Standards on Auditing

1 December 2023

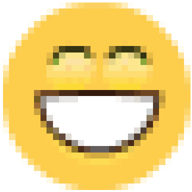
Agenda

01 SA 200 Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with Standards on Auditing

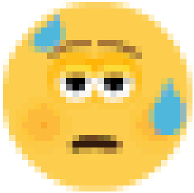
02 SA 570 (Revised) Going Concern

How do you feel?

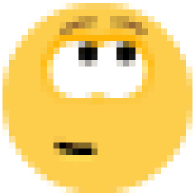
Worried



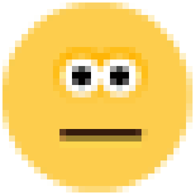
Excited



Anxious



Uncertain



Other

Meet Pavan and Carrie

Hi! I’m Pavan. I’m excited and a little nervous about not being able to grasp all the concepts. I’ll ask questions if I don’t understand ***why*** we are doing something.

Hi! I’m Carrie. I can’t wait to learn everything I need to know! Along the way I’ll ask questions as to ***why*** something is important if I am unsure.

Purpose of an audit

Question 1

What is an audit?

- **A** Performing bookkeeping and tax returns for an entity.
- **B** An independent examination of financial information of a profit-oriented entity only.
- **C** Applying analytical procedures and making inquiries of persons responsible for financial and accounting matters.
- **D** An independent examination of financial information of any entity, whether profit oriented or not, irrespective of its size or legal form.

Question 1: Debrief

What is an audit?

A. Performing bookkeeping and tax returns for an entity.

B. An independent examination of financial information of a profit-oriented entity only.

C. Applying analytical procedures and making inquiries of persons responsible for financial and accounting matters.

D. **An independent examination of financial information of any entity, whether profit oriented or not, irrespective of its size or legal form.**

Question 2

What does an auditor do to perform the audit? (Select all that apply.)

A Remain ethical and independent during the audit engagement, in addition to demonstrating competence and capabilities to perform the engagement.

B Form a close personal relationship with entity management and perform management functions of the entity when necessary.

C Exercise professional judgment, apply professional skepticism, and conduct the audit in accordance with standards.

D Plan and perform audit procedures to obtain reasonable assurance whether financial statements are free of material misstatements.

Question 2: Debrief

What does an auditor do to perform the audit? (Select all that apply.)

A **Remain ethical and independent during the audit engagement, in addition to demonstrating competence and capabilities to perform the engagement.**

B Form a close personal relationship with entity management and perform management functions of the entity when necessary.

C **Exercise professional judgment, apply professional skepticism, and conduct the audit in accordance with standards on auditing.**

D **Plan and perform audit procedures to obtain reasonable assurance whether financial statements are free of material misstatements.**

What is an audit?

SA 200

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- An audit is an independent examination of financial information of any entity, whether profit oriented or not, irrespective of its size or legal form.

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SA 200

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- An audit is an independent examination of financial information of any entity, whether profit oriented or not, irrespective of its size or legal form.
- An audit opinion enhances the credibility of the financial statements that are relied upon by others.

What is an audit?

SA 200

What is an audit?

- An audit is an independent examination of financial information of any entity, whether profit oriented or not, irrespective of its size or legal form.
- An audit opinion enhances the credibility of the financial statements that are relied upon by others.

An audit does NOT include bookkeeping or tax returns.

Question from Carrie

Why do I need to understand basic audit concepts before learning how to audit?

Question from Carrie

Why do I need to understand basic audit concepts before learning how to audit?

It's important to first understand the basics of ***what*** an audit is and learn the terminology so you can build on this foundational knowledge to better understand ***how*** to perform an audit.

What are the auditor’s responsibilities in performing an audit?

- Plan and perform audit procedures to obtain reasonable assurance whether financial statements are free of material misstatements.

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- Plan and perform audit procedures to obtain reasonable assurance whether financial statements are free of material misstatements.

- Demonstrate competence and capabilities to perform engagement.
- Exercise professional judgment and apply professional skepticism.
- Conduct audit in accordance with standards on auditing issued by the ICAI.

What are the auditor's responsibilities in performing an audit?

- Plan and perform audit procedures to obtain reasonable assurance whether financial statements are free of material misstatements.

- Demonstrate competence and capabilities to perform engagement.
- Exercise professional judgment and apply professional skepticism.
- Conduct audit in accordance with standards on auditing issued by the ICAI.

- Remain ethical and independent during the audit period and the professional engagement period.

Debrief: Exercise due professional care, judgment and skepticism

ISA 200, 240

Exercise professional judgment and apply professional skepticism.

Term	Definition and key notes
Professional judgment	▪ Applying knowledge, skills and experience in a way that's informed by standards, laws and ethical principles, to develop an opinion or decision. ▪ Exercising skill with reasonable care and diligence.
Professional skepticism	

Debrief: Exercise due professional care, judgment and skepticism

SA 200, 240

Exercise professional judgment and apply professional skepticism.

Term	Definition and key notes
Professional judgment	▪ Applying knowledge, skills and experience in a way that’s informed by standards, laws and ethical principles, to develop an opinion or decision. ▪ Exercising skill with reasonable care and diligence.
Professional skepticism	▪ Having a questioning mind that critically assesses audit evidence and watching out for conditions or evidence that may indicate a possible misstatement. ▪ Not being satisfied with less-than-persuasive evidence. ▪ Avoiding biases and traps in gathering and evaluating audit evidence.

Debrief: Ethical and independence requirements

ISA 200, 220

Remain ethical and independent during our audit engagement.

Comply

Be alert

Report

Debrief: Ethical and independence requirements

ISA 200, 220

Remain ethical and independent during our audit engagement.

Comply

Be alert

Report

Comply with relevant ethical and independence requirements.

Debrief: Ethical and independence requirements

ISA 200, 220

Remain ethical and independent during our audit engagement.

Comply	Comply with relevant ethical and independence requirements.
Be alert	Remain alert for evidence of noncompliance with ethical and independence requirements.
Report	

Debrief: Ethical and independence requirements

SA 200, 220

Remain ethical and independent during our audit engagement.

Comply	Comply with relevant ethical and independence requirements.
Be alert	Remain alert for evidence of noncompliance with ethical and independence requirements.
Report	Report breaches of ethical or independent policies promptly.

Who sets the ethics and independence rules?

India

ICAI, SEBI, Companies Act

Global body

IESBA

International Ethics Standards Board for Accountants

US professional and regulatory bodies

AICPA	GAO	PCAOB	SEC	FDIC
American **I**nstitute of **C**ertified **P**ublic **A**ccountants	**G**overnment **A**ccountability **O**ffice	**P**ublic **C**ompany **A**ccounting **O**versight **B**oard	US **S**ecurities and **E**xchange **C**ommission	**F**ederal **D**eposit **I**nsurance **C**orporation

Who uses the auditors' opinion?

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Potential and actual investors

Financial institutions (lenders)

Government agencies

Who uses the auditors' opinion?

- Potential and actual investors
- Financial institutions (lenders)
- Government agencies

Purpose of Audit

Serve and protect the capital markets and public interest.

Who uses the auditors' opinion?

Potential and actual investors

Financial institutions (lenders)

Government agencies

Purpose of audit practice

Serve and protect the capital markets and public interest.

Audit quality

Outcome when audits are executed consistently, in line with the requirements and intent of applicable professional standards, within a strong system of quality controls.

Who uses the auditors' opinion?

- Potential and actual investors
- Financial institutions (lenders)
- Government agencies

Purpose of audit practice

Serve and protect the capital markets and public interest.

Audit quality

Outcome when audits are executed consistently, in line with the requirements and intent of applicable professional standards, within a strong system of quality controls.

Understanding the users helps emphasize the importance of the work being performed and identify risks, plan appropriate responses and perform a high-quality audit.

Why is it important to consider my independence in relation to my audit engagements?

Why is it important to consider my independence in relation to my audit engagements?

By remaining ethical and independent you help instill public trust and avoid situations or relationships that, in fact or appearance, may impair your objectivity.

Types of audits

Standards relevant to Auditor and management

ISA 200

Accounting and reporting standards

Auditing standards

Standards relevant to Auditor and management

SA 200

Accounting and reporting standards

Auditing standards

Management

Auditor

Standards relevant to Auditor and management

SA 200

Accounting and reporting standards

Auditing standards

Management

Auditor

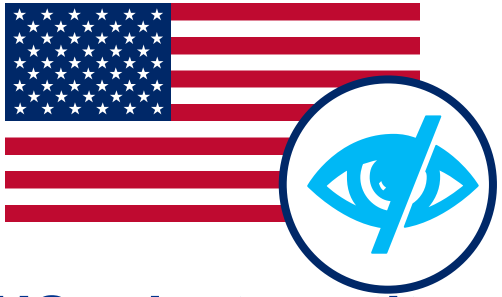
Applicable standards

Indian

engagements

International
engagements

US public company
engagements



US private entity
engagements

Question from Pavan

Why do I need to be familiar with the accounting, reporting and auditing standards applicable to different engagements?

Question from Pavan

Why do I need to be familiar with the accounting, reporting and auditing standards applicable to different engagements?

- As an auditor, you are responsible for being aware of all relevant standards.
- Applicable standards vary from engagement to engagement.
- You are expected to have an understanding of the standards.

What is a financial statement audit (FSA) ?

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Examine

Amounts and disclosures in the financial statements to determine whether they are presented fairly in accordance with the applicable accounting standards.

What is a financial statement audit (FSA) ?

Examine	Amounts and disclosures in the financial statements to determine whether they are presented fairly in accordance with the applicable accounting standards.
Report	Opinion on the financial statements.

Materiality basics

Do you audit every transaction?

Indicate your response:

Yes

No

Do you audit every transaction?

Indicate your response:

- As auditors, the engagement team does not guarantee absolute assurance.
- You use the concept of materiality to:
  - Plan and perform the audit,
  - Evaluate the results of the audit, and
  - Ultimately, form an opinion on the financial statements.

No

Do you audit every transaction?

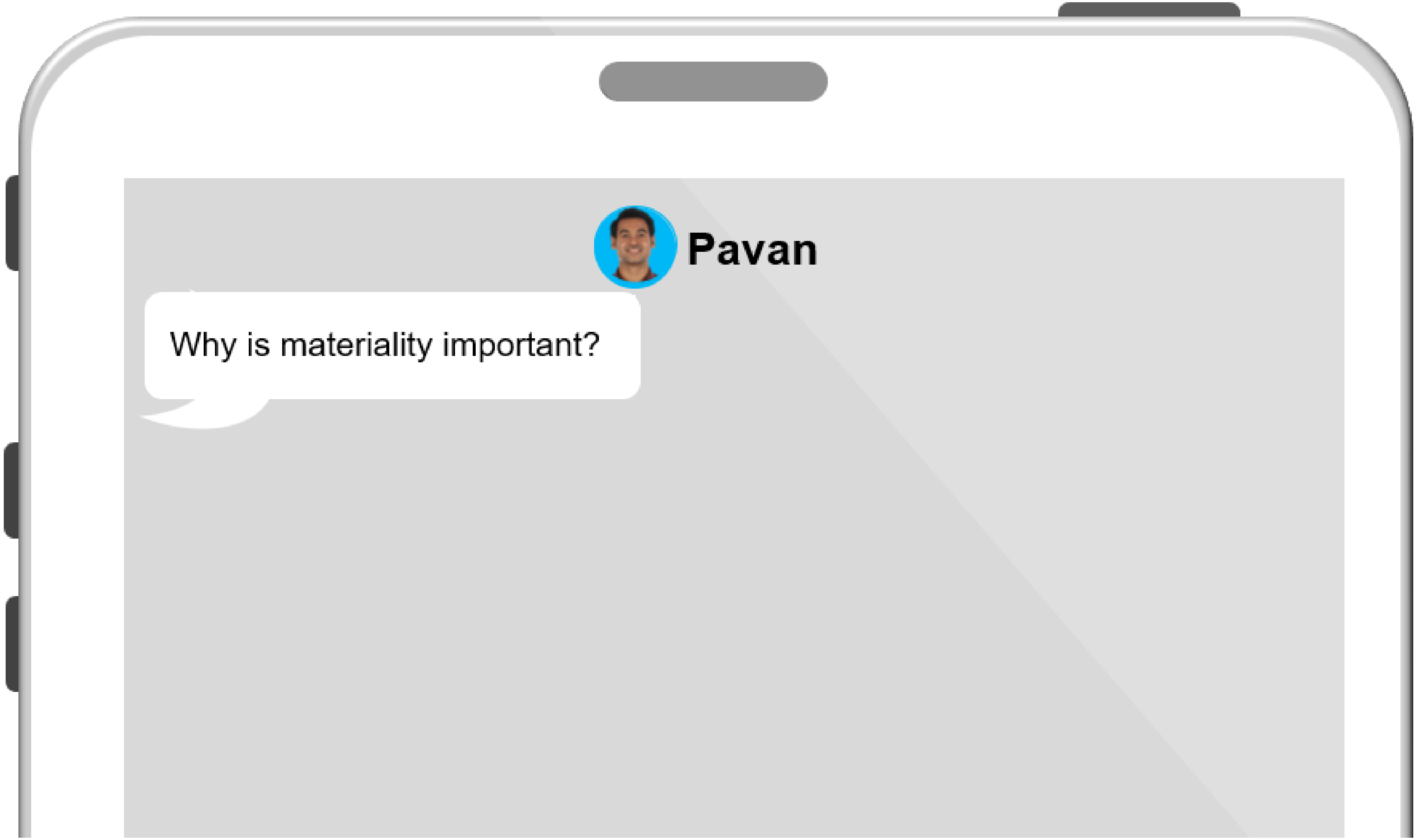
Indicate your response:

- As auditors, the engagement team does not guarantee absolute assurance.
- You use the concept of materiality to:
  - Plan and perform the audit,
  - Evaluate the results of the audit, and
  - Ultimately, form an opinion on the financial statements.

No

Materiality is the amount you believe will be **material** to the users of the financial statements.

Pavan is wondering ...



Pavan is wondering …

Pavan

Why is materiality important?

First, materiality affects most of the audit procedures you will perform as an associate!

Pavan is wondering ...

Pavan

Why is materiality important?

First, materiality affects most of the audit procedures you will perform as an associate!

Also, establishing an appropriate materiality level helps us gain sufficient appropriate audit evidence to support our audit opinion.

What is *material*?

Information that could reasonably be expected to lead users to make a different judgment about doing business with or investing in the entity.

Two different audit engagements...

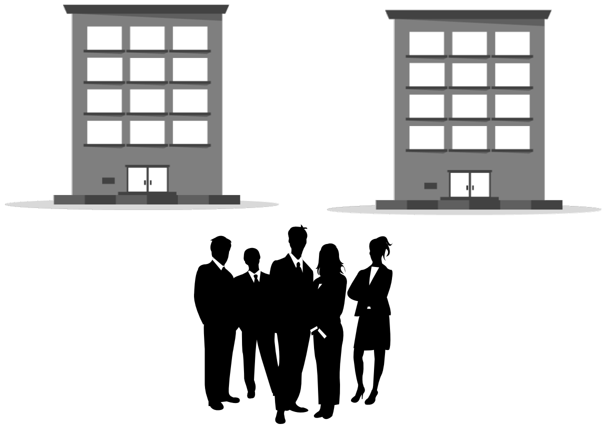
Two different audit engagements...

Engagement 1: Global retailer

Two different audit engagements...

Engagement 1: Global retailer

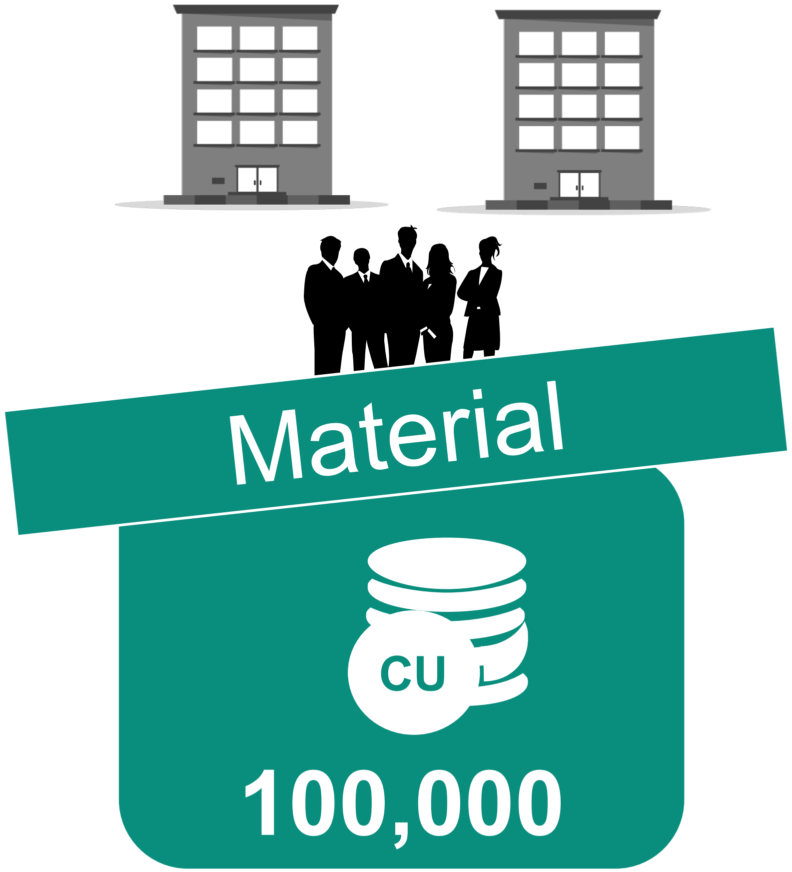
Engagement 2: Small boutique



Two different audit engagements...

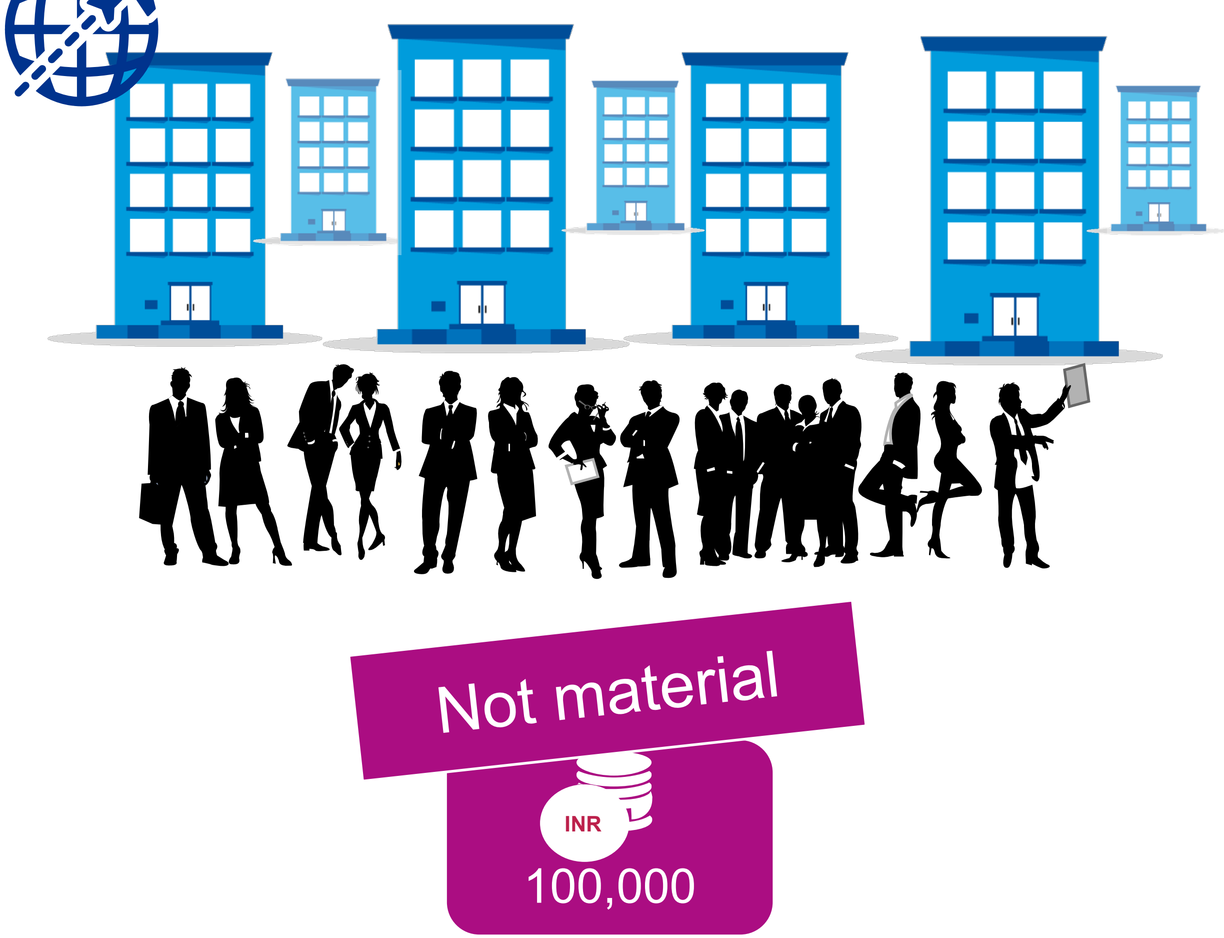
Engagement 1: Global retailer

Engagement 2: Small boutique



Two different audit engagements...

Engagement 1: Global retailer



Engagement 2: Small boutique

Steps in establishing materiality

Steps in establishing materiality

1

Identify relevant metrics, including the benchmark

Steps in establishing materiality

1 Identify relevant metrics, including the benchmark

- Document rationale for determined benchmark, including if the benchmark is different than prior year.
- Benchmark = ordinarily the metric that most influences economic decisions of users.

Steps in establishing materiality

1

Identify relevant metrics, including the benchmark

- Document rationale for determined benchmark, including if the benchmark is different than prior year.
- Benchmark = ordinarily the metric that most influences economic decisions of users.
- Use the Metrics and Benchmark Table (MBT) in methodology to help identify metrics.

Steps in establishing materiality

2. Determine amount of relevant metrics, including benchmark

1. Identify relevant metrics, including the benchmark

Steps in establishing materiality

1 Identify relevant metrics, including the benchmark

2 Determine amount of relevant metrics, including benchmark

- Use preliminary amounts, if necessary.
- Document the source of the amounts and how they were determined.
- Adjust the amounts when they are not representative of normal continuing operations and document rationale.

Steps in establishing materiality

1 Identify relevant metrics, including the benchmark

2 Determine amount of relevant metrics, including benchmark

3 Establish materiality as a specified amount for financial statements as a whole

Steps in establishing materiality

1. Identify relevant metrics, including the benchmark
2. Determine amount of relevant metrics, including benchmark
3. Establish materiality as a specified amount for financial statements as a whole

- Use professional judgment.

Steps in establishing materiality

3 Establish materiality as a specified amount for financial statements as a whole

2 Determine amount of relevant metrics, including benchmark

1 Identify relevant metrics, including the benchmark

- Use professional judgment.
- Team documents materiality in the Workflow as a specified amount.

PM and AMPT

Question 3

What is the definition of performance materiality?

- **A** A quantitative threshold for determining whether a misstatement is clearly trivial
- **B** A measure the engagement team uses to assess and respond to risk at the assertion level
- **C** The amount the engagement team believes will be material to the users of the financial statements
- **D** A quantitative threshold for determining whether to report the misstatement to those charged with governance

Question 3: Debrief

What is the definition of performance materiality?

A. A quantitative threshold for determining whether a misstatement is clearly trivial

B. **A measure the engagement team uses to assess and respond to risk at the assertion level**

C. The amount the engagement team believes will be material to the users of the financial statements

D. A quantitative threshold for determining whether to report the misstatement to those charged with governance

Performance materiality

What is the definition of performance materiality?

Performance materiality

What is the definition of performance materiality?

A measure the engagement team uses to assess and respond to risk at the assertion level.

- This is established at an amount less than materiality to:
  - Reduce aggregation risk.
  - Reduce audit risk to an appropriate level.

Performance materiality

What is the definition of performance materiality?

A measure the engagement team uses to assess and respond to risk at the assertion level.

- This is established at an amount less than materiality to:
  - Reduce aggregation risk.
  - Reduce audit risk to an appropriate level.
- Key input in determining sample sizes for substantive testwork.

Debrief: Aggregation risk

What is the definition of aggregation risk?

Debrief: Aggregation risk

What is the definition of aggregation risk?

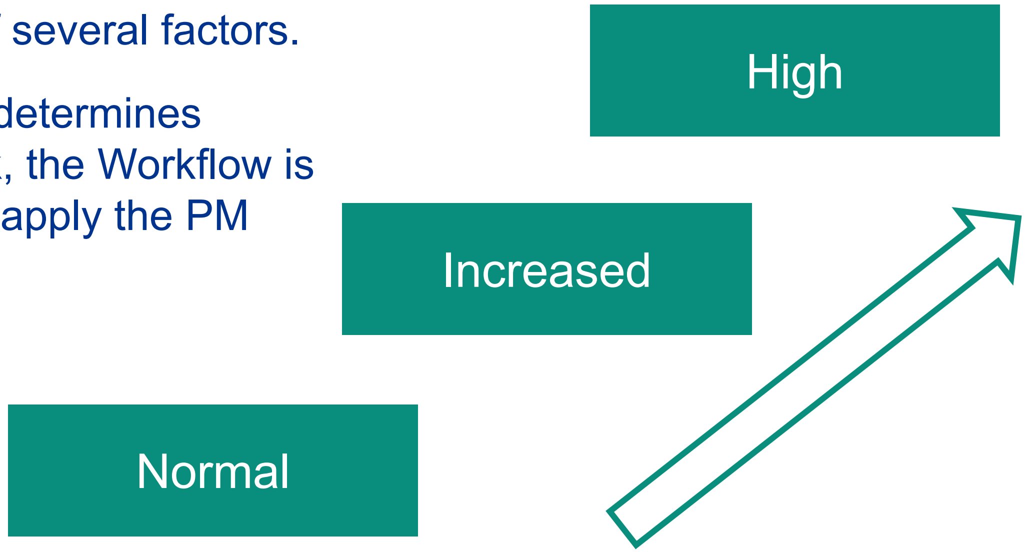
The risk that uncorrected and undetected misstatements exist and exceed materiality for the financial statements as a whole.

- The team's assessment of aggregation risk includes both:
  - Historical knowledge of the entity.
  - Information from the current period audit.

Aggregation risk levels

What are the three levels of aggregation risk?

- Engagement team determines aggregation risk based on consideration of several factors.
- Once the team determines aggregation risk, the Workflow is programmed to apply the PM percentage.



Examples of aggregation risk factors

Level of turnover of senior management or key financial reporting personnel.

Management's willingness to correct misstatements.

Debrief: AMPT

What is the definition of audit misstatement posting threshold?

Debrief: AMPT

What is the definition of audit misstatement posting threshold?

A quantitative threshold for determining whether a misstatement is clearly trivial.

- ‘Clearly trivial’ misstatements would not have a material effect on the financial statements, individually, in combination with other misstatements and when considering possible undetected misstatements.
- If you find a misstatement, check if it’s over AMPT.

Risks

What is audit risk?

ISA 200

What is audit risk?

SA 200

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

Audit opinion

SA 200

The audit opinion provides ***reasonable assurance***, not absolute assurance, that the financial statements are free from material misstatement due to error or fraud.

What is a material misstatement?

A misstatement is a difference between the reported amount, classification, presentation, or disclosure of a financial statement item and that required for the item to be in compliance with GAAP.

What is a material misstatement?

A misstatement is a difference between the reported amount, classification, presentation, or disclosure of a financial statement item and that required for the item to be in compliance with GAAP.

A material misstatement is one that the engagement team could reasonably expect to influence the economic decisions of the users of the financial statements.

Reduce audit risk

SA 200

Obtain audit evidence to reduce audit risk to an acceptably low level.

Question from Pavan

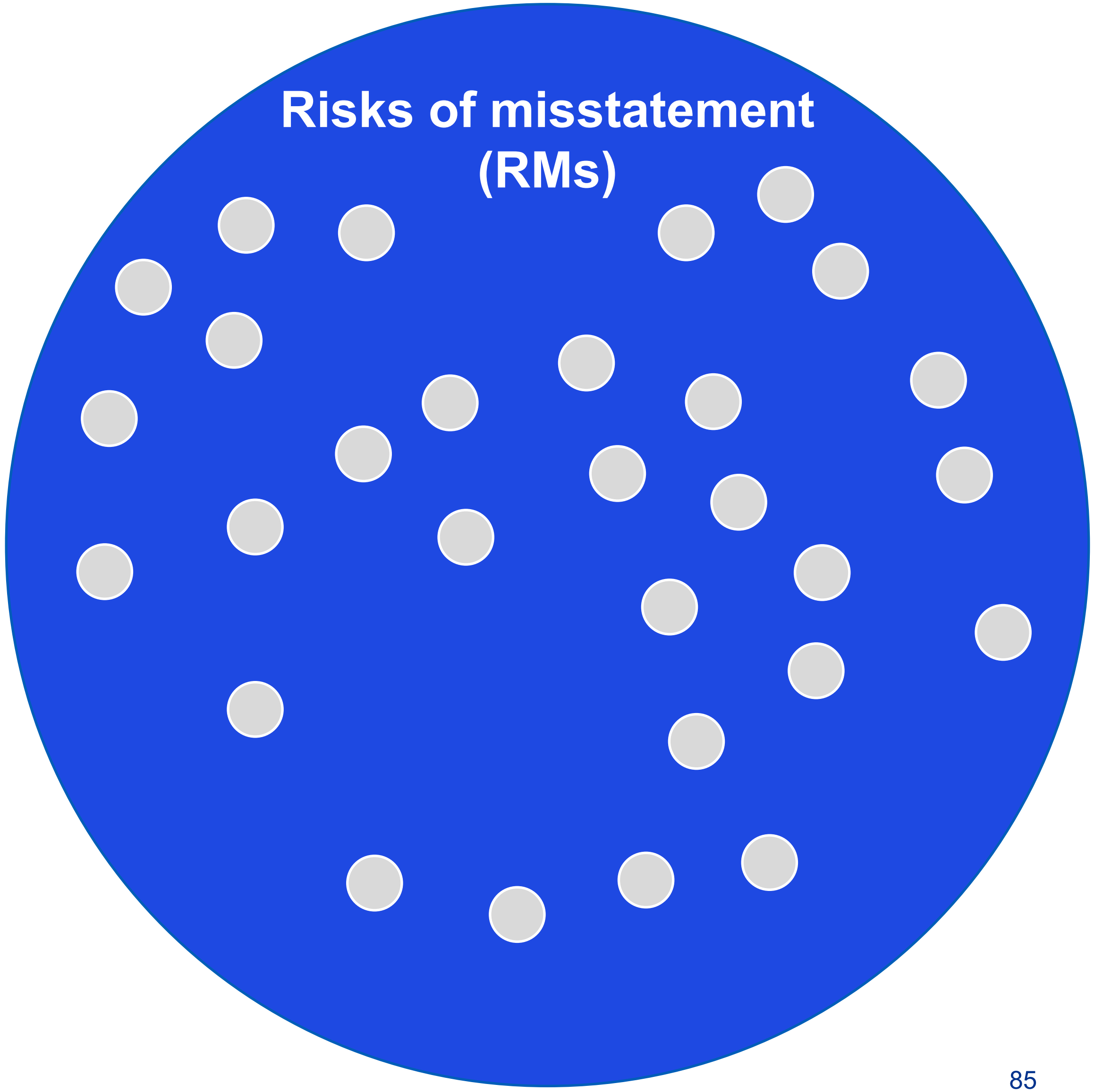
Why is understanding audit risk important to me?

Question from Pavan

Why is understanding audit risk important to me?

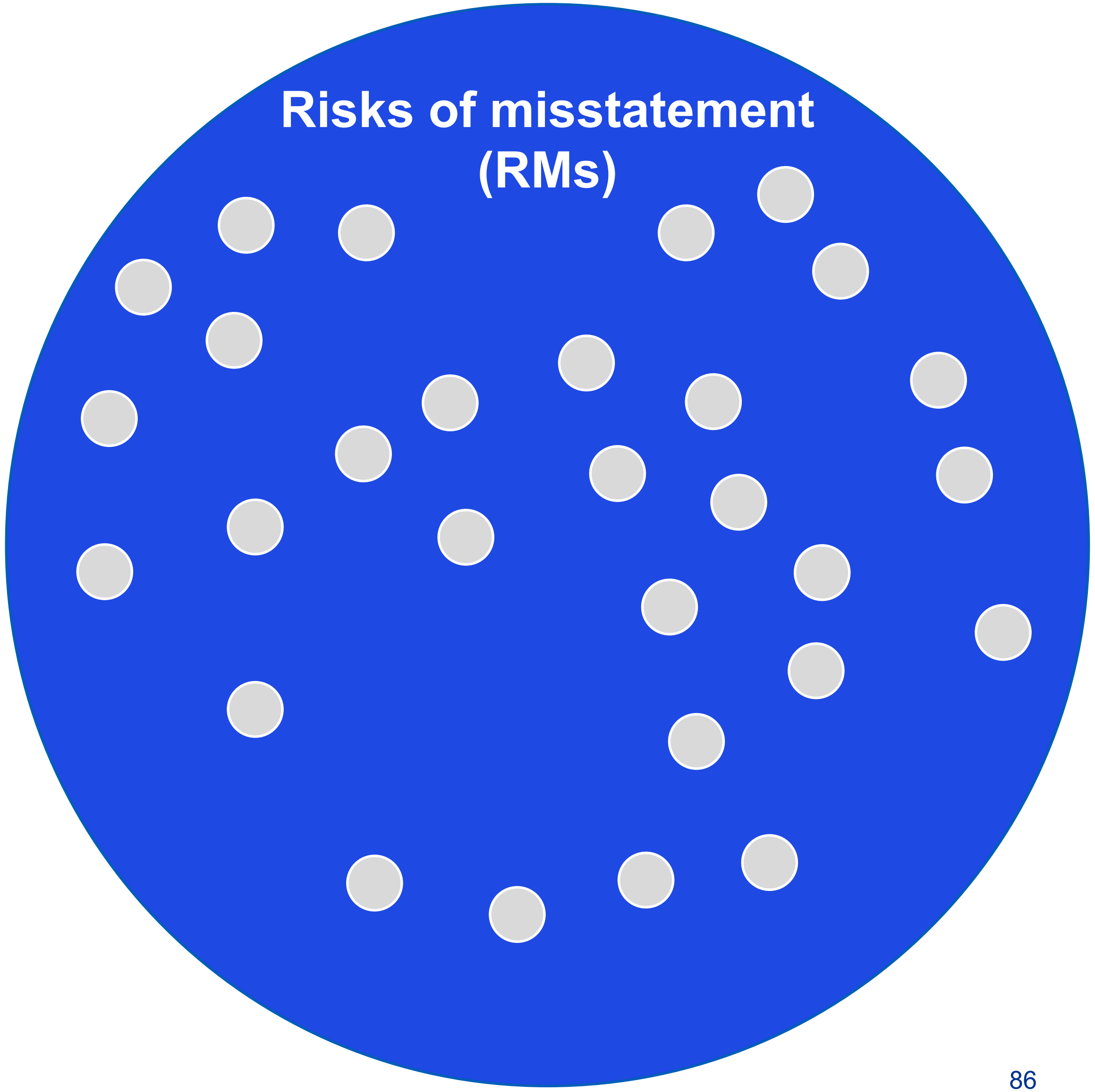
The audit procedures you perform reduce audit risk.

Risks of misstatement (RMs)



Risks of misstatement (RMs)

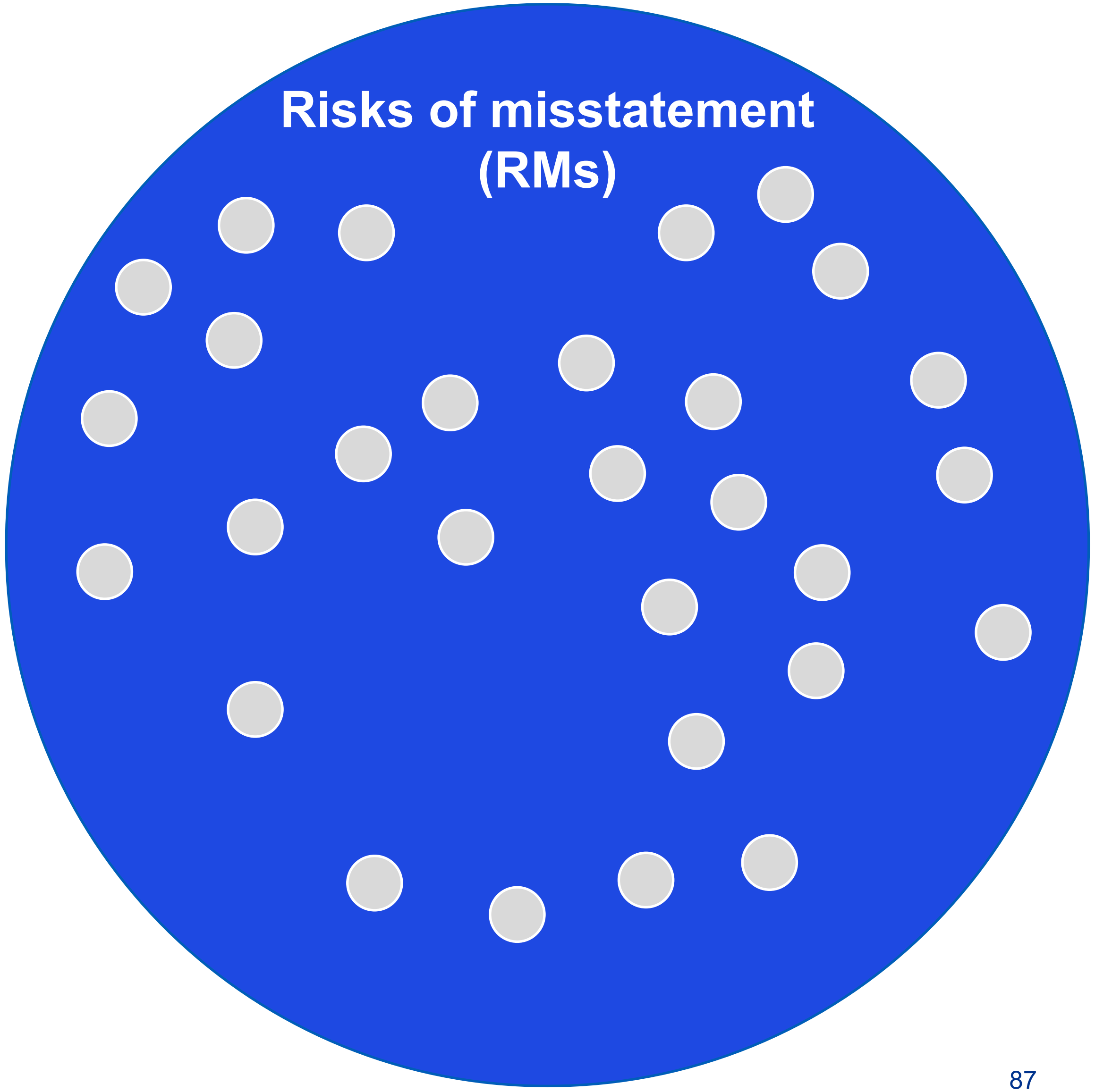
Description of a situation that could result in a misstatement to the financial statements.



Risks of misstatement (RMs)

Description of a situation that could result in a misstatement to the financial statements.

When the risk of misstatement applies to the financial statements we are auditing, the risk is identified as an RM.



Types of RMs

Assertion-level RMs

Financial statement level RMs (FSL RMs)

Types of RMs

Assertion-level RMs	Financial statement level RMs (FSL RMs)
Specific financial statement accounts, disclosures, and assertions.	

Types of RMs

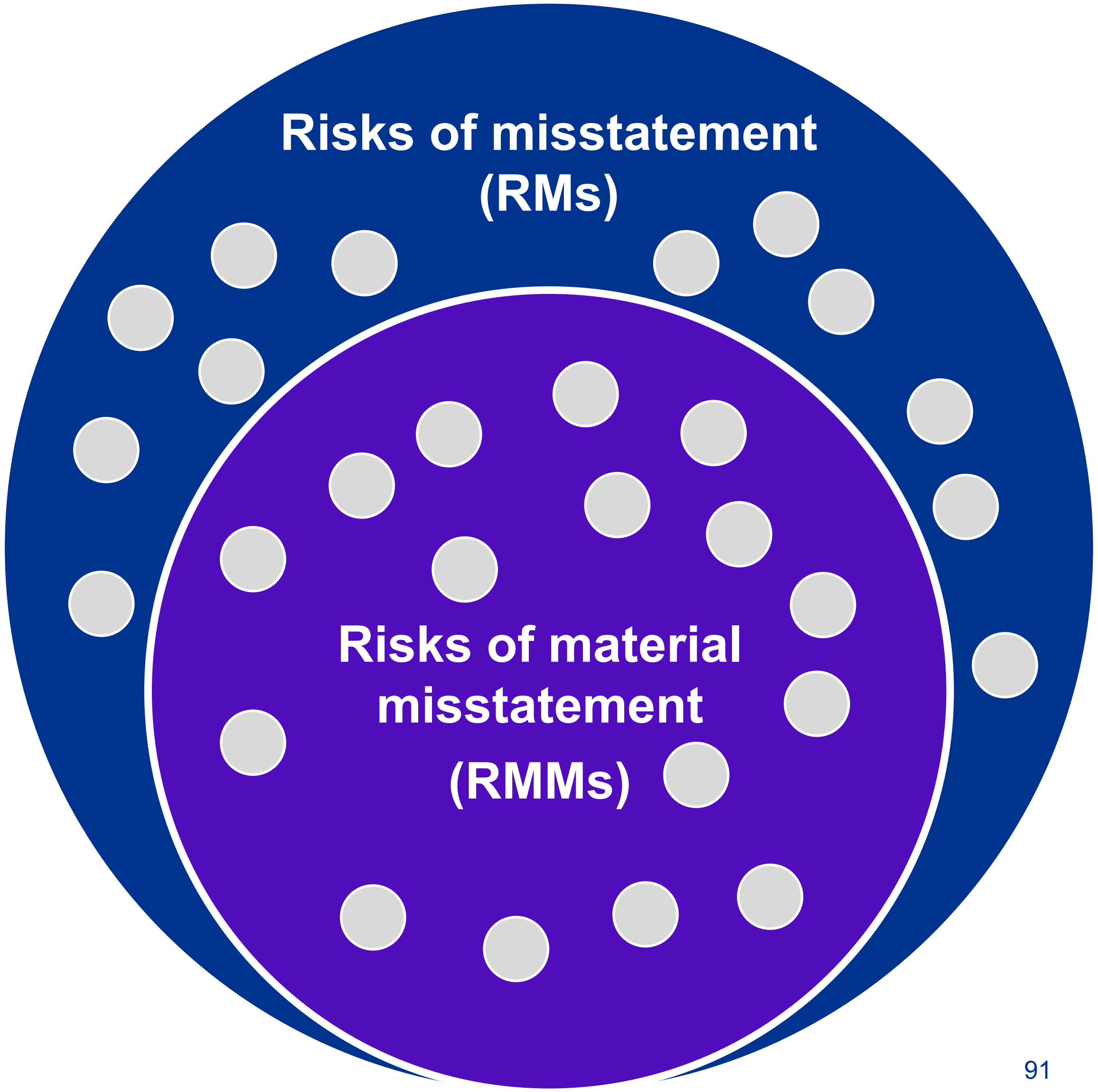
Assertion-level RMs

Specific financial statement accounts, disclosures, and assertions.

Financial statement level RMs (FSL RMs)

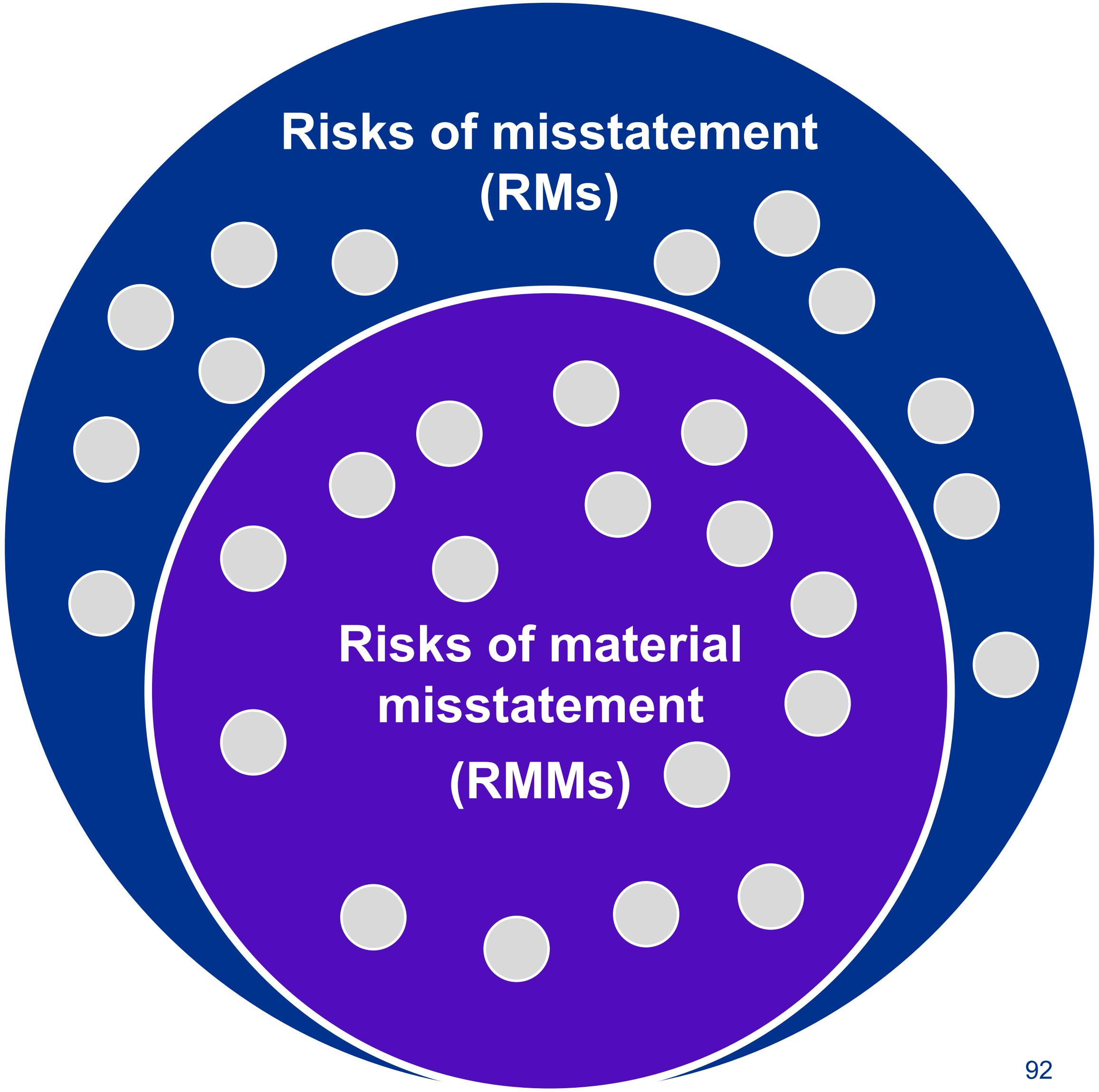
Risks that have **pervasive effect** on the financial statements as a whole and/or relate to many assertions.

Risks of material misstatement (RMMs)



Risks of material misstatement (RMMs)

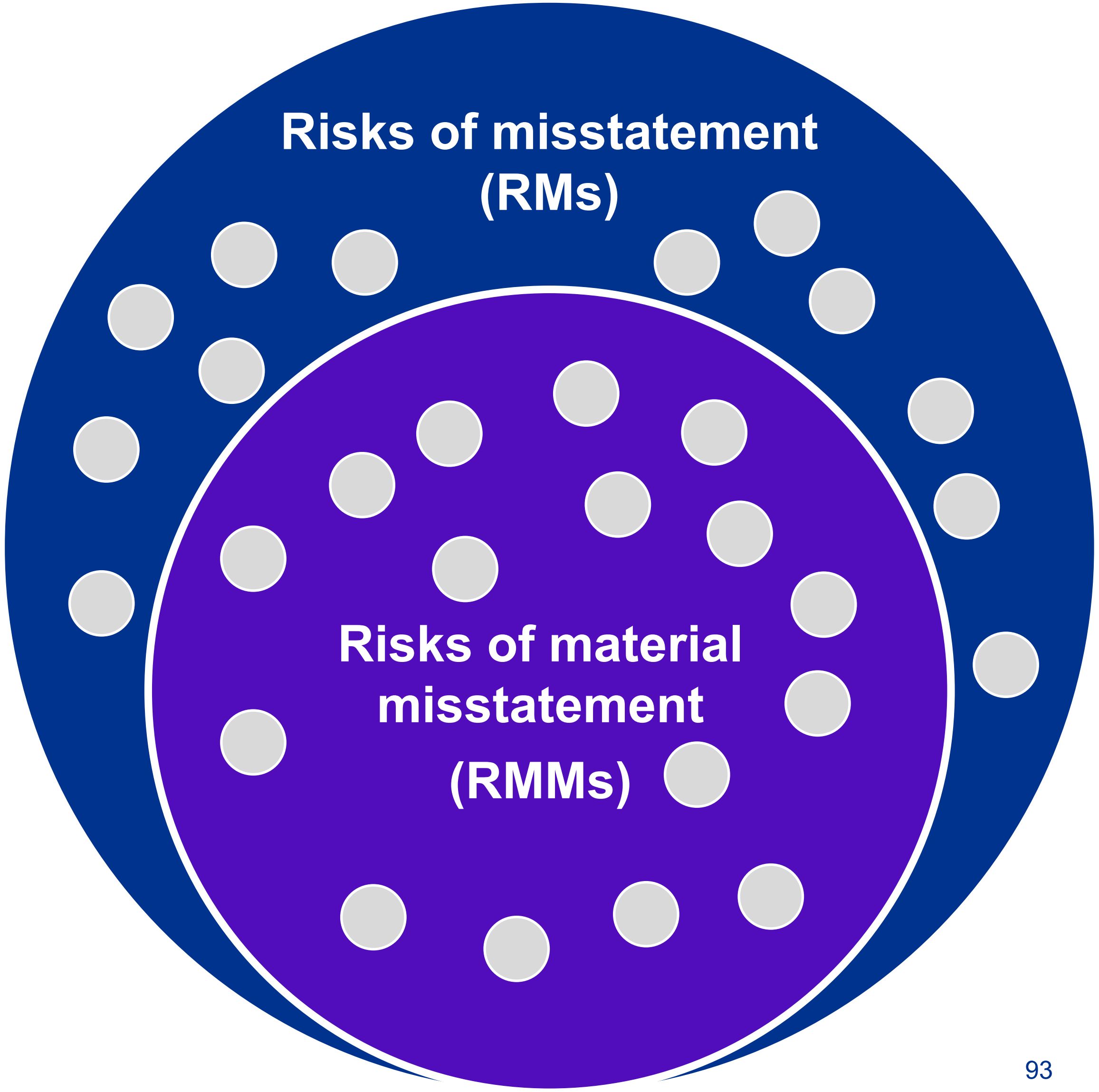
RMM is a description of a situation that could result in a material misstatement, either individually or in combination with others, to the financial statements.



Risks of material misstatement (RMMs)

RMM is a description of a situation that could result in a material misstatement, either individually or in combination with others, to the financial statements.

Once the population of RMs is identified, determine if each RM rises to the level of an RMM.



Risk of error and risk of fraud

Risk of error and risk of fraud

Error

Mistake, unintentional inaccuracy.

Risk of error and risk of fraud

Error

Mistake, unintentional inaccuracy.

Fraud

Intentional act that results in a material misstatement in the financial statements.

Risk of error and risk of fraud

Error

Mistake, unintentional inaccuracy.

Fraud

Intentional act that results in a material misstatement in the financial statements.

- Fraudulent financial reporting
- Misappropriation of assets

Question 5

Scenario: You keep cash under your bed and count it regularly. You count the money late at night when you are tired.

What type of risk does this represent?

A Error

B Fraud

C Reputational

Question 5: Debrief

Scenario: You keep cash under your bed and count it regularly. You count the money late at night when you are tired.

What type of risk does this represent?

- **A** **Error**
- **B** Fraud
- **C** Reputational

Another scenario

Your roommate, who is looking to pay off their credit card debt, came into your room without knocking and saw you counting your cash.

Your roommate doesn't know exactly where you keep your cash but knows when you are in your room and when you are not in your room, so there are opportunities to look in your room for your cash when you are not there.

Is this a risk of error or risk of fraud?

Risk of error

OR

Risk of fraud

Another scenario

Your roommate, who is looking to pay off their credit card debt, came into your room without knocking and saw you counting your cash.

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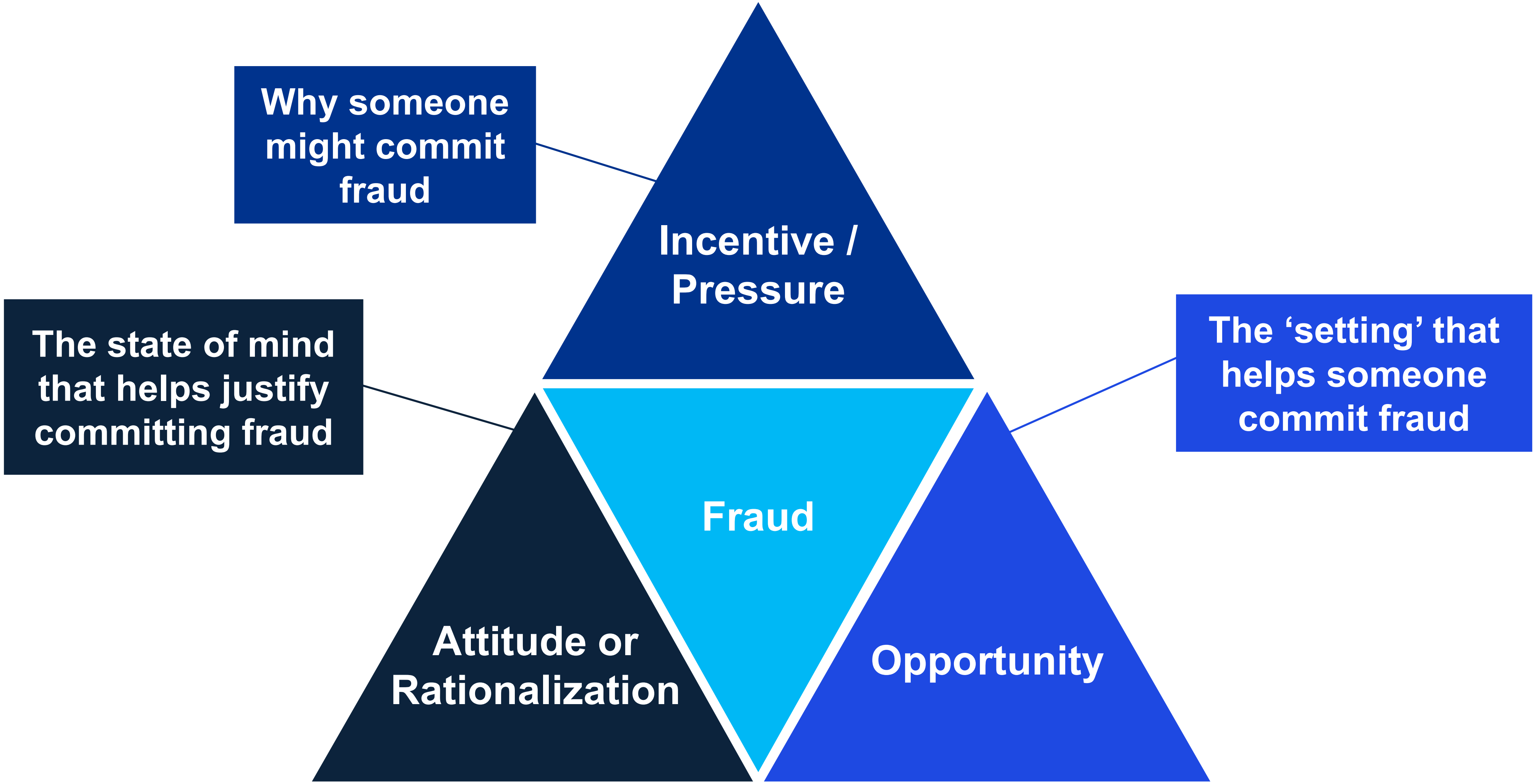
Is this a risk of error or risk of fraud?

Risk of fraud

Understanding of fraud risk factors



Presumed risk of fraud related to revenue

- Rebuttable presumption that there is a fraud risk involving improper revenue recognition.

Presumed risk of fraud related to revenue

- Rebuttable presumption that there is a fraud risk involving improper revenue recognition.
- During risk assessment, evaluate which specific revenue transactions may give rise to a fraud risk.

Question 1

In many industries, revenue is a key metric and an area of focus for investors and financial statement users, as it directly affects earnings and other key metrics. Therefore, an entity often has a greater __________ or _________ to manipulate revenue.

A Attitude or rationalization

B Opportunity or incentive

C Incentive or pressure

Question from Pavan

Why is it important for me to understand the RMMs due to fraud or error the engagement team identified?

Question from Pavan

Why is it important for me to understand the RMMs due to fraud or error the engagement team identified?

It's important to understand how the risks relate to the audit procedures you perform so you know **why** you are performing those procedures.

Audit evidence

What is audit evidence?

What is audit evidence?

Information obtained by performing audit procedures

What is audit evidence?

Information obtained by performing audit procedures

Supporting documentation

Documents the entity has to support their financial records

Sufficiency and appropriateness

Quantity (sufficiency) + Quality (appropriateness) = Persuasiveness of audit evidence

Sufficiency and appropriateness

Quantity (sufficiency) + Quality (appropriateness) = Persuasiveness of audit evidence

Sufficiency and appropriateness

Quantity (sufficiency) + Quality (appropriateness) = Persuasiveness of audit evidence

Relevance
Relationship of evidence and the objective of the procedure being performed

Reliability
How trustworthy the evidence is (nature and source)

Debrief: Which audit evidence is more reliable?

Evidence obtained from a knowledgeable source that is independent of the entity is generally more reliable than evidence obtained from ___________ sources.

Evidence obtained directly is generally more reliable than evidence obtained ___________.

Reliability is influenced by the ____________ and ____________ of the information and the circumstances under which it was obtained.

Debrief: Which audit evidence is more reliable?

Evidence obtained from a knowledgeable source that is independent of the entity is generally more reliable than evidence obtained from __**internal**__ sources.

Evidence obtained directly is generally more reliable than evidence obtained ___________.

Reliability is influenced by the ____________ and ____________ of the information and the circumstances under which it was obtained.

Debrief: Which audit evidence is more reliable?

Evidence obtained from a knowledgeable source that is independent of the entity is generally more reliable than evidence obtained from _**internal**_ sources.

Evidence obtained directly is generally more reliable than evidence obtained **indirectly**.

Reliability is influenced by the ____________ and ____________ of the information and the circumstances under which it was obtained.

Debrief: Which audit evidence is more reliable?

Evidence obtained from a knowledgeable source that is independent of the entity is generally more reliable than evidence obtained from __**internal**__ sources.

Evidence obtained directly is generally more reliable than evidence obtained __**indirectly**__.

Reliability is influenced by the __**source**__ and __**nature**__ of the information and the circumstances under which it was obtained.

Remember...

As audit risk increases, the engagement team seeks more ***persuasive*** audit evidence.

Sufficient, ***appropriate*** audit evidence supports the conclusion reached. The conclusion reached is what forms the audit opinion.

Question from Carrie

Why is understanding the sufficiency and appropriateness of audit evidence important to me?

Question from Carrie

Why is understanding the sufficiency and appropriateness of audit evidence important to me?

Audit quality is the outcome when audits are executed consistently, in line with the requirements and intent of applicable professional standards.
Every member of the engagement team is responsible for audit quality. For you, that includes obtaining sufficient and appropriate audit evidence when performing audit procedures.

Question 6

What type of assurance does the audit opinion on the financial statements provide?

- **A** Positive assurance
- **B** Absolute assurance
- **C** Reasonable assurance
- **D** Negative assurance

Question 6: Debrief

What type of assurance does the audit opinion on the financial statements provide?

- **A** Positive assurance
- **B** Absolute assurance
- **C** **Reasonable assurance**
- **D** Negative assurance

Question 7

In a financial statement audit, the engagement team obtains evidence in order to determine whether the amounts and disclosures in the financial statements are presented in accordance with the accounting standards.

True or false?

A True

B False

Question 7: Debrief

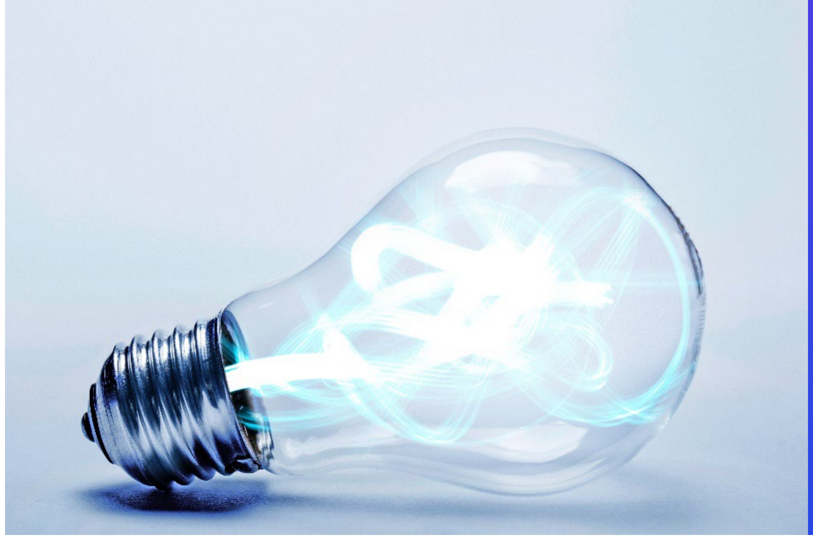
In a financial statement audit, the engagement team obtains evidence in order to determine whether the amounts and disclosures in the financial statements are presented in accordance with the accounting standards.

True or false?

A	**True**
B	False

Name that risk! #1

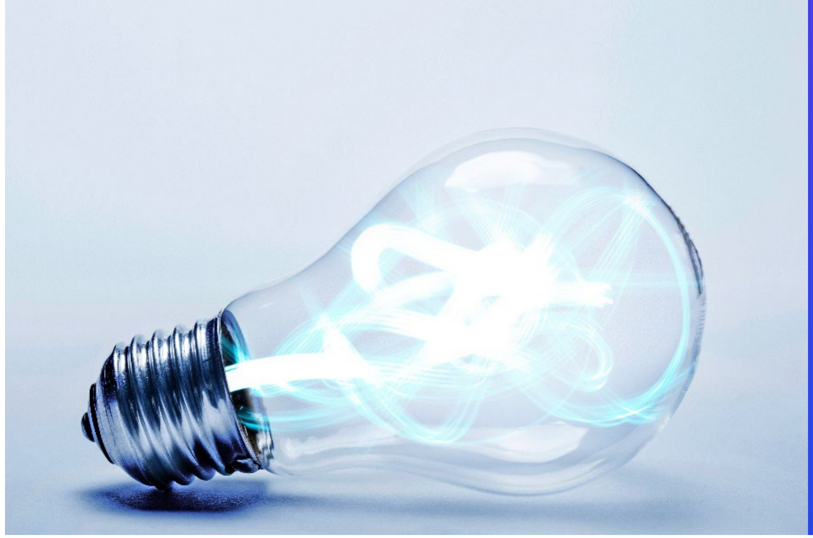
A risk that there is an intentional act that results in a material misstatement in the financial statements that are the subject of an audit is a:



Name that risk! #1

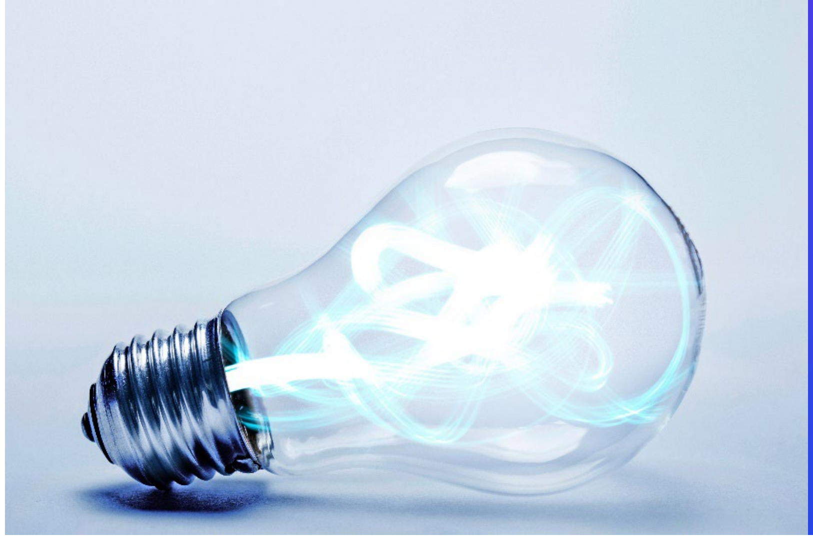
A risk that there is an intentional act that results in a material misstatement in the financial statements that are the subject of an audit is a:

fraud risk



Name that risk! #2

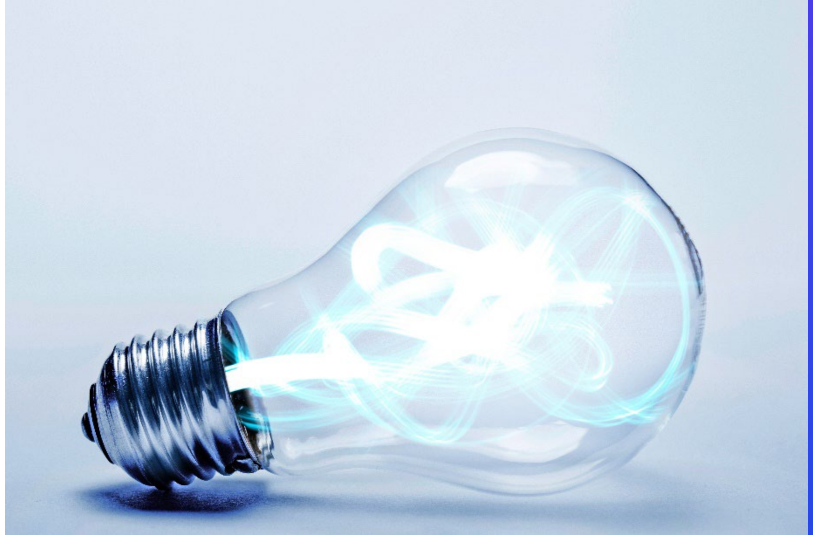
The risk that there could be a mistake or an unintentional inaccuracy is a:



Name that risk! #2

The risk that there could be a mistake or an unintentional inaccuracy is a:

risk of error



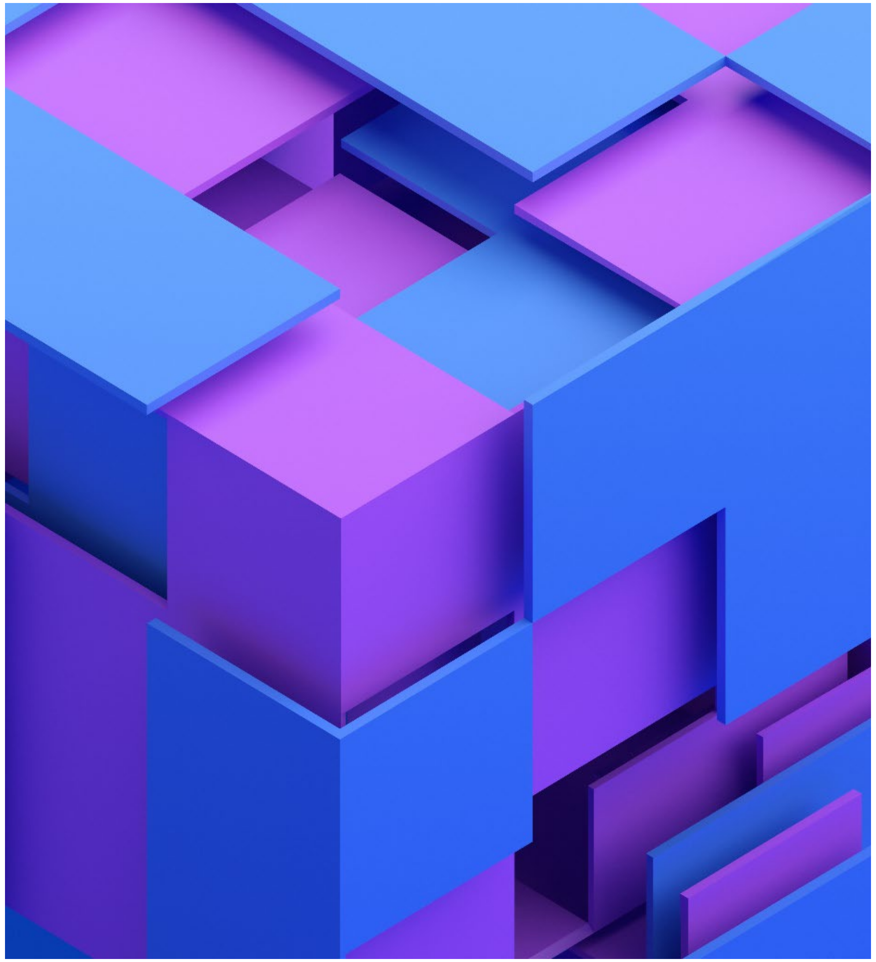
Key points to remember

01 An auditor's role is to plan and perform audit procedures to obtain reasonable assurance whether the financial statements are free of material misstatements.

02 The accounting, reporting and auditing standards vary depending on the type of entity being audited.

03 Risk of misstatement is a description of a situation that could result in a misstatement to the financial statements.

04 Generally, written evidence obtained directly, such as external confirmations, is more reliable than verbal evidence obtained only from internal entity sources, such as inquiry.



What questions do you have?

Modified audit opinion

Types of modified audit opinions

Nature of matter giving rise to modification	***Auditor's judgment about the Materiality and Pervasiveness of the Effects or Possible Effects on the financial statements***	
	Material but Not Pervasive	**Material and Pervasive**
Financial Statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

The effect of a material misstatement/possible misstatement is *Pervasive*, when:

(a) Where it pertains to an amount(s) in the financial statements, it is not confined to specific components, accounts or items of the financial statements. If it is so confined, it represents or could represent *a substantial portion* of the financial statements; or

(b) Where it pertains to disclosures, such disclosures or the matter(s) therein are / could be *fundamental* to the user's understanding of the financial statements.

Going concern

Key considerations

Why is our audit work on going concern critical?

Going concern periods

Sources of finance

Challenging management forecasts

Going concern scenarios – group support

Going concern disclosures

Forms of report

Conclusions

Why is our audit work on going concern critical?

Why is going concern so important?

- **Assessment fundamental to fair presentation of financial statements**
- **Importance to all stakeholders – investors, lenders, suppliers, employees**
- **Important to regulators**
- **Evaluation intrinsically difficult because it involves future – can auditor predict future?**
- **Expectation gap – what people think auditors do and what we actually do**
    - Managements perceives difficult situations as “normal blip” inherent in all businesses.
    - Can an expression of doubts on going concern basis become a self-fulfilling prophecy effecting all relationships including suppliers of funds and other resources and credit rating
- **Not disclosing going concern issues may result in liabilities on directors (especially independent directors) particularly if the company goes down at least within the next 12 months or soon thereafter**
- **Our risk exposure when it goes wrong – when we have signed a recent “clean” audit opinion and then the company goes bust**

Going concern - responsibilities

Management	Those Charged with Governance	Auditors
▪ When preparing financial statements, management has to make an assessment of going concern. ▪ Further, when management is aware, of material uncertainties that may cast significant doubt on entity’s ability to continue as going concern, disclosure of those uncertainties is required. ▪ Management takes into account all available information about future, which is at least, but is not limited to, twelve months from the end of reporting period.	Have responsibility to oversee management's assessment by virtue of their responsibility to oversee financial reporting process.	▪ Obtain sufficient appropriate audit evidence to conclude on, appropriateness of management's use of the going concern basis ▪ Conclude, whether a material uncertainty exists related to events or conditions that may cast significant doubt on going concern.

Going concern period

Going concern period

SA 570

“13. In evaluating management’s assessment of the entity’s ability to continue as a going concern, the auditor shall cover the same period as that used by management to make its assessment as required by the applicable financial reporting framework, or by law or regulation if it specifies a longer period. If management’s assessment of the entity’s ability to continue as a going concern covers less than twelve months from the date of the financial statements as defined in SA 560,4 the auditor shall request management to extend its assessment period to at least twelve months from that date. (Ref: Para. A11–A13)”

“Period beyond Management’s Assessment

15. The auditor shall inquire of management as to its knowledge of events or conditions beyond the period of management’s assessment that may cast significant doubt on the entity’s ability to continue as a going concern. (Ref: Para. A14–A15)”

Scenario 1 – 12 month's worth of cash

A company has no bank loans or facilities and cash at bank of INR 6.5m at the balance sheet date.

Base case forecasts for a 12 month period show that the company will continue to be loss making and cash negative by around INR 500k per month.

As they have enough cash to last > 12 months there is no going concern issue and no incremental disclosure is needed in the basis of preparation.

Do you agree?

Scenario 2 – facility expiring

The company's principal bank loan, which is fully drawn, is due to expire in the next period. The company does not have sufficient funds to repay the loan, but is trading profitably and has enough cash to meet its liabilities as they fall due, including paying the interest on the loan.

No negotiations have yet started with the bank. Consider these different scenarios of period to loan expiry:

A. 2 months after
B. 9 month after
C. 12 months and 1 day after
D. 18 months after balance sheet date

Now let's say negotiations have started with the bank and there are two months to expiry. What evidence do we need to avoid a material uncertainty?

1. A signed facility agreement
2. A heads of terms sheet with credit committee approval
3. Verbal confirmation from the bank

Scenario 3 – Upcoming covenant issue

The auditor is about to sign off on the June 20X0 interim results of the group on 30 July 20X0.

The Group is forecasting a covenant breach in December 20X1 which cannot be mitigated.

The year end financial statements are expected to be signed in March 20X1.

What might I consider beyond 12 months?

- The need to refinance debt
- An upcoming issue with a covenant
- Depleting cash balances
- Entrance of a competitor to the market
- Investors wishing to exit
- Legislative changes (eg climate related)

Sources of finance

Sources of cash quiz

How do the companies you audit meet their liabilities as they fall due?

Sources of cash quiz (answers)

How do the companies you audit meet their liabilities as they fall due?

Cash at bank

Bank term loan (drawn, committed but undrawn)

Bank Overdraft (drawn, committed but undrawn)

Bank Revolving Credit Facility (drawn, committed but undrawn)

Bank asset-specific facilities (eg only available for inventory / capital etc)

Securitisation of future cash receipts (eg from leases, licences, gate receipts)

Syndicated facilities

Loan notes

Shareholder loans

Debtor factoring arrangement

Supplier factoring arrangement

Credit insurance available to suppliers

Stretch of debtors / creditors

Intercompany trading balances

Cash pooling arrangements

Receipts from credit card companies (retail / B to C)

Restricted cash (country / currency, locked to facilities etc)

Future (net) cash receipts from ordinary activities

Proceeds from sale / sale and leaseback of assets

What uncertainties affect each of these:

- ❑ Bank term loan
- ❑ Shareholder loans
- ❑ Stretch of creditors
- ❑ Net cash receipts from ordinary activities

Challenging management's forecasts

Challenging management's forecasts

Management's base case

£million	20x1
Revenue	13,500
Cost of sales excluding depreciation	-10,385
Admin costs excluding depreciation	-1,350
EBITDA	1,765
Depreciation	-200
EBIT	1,565
Interest	-600
PBT	965
Tax	-193
Profit after tax	772
Interest cover	
EBIT/interest	2.61
Covenant threshold	2.50
Covenant met?	**Yes**

Sensitised forecast

£million	20x1
Revenue	12,780
Cost of sales excluding depreciation	-9,860
Admin costs excluding depreciation	-1,450
EBITDA	1,470
Depreciation	-200
EBIT	1,270
Interest	-600
PBT	670
Tax	-134
Profit after tax	536
Interest cover	
EBIT/interest	2.12
Covenant threshold	2.50
Covenant met?	**No**

Challenging forecasts – what's "severe but plausible"?

Challenging management's forecasts

Mitigating actions

Which mitigating actions are within the control of the Company?

Scenario – mitigating actions

The company has prepared detailed cash flow forecasts. If the company meets its forecasts it will be able to operate within the funds available and comply with its covenants.

The company has run downside sensitivities which show a breach of the covenants in the forecast period. However, it believes that it can mitigate those sensitivities by delivering all of a package of actions:

a. Cancelling dividends
b. Cutting capex
c. Cutting discretionary bonuses
d. Cutting contracted pay
e. Making cost savings in its operations
f. Significantly curtailing its expansion plans, such that it survives on a base-line
g. Selling a property which is surplus to requirements

Is there a material uncertainty?

Audit approach

- ❑ **Management must identify a severe but plausible downside scenario**
- ❑ **We use history and understanding of the business to challenge forecast of the future**
  - ➢ Budget process: understand how management identify upside / downside / stretch budgets
  - ➢ Historical variability – how bad has it got before? What went wrong? By how much?
  - ➢ How might the future be different both:
    - ▪ externally (technological / economic / industry changes); and
    - ▪ internally (new strategy / products)
  - ➢ Consistency with (eg) principal risks, short-term bonus targets, covenant negotiations when facilities last renewed
  - ➢ Flex operational metrics and KPIs not “10% of EBITDA”
- ❑ **Understand the underlying assumptions:**
  - ➢ Sensitivity
  - ➢ What would it take to break it?
- ❑ **Remember that management is likely to be optimistic**
- ❑ **Mitigating actions outside the control of management generally do not remove a material uncertainty**
- ❑ **Useful in other scenarios: impairment, recoverability of DT assets, inventory etc**

When it goes wrong

- **Errors in the integrity of the company's model**
- **Mitigating actions are not within management's control**
- **Downsides are not sufficiently challenging**
- **Lack of third party evidence for key assumptions**
- **Heroic cost saving plans**
- **Inconsistency of assumptions, for instance:**
  - Cutting marketing spend, with no impact on subsequent revenue
  - Cutting capex, with no impact on cost of delivery
  - Cutting headcount with no impact on ability to deliver sales

Going concern scenarios – group support

A letter of support

IS:

A useful source of evidence of a shareholder’s intention

IS NOT:

A legally binding commitment

REMEMBER:

A letter of support is not enough on its own. In considering whether the investor will be able to honour the letter of support, need to evidence:

- **Ability**
- **Intention**

Evidencing investor's ability

- Why do the directors of the subsidiary you are auditing believe that they can rely on the letter of support?
- Recent published financials of investor
- Recent funding provided by investor
- Publicly available information on the company
- Evidence direct from group finance – group forecasts
- Involvement of the group auditors – what work have they done?

Evidencing investor’s intention

- **Why do the directors of the subsidiary you are auditing believe that they can rely on the letter of support?**
- **Understand the group and subsidiary’s strategy – do they match up?**
- **Why is the subsidiary important to the group?**
- **How integrated are the operations of the subsidiary with the group?**

Key points to take away

- ❑ **Director’s responsibility to assess ability to continue as a going concern**
- ❑ **Talk to management early on in the process**
- ❑ **Try to align signing of subsidiary stats to coincide with the signing of the group year end or interim results**
- ❑ **Talk to your group auditor early on in the process**
- ❑ **Obtain evidence from as many sources as you can**

Going concern disclosures

5 step process

1. How does the company finance/expect to finance its operations over the forecast period?
2. Is the forecast period appropriate and has management prepared a severe but plausible downside scenario?
3. What uncertainties exist that need to be explained?
4. Has the Company identified mitigating actions that are within its control?
5. Is the Company's conclusion appropriate?

Forms of report

Going concern evaluation - Outcome 1

Going concern basis is appropriate and no ‘material uncertainty’ or ‘close call’

In the Statement of Accounting Policies, normal disclosure regarding use of going concern assumption. No specific disclosure required in audit report.

Material uncertainty is significant doubt on ability or intention to continue operations for foreseeable future and magnitude of such events/ conditions and the likelihood of occurrence are such that appropriate disclosure is necessary to achieve fair presentation (SA 570.A21/ A22)

Close call is when auditor concludes that no material uncertainty exists yet additional disclosures in financial statements are necessary regarding events or conditions that may cast significant doubt on entity’s ability to continue as going concern e.g., there are no material uncertainties but reaching such conclusion involved significant judgement by management (SA 570.20)

No bright lines; there may be a spectrum or continuum of possible circumstances with an increasing need for judgement

Going concern evaluation - Outcome 2

Going concern basis is appropriate and no material uncertainty but possibly 'close call'

- If additional disclosures are necessary for fair presentation of events/conditions that may cast significant doubt on ability to continue as a going concern, same should be disclosed in financial statements.
- Normally disclosures would be of principal events or conditions, management's evaluation thereof relating to entity's ability to meet its obligations, plans for mitigating factors and significant judgements made by management
- No separate para of material uncertainty in auditor's report but evaluate it for Key Audit Matter.

Going concern evaluation - Outcome 3

Going concern basis is appropriate but there is material uncertainty

- Auditor should determine whether financial statements
  - Adequately disclose events/conditions that may cast significant doubt and management's plans to deal with them
  - Disclose clearly that there is material uncertainty related to events/ conditions that may cast significant doubt on entity's ability to continue as a going concern and may be unable to realise its assets and discharge its liabilities in normal course of business (SA 570.19b)
- Where adequate disclosures about material uncertainty are made in financial statements, include in audit report a separate paragraph titled "material uncertainty related to going concern"
- States that material uncertainty exists that casts significant doubt on entity's ability to continue as going concern and opinion is not modified in respect of this matter
- In substance is a specific EOM which gives prominence to this evaluation

Adequate disclosures NOT made in financial statements - Express a qualified or adverse opinion

Material uncertainty relating to going concern paragraph

This paragraph is not:

- A substitute for obtaining sufficient appropriate audit evidence. If we are unable to obtain sufficient appropriate audit evidence we disclaim our opinion
- A substitute for adequate disclosure in the financial statements. If disclosure is inadequate we issue a modified opinion (qualified or adverse)

- **We do not include this para in KAMs**
- The KAM section instead refers to the relevant section in auditor's report (Material Uncertainty Related to Going Concern or Basis for Qualified/ Adverse Opinion)

Going concern evaluation - Outcome 4

Where there are multiple uncertainties that are significant to financial statements as a whole that it can not be concluded whether going concern assumption appropriate

- Adequate disclosures required in financial statements
- Disclaimer of audit opinion

Do not include:

- Material Uncertainty Related to Going Concern paragraph
- KAMs
- Other Information section

Would be a rare situation

Going concern evaluation - Outcome 5

Going concern basis is inappropriate

Management either intends or in auditor's judgement has no realistic alternative other than to liquidate the entity or to cease operations

- Financial statements to be prepared on basis other than going concern (e.g., liquidation basis)
- Adequate disclosure in financial statements regarding use of basis other than going concern, including underlying reasons, detailed alternative accounting policies / impact thereof and status of liquidation etc.
  - If above are met, unmodified opinion with necessary changes in wording and EOM containing adequate disclosures regarding alternative basis of accounting, its impact and status of liquidation
  - Give adverse opinion if the above are not met i.e., where financial statements are still prepared on going concern basis or the alternative basis not properly applied or not properly disclosed

What questions do you have?

Thank you!

Speaker - Saurabh Aggarwal

saurabhaggarwal.delhi@gmail.com

+91-9717795656