Striving Towards a Better Audit in 2017

Audit Solutions Queensland

McConachie Stedman

Who we are

At Audit Solutions Queensland, our focus is on providing a comprehensive, independent and efficient audit process. Our difference is our personal approach which provides quality advice beyond the audit report.

Audit Solutions Queensland is part of McConachie Stedman, a team of accountants, advisors and financial planners that are committed to the success of their clients. With over 68 years experience, McConachie Stedman's extensive knowledge helps businesses and organisations achieve their potential.

Our main office is centrally located in the business district of Toowoomba, with office serviced in Brisbane, St George, Crows Nest and Melbourne.

Disclaimer

The material shown in this presentation is for general information purposes only. It is not intended to be, nor should it be read as specific financial, business planning or risk advice.

Whilst all care is taken in the preparation of this material no warranty is given with respect to the information provided and accordingly no responsibility for errors or omissions, including responsibility to any person by reason of negligence is accepted by McConachie Stedman and Audit Solutions Queensland or any member or employee of this organisation.

Before acting on any of the information contained in this presentation you should obtain special advice from a specialist advisor, which is appropriate to your specific business risk needs, objectives and financial situation.

Agenda

- Background – What is an Audit?
- Preparing for a Successful Audit
- Common Tips and Traps
- Upcoming Changes – Financial Reporting
- Importance of Transparency in Reporting

Goals

Take 1 or 2 points to take back to improve your end of year pack for the 2017 year end

Keep the notes as a reference for tough questions when they arise

Background – What is an Audit?

- It is an examination of the financial report to provide assurance by an independent person
- An audit has changed considerably in the last 10 years, and is continuing to evolve.
  - Previously the role had a significant accounting assistance element
- An audit cannot:
  - cover every transaction
    - Sampling and the review of processes and controls are used
  - prevent fraud (although it is definitely considered in our procedures)
  - judge the appropriateness of management or business strategy

Background – What is an Audit?

It is crucial that your auditor is not making management decisions

Providing input and recommendations is allowable - but decision making rests with management

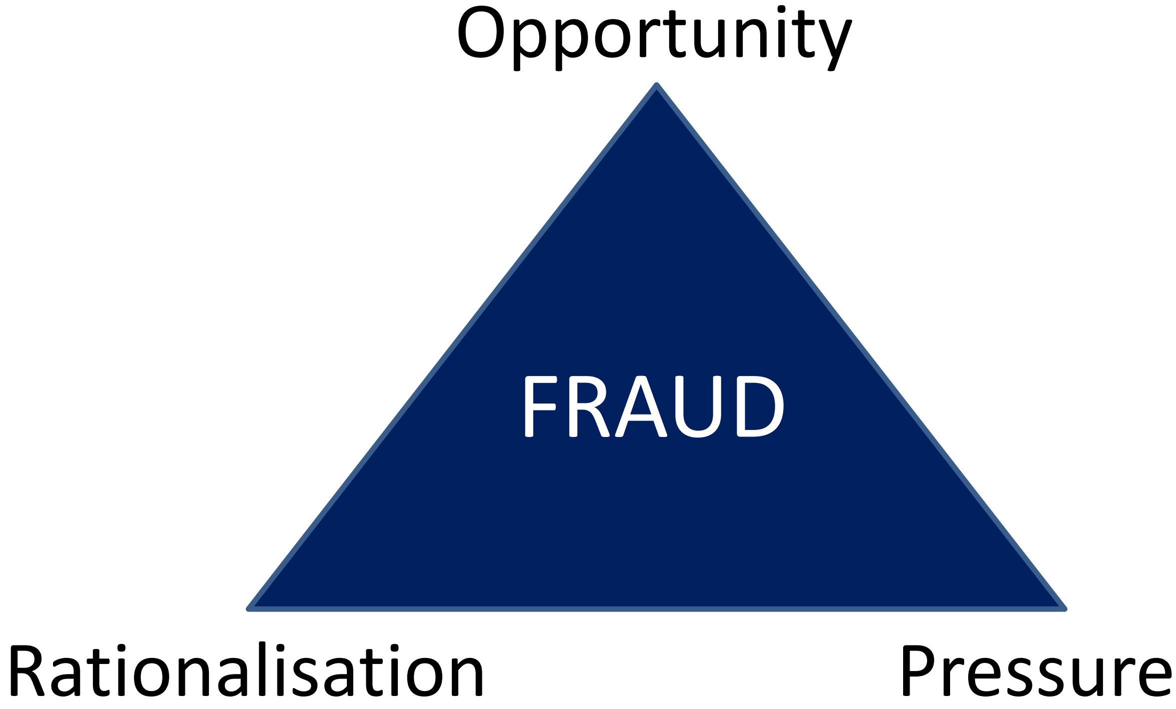
Key Terms

Professional scepticism

Professional scepticism plays a critical role in the professional judgement of auditors, and it is an essential part of the auditor's mindset

Key Considerations

Why is Professional Scepticism Important



Key Considerations

Fraud

- ASA 240 - An auditor conducting an audit in accordance with Australian Auditing Standards is responsible for obtaining reasonable assurance that the financial report taken as a whole is free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial report may not be detected, even though the audit is properly planned and performed in accordance with Australian Auditing Standards.
- The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.

Key Considerations

Materiality

*Information is material if its omission or misstatement could **influence the economic decisions** of users taken on the basis of the financial statements. Materiality depends on the **size of the item** or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a **threshold or cut-off point** rather than being a primary qualitative characteristic which information must have if it is to be useful.*

Key Considerations

Materiality

– Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial report;

Key Considerations

Materiality

Practically, our assessment:

- Impacts on the level of testing performed; and,
- Uses business risk, financial performance, position and industry factors are considered (amongst many other factors) to form a base.

Key Considerations

Going Concern

- ***As an auditor we must:***
  - consider the appropriateness of applying the going concern basis of preparation of the financial statements for the financial year in carrying out our engagement procedures.
- ***Our procedures include reviewing management and the entity's own going concern assessment procedures and documentation.***
  - Board and management representations
  - Budgets
  - Historical operating results

Preparation for a Successful Audit

Preparation for a Successful Audit

Before the audit date

- Early communication
- Completion of an audit pack
- Send the data in early where possible
  - Early access to a finalised trial balance/accounting system can save hours on site
- Not leaving known errors requiring reconciliation until the day of the auditors attendance
  - Have the discussion before the auditor arrives

Preparation for a Successful Audit

During the audit

- Set clear deadlines
- Plan the day with the Auditor – meetings etc.
- Understand the journal entries you are provided with
- Exit interview:
  - Management and Board
  - Discussion with the Auditor and Board members without management present

Preparation for a Successful Audit

Strategies for Early Financial Report Preparation

- Planning the process
  - Internal use of timetables
  - Agreed upon timelines
  - Planning meeting dates for sign-off
- Knowledge of the framework and accounting policy changes
- Financial statement working papers
  - Based on prior year financial statements
  - Lead schedules for all key balances attached to supporting documentation:
    - Our audit system generates these, and I am more than happy to provide them to our clients

Preparation for a Successful Audit

After the audit

- Attendance at Board/Finance Committee meeting with auditor
- Management letter – have a response ready
- Understand what you are signing
- AGM
  - invite the auditor to attend
  - show the auditor the annual report

Common Tips and Traps

Common Tips and Traps

Definition of a liability?

Conceptual Framework – Para's 60-64

- An essential characteristic of a liability is that the entity has a present obligation.
- A distinction needs to be drawn between a present obligation and a future commitment.
- Liabilities result from past transactions or other past events.

Common Tips and Traps

Definition of a liability?

Accruals – for funding program expenditure

- *A decision by the management of an entity to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the entity enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the entity with little, if any, discretion to avoid the outflow of resources to another party.*

Common Tips and Traps

Is a Liability Current or Non-Current?

- AASB 101 – Presentation of Financial Statements (para 69)
  - An entity shall classify a liability as current when:

    (a) it expects to settle the liability in its normal operating cycle;

    (b) it holds the liability primarily for the purpose of trading;

    (c) the liability is due to be settled within twelve months after the reporting period; or,

    (d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period (see paragraph 73). Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.
  - An entity shall classify all other liabilities as non-current.

Common Tips and Traps

Is a Liability Current or Non-Current?

- AASB 101 – Presentation of Financial Statements (para 69)
  - An entity shall classify a liability as current when:

    (d) it does not have an ***unconditional right to defer settlement of the liability for at least twelve months after the reporting period*** (see paragraph 73). Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.
- *Impacts on long service leave, annual leave and most importantly, borrowings*

Common Tips and Traps

Are employee benefits correctly valued?

*Provision is made for the entity's liability for employee benefits arising from services rendered by employees to balance date. Employee benefits that are expected to be settled within one year have been measured at the **amounts expected to be paid when the liability is settled, plus related on-costs**. Employee benefits payable later than one year have been measured at **present value of the estimated future cash outflows to be made for those benefits.***

Common Tips and Traps

Are employee benefits correctly valued?

- Annual leave – expected pay rate + on-costs
  - amounts expected to be paid when the liability is settled, plus related on-costs
- Long service leave – probability model
  - Current portion – per annual leave above
  - Non-current portion:
    - present value of the estimated future cash outflows to be made for those benefits.

Common Tips and Traps

Property, Plant and Equipment

Cost v fair value?

Common Tips and Traps

Property, Plant and Equipment

AASB 116 – Cost includes:

- Purchase price
- Any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management
  - Site preparation, delivery and handling, installation, testing and professional fees
  - Staffing costs
  - Borrowing costs as allowed

Common Tips and Traps

Property, Plant and Equipment

Repairs & Maintenance or Asset?

Common Tips and Traps

Property, Plant and Equipment

Repairs and maintenance or asset?

AASB 116 - An entity does not recognise in the carrying amount of an item of property, plant and equipment the costs of the day-to-day servicing of the item. Rather, these costs are recognised in profit or loss as incurred. Costs of ***day-to-day servicing*** are primarily the costs of labour and consumables, and may include the cost of small parts. The purpose of these expenditures is often described as the 'repairs and maintenance' of the item of property, plant and equipment.

Common Tips and Traps

Property, Plant and Equipment

Repairs and maintenance or asset?

Parts of some items of property, plant and equipment may require replacement at regular intervals... Items of property, plant and equipment may also be acquired to make a less frequently recurring replacement, ***such as replacing the interior walls of a building,*** or to make a non-recurring replacement. Under the recognition principle in paragraph 7, an entity ***recognises in the carrying amount of an item of property, plant and equipment the cost of replacing part*** of such an item when that cost is incurred if the recognition criteria are met. ***The carrying amount of those parts that are replaced is derecognised*** in accordance with the derecognition provisions of the Standard.

Common Tips and Traps

Property, Plant and Equipment

Subsequent Costs:

- Replacement of Carpet (as an example)
  - AASB 116 requires that the cost be recognised as an asset, and the carrying value of the asset replaced be derecognised.

Common Tips and Traps

Property, Plant and Equipment

Subsequent Costs:

70 - If, under the recognition principle in paragraph 7, an entity recognises in the carrying amount of an item of property, plant and equipment the cost of a replacement for part of the item, then it derecognises the carrying amount of the replaced part regardless of whether the replaced part had been depreciated separately. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed.

Common Tips and Traps

Property, Plant and Equipment

Borrowing Costs – 2 criteria:

- Qualifying Asset – An asset that takes a substantial period of time to get ready for its intended use or sale
- Borrowing costs allowed to be capitalised are those that would have been avoided if the expenditure on the qualifying asset had not been made

Common Tips and Traps

Property, Plant and Equipment

Borrowing Costs – what interest to use?

- Where funds borrowed specifically – use actual borrowing costs
- Where funds borrowed generally (e.g. overdraft – use a capitalisation rate/day)

Cease capitalising when (substantially) all activities to prepare qualifying asset for use are complete

Common Tips and Traps

Donated Assets

- Income from a contribution shall be measured at the fair value of the contributions received or receivable.

- Income arising from the contribution of an asset to the entity shall be recognised when, and only when, all the following conditions have been satisfied:
  - the entity obtains control of the contribution or the right to receive the contribution;
  - it is probable that the economic benefits comprising the contribution will flow to the entity; and,
  - the amount of the contribution can be measured reliably.

Common Tips and Traps

Prepaid expenses and accrued interest

- Prepayments – use of the matching concept
  - Common prepayments:
    - Insurance, commercial bill interest and fees, software subscriptions, future year stock acquired
- Accrued interest – term deposits

Common Tips and Traps

Be Prepared for Doubtful Debt Questions

- Your assessment of debtors will assist the auditor
  - Review the debtors listing in May and have file notes prepared

Common Tips and Traps

Leaving clearing account reconciliations until the end of the financial year (including GST, Superannuation and PAYG)

- Regular reconciliation of clearing accounts is essential to allow for complete and accurate records.
- An accounting system without a regular review of clearing accounts can be susceptible to fraud, or misstatement.

Transparency in Reporting

Transparency in Reporting

- Builds confidence in your organisation
- Annual and financial report demonstrates:
  - Financial Viability
  - Mission & Vision
  - Strategies and Resource Allocation
  - Performance (financial and non-financial)
  - Outputs

Transparency in Reporting

- ***Annual Reports:***
  - Presentation
    - Simple, clear concise
  - Strategy
    - Demonstrate progress towards goals
  - Demonstrate impact, outcome and outputs
  - Sustainability of funding

Transparency in Reporting

- ***Financial Reports:***
  - Consider the reduced disclosure regime
  - Disclosures:
    - Meaningless notes
    - Use of “other”
  - Goods for no consideration
  - Related party disclosures
  - Presenting to members

Upcoming Changes

Upcoming Changes

- AASB is currently undertaking a research project to explore the Australian Reporting Framework.
- Will cover for and not-for profit entities
- Will review special vs general purpose entities

Upcoming Changes

- AASB 15 – Revenue from Contracts
- AASB 1058 – Income of Not-for-Profit Entities
- AASB 16 – Leases
    - Applicable for reporting periods beginning on or after 1 January 2019 – so for the 30 June 2020 year end.

Upcoming Changes

- Under the new income recognition model, a NFP first considers whether AASB 15 Revenue from Contracts with Customers applies to a transaction or part of a transaction. In order for AASB 15 to apply to a transaction, the performance obligation(s) arising from the transaction needs to be ‘sufficiently specific’ and ‘enforceable’.

Upcoming Changes

AASB 15 Steps:

1. Identify the contract with the customer (can be third party beneficiary)
2. Identify the separate performance obligations
3. Determine the transaction price
4. Allocate the transaction price to the separate performance obligations
5. Recognise revenue when or as performance obligations are recognised

Upcoming Changes

- To assist the NFP sector in applying AASB 15 principles, particularly in circumstances where a for-profit perspective does not readily translate to a NFP perspective, the AASB has now added NFP application guidance and illustrative examples as an appendix to AASB 15.
- As noted earlier, in order for AASB 15 to apply to a NFP transaction, there are two critical elements that need to be satisfied:
  - the agreement between two or more parties must create ‘enforceable’ rights and obligations
  - the NFP entity’s promise to transfer a good or service needs to be ‘sufficiently specific’.

Upcoming Changes

- When AASB 15 does not apply to a transaction or part of a transaction, the NFP then considers whether AASB 1058 applies. AASB 1058 will apply when a NFP:
  - enters into a transaction where the consideration to acquire an asset is significantly less than fair value principally to enable the NFP to further its objectives and,
  - receives volunteer services (recognition of volunteer services is only mandatory to entities in the public sector).

Upcoming Changes

Under AASB 1058, the timing of income recognition will depend on whether a transaction gives rise to a performance obligation, liability or contribution by owners.

- Where a NFP receives an asset for significantly less than its fair value principally to enable the NFP to further its objectives, it recognises the asset in accordance with the relevant standard (e.g. donated inventory is recognised in accordance with AASB 102 Inventories). The NFP then considers the relevant accounting standard that applies to the other side of the entry (called ‘related amounts’).
- The difference (if any) between the consideration transferred for the asset and the fair value of the asset received after recording any ‘related amounts’ is recognised as income.

AASB 15 & AASB 1058 - Example

An entity holds an annual fundraising dinner in its local community. The ticket price is $600 per head, and is partially refundable if the dinner is cancelled, in which case the customer will receive a refund of $300.

Based on the menu, the retail price of the dinner at a local restaurant is $200 per ticket. Hosting the dinner also provides patrons (customers) with the benefit of socialising with a wide range of community members (including networking) and the amount of consideration to which the Entity expects to be entitled in exchange for transferring the promised goods or services (the dinner and networking) to the customer is $250.

AASB 15 & AASB 1058 - Example

The entity determines there is a contract with a customer to be accounted for under AASB 15, as there is:

- an enforceable contract due to the return obligation; and
- a sufficiently specific performance obligation requiring the provision of the dinner and networking to the customer, which would be satisfied at the point in time when provided.

The element not related to the performance obligation is considered material.

AASB 15 & AASB 1058 - Example

For each ticket sold, the entity recognises:

- a contract liability of $250, in accordance with AASB 15, which represents the transaction price of the dinner and networking to be provided to the ticketholder. The entity would recognise this amount as revenue when it provides the dinner event; and
- income of $350, in accordance with AASB 1058 – the residual of $350 is a result of a transaction where the consideration provided by the entity ($250) is significantly less than the fair value of the asset (cash of $600) principally to enable the entity to further its objectives and therefore AASB 1058 applies, with immediate recognition of income.

AASB 15 & AASB 1058 - Example

A refund obligation is recognised only to the extent that the entity does not expect to retain the refundable amount. The entity therefore does not recognise the refund obligation of $300 unless the dinner is cancelled or is expected to be cancelled. In that case, and subsequent to the initial accounting above, the entity would then recognise in respect of each ticket:

- the reversal of the contract liability of $250 (debit), as settlement is no longer expected;
- a reduction in cash of $300 (credit), being the refund to the ticket holder; and
- the difference of $50 (debit) is either an expense or a reduction of donation income previously recognised. This results in a net donation of $300 per ticket, reflecting the net cash received for each ticket after the refund has been made.

Upcoming Changes

Grants for construction or acquisition of non-financial assets AASB 1058 includes specific requirements with respect to grants for construction or acquisition of recognisable non-financial assets.

- When a NFP receives a grant to construct a building to be controlled by the NFP, the funds received are initially recognised as a financial asset (cash) with a corresponding liability (obligation to construct the building). Subsequently, the liability is derecognised as the performance obligation is satisfied (i.e. as the construction of the building is completed).
- Where a NFP receives a grant to acquire specific assets, it recognises income when the relevant assets are acquired. If a NFP receives a grant to develop an asset which does not satisfy the recognition criteria in other accounting standards (e.g. a research grant to develop the NFP's intellectual property), income is recognised when the funds are obtained.

Upcoming Changes

Leases with significantly below market rates (i.e. peppercorn leases) are quite common in the NFP environment.

- Presently, NFPs account for below market leases that are finance leases by measuring the leased asset and lease liability at present value of the minimum lease payments which results in a negligible amount.
- Under the new requirements, such leased assets will be measured at fair value at the inception of the lease whereas the lease liability will be recognised at present value of peppercorn lease payment amounts. The difference between the lease asset and liability will be recorded as income under AASB 1058.

Key Points

- Use your audit as an opportunity to refine and improve
- Understand what you are signing and what your journals are for
- Preparation (from management, the Board and the auditor) allows for an efficient process
- Tailor the annual and financial report to meet your needs
- Changes in revenue recognition is here in 2020

Contact Us

For more information, contact Ben Horner, Director, Audit Solutions Queensland:

P: (07) 4632 1150

E: ben.horner@auditsolutionsqueensland.com.au

W: auditsolutionsqueensland.com.au / mcconachiestedman.com.au