KPMG

Fiji Institute of Accountants

Technical Workshop - Challenges and dilemmas faced by the auditing profession

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Financial statement audit

- Financial statement audits play a critical role in creating and maintaining investor confidence and can unlock valuable insights into the business.
- Independent auditors perform the valuable role of being a trusted intermediary between the providers of business information and the users of that information.
- Put simply, audit is about examining organisations and ensuring their published accounts provide a 'true and fair' view of their financial position and results.

- **Challenge** - perception of audit as a box-ticking exercise

Responsibilities of management and TCWG

- Management is responsible for the preparation of financial statements that give a true and fair view in accordance with IFRS, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.
- In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.
- Those charged with governance (TCWG) are responsible for overseeing the Company's financial reporting process.

Auditor's responsibilities

- Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion.
- Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with International Standards on Auditing (ISAs) will always detect a material misstatement when it exists.
- Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

- **Challenge**
  - Difference in opinion or understanding as to what are management's responsibilities regarding the financial reporting process, as opposed to those of the auditor.
  - With the changing business environment, new laws and regulations and the ever increasing occurrence of fraud, auditors are often blamed for not detecting fraud, errors or non-compliance with laws and regulations – responsibilities that reside with management.

Audit Quality!

- As auditors we recognize our work is pivotal to addressing the key global challenge of our time: restoring public trust in institutions.
- As independent auditors our integrity is our currency.
- So when we talk about audit quality, and how we are striving to maintain and improve quality, it is not some abstract aspiration. It is fundamental to our purpose.
- Audit quality is not just about reaching the right opinion, but how that opinion is reached. It is about the processes, thought and integrity behind the auditors' report.
- The outcome of a quality audit is the delivery of an appropriate and independent opinion in compliance with relevant professional standards and applicable legal and regulatory requirements.

- **Challenge**
  - Increased reporting requirements/complexity (e.g. valuations, estimates)/ documentation requirements (e.g. estimates)
  - Increased regulatory pressure/vigilance
  - High profile audit failures and repercussions

Auditor independence!

- An auditor being independent of mind and in appearance from its clients is a cornerstone of international professional standards and regulatory requirements.
- The regulatory rules and systems relating to the provision of non-audit services to an audited entity are extensive, which is appropriate given the risk of creating a real or perceived independence issue.
- We are required, at a minimum, to comply with IESBA principles and applicable laws and regulations related to the scope of services that can be provided to audit clients.
- Threats to audit objectivity and independence may arise from:
  - the auditor (or others in the firm) performing non-audit services the results of which are reflected in the amounts included or disclosed in the financial statements of the audited entity (self-review threat)
  - partners and employees of the audit firm making judgements or taking decisions on behalf of the management of the audited entity (management threat)
  - the auditors conduct being influenced by fear or threats (intimidation threat)

Auditor independence! (cont'd)

- **Challenge**
  - Expectations by clients that auditors will assist with:
    - selection/application of accounting policies (management threat)
    - financial reporting process (self review threat)
  - Audit failures
    - Enron (collapse of Arthur Anderson)
    - Flow on impact on all Big 4 (including KPMG)

Three lines of defence model

- The 'Three Lines of Defence' is the method used by organisations to describe the roles and responsibilities of stakeholders relating to the organisation's framework for governance and risk management.
  - 1st line of defence - consists of the executive management team and functional areas within the business that are responsible for the day-to-day ownership and management of risks.
    - Key players: First line of defence functions report into the Chief Executive Officer, often via other C-suite 1st line positions or departmental heads e.g. CFO, COO etc.
  - 2nd line of defence - responsible for establishing an appropriate and effective risk management framework and for ensuring ongoing oversight and challenge to risk management across the business.
    - Key players: The 2nd line of defence is provided by the Compliance and Risk function, headed by the Chief Risk Officer (CRO) or Chief Compliance Officer (CCO). The CRO/CCO typically reports into one or more of the CEO, the Chairman of the Board or the Risk Committee Chair depending on the underlying governance model adopted by the firm.

Three lines of defence model (cont'd)

- 3rd line of defence - provides independent assurance on the appropriateness and effectiveness of controllership across the business, the effectiveness of risk management activity (undertaken by the first and second lines) and the overall effectiveness of governance.
  - Key players: The 3rd line of defence is the Internal Audit function headed by the Chief Internal Auditor/Head of Internal Audit, who reports directly into the Board/Audit Committee Chair.
- What works best for the organisation depends on its size, complexity and risk profile.

- **Challenge** – external audit is relied on as the first line of defence.

Audit evidence

- Auditors are required to assess the **sufficiency** and **appropriateness** of audit evidence obtained.
- Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.
- However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.
- Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. For purposes of the ISAs:
  - Sufficiency of audit evidence is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.
  - Appropriateness of audit evidence is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

Audit evidence (cont'd)

- **Challenge**
  - Inadequate accounting records
  - Inappropriate supporting documents
    - Journal entry vouchers without any supporting documents
  - Clients opting for modified opinions as an 'easy way out'
  - Auditing standards are more prescriptive e.g. management representation letter was not mandatory previously. Now requirements include certain must have inclusions.
  - If not on file (i.e. not documented), then evidence does not exist. This is a change from the past and driven by regulators.

Internal controls

- We are required to obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control.
- Management is responsible to establish and maintain an effective system of internal control.
- An effective internal control system provides reasonable assurance that policies, processes, tasks, behaviours and other aspects of an organisation, taken together, facilitate its effective and efficient operation, help to ensure the quality of internal and external reporting, and help to ensure compliance with applicable laws and regulations.
- The audit committee/Board should be satisfied that proper control policies, procedures and activities have been established and are operating as intended.
- The performance of the system of internal control should be assessed through ongoing monitoring activities, separate evaluations such as internal audit, or a combination of the two. Procedures for monitoring the appropriateness and effectiveness of the identified controls should be embedded within the normal operations of the organisation.

- **Challenge** – more persuasive audit evidence are required when weaknesses in the company's control environment are identified.

Fraudulent financial reporting

- We are required to:
  - identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error;
  - design and perform audit procedures responsive to those risks; and
  - obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion.
- The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- **Challenge**
- Withholding evidence or misrepresenting information in response to inquiries or by falsifying documentation.
- Opting for limited/minimum disclosures.
- Impacts of COVID19
  - Remote auditing – increased professional skepticism
  - Increased estimation uncertainty e.g. impairment of non-financial assets, property valuations, equity security valuations, allowance for ECL etc.

Fraudulent financial reporting (cont'd)

- Enron
- Worldcom
- Lehman Brothers

Fraudulent financial reporting (cont'd)

- The Parmalat accounting fraud is one of the largest cash and investment frauds ever recorded. The finance director participated in a 'cut and paste' forgery, in which a document with Bank of America letterhead was scanned and then added to a document verifying a deposit account with that bank holding over $4.98 billion. The document was then passed through a fax machine several times in order to appear authentic and provided to and then relied on by the auditors.
- In the 1980s, the highly glamorized story of ZZZZ best carpet cleaning highlighted how a single executive, the CFO, used white out and a copy machine to create over 10,000 false documents including false bank statements to provide auditors the paper evidence needed to defraud banks and investors out of $100 million.
- In 2002 it was discovered that over 14 people at HealthSouth conspired to create thousands of false documents leading their auditors to certify financial statements that included $300 million in false cash.

Familiarity with the standards

- We are required to:
  - evaluate the appropriateness of accounting policies used;
  - the reasonableness of accounting estimates and related disclosures made by management;
  - evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

- **Challenge**
  - Expectations by clients that auditors will assist with:
    - selection/application of accounting policies e.g. revenue recognition requirements, leases requirements (modifications/remeasurements) etc.
    - financial reporting process including recording of transactions and events in the general ledger e.g. allowance for ECL.
    - compilation of financial statements
  - Linking business operations to IFRS requirements e.g. inventory costing
  - Engaging/consulting early with the auditors when faced with an issue.
  - Audit readiness.

Involvement of specialists

- A specialist is an individual (or firm) that possesses special skill or knowledge in a particular field other than accounting or auditing whose work is used to assist us in obtaining sufficient appropriate audit evidence.
- Specialists can be categorised into two types depending on their role and relationship to the audit engagement:
  - auditors specialists - specialists who are either employed or engaged by the auditors.
  - management's specialists - specialists who are either employed or engaged by the entity to assist management in the financial reporting process.
- Auditors specialists may be involved because the audit is to be performed by a person or persons having adequate knowledge, skill and ability.
  - Knowledge and skill relate to the competence of the individuals participating in the audit engagement. In other words, it means adequate technical training and proficiency as an auditor.
  - Ability relates to the capability of those individuals to exercise their competence in the circumstances of the engagement.

- **Challenge** – reluctance to involve specialists when audit teams do not have the required knowledge, skill and ability.

Information Risk Management (IRM)

- Organizations depend on IT for complete and accurate financial reporting and external auditors, in their turn, rely on IT systems and controls for an efficient and effective audit.
- Auditors obtain, when performing their risk assessment procedures, an understanding of an entity's IT systems relevant to financial reporting and related control activities, both application controls and general IT controls (GITCs) that support them.

- **Challenge**
- More audit evidence from substantive procedures are required when automated controls or reports from the IT system cannot be relied upon due to weaknesses in the company's general IT control environments.
- Reliance on IT is becoming more and more critical

Value-added audits

- Audit remains a highly valuable and important part of the workings of the capital markets.
- However, as both audit stakeholders, investors and auditors agree, it has to evolve if it is to retain its relevance.
- Why is this? One of the principal factors is that the audit remains primarily an examination of historical financial information – but investors are looking for more forward-looking and contemporary information.
- We are keenly aware of the reliance that audit committees, investors, companies and other stakeholders place in our work which underpins the efficient operation of our capital markets.

- **Challenge** – client timelines and timeliness of information flow could be an impediment at times which impacts the audit teams ability to deliver value.

Going concern

- We are required to:
  - conclude on the appropriateness of management's use of the going concern basis of accounting; and,
  - based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the company's ability to continue as a going concern.
- Our conclusions are based on the audit evidence obtained up to the date of our auditors' report.

- **Challenge** – availability of formal assessment from management supporting the going concern assumption.

ESG reporting

- Environmental, social and governance (ESG) issues are a key financial risk. As ESG matters move to the top of the agenda, expectations for high-quality disclosures are rising.
- Corporate success is no longer solely defined by profit, but also by your organization's impact on society and the environment.
- Corporate reporting used to be about seeking capital from public shareholders.
- But now it's increasingly about gaining consent to operate your business. To show the world how you're acting with purpose and contributing to a better future.
- Consequently, the investment community – investors, asset managers and ratings agencies – is factoring ESG reporting into its assessment of corporate performance.
- An increasing number of today's investors take non-financial data just as seriously as financial data.
- They believe that those companies that measure and report ESG risks are also likely to be managing these risks better and delivering greater long-term value.

- **Challenge**
- What to report?
- Where to start?

Audit costs and audit fees

- The cost of performing audits has increased significantly over the years.
- This is attributed to factors such as:
  - increase in staff salaries
  - professional indemnity insurance
  - increasing technology costs
  - impact of changing audit methodologies and new accounting standards, which are time consuming to audit.
  - Increased audit complexity and documentation requirements.

- **Challenge -** setting audit fees in a manner that will ensure an effective external audit.

Thank you

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