

RISK, GOVERNANCE AND AUDIT

CORPORATE LEVEL

TUTE 03



by

Jeewantha Perera

(FCA, ACCA, MBA, B.Sc Accountancy (sp))

The logo for JMC vLearning, featuring a stylized 'J' composed of two overlapping 3D rectangular blocks, one light blue and one light orange. To the right of the 'J' is the text 'JMC vLearning' in a bold, sans-serif font, with 'JMC' in blue and 'vLearning' in orange. Below this, the tagline 'your virtual learning partner' is written in a smaller, blue, sans-serif font.

A) Introduction

Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. When the use of the going concern assumption 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. The financial statements should be prepared on the going concern basis unless management either intends to liquidate the entity or has no realistic alternative but to do so. The going concern assumption is a fundamental principle in the preparation of the financial statements and therefore requires management to assess whether the entity is a going concern.

It is vital that the going concern assumption is considered, since it affects the value of many areas of the financial statements, how account balances are presented and the financial statement disclosures. Since the going concern assumption has such significance in the preparation of the financial statements, the going concern review is a very important part of the audit.

The objectives of the auditor in respect of going concern are:

- To obtain sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern assumption.
- To conclude 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.

B) Events or Conditions that may cast doubt about the Going Concern assumption

A) Financial Indicators

- Net liability or net current liability position
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment
- Indications of withdrawal of financial support by creditors
- Negative operating cash flows (historical or prospective)
- 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 terms and conditions of the loan agreements
- Change from suppliers from credit to cash basis

B) Operating Indicators

- Management intentions to liquidate or cease operations
- Loss of key management without replacement
- Loss of a major market, key customers, licence, or principal suppliers
- Labour difficulties
- shortages of important supplies

C) Other Indicators

- 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 laws/regulations/government policy expected to adversely affect the entity

‘C) 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. Because general purpose financial statements are prepared on a going concern basis, the going concern assumption 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.

From Managements perspective, they are responsible to perform a proper assessment with regard to the Going Concern ability of the organization

Important

If, during their assessment, management becomes aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, then those uncertainties must be disclosed in the financial statements

D) 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. The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern.

E) 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 and having discussions with Management
 - a) Analyse and discuss cash flow, profit and other relevant forecasts with management
 - b) Analyse and discuss the entity's latest available interim financial statements (or management accounts)
 - c) Evaluating the reliability of underlying data used to prepare a cash flow forecast and considering the assumptions used to make the forecast
 - d) Confirm the existence, terms and adequacy of borrowing facilities
- Read minutes of the meetings of shareholders, the board of directors and important committees for reference for the matters which is applicable for Going Concern Assumption
- Enquire of the entity's lawyer regarding litigation and claims
- Requesting written representations from management and those charged with governance about plans for future action and the feasibility of these plans

F) Communicating with Those Charged with Governance

The auditor shall communicate with those charged with governance events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern.

Such communication with those charged with governance shall include the following:

- Whether the events or conditions constitute a material uncertainty
- Whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements
- The adequacy of related disclosures in the financial statements

G) Audit Reporting

The auditor shall consider whether a material uncertainty exists related to events or conditions which may cast doubt on the entity's ability to continue as a going concern, as this will have an impact on the opinion issued in the auditor's report because the uncertainty must be disclosed.



AUDIT EVIDENCE (S.L.Au.S 500)

The objective of the above mentioned/referred standard is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

A) Definition

Audit Evidence can be defined as **"all of the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based."**

Audit evidence includes both information contained in the accounting records underlying the financial statements and other information gathered by the auditors such as confirmations from third parties.

Sufficiency and Appropriateness of Audit Evidences

The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining **sufficient appropriate audit evidence.**

Sufficiency

The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

Appropriateness

The measure of the quality of audit evidence; that is, its relevance, quality and its reliability in providing support for the conclusions on which the auditor's opinion is based.

The sufficiency and appropriateness of audit evidence are interrelated.

The logo for JMC vLearning is located in the bottom left corner. It consists of a stylized graphic of two overlapping rectangular blocks, one light blue and one light orange, positioned to the left of the text "JMC vLearning". The text "JMC" is in a large, bold, blue font, and "vLearning" is in a smaller, blue font. Below the main text, the tagline "your virtual learning partner" is written in a smaller, italicized, blue font.

What is Audit Risk?

The risk that the Auditor expresses an inappropriate audit opinion when the financial statements are materially misstated is referred as Audit Risk. The Audit Risk is the function of "Risk of Material Misstatements" and "Detection Risk"

Audit Risk can be divided into two key elements

- A) Risk of Material Misstatements
- B) Detection Risk

A) Risk of Material Misstatements

The risk that the Financial Statements are materially misstated prior to audit is referred as Risk of Material Misstatements. The risk of material misstatements consists of two components

1) Inherent Risk

The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements before consideration of any related control.

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

2) Control Risk

The Risk that a misstatement that could occur in an assertion, about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely manner by the entity's internal controls.

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

B) Detection Risk

The risk that the procedures performed by the Auditor to reduce the Audit Risk to an acceptable low level will not detect a misstatement that exists, and that could be material, either individual or when aggregated with other misstatements

.....

.....

.....

.....

.....

.....

.....

.....

Methods used to obtain Audit Evidences

A) Risk Assessment Procedures

The audit procedures performed by an auditor to obtain an understanding of the entity and its environment, including the entity's internal controls to identify and assess the risk of material misstatements, whether due to fraud or error in the financial statements are referred to as Risk Assessment Procedures.

B) Test of Controls

Test of controls are performed to obtain audit evidence about the operating effectiveness of controls in preventing or detecting and correcting material misstatements at the assertion level. Test of Controls are mainly focus on the Existence, Effectiveness and Continuity of the Accounting and Internal Control System.

Eg:

.....

.....

.....

.....

.....

.....

.....

.....

C) Substantive Procedures

Substantive procedures are audit procedures performed to detect material misstatements at the assertion level. substantive procedures must always be carried out for material classes of transactions, account balances and disclosures.

D) The Reliability of the Audit Evidence

Reliability of audit evidence mainly depends on the Source which the audit evidence obtained and the Nature of the evidence. So auditor needs to decide the level of the reliability, and it depends on Auditor's Professional Judgment. However, auditor needs to focus on the following examples when performing the audits

- Audit evidence obtained from the external sources are much more reliable than the audit evidence obtained from internal sources.
- Audit evidence obtained directly by the auditor is much more reliable than the audit evidence obtained indirectly.
- Audit evidence obtained in the written format is much more reliable than the audit evidence obtained in the oral format
- Audit evidence obtained in the original form is much more reliable than the audit evidence obtained in photocopies or duplicate copies
- When there are strong internal controls (In a situation where you see EEC), the audit evidence obtained through the entity is having a higher level of reliability

Therefore, audit evidence obtained through external sources, directly, in the written format is more reliable than the audit evidence obtained through internal sources, indirectly in the oral format

E) Factors to be Considered when obtaining Sufficient and Appropriate Audit Evidence

- The materiality/importance of the item which the auditor is searching at/looking for**

When the significance increases, the auditor needs to obtain more sufficient and appropriate audit evidence and when the significance decreases, auditor can be focus on lesser audit evidence.

- The Source and the Reliability of the audit evidence**

The auditor always tries to obtain the audit evidence from External Sources. Because, the audit evidence obtained from the external sources are much more reliable than the audit evidence obtain internally. However, when there is a practical difficulty of obtaining audit evidence externally, auditor must obtain the audit evidence from internal sources. When obtaining audit evidence internally, auditor needs to increase the volume of the audit evidence

- Inherent Risk, Control Risk and Nature of the Accounting and Internal Control Systems**

When there is high tendency to have higher Inherent Risk and higher Control Risks, it seems to be that the internal controls are weak. So, in this kind of a situation, auditor needs to obtain much more sufficient and appropriate audit evidence.

4) Auditors' knowledge of Business and the Previous Years' Experience

When the Auditor has less knowledge of the business and lesser experience, auditor needs to obtain much more sufficient and appropriate audit evidence.

F) The Procedures to Obtain the Audit Evidence

a) Inspection

.....

.....

.....

.....

b) Observation

.....

.....

.....

.....

c) Questionnaires and Confirmations

.....

.....

.....

.....

d) Re-computations

.....

.....

.....

.....

e) Analytical Review Procedures

.....

.....

.....

f) Re-performance

.....

.....

.....

G) Important

Auditors need to obtain audit evidence from various sources. If the evidence collected from one source is contradicted to the audit evidence obtain from another source, Auditors' high attention needs to be devoted to those instances

Auditor needs to obtain audit evidence of all the Assertions. The audit evidence obtains which relates to one assertion, neither treated as a substitute for another audit evidence that should obtain by the auditor for another assertion nor to another audit procedure which need to perform by the auditor





JMC vLearning
"your virtual learning partner"