Audit Reporting, Going Concern and Completion

Interview preparation summary · AU track

IN THIS SUMMARY

- Completion
- The opinion

INT.UO.1.a · Completion

Classify events after the year-end as adjusting or non-adjusting, say what auditors do to find them up to the date of the report, and explain what written representations are and are not worth.

Financial statements are signed weeks or months after the year-end, and things happen in between. Auditing standards require procedures up to the date of the audit report to find events that need adjustment or disclosure. The test is the cause, not the date. An adjusting event gives further evidence of a condition that already existed at the year-end, for example a customer going into administration soon afterwards, which shows the receivable was already impaired, so the figures change. A non-adjusting event arises from conditions that came afterwards, such as a fire or a share issue, so the figures stay and a material one is disclosed. Typical procedures are reading later minutes, asking management, reviewing the latest management accounts, checking cash received after the year-end, and reading legal correspondence. Written representations are then obtained, confirming among other things that all transactions are recorded and all known events disclosed. They support other evidence and never replace it. If management refuses to give them, the auditor reconsiders management's integrity and the effect on the opinion. The usual mistake is to decide by date, not cause.

WORKED EXAMPLE: SORTING THREE EVENTS AT HARLOW TILES

Harlow Tiles is an invented ceramics manufacturer with a 31 December year-end. The statements will be approved on 15 April. Overall materiality is 0.45m. Three things happen after the year-end. On 20 January a customer, Calder Builders, enters administration; it owed 0.64m at the year-end, and the administrator expects to pay 10p in the pound. On 3 March a fire destroys finished goods carried at 0.95m in a warehouse. On 12 February the board proposes a final dividend of 0.50m. The manager asks you to classify each, say what changes in the statements, and say what you need from management before the report is signed.

Answer: Adjust for the customer failure by providing 0.576m, about 0.58m. Disclose the 0.95m fire and the 0.50m dividend without adjusting. The tests were the cause of each event and whether it is above materiality of 0.45m.

> **Interview tip:** Say: I ask whether the event shows something that was already true at the year-end. If so the numbers change; if not, I disclose it when it is material. Then name two procedures you would use to find such events.

INT.UO.1.b · Completion

Accumulate and project misstatements, compare the total with the materiality thresholds, weigh quantitative and qualitative factors, and explain what the auditor does with other information in the annual report.

During the audit the team records every misstatement above the clearly trivial threshold on a schedule. Factual misstatements are certain, judgemental ones arise from an estimate that the auditor considers unreasonable, and projected ones are an extrapolation of errors found in a sample to the whole population. At completion the auditor compares the total of uncorrected misstatements with overall materiality, asks management to correct them, and considers whether the uncorrected balance, together with errors that may remain undetected, could make the statements materially wrong. Gross and net totals both matter, because netting an overstatement against an understatement can hide two large errors. Qualitative factors can make a small item material: it turns a loss into a profit, hides a covenant breach, touches a related party, or all errors lean in one direction. Separately, the auditor reads other information in the annual report, such as the strategic report, to check that it is consistent with the statements and with what the auditor learned. The usual mistake is to stop at the percentage and ignore the nature of the item.

WORKED EXAMPLE: TOTALLING MISSTATEMENTS AT CORRIN COMPONENTS

Corrin Components is an invented engineering group with draft profit before tax of 16.0m. Using common rules of thumb, the team set overall materiality at 5% of profit before tax = 0.80m, performance materiality at 65% of that = 0.52m, and the clearly trivial threshold at 5% of overall materiality = 0.04m. Four items overstate profit: a revenue cut-off error of 0.18m, an inventory costing error of 0.22m, a receivables sample in which errors of 0.05m were found in a sample of 2.0m from a population of 12.0m, and a warranty provision where the auditor's estimate differs from management's by 0.15m. A fifth item of 0.03m is a misclassification. Evaluate the position.

Answer: Uncorrected misstatements total 0.85m against materiality of 0.80m, so correction is needed; after correcting the factual items 0.45m remains, below materiality but reported to governance.

> **Interview tip:** Say the total, the threshold and the gap, then say what you would do next: ask management to correct, and report what is left. Mention that you looked at direction and nature, not only size.

INT.UO.1.c · Completion

Describe what the auditor communicates to those charged with governance and when, and explain how the review process on an audit file works before the report is signed.

Those charged with governance are the people responsible for overseeing the company's direction and accountability, usually the board or its audit committee. Auditing standards require two-way communication with them. Early in the audit the auditor explains responsibilities, the planned scope and timing, and the significant risks. At the end the auditor reports significant findings: views on the quality of accounting practices and estimates, significant difficulties met, uncorrected misstatements (other than clearly trivial ones, whatever their size against materiality), significant deficiencies in internal control, matters about fraud or non-compliance, and the firm's independence. Written communication is typical for the matters that matter most. In parallel the file is reviewed in layers: the preparer's work is checked by a senior, then the manager, then the partner, with an independent engagement quality review for the audits of listed or higher-risk entities. Review notes are cleared on the file with evidence, not by a verbal answer. The usual mistake is to leave review to the last days, when there is no time to fix what it finds.

WORKED EXAMPLE: WHAT WEXCOMBE FOODS'S COMMITTEE MUST HEAR

Wexcombe Foods is an invented food manufacturer with draft profit before tax of 12.4m and overall materiality of 5% = 0.62m. Three misstatements remain uncorrected, all overstating profit: inventory obsolescence of 0.12m, a bonus accrual of 0.09m and a useful-life estimate for equipment of 0.21m. The finance director says they are all below materiality and need not go to the audit committee. The directors' bonus pool pays out only if profit before tax is at least 12.0m. Explain what you would tell the committee and how the file gets reviewed.

Answer: Tell the committee about all three items, 0.42m in total, point out that correction would bring profit to 11.98m, below the 12.0m bonus trigger, and clear the review points on the file before signing.

> **Interview tip:** Say that below materiality is not the same as nothing to report, and mention one qualitative factor (direction, a threshold or a trend). Then say review is layered and cleared on the file.

INT.UO.2.a · The opinion

Choose between an unmodified, qualified, adverse and disclaimer of opinion by asking whether a matter is material and whether it is pervasive, and say whether it arises from a misstatement or from a limit on evidence.

The audit report gives an opinion on whether the statements give a true and fair view, or are fairly presented. An unmodified opinion says they do. A modified opinion is needed when the statements contain a material misstatement or the auditor cannot obtain enough evidence, and the choice depends on two questions. First, is the matter material, and is it pervasive, meaning it affects many items, is a large share of the statements, or is fundamental to users' understanding? Second, is the cause a disagreement over a misstatement or a limitation of scope? Material but not pervasive gives a qualified opinion, an 'except for' conclusion, in either case. A material and pervasive misstatement gives an adverse opinion, which says the statements do not give a true and fair view. If the possible effect of a limitation is both material and pervasive, the auditor disclaims, saying no opinion is expressed. Size alone does not make something pervasive, so quote the effect and its reach, not only the amount. Candidates often confuse a qualified opinion with an adverse one, or treat a limitation as a misstatement.

WORKED EXAMPLE: FOUR OPINIONS AT THORNBURY PACKAGING

Thornbury Packaging is an invented group with profit before tax of 10.0m, total assets of 40.0m, group revenue of 63.0m and overall materiality of 0.50m. Four separate situations arise. A: management will not reverse a provision release of 1.1m that the auditor considers unsupported. B: management has not consolidated a subsidiary with assets of 14.0m and revenue of 21.0m. C: the auditor could not attend inventory at an overseas site carrying 0.9m and could find no other way to verify it. D: the sales ledger for the whole year has been lost, with no backup, so revenue cannot be verified at all. Decide the opinion in each case.

Answer: A qualified (misstatement); B adverse; C qualified (limitation); D disclaimer. The deciding questions were material or not, pervasive or not, and misstatement or limitation.

> **Interview tip:** Give the two questions out loud: how material, how pervasive, and is it a misstatement or a limit on evidence. Then apply them with a figure, not an adjective.

INT.UO.2.b · The opinion

Distinguish emphasis of matter, other matter and key audit matters from a modified opinion, and explain how comparatives and the predecessor auditor affect the report.

Not every difficult matter changes the opinion. An emphasis of matter paragraph draws attention to something already properly presented and disclosed in the statements, such as a significant litigation uncertainty, that the auditor judges fundamental to users' understanding. An other matter paragraph covers something not in the statements that is relevant to understanding the audit or the report, for example that the prior year was audited by a different auditor. Key audit matters, required for listed entities and often given voluntarily elsewhere, describe the matters of most significance in the current audit, chosen from those discussed with governance, and say why each mattered and how the audit responded. None of these is a substitute for a modified opinion: if a matter is misstated or inadequately disclosed, the opinion is modified, whatever else the report says. Comparatives are the prior year figures shown beside the current ones. The auditor's opinion covers the current period, but the auditor checks that the comparatives agree to what was reported, are consistently presented, and do not reveal a misstatement affecting the current year. The usual mistake is to treat emphasis as a gentler qualification.

WORKED EXAMPLE: THREE PARAGRAPHS FOR FENWICK LOGISTICS

Fenwick Logistics is an invented listed group. Overall materiality is 5% of profit before tax of 62.0m = 3.1m. Three matters arise. First, goodwill of 48.0m out of total assets of 310.0m depends on a long-term forecast; the audit spent 380 of 4,200 hours testing it and challenged management's growth assumptions twice. Second, a customer has claimed 6.5m for a failed delivery contract; the outcome is uncertain, and the note describes the claim and the range of outcomes fully. Third, the prior year statements were audited by another firm, which gave an unmodified opinion. Decide how the report treats each.

Answer: Goodwill: key audit matter. Claim: emphasis of matter, opinion unmodified because the disclosure is adequate. Prior year: other matter paragraph. The opinion itself stays unmodified.

> **Interview tip:** Say that these paragraphs point to something properly handled, while a modification says something is wrong. Give one example of each.

INT.UO.2.c · The opinion

Explain how the going concern assumption is assessed, what makes a material uncertainty, and how each outcome of the assessment changes the audit report.

The going concern basis assumes the company will keep operating for the foreseeable future, which standards typically take as at least twelve months from the date the statements are approved. Management makes the first assessment, using cash flow forecasts, loan repayment dates, covenants, undrawn facilities and plans. The auditor evaluates it by testing the forecast's assumptions, running downside cases, reading lender correspondence, checking events after the year-end, and asking whether management's plans are feasible. There are three outcomes. If the basis is appropriate and there is no material uncertainty, nothing is added. If the basis is appropriate but a material uncertainty exists and is adequately disclosed, the opinion is unmodified and a separate section headed material uncertainty related to going concern directs readers to the note. If disclosure is inadequate, the opinion is qualified or adverse. If the basis itself is inappropriate, for example the company will cease trading, but the statements were prepared on it, the opinion is adverse. The usual mistake is to treat a loss or a shortfall as automatically meaning doubt without testing the available funding.

WORKED EXAMPLE: LANTERN BAKERIES AND THE CASH LOW POINT

Lantern Bakeries is an invented chain with annual revenue of 30.0m and a contribution margin of 40%. The statements are about to be approved on 28 February, and the forecast covers the twelve months from then. Cash is 1.1m. Management's forecast for the twelve months after approval, before financing, is quarterly net cash flow of -0.9m, -0.4m, +0.5m and +0.3m. An overdraft of 0.5m is agreed and undrawn. A 3.0m term loan falls due on 31 May, in the first quarter of the forecast, and the bank has given only an indicative renewal that has not been signed. Assess the position and the report.

Answer: The low point is -0.2m with 0.3m of headroom, reduced to 0.06m in the downside. The loan renewal is unsigned, so unless it is signed, a material uncertainty exists and, if disclosed, the opinion is unmodified with a separate section.

> **Interview tip:** Show you test the plan, not only the forecast. Say: what is the low point, what funding covers it, how little needs to go wrong, and is that funding signed.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.