The Westworth Kemp Review of 2018

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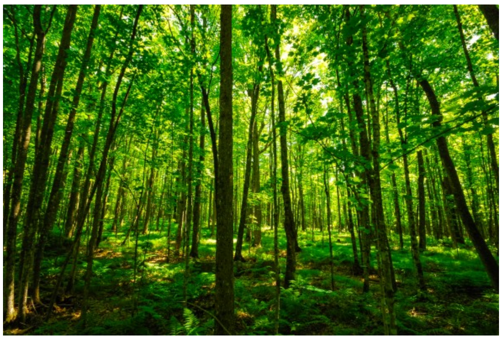
Introduction

We hope our newsletter finds our readers in good health, refreshed from the holiday season and looking forward to a stimulating 2019. With the release of the Hayne Royal Commission Report, those of us involved in or on the periphery of financial services have had to hit the ground running. We have got to hand it to them – Hayne and his counsel assisting have managed to complete a huge amount of work over the last year and shine a light on some business ethics that some might have preferred to have kept in the shadows.

While Westworth Kemp would not appear to be directly involved in financial services, we have been following the Royal Commission with interest as so many of our matters reveal the collateral damage faced by investors who have been put into dubious investments by financial planners. Because the financial planners tend to be separate small businesses, they are too expensive to sue individually and the class action lawyers and litigation funders tend to focus on the responsible entities for the investment schemes and their auditors, rather than the financial planners who recommended investors into the schemes.



Trees were a recurring theme for us in 2018, with forestry schemes and timber growers, including one file that had real trees that were poorly accounted for and another which contained lots of wonderful work under IAS 41 Agriculture, but sadly the trees themselves turned out to be fictitious!

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Integrity, audit quality and limitation of liability

We have put these three items under one heading because we see an important link.

Starting with integrity, in January we were shocked to read the latest episode of the Hastie saga in Sadie Ville Pty Ltd v Deloitte Touche Tohmatsu. The disappearance of the audit working papers from the secure litigation room is intriguing to say the least, particularly since it follows on from an assertion that the partner cannot hand them over as they might incriminate him. We await the next instalment with interest and wonder whether ASIC is capable of responding to what appears to be an admission of audit failings.

In our work we almost always find that where there is corporate collapse the auditor has not met auditing standards (although there is sometimes a rush to do some quite good audit work at the auditee's death knell).

In some cases there is pervasive negligence and carelessness. More generally though the audits exhibit a real lack of intellectual rigour. Call it a lack of scepticism if you want, but that phrase has become so hackneyed as to be meaningless.

What we see is:

- a significant lack of understanding of the purpose of the audit, i.e. to report to the owners of the business;
- pervasive failure of intellectual analysis, including the understanding of the client's business and the risks to which it is exposed; and
- an unwillingness to challenge the client both when conducting work and when issuing formal reports.

Loth though we are to say this, there is no real penalty for a bad audit. Staff leave and pursue other careers; partners pursue other paths sometimes within the same firm or give up auditing; the insurers pickup the tab or the auditor is so underinsured that there is no money for the parties that auditor was supposed to protect - investors.

So to limitation of liability. Firstly, the scheme has not been tested and may not withstand determined litigious challenge. Secondly, and more importantly, we believe the scheme does not provide an appropriate social purpose.

We propose that there should be a compulsory insurance requirement for all auditors that provides cover related to the size of the clients being served rather than the auditor's fees. Limitation of liability should be abandoned. There is already sufficient protection through apportionment of liability and the challenges of causation.

We do not know whether this proposal would result in an initial increase in premiums. Our thoughts on this are twofold: insurance premiums are part of the cost of doing audits and secondly if audits improve and claims reduce then premiums will fall.

If trust is to be the mantra of auditors, they should not hide behind limitation of liability or insurance cover that is too low but accept risk and work to reduce liability by actually working to improve audits. It may be that more work will drive up audit costs, but smarter work will provide the insights that should be presented as key audit matters and serve the needs of owners.

Practical insights based on what we have seen this year – banking covenants

Often a company fails because it breaches its banking covenants and its bankers decide not to renew its facility or to foreclose. Sometimes the entity is borderline insolvent, but it is the deterioration of the relationship between management and the bank that pushes it over the edge, as the bank loses confidence and patience.

In many cases, these banking covenants are the subject of some kind of checking by the auditor and reporting to the bank. We have come up with three points to look out for when dealing with banking covenants:

a. First of all, what is generally expected of the auditor? Think about general principles for the audit of liabilities and going concern and the disclosure of the loan as current or non-current.

b. Does the banking document have a specific requirement that the calculation should be checked by the auditor? Does the auditor report directly to the bank or check calculations that the client gives to the bank?

c. Terminology – banking covenants are often very difficult documents to read, a cross between legalese and sometimes out of date accounting jargon. At first, the instructions for calculations may seem to be at odds with accounting standards, but they may make sense within the context of how the borrowing facility has been arranged.

Practical insights based on what we have seen this year – auditing SMSFs

This is an area in a state of change, which needs to be carefully monitored. SMSFs were initially envisaged as a product for the financially literate, but increasingly trustees are relying on their auditor to keep them safe from malevolent financial advisers and the courts are finding in favour of the trustees, in spite of the fact that the reports are special purpose and the trustees have signed minutes approving the fund's activities.

There have been two recent decisions emphasising the auditor's duty as regards asset values – see https://www.ato.gov.au/Super/Sup/The-SMSF-auditor-and-verifying-market-values-in-an-SMSF/, which states: "Under regulation 8.02B of the Superannuation Industry Supervision Regulations 1994 (SISR), assets must be valued at market value in the SMSF's accounts and statements. SMSF auditors need to obtain sufficient appropriate audit evidence from SMSF trustees to verify the value of a fund's investments."

Just because a SMSF prepares special purpose financial reports, its advisors cannot ignore the requirement that "the financial report:

[Select one option]

"a) **presents fairly**, in all material respects, in accordance with the accounting policies described in the notes to the financial statements, the financial position of the fund at 30 June ____ and the results of its operations for the year then ended

[year]

"OR

“b) **presents fairly**, in all material respects, in accordance with the accounting policies described in the notes to the financial statements, the net assets of the fund as at 30 June ____ and the changes in net assets for the year then ended
[year]

“OR

“c) **presents fairly**, in all material respects, in accordance with the accounting policies described in the notes to the financial statements (and the SMSF’s governing rules), the operations of the fund for the year ended 30 June _____.
[year]”[1]

An unresolved issue – the professional accountant’s responsibility for a compilation

When an independent professional accountant has been involved in the preparation of the financial report that is the subject of audit negligence litigation, the question arises as to how much responsibility the accountant bears for the any deficiencies in the financial report.

While a compilation engagement offers no assurance, nevertheless, a member in public practice is bound by the requirements of the Code of Ethics to apply integrity, objectivity, professional competence and due care to all his or her work.

APES 315 in Section 7 contains a requirement that the member in public practice “shall assess whether the Compiled Financial Information … is appropriate in form and content and free from Misstatements.” Where he or she “forms the view that the information supplied by a Client includes a Misstatement, the Member shall consider performing the following procedures or other alternative procedures:

“(a) making inquiries of management to assess the reliability, accuracy and completeness of the information provided;

“(b) assessing internal controls; or

“(c) verifying any relevant matters or information.”

In light of the recent SMSF cases discussed above, it would be unwise for accountants to be too complacent about compilation engagements.

ASIC inspection report

Financial reporting inspections

ASIC’s financial reporting inspections of 30 June 2018 reports are described at https://asic.gov.au/about-asic/news-centre/find-a-media-release/2019-releases/19-014mr-findings-from-30-june-2018-financial-reports/ . The media release contains details of the findings, but they are summarised as follows:

[1] https://www.ato.gov.au/Forms/SMSF-independent-auditor-s-report/ (accessed 5/2/2019)

Matter	Number of inquiries
Impairment and other asset values	28
Revenue recognition	18
Tax accounting	11
Consolidation accounting	4
Business combinations	3
Expense deferral	3
Other matters	12
Total	**79**

The two most prevalent issues are impairment and asset values and revenue recognition. The issues on ASIC's list are not surprisingly very similar to the issues that we see in our litigation support work.

The media release also noted that "ASIC continues to find that some key audit matters were described in general terms rather than being specific to the circumstances of the entity. In some cases, the audit procedures performed were not clearly described."

Audit inspections

Audit inspections for 2017 – 2018 https://asic.gov.au/about-asic/news-centre/find-a-media-release/2019-releases/19-013mr-audit-inspection-findings-for-2017-18/

The findings do not make for happy reading: "In 24% of the total 347 key audit areas that ASIC reviewed across 98 audit files, auditors did not, in our view, obtain reasonable assurance that the financial report was free from material misstatement. This compares to 25% of 390 key audit areas in the previous 18-month period ended 31 December 2016.

"In reviews of the audit files at the six largest firms (included in the figures above), ASIC found in 20% of the key audit areas, auditors did not, in our view, obtain reasonable assurance that the financial report was free from material misstatement."

A key recommendation is that firms and partners should be committed to audit quality and in particular, "Audit engagement partners should:

- spend significant time at the audited entities to understand the business and risks, engage with directors and management, and involve themselves in risk areas of the audit on a timely and comprehensive basis;
- work directly with the audit team on risk areas to ensure timely and quality audit work, apply their knowledge and experience throughout the audit process and upskill staff; and
- undertake comprehensive reviews of the audit files at the premises of audited entities, focusing on possible risk areas."

The full report can be found at https://asic.gov.au/regulatory-resources/find-a-document/reports/rep-607-audit-inspection-program-report-for-2017-18/.

Emerging Issue: Auditing and the Cloud

Cloud computing provides access to cheap versatile services which are very appealing to emerging businesses, products like Xero, DropBox and corporate subscriptions to Gmail, but presents problems from an audit perspective. These problems can include

a. the lack of control over the service by the client – in this respect, the situation is like any outsourcing situation and the appropriate standard is ASA 402

b. the level of client control varies from something bespoke commissioned by the client through to off the peg offerings like Xero, with a consequent impact on controls and the audit

c. security of information in the cloud – public versus private clouds

d. establishing an audit trail and the availability of audit evidence

e. level of understanding by the client of the services they have secured and attendant risks

There is a good introductory article by a KPMG technology specialist at https://www.charteredaccountantsanz.com/news-and-analysis/news/auditing-in-the-cloud.

Resources on changes to accounting standards and examples of financial statements

There is a wealth of information freely available on various websites relating to changes in standards, in addition to the official information on the AASB's site. These updates give accountants a way in to the standard and make it easier to then apply the detail to the circumstances of their clients.

Many websites also contain specimen financial reports, again free to download, which can assist with drafting disclosures in respect of new and existing standards. While an example may not exactly fit the entity's circumstances, it provides a starting point for drafting something specifically tailored to the its needs.

CA ANZ	Commentary and "blueprints" on new standards	https://www.charteredaccountantsanz.com/member-services/technical/reporting
Caseware	Example financial statements	http://caseware.com.au/faq/article.php?id=519
Deloitte	Example financial statements	https://www2.deloitte.com/au/en/pages/audit/articles/illustrative-financial-reports.html
	Articles and papers	https://www2.deloitte.com/au/en/pages/audit/articles/accounting-alerts-2016.html
EY	Home page for financial reporting papers and specimen accounts	http://www.ey.com/au/en/issues/ifrs/issues-au-ifrs-local-publications
Grant Thornton	Example financial statements	https://www.grantthornton.com.au/insights/technical-publications--ifrs/example-financial-statements/

	Financial reporting issues updates	https://www.grantthornton.com.au/en/insights/technical-publications--ifrs/local-technical-and-financial-reporting-alerts/
	IFRS news	https://www.grantthornton.com.au/en/insights/technical-publications--ifrs/ifrs-news-special-bulletins/
	IFRS factsheets	https://www.grantthornton.com.au/en/insights/technical-publications--ifrs/ifrs-factsheets/
KPMG	Example financial statements	https://home.kpmg.com/au/en/home/insights/2015/11/example-financial-statements-public-company.html
	Australian reporting updates	https://home.kpmg.com/au/en/home/insights/2015/12/reporting-updates.html
	Standards on issue	List of recently issued standards, hyperlinked to more detailed commentary https://home.kpmg.com/au/en/home/insights/2010/04/standards-on-issue.html
PwC	Example financial statements	https://www.pwc.com.au/ifrs/value-accounts.html
	Home page with links to various types of guidance	https://www.pwc.com.au/ifrs.html;

As well as the international and local standards and ASIC materials which are well publicised, it is worth keeping an eye on agenda decisions of the IASB's Interpretations Committee. These are now easier to find thanks to the recent upgrade of IASB website. They can now be found at http://www.ifrs.org/supporting-implementation/how-the-ifrs-interpretations-committee-helps-implementation/#agendadecisions as well as the Deloitte IAS Plus site which has them hyperlinked by standard - https://www.iasplus.com/en/projects/not-added, and the IASB's hard copy "Green Book".