

Auditing subsequent events (Lecture A798 – 11.33 minutes)

ISA (UK) 560 *Subsequent Events* provides guidance to the auditor in auditing those events that arise after the balance sheet date but before the date of the auditor's report. The overall objectives of the auditor according to ISA (UK) 560 are:

To obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statement are appropriately reflected in those financial statements in accordance with the applicable financial reporting framework; and

ISA (UK) 560,
para 4(a) and
(b)

To respond appropriately to facts that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.

As covered earlier in the course, in almost all cases, the financial statements of an entity will not be finalised until a period of time has elapsed between the balance sheet date and the date on which the financial statements are authorised for issue. It is important that the auditor has regard to events which take place between these dates as they could have an impact on the amounts reported, or disclosed, in the financial statements.

The auditor must carry out audit procedures which are designed to obtain sufficient appropriate audit evidence that all events which take place between the date of the financial statements and the date of the auditor's report which require adjustment of, or disclosure in, the financial statements have been identified.

It is important to understand that it is **not** the auditor's responsibility to identify events after the end of the reporting period – this responsibility rests with management. It is the auditor's responsibility to ensure that such events are properly reflected in the financial statements as either adjusting or non-adjusting events.

The auditor must clearly understand their objectives and the work that needs to be done in respect of subsequent events. This is an area that lends itself to a lot of criticism by file reviewers and professional body monitoring officers who have complained in the past that auditors have failed to carry out adequate subsequent events procedures, or there is insufficient evidence on the audit file that demonstrates compliance with ISA (UK) 560.

It is necessary to carry out procedures on subsequent events **up to the date of the auditor's report** because the auditor is providing reasonable assurance that all subsequent events which need reflecting, or disclosing, in the financial statements have been considered up to the date of the auditor's report. If procedures are not carried out up to the date of the auditor's report, a material adjusting, or non-adjusting event may not be properly reflected in the financial statements meaning audit risk (the risk that the auditor expresses an inappropriate audit opinion on the financial statements) is increased.

1.1 Audit procedures for subsequent events

The types of audit procedures the auditor will carry out on an entity's subsequent events will, of course, be driven by the risk assessment (i.e. the risk of material misstatement in the financial statements). All audits are inherently different, and some audits will require more detailed audit procedures than others.

However, as a minimum, the auditor should at least carry out the following:

- Obtain an understanding, and consider the effectiveness, of the procedures that management has established to ensure that subsequent events are identified. Where management have not established procedures to identify subsequent events, the risk of material misstatement is heightened.
- Enquire of management and, where appropriate, those charged with governance, as to whether any subsequent events have taken place. Inquiry is a valid audit procedure under ISA (UK) 500 *Audit Evidence*, however, in itself, inquiry is a weak procedure and should only be used to complement other forms of audit evidence.
- Read minutes of meetings of management and those charged with governance. Meeting minutes will often provide an indication of subsequent events that have arisen such as the commencement of legal proceedings, the incurrence of a bad debt or restructuring of the organisation.
- Consider the external environment in which the entity operates in case it indicates there are factors that management have not considered. These may indicate legal, regulatory, societal, political, or technological changes which could impact the company.
- If the reporting entity is going through a legal case, inquire of the legal advisers as to whether there is a likelihood of the claim being successful and hence considering whether a provision for liabilities should be recognised, or a contingent liability disclosed. For ongoing legal claims, it is important that the auditor receives timely updates.
- Obtain the latest interim financial statements (where applicable) and carry out a review of these to identify any subsequent events.
- Review accounting records, including budgets and forecasts.
- Ask the directors about the progress of reported provisions and contingencies.

Example – Contingent liability becomes a provision

The audit of the financial statements of Cahill Ltd for the year ended 31 July 2022 is nearing completion. Final audit procedures are being carried out and the auditor's report is due to be signed in a week's time.

During the audit, the auditor became aware of a legal claim against the company for an injury sustained by a former employee. The employee is claiming damages of £10,000 and loss of earnings of £6,000. The auditor held discussions with the finance director who confirmed that the legal advisors had suggested

the claim will be dismissed but a contingent liability had nonetheless been disclosed in the draft financial statements. The finance director was also able to show the auditor written notification from the legal advisers to corroborate this assertion.

The case was heard by the court three days prior to the auditor's report being signed and the judge awarded the former employee damages and loss of earnings totalling £15,000. The amount is not material in isolation but becomes material when aggregated with other misstatements identified during the audit.

The awarding of damages and costs to the former employee is evidence of an adjusting event because the conditions giving rise to the liability existed at the balance sheet date. Consequently, the financial statements for the year ended 31 July 2022 should be adjusted to reflect a provision for a liability for £20,000 with a corresponding expense in profit or loss. As the amount is material in the aggregate, if the directors refuse to amend the financial statements the auditor must express a qualified opinion as the financial statements will not comply with FRS 102, Section 32 *Events after the End of the Reporting Period*. A basis for qualified opinion paragraph would also be included underneath the opinion paragraph which would explain the incorrect treatment of the adjusting event.

1.2 Written representation

Written representations are dealt with in ISA (UK) 580 *Written Representations*. Appendix 1 to ISA (UK) 580 contains a list of paragraphs within the other ISAs (UK) which should be included in the written representation letter requested from management and, where appropriate, those charged with governance. ISA (UK) 580 requires a written representation to be obtained from management that all events occurring subsequent to the balance sheet date and which either require reflecting in the financial statements themselves, or disclosed because they are non-adjusting events, have been reflected or disclosed accordingly.

It must be emphasised that a written representation cannot be regarded as sufficient appropriate audit evidence on its own in respect of subsequent events. This is because written representations are internally generated by management and those charged with governance so should serve to complement other forms of audit evidence.

Example – Extract from a written representation relating to subsequent events

All events subsequent to the date of the financial statements and for which FRS 102, Section 32 *Events after the End of the Reporting Period* require adjustment or disclosure have been adjusted or disclosed.

1.3 Facts become known to the auditor after the date of the auditor's report

Once the auditor has signed their report on the financial statements, they are under no obligation to perform additional procedures on those financial statements. However, if facts become known to the auditor after they have signed the auditor's report (but prior to the financial statements being issued) which, had those facts been known to the auditor at the time of issuing the auditor's report, would have caused the auditor to amend the report, the auditor is required to carry out the following steps:

- (a) Discuss the fact(s) with management and, where appropriate, those charged with governance.
- (b) Establish whether, or not, the financial statements need to be amended in light of the fact(s).
- (c) Enquire with management how they intend to address the issue(s) in the financial statements.

Example – Discovery of a material error

The audit of the financial statements of Freya Ltd for the year ended 30 April 2022 has been completed and the auditor signed their report on 14 August 2022. The financial statements are due to be issued on 19 August 2022.

On 17 August 2022, the new financial controller discovered that the company had been incorrectly claiming VAT on certain purchases which were either exempt from VAT or which the company was ineligible to claim the VAT back on. This resulted in an amount of £65,000 being owed back to HMRC and an immediate voluntary disclosure was made to HMRC.

The error is material to the financial statements and relates to the year ended 30 April 2022 resulting in liabilities being understated and profit before tax being overstated. The finance director has concluded that the financial statements will need amendment as the amount in question is material.

In this example, the financial statements have not been issued. The auditor's report has been signed but management have amended the financial statements and hence ISA (UK) 560, para 11 will apply which requires the auditor to:

- carry out audit procedures on the amendment;
- extend the subsequent event audit procedures to the date of the new auditor's report; and
- provide a new auditor's report on the amended financial statements.

In the above example, management had amended the financial statements for the effects of facts that became known to them after the auditor's report had been signed but before the financial statements had been issued. ISA (UK) 560, para 11(b)(ii) requires the auditor to then provide a new auditor's report on the amended financial statements. However, it is important that the new auditor's report is not dated any earlier than the date of approval of the amended financial statements.

Important point in the engagement letter

The terms of an audit engagement must include the agreement of management to inform the auditor of any facts which may affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued. In practice, the date of the auditor's report and the date of approval of the financial statements are often the same date. Once management have approved the financial statements, it is usually common practice to authorise them for issue on the same date.

If management are not prohibited by law or regulation from restricting the amendment of the financial statements to the effects of the event causing that amendment (i.e. in the example of Freya Ltd above with the additional VAT that has become payable) and those responsible for approving the financial statements are not prohibited by law or regulation from restricting their approval to that amendment, the auditor is then permitted to restrict their audit procedures to that amendment. Putting this into perspective, the auditor of Freya Ltd above would only need to restrict their audit procedures to the additional VAT that has become payable following their audit.

Where the circumstances above arise, the auditor amends the auditor's report to include an additional date which is restricted to the amendment. The date of the auditor's report on the financial statements prior to the amendment being made is unchanged as this informs the user of the date on which the audit work on those financial statements was completed. The auditor must, however, include an additional date in the auditor's report which informs the user that the audit procedures on subsequent events were restricted to the matter giving rise to the amendment.

ISA (UK) 560, para A12 includes an illustrative example as follows:

(Date of auditor's report), except as to Note Y, which is as of (date of completion of audit procedures restricted to amendment described in Note Y).

ISA (UK) 560,
para A13

The auditor could also provide a new or amended auditor's report which includes a statement in an Emphasis of Matter paragraph, which explains that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.

Example – Emphasis of Matter paragraph in respect of subsequent events

Emphasis of Matter

As described in note 34 to the financial statements, additional audit procedures have been performed subsequent to the original date of the auditor's report which was 28 November 2022. The procedures performed on the subsequent event described in note 34 are restricted solely to the amendment of the financial statements after the date of our original report.

1.4 If management do not amend the financial statements

ISA (UK) 560 recognises that in some jurisdictions there may be no requirement by law, regulation, or financial reporting framework to amend the financial statements. In such cases, the auditor does not have to provide an amended or new auditor's report thereon. This should not, however, be taken as absolute because the auditor may feel that the subsequent event is sufficiently material to warrant the financial statements needing amendment. This could arise, for example, where a material fraud or error is discovered after the auditor's report has been signed, but before the financial statements are authorised for issue. There are two scenarios relevant to this situation:

1. where the auditor has not yet provided the auditor's report to the reporting entity, the opinion is modified accordingly as required by ISA (UK) 705 *Modifications to the Opinion in the Independent Auditor's Report* and then provide the auditor's report; or
2. where the auditor has already provided their report, the auditor notifies management and those charged with governance not to issue the financial statements to third parties before the necessary amendments have been made. If the entity has already issued the financial statements, the auditor must take appropriate action to stop those third parties from placing reliance on the auditor's report. In these situations, the auditor would be advised to seek legal advice.

1.5 Facts become known to the auditor after the date of the auditor's report and after they have been issued

As noted earlier, the auditor is under no obligation to perform additional audit procedures on the financial statements once the auditor's report has been signed and the financial statements have been issued. Nonetheless, facts may become known by the auditor which, had they been known at the date they signed the auditor's report, would have caused the auditor to amend the auditor's report accordingly. In such instances, the auditor is required to take specific action as follows:

- Discuss the matter with management and, where appropriate, those charged with governance.
- Determine if the financial statements require amendment.
- If the financial statements do require amendment, discuss with management how they intend to address the matter in the financial statement.

If management choose to amend the financial statements to reflect the subsequent event, the auditor should then carry out the necessary audit procedures on the amendment. The auditor should also review the steps taken by management to ensure that anyone in receipt of the previous version of the financial statements and auditor's report thereon is informed of the situation.

In the UK, the auditor of a company has a legal right to attend the Annual General Meeting and be heard on any aspect of the business of that meeting which concerns them as the company's auditor. This would also include making a statement about the facts which have been discovered after the date of the auditor's report.

The auditor may perform full subsequent events procedures on the period between the date of the previous auditor's report and the date of the next auditor's report following the subsequent event. Where this does happen, the date of the new auditor's report must be no earlier than the date of approval of the financial statements.

Management may not be restricted from amending the financial statements to the extent of only the matter giving rise to the amendment and those approving the financial statements may not be restricted in approving that amendment. Where this is the case, the auditor only

needs to perform subsequent events procedures on that amendment. Again, the auditor could choose to provide a new auditor's report or amend the previous auditor's report. In any event, the auditor must include in the new, or amended, auditor's report an Emphasis of Matter paragraph or Other Matter(s) paragraph which refers to a note in the financial statements which explains the reasons for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.

Management does not amend the financial statements

If the auditor concludes that the financial statements should be amended to reflect the additional facts that have become known to them, and management does not make the amendment, the auditor must notify management and those charged with governance that they will seek to prevent future reliance on the auditor's report. The course of action taken by the auditor will depend on their legal rights and obligations but the need to seek legal advice should be borne in mind.

The auditor may make an appropriate statement in the company's Annual General Meeting, but they do not have the legal right to communicate in writing with the shareholders. However, if the extent of the circumstances is such that they choose to resign, or are removed or not reappointed, the auditor does have various duties under the Companies Act 2006. In addition, s519 would require the auditor to issue a statement in relation to their ceasing to hold office.