7 - Auditing and Stewardship of Limited Companies

The role and function of external auditors

Financial statements are used for a variety of purposes and decisions. For example, financial statements are used by owners to evaluate management's stewardship, by investors for making decisions about whether to buy or sell securities, by credit rating services for making decisions about credit worthiness of entities, and by bankers for making decisions about whether to lend money. Effective use of financial statements requires that the reader understand the roles of those responsible for preparing and auditing financial statements.

Financial statements are the representations of management. When using management's statements, the reader must recognize that the preparation of these statements requires management to make significant accounting estimates and judgments, as well as to determine from among several alternative accounting principles and methods those that are most appropriate within the framework of generally accepted accounting standards.

In contrast, the auditor's responsibility is to express an opinion on whether management has fairly presented the information in the financial statements. In an audit, the financial statements are evaluated by the auditor, who is objective and knowledgeable about auditing, accounting, and financial reporting matters.

During the audit, the auditor collects evidence to obtain reasonable assurance that the amounts and disclosures in the financial statements are free of material misstatement. However, the characteristics of evaluating evidence on a test basis, the fact that accounting estimates are inherently imprecise, and the difficulties associated with detecting misstatements hidden by collusion and careful forgery, prevent the auditor from finding every error or irregularity that may affect a user's decision.

The auditor also evaluates whether audit evidence raises doubt about the ability of the client to continue as a going concern in the foreseeable future. However, readers should recognize that future business performance is uncertain, and an auditor cannot guarantee business success.

Through the audit process, the auditor adds credibility to management's financial statements, which allows owners, investors, bankers, and other creditors to use them with greater confidence.

The auditor expresses his assurance on the financial statements in an auditor's report. The report, which contains standard words and phrases that have a specific meaning, conveys the auditor's opinion related to whether the financial statements fairly present the entity's financial position and results of operations. If the auditor has reservations about amounts or disclosures in the statements, he modifies the report to describe the reservations.

The auditor's report and management's financial statements are only useful to those who make the effort to understand them.

Introduction to Audits and Financial Reporting

In today's economy, information and accountability have assumed a larger role in our society. As a result, the independent audit of an entity's financial statements is a vital service to investors, creditors, and other participants in economic exchanges.

The auditor communicates audit results in a standard report. The auditor's is based on rigorous work performed by highly trained professionals.

Need for Financial Statements

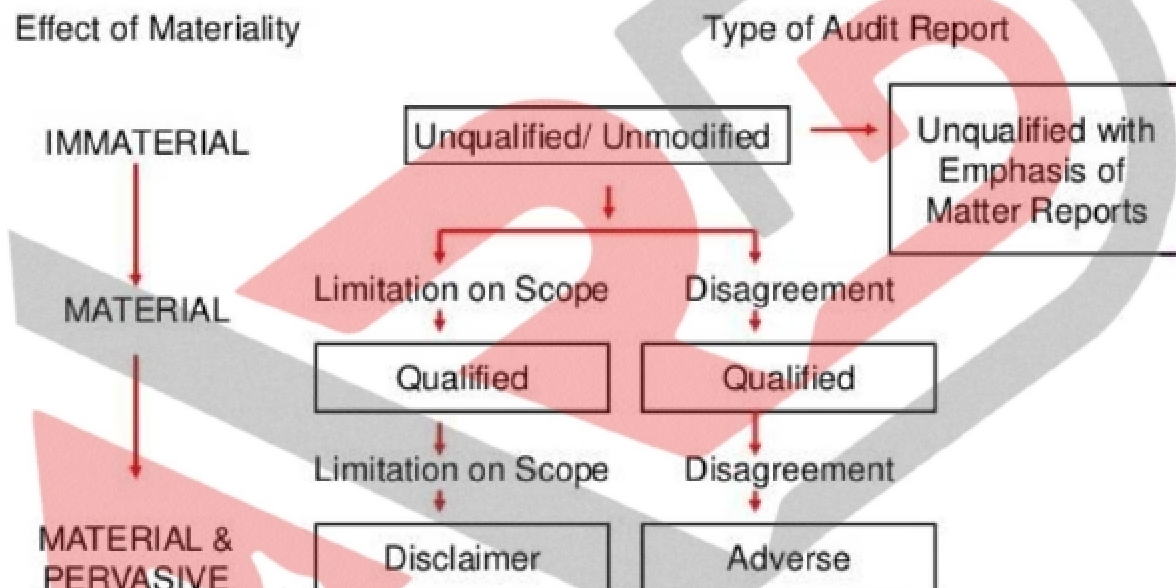
Regardless of the type of entity — whether in the public or private sector, or whether for profit or not — all entities use economic resources to pursue their goals. Financial statements enable an entity's management to provide useful information about its financial position at a particular point in time and the results of its operations and its changes in financial position for a particular period of time. External financial reporting for these entities is directed toward the common interest of various users. Financial statements provide owners with information about the stewardship of management. They also provide a basis for investors' decisions about whether to buy or sell securities; for credit rating services' decisions about the credit worthiness of entities; for bankers' decisions about whether to lend money, and for decisions of other creditors, regulators, and others outside of the entity.

The Financial Statement Audit

The objective of the financial statement audit is to add credibility to management's financial statements. Access to capital markets, mergers, acquisitions, and investments in an entity depends not only on the information that management provides in financial statements, but also on the degree of assurance that the financial statements are free of material error and fraud. In the process of providing reasonable assurance that financial statements are fairly presented, an auditor assesses whether:

- Transactions and amounts that should have been recorded are reported in the financial statements.
- The assets and liabilities reported in the financial statements existed at the balance sheet date, and the transactions reported in the financial statements occurred during the period covered by the statements.
- Reported assets are owned by the entity and liabilities owed by the entity at the balance sheet date are reported.
- The financial statement amounts (assets, liabilities, revenues, and expenses) are appropriately valued in conformity with accounting standards.
- The financial statement amounts are properly classified, described, and disclosed in conformity with accounting standards.

The independent auditor forms an opinion on the overall fairness of the financial statements by testing the above representations. The opinion is communicated in the auditor's report. The standard auditor's report contains an unqualified opinion, which means that an auditor believes, without reservation, that tie financial statements present fairly the entity's financial position and results of operations in conformity with accounting standards. A qualified report, in contrast, notifies financial statement readers about concerns the auditor has about matters affecting the financial statements (such as the selection of accounting policies or the method of their application or the adequacy of financial statement disclosure) or about limitations in the scope of the auditor's work. Therefore, a user should understand the implications of a qualified opinion and read this ype of report carefully.



Responsibility for Financial Statements

Effective use of financial statements requires that the reader understand the roles of those responsible for preparing, auditing, and using financial statements.

Management is responsible for the content of its financial statements, regardless of an organization's size or form of ownership. The preparation of these statements requires management to make significant judgments and estimates. Management's responsibility for financial statements is not lessened by having the statements audited.

The Independent Audit

An audit allows creditors, bankers, investors, and others to use financial statements with confidence. While the audit does not guarantee financial statement accuracy, it provides users with a reasonable assurance that an entity's financial statements give a true and fair view (or "present fairly") its financial position, results of operations, and changes in financial position in conformity with accounting standards. An audit enhances users' confidence that financial statements do not contain material error and fraud because the auditor is an independent, objective professional who is knowledgeable of the entity's business and financial reporting requirements.

An Auditor Is Independent

The principles of independence and objectivity impose the obligation on auditors to be fair, intellectually honest, and free of conflicts of interest in relation to clients. For example, an auditor may not be financially involved with his client nor accept goods or services from him except on business terms no more favourable than those generally available to others. This ensures that an auditor is objective and, therefore, enables the public to place faith in the audit function.

Although the entity is the auditor's client, the auditor has a significant responsibility to users of the audit report. The auditor must not subordinate his judgment to any specific group, including his client. The auditor's independence, integrity, and objectivity encourages third parties to confidently use the audited financial statements.

Auditor's Responsibility for Detecting Material Error and Fraud

Auditors are responsible for planning and performing an audit to obtain reasonable assurance that the financial statements are free of material error and fraud. The concept of reasonable assurance, however, does not insure or guarantee the accuracy of the financial statements. The following characteristics of an audit are important to understanding the difference between reasonable assurance and a guarantee or absolute assurance.

Detection of Error or Fraud

In an audit of financial statements, the auditor assesses the risk of material error and fraud and, accordingly, designs the audit to provide reasonable assurance of detecting significant errors or fraud. However, some irregularities or frauds are concealed through forgery or collusion (among client personnel or outsiders). Auditors are not trained to detect forgeries, nor will customary audit procedures detect conspiracies. As a result, a properly designed and executed audit may not detect material fraud. Therefore, audits can only provide reasonable assurance that financial statements are free of material misstatements and cannot absolutely guarantee the accuracy of financial statements. Likewise, the auditor may have some responsibility for the detection of certain types of illegal acts.

Materiality in the Financial Statements

Although financial statements contain approximations, they must reflect a reasonable degree of accuracy. If the degree of misstatement is significant enough to influence the decisions of financial statement users, it is considered material.

Materiality is a relative concept. For example, a $100,000 misstatement of sales for a company with a $200,000 net income is material, while that same misstatement for a company with a $5,000,000 net income may be immaterial. In addition, qualitative characteristics influence materiality. For example, an error in the financial statements might be small as a percentage of a critical component. This small error, however, may be considered material because it could cause an entity to breach a loan agreement, which could result in a misclassification of current and noncurrent debt. An auditor considers both quantitative and qualitative aspects of errors found during the audit..

Reporting Material Error and Fraud
If material error or fraud are discovered and not corrected in the financial statements, the auditor brings such items to the attention of management and issues a qualified opinion.

The role of directors and their responsibilities to shareholders (stewardship)

BOARD COMPOSITION

The UK Corporate Governance code consists of two sections relating to the board of directors. The first, "Leadership" deals with the makeup of the board, dealing with the structure and defining key roles.

Beyond the UK board structure can differ significantly, possibly extending to the use of two boards rather than one and with differing levels of concern or support for Chair and Independent directors roles. The general trend towards globalisation and the need to attract investment from global financial institutions suggests that, over a long period of time, the structure of boards will rationalise towards a UK/US standard, whilst still allowing for local variants.

Board roles and responsibilities

Every board of directors has a unique sense of its role and responsibilities. However, whatever perception they have, it is important that they take the time to tangibly define and document their role so that it can be used to provide shareholders with a sense of assurance that the board has a formal view of this issue. Having defined their role the board can also use this as a basis for performance appraisal and through this attempt to continuously improve on their performance.

Responsibilities of the board

- To act in the shareholder's best interests.
- To safeguard the assets of the organisation.
- To uphold the law.
- To uphold the Corporate Governance Code.
- To uphold stakeholder obligations.

Roles of the board

- To define and implement strategy.
- To monitor corporate performance.
- To define risks and exact internal control.
- To focus on shareholder relationships.
- To evaluate board performance.

Non-executive directors (NEDs)

The UK code is explicit about the importance and need for sufficient NEDs to sit alongside the executive on the board of directors. A NED is an outsider, voted onto the board by shareholders to act in a monitoring capacity on their behalf. At least half of the board must be made up of NEDs.

CEO / Chair split

The Chairman is the leader of the board of directors. He must operate to the same independence criteria as NEDs in order to ensure that he is deemed to act in the interests of shareholder's without undue influence of the executive directors.

THE BOARD IN OPERATION

Board operation can be viewed in relation to the execution of their roles and responsibilities. Corporate governance offers advice to improve on the ability of the board to perform these tasks through section B of the code, "Effectiveness".

This is the largest section of the UK Corporate Governance Code, impressing the need to employ fundamental management functions at the top of the organisation in line with those that permeate all other levels of the company. The fact that the code needs to offer advice as to the need to train and induct directors, for example, is a deep criticism of the lack of professionalism at the top of many organisations.

Performance appraisal

The board must evaluate its performance annually and commit to a process of continuous improvement. The criteria for such a review should be formally documented by the board and the results of the review included in disclosure.

True and Fair View of Financial Statements

Definition

True and fair view in auditing means that the financial statements are free from material misstatements and faithfully represent the financial performance and position of the entity

Explanation

Although the expression of true and fair view is not strictly defined in the accounting literature, we may derive the following general conclusions as to its meaning

True suggests that the financial statements are factually correct and have been prepared according to applicable reporting framework such as the IFRS and they do not contain any material misstatements that may mislead the users. Misstatements may result from material errors or omissions of transactions & balances in the financial statements

Fair implies that the financial statements present the information faithfully without any element of bias and they reflect the economic substance of transactions rather than just their legal for

Application and Importance

Preparation of true and fair financial statements has been expressly recognized as one of the responsibilities of the directors of companies in the corporate law of several countries such as in the Companies Act 2006 in the UK. Auditors must therefore consider whether directors have fulfilled their responsibility for the preparation of true and fair financial statements when providing an audit opinion.

Company law of certain jurisdictions require the auditors to expressly state in their audit report whether in their opinion the financial statements present a true and fair view of the financial performance and position of the entity.

Audit and Assurance

Q1. The turnover of Soames Limited has been increasing and the directors have been advised that they must now produce audited accounts. They are therefore required to appoint an auditor to provide the company with an audit report.

REQUIRED

(a) List **five** duties which the auditor would carry out during an audit. [5]

Additional information

The first audit report was qualified. Included in current assets was inventory valued at cost price of $1 million. This had become damaged and now could only be sold for $750 000 after repairs costing $200 000.

REQUIRED

(b) Explain what is meant by a qualified audit report. [2]

(c) Explain, with reference to the relevant International Accounting Standard, the necessary adjustment that must be made to the financial statements. [8]

(d) Analyse the importance to the shareholders of Soames Limited of the auditors providing a true and fair view of the company's accounts. [6]

Additional information

The audit report was signed by Aamir, the brother of the finance director of Soames Limited. Aamir was an unqualified auditor.

(e) Evaluate the validity of this audit report. [4]

[Total: 25]

Q2. XY Limited has been trading for many years.

Before the end of year audit, the chairman made the following statement:

'I am pleased to report that the profit for the year ended 31 March 2016 has increased from $86 000 to $174 000. These results have been achieved through careful cost control and concentrating on those areas which offer the greatest return.'

However during the end of year audit the auditors discovered the following:

1 Equipment with a net book value of $180 000 had become obsolete during the year but had not been written off. The directors believed that the buildings have increased in value by $200 000, which cancelled out any loss on the obsolete equipment. So no adjustment had been made.

2 The method of inventory valuation had been changed at the end of the year from AVCO to FIFO. The AVCO valuation had been $142 000 whereas the FIFO valuation was $184 000.

3 At 31 March 2016 the trade receivables amounted to $675 000. During the year a debt for $81 000 had been written off. However, a cheque for 75% of this amount had been discovered during the audit. The cheque had not been recorded in the books of account but is expected to clear the bank.

REQUIRED

(a) Explain the term stewardship. [2]

(b) Explain the purpose of an end of year audit. [2]

(c) State whether the published audit report will be qualified or not. [1]

(d) (i) Describe the correct accounting treatment of points 1, 2 and 3 with reference to the relevant accounting standards. [9]

(ii) Analyse the effects of any correction on the profit for the year ended 31 March 2016. [6]

(e) Assess the implications of a qualified audit report. [5]

[Total: 25]

Q3. Lushan and Samson are the directors of Z Limited which was newly formed on 1 January 2016. They understand that they are legally obliged to prepare financial statements in accordance with International Accounting Standards.

REQUIRED

(a) State **four** reasons why the business should comply with International Accounting Standards when financial statements are being prepared. [4]

(b) Explain what is meant by stewardship with regard to the role of the directors. [2]

Additional information

The directors prepared the following draft statement of financial position at 31 December 2016:

Z Limited
Statement of financial position at 31 December 2016

	$
Non-current assets	
Property, plant and equipment	478 000
	478 000
Current assets	
Inventories	124 000
Trade receivables	217 000
Cash and cash equivalents	132 000
	473 000
Total assets	951 000
Equity and liabilities	
Equity	
Ordinary shares of $1 each	500 000
Retained earnings	210 000
Total equity	710 000
Current liabilities	
Trade payables	188 000
Taxation	53 000
	241 000
Total equity and liabilities	951 000

Q4. Julia is the auditor of Z Limited. During the course of conducting her audit she was provided with the following information.

1 On 31 December 2016, Z Limited had been sued for an amount of $29 000. Legal advice indicated that Z Limited had a 90% chance of losing the case.

2 Included in the trade receivables was a debt of $30 000 owed by P Limited which was in financial difficulty. The directors of Z Limited had accepted office equipment from P Limited on 31 December 2016 to settle 70% of P Limited's debt. They were of the opinion that the recovery of the remaining debt was highly improbable.

3 A piece of machinery had been purchased on 1 January 2016 for $50 000. The machinery had been depreciated at an annual rate of 20% by using the straight-line method. At 31 December 2016, it had an estimated fair value of $32 500 and the estimated value in use was $19 500.

REQUIRED

(c) Prepare a **revised** draft statement of financial position at 31 December 2016 after considering the information provided to Julia. [8]

(d) Explain the adjustments you have made to the statement of financial position in **(c)**. [6]

Additional information

Jack, Julia's brother, is the sole trader of a small business. He has asked his sister if his accounts should be audited.

REQUIRED

(e) Discuss the advantages and disadvantages to Jack of having his accounts audited. [5]

[Total: 25]

Q4. The directors of G Limited prepared the following draft statement of financial position at 31 December 2016:

G Limited
Statement of Financial Position at 31 December 2016

	$
Non-current assets	642 000
Current assets	
Inventory	78 000
Trade receivables	189 000
Other receivables	3 000
Cash and cash equivalents	54 000
	324 000
Total assets	966 000
Equity and liabilities	
Equity	
Ordinary shares of $1 each	550 000
Retained earnings	235 000
	785 000
Current liabilities	
Trade payables	171 000
Other payables	10 000
	181 000
Total equity and liabilities	966 000

The auditor brings the following items to the attention of the directors:

1 G Limited entered into an 18-month rental agreement for a warehouse on 1 May 2016. The following payments totalling $220 000 were made and charged as an expense in the draft income statement:

$20 000 rental deposit which is refundable at the end of the lease period; and
$200 000 total rent covering the period from 1 May 2016 to 28 February 2017.

2 After an inspection of G Limited's office premises by the local authority in December 2016, it was found that the fire exits did not meet the safety specifications. A penalty of $27 000 is probable and G Limited will incur a cost of $47 000 to rebuild the fire exits. No accounting entries had been made for this.

3 A customer who owed $12 000 at 31 December 2016 was declared bankrupt on 12 January 2017. It is probable that only 20% of the debt is recoverable. No accounting entries had been made for this.

REQUIRED

(a) Prepare the **revised** statement of financial position at 31 December 2016. [10]

(b) Explain how **each** of items 1 and 2 should be treated in the financial statements. [5]

(c) Explain the role of an external auditor. [4]

(d) Explain why the audit report of a limited company is addressed to the company's shareholders and not its directors. [2]

Additional information

G Limited adopted the Weighted Average Cost (AVCO) method to ascertain the value of inventories in 2016. The purchase price has been increasing over recent years. The directors are now considering changing to First in, First out (FIFO) method to value inventory in 2017.

REQUIRED

(e) Advise the directors whether or not the method of valuing inventory should be changed. Justify your answer. [4]

[Total: 25]