Chapter 14

Final review: post-balance sheet period, provisions, contingencies, letter of representation
Learning objectives

• To describe the nature of the work the auditor performs immediately prior to preparation of the audit report.

• To detail the specific procedures the auditor performs in respect of post-balance sheet events.

• To explain the nature of provisions, contingent liabilities and contingent assets, and detail audit procedures in respect of them.

• To describe the final working paper review procedures performed by the auditor prior to forming the final audit opinion.

• To explain the nature and role of the management letter of representation, in the context of the evidence search.
Final Work

• Advanced stage in the audit process.
• Pulling earlier evidence together, reviewing earlier conclusions and forming view on financial statements.

• Some new topics:
  – Post-balance sheet date work
  – Audit work on provisions
  – Audit work on contingencies
  – Final working file review
  – Validity of the going-concern concept
  – Management letter of representation
Definition of subsequent events

• Those events, favourable and unfavourable, that occur between the balance sheet date and the date when the financial statements are authorised for issue. Two types of event can be identified:
  a) those that provide evidence of conditions that existed at the balance sheet date (*adjusting events*); and
  b) those that are indicative of conditions that arose after the balance sheet date (*non-adjusting events*). (IAS 10)

• But the auditor considers events after date financial statements are authorised – up to and even beyond date of the AGM.
Post-balance sheet events – post balance sheet period – events occurring Figure 14.1
Post-balance sheet events – post balance sheet period (1)

- 22 January 2016: customer owing £100 000 goes into liquidation.
Post-balance sheet events – post balance sheet period (2)

• 18 February 2016: fire in the new warehouse damages inventory with a cost value of £250 000; the auditor discovers an error in the allocation of overheads to inventory so that inventories, other than those lost in the fire, are overstated by £500 000.
Post-balance sheet events – post balance sheet period (3)

• 7 April 2016: the company sells its former head office at an historical cost profit of £2 000 000.
Post-balance sheet events – post balance sheet period (4)

- 29 July 2016: government legislation bans the sale of a product manufactured by the company.
Provisions (1)

- FRS 12 and IAS 37 stop income smoothing, ‘big bath accounting’.
- Provision recognized when an entity has:
  1. Present obligation (legal or constructive)
  2. As a result of a past event
  3. Probably a transfer of economic benefits will be required
  4. Reliable estimate of amount of the obligation.
  
  **Activity 14.4** – Toxic waste scenario from Activity 2.9.
  **Activity 14.5** – Legal or constructive obligation?
  **Activity 14.6** – Steps to determine amount of obligation.
  **Activity 14.7** – Disclosure of provision, if justified.
  **Activity 14.8** – Over-provision at the previous year-end.
Provisions (2)

<table>
<thead>
<tr>
<th>Class of assertion</th>
<th>Assertions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Genuine</td>
<td>Though uncertain in timing and amount, there is a present obligation as a result of a past event and it is probable that a transfer of economic benefits will be required to settle the obligation. (Occurrence and obligation) The past event is an obligating event, that is, it can be enforced by law or gives rise to a constructive obligation arising from valid expectations in other parties that the entity will discharge the obligation. (Occurrence and obligation)</td>
</tr>
<tr>
<td>Accurate</td>
<td>Reliable estimates based on a range of possible outcomes can be made of the present obligation as a result of the past event. (Valuation) The provision relates to the correct period. (Cut-off)</td>
</tr>
<tr>
<td>Complete</td>
<td>All provisions are properly and separately disclosed, including brief descriptions of their nature, and indications of the uncertainties about amounts and timing. (Complete and classification)</td>
</tr>
</tbody>
</table>
Contingent liability (1)

a) Possible obligation – arises from past events and whose existence will be confirmed only by the occurrence of ... uncertain future events not wholly within the entity’s control; or

b) Present obligation – arises from past events but is not recognized because:
   i. it is not probable that a transfer of economic benefits will be required to settle an obligation; or
   ii. the amount of the obligation cannot be measured with sufficient reliability.

• ‘Possible’ not as strong as ‘probable’:
  – Directors consider estimate of outcome and financial effect
  – Directors review events after balance sheet date
  – Accounting treatment – consider expected outcome/nature

• Chart on page 570 gives basic assertions about them.

• Activities 14.9 and 14.10 deal with a damages claim.
### Contingent liabilities (2)

<table>
<thead>
<tr>
<th>Class of assertion</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Genuine</td>
<td>The events giving rise to the contingent liabilities have actually occurred. (Occurrence and obligations)</td>
</tr>
<tr>
<td>Accurate</td>
<td>The possibility that an outflow of economic benefits will occur is remote or not probable has been reasonably assessed. (Valuation)</td>
</tr>
<tr>
<td></td>
<td>Estimates of financial effects, uncertainties and possible reimbursements are reasonably based. (Valuation)</td>
</tr>
<tr>
<td></td>
<td>The contingent liabilities have been recorded in the correct period. (Cut-off)</td>
</tr>
<tr>
<td>Complete</td>
<td>All contingent liabilities have been identified. (Complete)</td>
</tr>
<tr>
<td></td>
<td>Contingent liabilities are properly disclosed in the financial statements, including brief description of nature, estimate of financial effect, indication of uncertainties, possibility of any reimbursement. (Classification)</td>
</tr>
</tbody>
</table>
Treatment of contingent liabilities

• FRS 12 and IAS 37 – do not adjust
• Transfer of economic benefits *probable* – provision
• Management inform auditor of developments
• Transfer of economic benefits *remote* no disclosure
• If *neither probable nor remote*:
  – Brief description
  – Estimate of financial effect
  – Indication of the uncertainties
  – Possibility of reimbursement
• Possibility and probability – judgement matters
• Consider counterclaims against third parties
Contingent assets (1)

- **Contingent asset**: a possible asset that derives from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity’s control.

- Chart on page 572 for basic assertions.

- IAS 37 and FRS 12 – do not recognize.

- Inflow of economic benefits **virtually certain** not a contingent asset.

- **Probable but not virtually certain** – disclose nature and estimate of financial effect.

- ‘**Virtually certain**’, ‘**probable**’ and ‘**possible**’ – judgement

**Activity 14.11** – grant to a small publisher of poetry.
## Contingent assets (2)

<table>
<thead>
<tr>
<th>Class of assertion</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Genuine</td>
<td>The events giving rise to the contingent assets have actually occurred. (Occurrence and rights)</td>
</tr>
<tr>
<td>Accurate</td>
<td>The decision that the inflow of economic benefits is probable, but not virtually certain is reasonably based. (Valuation) Estimates of financial effects are reasonably based. (Valuation) The contingent assets have been recorded in the right period. (Cut-off)</td>
</tr>
<tr>
<td>Complete</td>
<td>All contingent assets have been identified. (Complete) Where it is probable that there will be an inflow of economic benefits, the contingent assets are properly disclosed in the financial statements, including brief description of their nature, and estimate of their financial effect. (Classification)</td>
</tr>
</tbody>
</table>
Audit work to detect post-balance sheet events and contingencies

- Company procedures to detect
- Minutes of shareholders and TCWG
- Management accounts and accounting records
- Profit and cash flow forecasts for the subsequent period
- Enquiry of the legal department and external lawyers
- Known risk areas and contingencies
- Correspondence and memoranda
- Confirmation from third parties
- Information in the public domain
- Management interviews:
  - Known risk areas
  - New commitments
  - Significant assets movements
  - Going-concern status
  - Significant losses of assets.
- Auditor should already be aware of significant matters of subjective judgement
Management letter of representation – audit objectives

a) To obtain written representations from management ... that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information ... to the auditor;

b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements ... if determined necessary by the auditor ...; and

c) To respond appropriately to written representations provided by management ... , or ... if they do not provide the written representations requested by the auditor.
Management letter of representation

- Who should be asked to make written representations?
- What are the representations required from management?
- Written representations required by other ISAs.
- Date of written representations.
- Illustrative representation letter.
- Doubts about reliability or not provided? – Activities 14.16 and 14.17 (p 581).
- Informing those charged with governance.
- Note for readers in the UK and Ireland.
- Two further activities: Activities 14.18 and 14.19 (p583).
Activity 14.15

• Explain why the management letter of representation should bear the same date as the audit report.
Activity 14.16

• What do you think the consequences would be if management refused to sign the letter of representation or if they wished to exclude a matter that the auditors regarded as important?
Activity 14.17

• What do you think the consequences would be if the auditors have doubts about the reliability of written representations?
Activity 14.18

During the audit of Coldingham plc you come across a sales transaction with Littledean Ltd, in which Coldingham has a 20% interest, at a sales price lower than transactions with third parties. What action would you take and would you wish to include the matter in the letter of representation?
Activity 14.19

• Does the management letter of representation change the liability of management and auditors in any way?
Audit documentation (1)

Major purposes
1. Record audit evidence – basis of conclusions and opinion.
2. Increase efficiency and effectiveness of audit.

Basic rule: Sufficient for experienced auditor to understand:
   – Nature, timing and extent of audit procedures
   – Results of audit procedures, and audit evidence obtained
   – Significant matters arising in audit, conclusions/judgments

Two kinds of review: ‘cold reviews’ and ‘hot reviews’ (by EQCR?)

Practical matters:
   a) Referencing system
   b) No delay in preparing
   c) Who prepared and when
   d) Who reviewed
   e) Action taken after review
   f) After completion no changes to or removals of documentation

Audit documentation finalised shortly after date of audit report

Figure 14.2 shows kinds of audit documentation
Audit documentation
(2)
Figure 14.2
Role of the final review

a) All routine matters dealt with – no outstanding matters in the audit documentation
b) All important matters have been covered
c) Financial statements reviewed – as a whole show a true and fair view

• The auditor records:
  – Results of analytical review
  – Conclusions on financial statement headings.
  – Memorandum on major account headings
  – Whether evidence recorded supports conclusions
  – Management letter of representation.
Figure 14.1 Accounting reference period and post-balance sheet period

1 January 2015
- Accounting reference period (1 January 2015 to 31 December 2015)
- Balance sheet date

31 December 2015
- Customer owing £100,000 goes into liquidation

22 January 2016
- Date of finalizing draft financial statements

1 February 2016
- Fire in new warehouse damages inventories with a cost value of £250,000; while investigating this matter, the auditor discovers an error in the allocation of overheads to inventories, so that other inventories are overstated by £50,000

18 February 2016
- Date of completing audit fieldwork; date of signing audit report; date on which directors sign financial statements; date of management letter of representation

15 March 2016
- Company sued by customer for damages resulting from a faulty product

16 March 2016
- Date of submitting the financial statements to shareholders

25 March 2016
- The company sells its former head office at an historical profit of £2,000,000

7 April 2016
- Date of annual general meeting at which financial statements are to be approved by shareholders

29 April 2016
- On this date government legislation bans the sale of a product manufactured by the company. The auditor had considered the matter during the audit as there were substantial inventories of this product on hand at 31 December 2011. They had concluded that no adjustment was necessary on the ground that the possibility of legislation was remote. The auditor feared that inventories may still be held and goods may be returned by customers
Figure 14.2 Audit documentation: relationships and contents