on the financial statements of a user entity.
A **service auditor** is an auditor who, at the request of the service organisation, provides an assurance report on the controls of a service organisation.

SLAuS 402 Audit considerations relating to an entity using a service organization provides guidance to auditors whose clients use such an organisation. It expands on how the user auditor obtains an understanding of the user entity, including internal control sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.

A client may use a service organisation such as one that executes transactions and maintains related accountability, or records transactions and processes related data. Many companies outsource aspects of their business activities to external service organisations. Examples relevant to the independent auditors include:

• Payroll processing
• Maintenance of accounting records
• Maintenance of IT systems relevant to financial reporting

Understanding the services provided
User auditors must obtain an understanding of the services provided by the service organisation in accordance with SLAuS 315. This understanding must include the following:

- Nature of services provided and the significance of these to the user entity, including effect on user entity's internal control
- Nature and materiality of transactions processed or financial reporting processes affected
- Degree of interaction
- Nature of relationship, including contractual terms

When obtaining an understanding of the internal control relevant to the audit, the user auditor must evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organisation.
The user auditor needs to determine whether a sufficient understanding of the nature and significance of the services provided, and their effect on internal control, has been obtained to allow for the identification and assessment of risks of material misstatement in the financial statements.
If the user auditor cannot get this understanding from the user entity, the understanding needs to be obtained from one or more of the following procedures:

- Obtaining a type 1 report (report on description and design of controls at a service organisation) or type 2 report (report on the description, design and operating effectiveness of controls at a service organisation) from a service auditor, if available
- Contacting the service organisation through the user entity
- Visiting the service organisation and performing necessary procedures
- Using another auditor to perform necessary procedures

If the user auditor uses a type 1 or type 2 report to obtain an understanding of the services, the auditor must be satisfied as to the service auditor's professional competence and independence, and the adequacy of standards used.

Responding to the assessed risks of material misstatement
In responding to the assessed risks in accordance with SLAuS 330, the user auditor must:
(a) Determine whether **sufficient appropriate audit evidence** concerning the relevant financial statement assertions is available from records held at the user entity; and if not

(b) Perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organisation on the user auditor's behalf.

Reporting by the user auditor
The user auditor is always **solely responsible** for the auditor's opinion. He must be assured that he has gained sufficient appropriate audit evidence to form an opinion on the financial statements and he must then express his opinion in the auditor's report. The user auditor must therefore not refer to the work of a service auditor in the user auditor's report if it contains an unmodified opinion (unless required by law or regulation). If the user auditor makes reference to the work of a service auditor in the user auditor's report because it is relevant to understanding a modification to the opinion, the user auditor must state in the user auditor's report that this reference does not reduce the user auditor's responsibility for the opinion.

ISA 505 - External Confirmations

01. What is external confirmation?

External confirmation is the process of obtaining and evaluating audit evidence through a representation of information or an existing condition directly from a third party in response to a request for information about a particular item affecting assertion16110

s in the financial statements or related disclosures.

02. Situations where external confirmations may be used

External confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items. The follow ing are examples of situations where external confirmations may be used include the following:

- Bank balances and other information from bankers.
- Accounts receivable balances.
- Stocks held by third parties at bonded warehouses for processing or on consignment.
- Property title deeds held by lawyers or financiers for safe custody or as security.
- Investments purchased from stockbrokers but not delivered at the balance sheet date.
- Loans from lenders.
- Accounts payable balances.

03. Assertions Addressed by External Confirmations

External confirmation of an account receivable provides reliable and relevant audit evidence regarding the existence of the account as at a certain date.

Confirmation also provides audit evidence regarding the operation of cutoff procedures. However, such confirmation does not ordinarily provide all the necessary audit evidence relating to the valuation assertion, since it is not practicable to ask the debtor to confirm detailed information relating to its ability to pay the account.

Similarly, in the case of goods held on consignment, external confirmation is likely to provide reliable and relevant audit evidence to support the existence and the rights and obligations assertions, but might not provide audit evidence that supports the valuation assertion.

04. Use of Positive and Negative Confirmations

A positive external confirmation request asks the respondent to reply to the auditor in all cases either by indicating the respondent's agreement with the given information, or by asking the respondent to fill in information

A negative external confirmation request asks the respondent to reply only in the event of disagreement with the information provided in the request.

05. Management Requests

When the auditor seeks to confirm certain balances or other information, and management requests the auditor not to do so, the auditor should consider whether there are valid grounds for such a request and obtain audit evidence to support the validity of management's requests. If the auditor agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should apply alternative audit procedures to obtain sufficient appropriate audit evidence regarding that matter.

If the auditor does not accept the validity of management's request and is prevented from carrying out the confirmations, there has been a limitation on the scope of the auditor's work and the auditor should consider the possible impact on the auditor's report.

06. No Response to a Positive Confirmation Request

The auditor should perform alternative audit procedures where no response is received to a positive external confirmation request. The alternative audit procedures should be such as to provide audit evidence about the assertions that the confirmation request was intended to provide.

07. External Confirmation Process

When the auditor decides to request positive or negative confirmations, the auditor shall plan, design, undertake and control the external confirmation procedures, including:

(a) Identification of the member or members of the audit team responsible for controlling the external confirmation process, the resources assigned and the timing of the related procedures;

(b) Selection of items for which external confirmations will be requested;

(c) Design and preparation of the confirmation requests;

(d) Communication of the confirmation requests to the appropriate confirming party;

(e) Consideration of the results (responses, non-responses and exceptions) of confirmation requests; and

(f) Evaluation of the evidence obtained from the confirmation requests. (Ref: Para. A15-A26)

The auditor shall only use negative confirmations to reduce the risk of financial statement misstatement to an acceptable level without also performing other substantive procedures when:

(a) The assessed risk of material misstatement associated with the relevant financial statement assertion is low;

(b) A large number of small balances is involved;

(c) A substantial number of errors is not expected; and

(d) The auditor believes that respondents will not disregard the confirmation requests.