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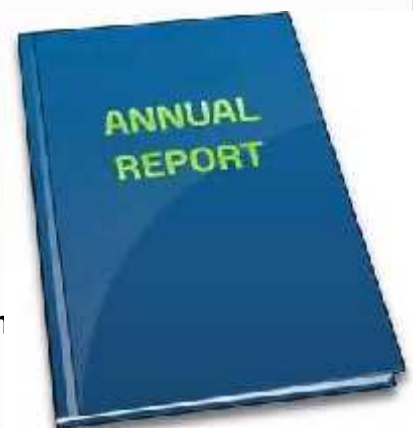
ESSENTIAL ISSUES IN AUDITING: A PRACTICAL APPROACH



Reporting

Presentation by: FCPA John Kabiru

**Date: 11th August 2015 , 2.00pm- 4.00pm
Safari Park Hotel**



Contents



- The Audit Opinion.
- Communicating Identified Misstatements & Audit Findings
- Obtaining Written Representation
- Compiling the Audit File
- Practical Challenges



The Annual Report



A company's annual report is typically made up of

- The audited financial statements and
 - A narrative, containing management's description of the company's performance and activities.
- The narrative part of the annual report is not normally audited.
- However auditors read the narrative statements in the annual report to identify any material inconsistencies with the audited information in the financial statements.
- Inconsistencies, are communicated to management and those charged with governance.

Other Reports



- In addition to publishing full financial statements every year, public companies typically also need to issue less detailed financial information at other points throughout the year.
- However, the company will generally ask its auditors to read the announcement prior to its release and inform them of any material inconsistencies which have come to their attention.
- This review is not strictly an audit.



POINT OF VIEW

Try to see it from someone else's.

Opinion
matters

Audit Opinion



- The auditor is responsible for expressing an opinion indicating that reasonable assurance has been obtained that the financial statements as a whole are free from material misstatement, whether due to fraud or error, and that they are fairly presented in accordance with the relevant accounting standards (e.g., International Financial Reporting Standards).
- The auditor issues a 'clean' opinion when it concludes that the financial statements are free from material misstatement.
- An audit opinion that is not considered 'clean' is one that has been modified

Audit Opinion



- Auditors issue a modified audit opinion if they,
 - disagree with management about the financial statements.
 - have not been able to carry out all the work they feel is necessary,
 - have been unable to gather all the evidence they need
- Auditors can also modify the audit report without modifying the opinion by adding additional paragraphs to draw users' attention to specific significant matters e.g aspects subject to material degree of uncertainty even if fully disclosed, they may draw it to attention – **Emphasis of Matter**

Going Concern Assumption



- A company is viewed as continuing in business for the foreseeable future
- Financial statements are prepared on a going concern basis
- It is fundamental to the values at which the assets and liabilities are recognised in the company's balance sheet
- It is not a guarantee of the company's solvency.
- Requires significant judgement as no statement about the future can be guaranteed.
- It is management's responsibility to make a judgement on going concern

'Going concern' concept

assumes a business will continue to trade for the foreseeable future

allows costs and revenues to be allocated to future accounting periods

provides a more realistic value of business assets

allows fixed assets to be written off proportionally over their useful life

Going Concern Concept



- If management considers that the company will not continue to operate for the foreseeable future, the financial statements must be prepared on a 'liquidation' (or 'break-up') basis
- meaning that the value of their assets must take account of potential forced sales which will likely be significantly lower and their liabilities may be significantly higher.
- The most common recent form of such uncertainty is where additional financing is needed to continue to develop a company's business and fully fund its working capital.**

Misstatements



WHEN ACCOUNTANTS GET SCHIZOPHRENIA

Misstatements



- A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be presented fairly in accordance with the applicable financial reporting framework.
- Misstatements can arise from fraud or error.
- It is the auditor's responsibility to evaluate the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on the financial statements

Misstatements



Misstatements may result from fraud or error, such as

- inaccuracy in gathering or processing data from which the financial statements are prepared,
- omission of an amount or disclosure,
- disclosure that is not presented in accordance with the applicable financial reporting framework,
- incorrect accounting estimate arising from overlooking or clear misinterpretation of facts, and
- judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection or application of accounting policies that the auditor considers inappropriate.

Misstatements Distinction



- ***Factual misstatements*** are misstatements about which there is no doubt.
- ***Judgmental misstatements*** are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection or application of accounting policies that the auditor considers inappropriate.
- ***Projected misstatements*** are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire population from which the samples were drawn.

Financial Statement Fraud



- Financial statements are sometimes prepared in ways that **intentionally misstate** the financial position and performance of an organization.
- Misstatement of financial statements can result from **manipulating, falsifying, or altering accounting records**.
- Misleading financial statements cause serious problems in the market and the economy

Fraudulent Financial Reporting



- **What is Financial statement Fraud:** It is deliberate misstatements or omissions of amounts or disclosures of financial statements misrepresent financial statement users
- This is orchestrated through various means including falsification, alteration, or manipulation of material financial records, or business transactions, material intentional omissions or misrepresentations of events, transactions, accounts, or other significant information
- Financial frauds generally fall into four broad categories;
 - Fraudulent financial reporting schemes.
 - Misappropriation of assets.
 - Revenue and assets obtained by fraud.
 - Expenditures and liabilities for an improper purpose.

MATERIAL MISSTATEMENT

Mark Kingsbury



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Misstatement



The objective of the auditor is to evaluate the effect of

- a. identified misstatements on the audit and
- b. uncorrected misstatements, if any, on the financial statements

- The auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial.

- overall audit strategy and audit plan need to be revised if nature and circumstances of indicate that more misstatements may exist and may affect materiality

Communication and Correction of Misstatements



- The auditor should communicate on a timely basis with management all misstatements
- The auditor should request management to correct those misstatements
- the auditor should perform additional audit procedures to determine whether misstatements remain
- If management refuses to correct some or all of the misstatements, then obtain an understanding of management's reasons for not making the corrections
- take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

Communication and Correction of Misstatements



- Law or regulation may restrict the auditor's communication of certain misstatements to management or others within the entity that might prejudice an investigation by an appropriate authority
- Potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider seeking legal advice.

Evaluating Errors in Previously-Issued Financial Statements



- Errors financial statements are evaluated using the "iron curtain" method and the "rollover" method.
- The use of both methods is commonly referred to as the "dual" method of evaluating errors.
- If the previously-issued financial statements are materially misstated, they should be corrected promptly.
- Users of the financial statements also must be notified that they should no longer rely on the previously-issued financial statements.

Evaluating Errors in Previously-Issued Financial Statements



- the correction of a material misstatement is ordinarily accomplished by the company issuing corrected financial statements which indicate that they have been restated and including its auditor's re-issued audit report.
- If the previously-issued financial statements are not materially misstated, then the error may be corrected prospectively.
- Materiality analyses require significant professional judgment

Quantifying Errors



- Error Identification.
- Error Quantification
- Evaluation for Materiality
- Errors are evaluated under both the "rollover" method and the "iron curtain" method.
- The principal difference between these two methods lies in how income statement errors are quantified.

Quantifying Errors



- The **"rollover"** method quantifies income statement errors based on the amount by which the income statement is actually misstated — including the reversing effect of any prior errors. Identified misstatements in the previous period that were not corrected need to be considered to determine the "carryover effects".
- The **"iron curtain"** method quantifies income statement errors based on the amount by which the income statement would be misstated if the accumulated amount of the errors that remain in the balance sheet were corrected through the income statement of that period.

Quantifying Errors



- The corrected financial statements should include disclosures required- *Accounting Changes and Error Corrections*.
- These disclosures include the nature of the error and the quantitative effects of correction on each affected financial statement line item (including per share amounts).
- Affected column headings should be labeled "Restated" (or something comparable).
- A re-issued audit report should include an explanatory paragraph indicating that the previously-issued financial statements have been restated and also include a reference to the company's disclosure of the correction.

Quantifying Errors



- Business entities may present historical, statistical-type summaries of financial data for a number of periods—commonly 5 or 10 years.
- A quantitative and qualitative analysis should be included
- Management should consult with its counsel to determine the appropriate steps and timing for providing notice that the materially misstated financial statements should no longer be relied upon.
- Errors may be corrected as an "out-of-period" adjustment if the correction would not result in a material misstatement of the estimated income/loss for the year in which the adjustments are made or to the trend in earnings.

Evaluation Framework and Practical Example



- Company X has a calendar year-end. In early April 2013, Company X identified a long-term incentive compensation obligation for one of its salespeople which it had inadvertently neglected to record since 2009.
- If Company X had properly accounted for the plan, it would have recorded an additional \$30 of compensation expense in each of the years 2009 through 2012.
- Company X's reported income in each of the years 2009 through 2012 was \$1,000.
- Company X projects its 2013 income will be \$1,000.

Quantifying Errors



Year	Reported Income	Rollover Method	Iron Curtain Method
2009	\$1,000	\$30 (3%)	\$30 (3%)
2010	\$1,000	\$30 (3%)	\$60 (6%)
2011	\$1,000	\$30 (3%)	\$90 (9%)
2012	\$1,000	\$30 (3%)	\$120 (12%)
2013	\$1,000 (Projected)	N/A	N/A

Documentation of Misstatements



The auditor should include in the audit documentation

- the amount below which misstatements would be regarded as clearly trivial;
- all misstatements accumulated during the audit and whether they have been corrected; and
- the auditor's conclusion about whether uncorrected misstatements are material, individually or in the aggregate, and the basis for that conclusion.
- Undetected misstatements could exist because of the presence of sampling risk and non-sampling risk

Documentation of Misstatements



Written Representations addresses management representations, including representations with respect to uncorrected misstatements.

Instance where h a high degree of estimation uncertainty

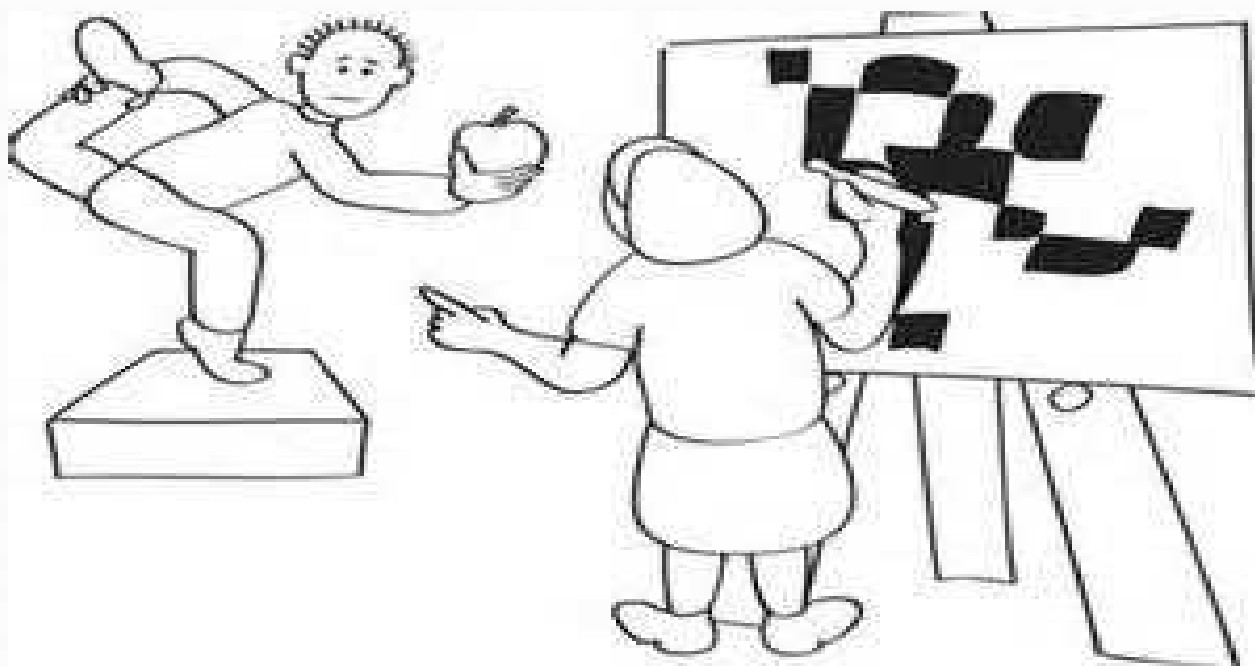
- provisions for insurance claims in the case of an insurance company;
 - oil rig decommissioning costs in the case of an oil company; or
 - more generally, legal claims against an entity
- may influence the auditor's assessment of what users might consider material misstatement.







Obtaining Written Representation



Written Representation



- A written statement by management is provided to the auditor to confirm certain matters or to support other audit evidence.
- Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.
- It is the auditor's responsibility to obtain written representations from management and, when appropriate, those charged with governance in an audit of financial statements.

Written Representation



- **Audit evidence** is the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based.
- Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements.
- Complement other auditing procedures and do not provide sufficient appropriate audit evidence on their own
- Obtaining reliable written representations does not affect the nature or extent of other audit procedures

Management from Whom Written Representations Are Requested



- The auditor should request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

Preparation and Fair Presentation of the Financial Statements



The auditor should request management to provide a written representation that it has fulfilled its responsibility, as set out in the terms of the audit engagement,

- *a.* for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework; and
- *b.* for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error

Information Provided and Completeness of Transactions



The auditor should request management to provide written representations that

- a. it has provided the auditor with all relevant information and access, as agreed upon in the terms of the audit engagement, and
- b. all transactions have been recorded and are reflected in the financial statements

Other Written Representations *Fraud*



The auditor should request management to provide written representations that it

- a.* acknowledges its responsibility for the design, implementation, and maintenance of internal controls to prevent and detect fraud;
- b.* has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud;

Other Written Representations *Fraud*



c. has disclosed to the auditor its knowledge of fraud or suspected fraud affecting the entity involving

- i. management,
- ii. employees who have significant roles in internal control, or
- iii. others when the fraud could have a material effect on the financial statements; and

d. has disclosed to the auditor its knowledge of any allegations of fraud or suspected fraud affecting the entity's financial statements communicated by employees, former employees, regulators, or others

Laws and Regulations



The auditor should request management to provide written representations that all instances of identified or suspected noncompliance with laws and regulations whose effects should be considered by management when preparing financial statements have been disclosed to the auditor.

Uncorrected Misstatements



The auditor should request management to provide written representations about whether it believes the effects of uncorrected misstatements are immaterial, individually and in the aggregate, to the financial statements as a whole.

A summary of such items should be included in, or attached to, the written representation.

Litigation and Claims



The auditor should request management to provide written representations that all known actual or possible litigation and claims whose effects should be considered by management when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework.

Estimates



The auditor should request management to provide written representations about whether it believes significant assumptions used by it in making accounting estimates are reasonable.

Related Party Transactions



The auditor should request management to provide written representations that

- a. it has disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which it is aware and
- b. it has appropriately accounted for and disclosed such relationships and transactions.

Subsequent Events



The auditor should request management to provide written representations that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

Additional Written Representations



If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor should request such other written representations.

Date of, and Period(s) Covered by, Written Representations



The date of the written representations should be as of the date of the auditor's report on the financial statements.

The written representations should be for all financial statements and period(s) referred to in the auditor's report.

Form of Written Representations



The written representations should be in the form of a representation **letter** addressed to the auditor.

Doubt about the Reliability of Written Representations



If written representations are inconsistent with other audit evidence, the auditor should perform audit procedures to attempt to resolve the matter.

If the matter remains unresolved, the auditor should reconsider the assessment of the competence, integrity, ethical values, or diligence of management or of management's commitment to, or enforcement of, these and should determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general

Written Representations about Management's Responsibilities



The auditor should disclaim an opinion on the financial statements or withdraw from the engagement if

- a. the auditor concludes that sufficient doubt exists about the integrity of management such that the written representations required by paragraphs are not reliable or
- b. management does not provide the written representations required by paragraphs

Compiling Audit File



This should cover entire audit process:

- Planning
- Risk Assessment
- Audit Plan and Strategy
- Gathered Evidence
- Conclusion

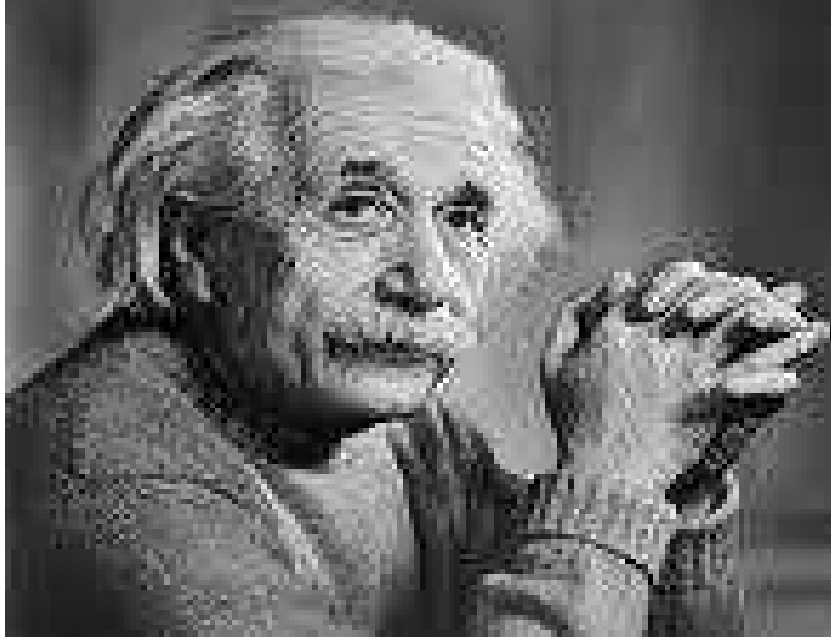
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Questions & Answers

If you can't explain it **simply**, you
don't understand it well enough.

– Albert Einstein





Thank you