Subsequent events

Students of financial reporting and auditing papers will have to gain an understanding of how subsequent events (also known as 'events after the reporting period') affect the financial statements of an entity. This article will consider the financial reporting aspects concerning subsequent events using a case study type scenario, and will then discuss the auditing requirements that candidates of Paper F8, *Audit and Assurance* need to be aware of.

Financial reporting considerations

In almost all circumstances, financial statements will not be finalised until a period of time has elapsed between the year-end date and the date on which the financial statements are (expected to be) issued. Therefore, regard has to be given to events that occur between the reporting date and the date on which the financial statements are (expected to be) authorised for issue.

IAS 10, *Events After the Reporting Period* stipulates the accounting and disclosure requirements concerning transactions and events that occur between the reporting date and the (expected) date of approval of the financial statements. Among other things, IAS 10 determines when an event that occurs after the reporting date will result in the financial statements being adjusted, or where such events merely require disclosure within the financial statements. Such events are referred to in IAS 10 as 'adjusting' or 'non-adjusting' events.

Students who have studied Paper F3, *Financial Accounting* will have come across such terminology and it is imperative that they can differentiate between an *adjusting* and a *non-adjusting* event. IAS 10 prescribes the definitions of such events as follows:

Adjusting event

An event after the reporting period that provides further evidence of conditions that existed at the end of the reporting period, including an event that indicates that the going concern assumption in relation to the whole or part of the enterprise is not appropriate.[1]

Non-adjusting event

An event after the reporting period that is indicative of a condition that arose after the end of the reporting period.[1]

Example 1

You are the trainee accountant of Gabriella Enterprises Co and are preparing the financial statements for the year-ended 30 September 2010. The financial statements are expected to be approved in the Annual General Meeting, which is to be held on Monday 29 November 2010. Today's date is 22 November 2010. You have been made aware of the following matters:

1. On 14 October 2010, a material fraud was discovered by the bookkeeper. The payables ledger assistant had been diverting funds into a fictitious supplier bank account, set up by the employee, which had been occurring for the past six months. The employee was immediately dismissed, legal proceedings against the employee have been initiated and the employee's final wages have been withheld as part-reimbursement back to the company.

2. On 20 September 2010, a customer initiated legal proceedings against the company in relation to a breach of contract. On 29 September 2010, the company's legal advisers informed the directors that it was unlikely the company would be found liable; therefore no provision has been made in the financial statements, but disclosure as a contingent liability has been made. On 29 October 2010, the court found the company liable on a technicality and is now required to pay damages amounting to a material sum.

3. On 19 November 2010, a customer ceased trading due to financial difficulties owing $2,500. As the financial statements are needed for the board meeting on 22 November 2010, you have decided that because the amount is immaterial, no adjustment is required. The auditors have also confirmed that this amount is immaterial to the draft financial statements.

Required:
(a) For each of the three events above, you are required to discuss whether the financial statements require amendment.

Answer:
When presented with such scenarios, it is important to be alert to the timing of the events in relation to the reporting date and to consider whether the events existed at the year-end, or not. If the conditions *did* exist at the year-end, the event will become an *adjusting* event. If the event occurred after the year-end, it will become a *non-adjusting* event and may simply require disclosure within the financial statements.

1. Fraud

Clearly the fraud committed by the payables ledger clerk has been ongoing during, and beyond the financial year. Fraud, error and other irregularities that occur prior to the year-end date – but which are only discovered after the year-end – are adjusting items, and therefore the financial statements would require amendment to take account of the fraudulent activity up to the year-end.

2. Legal proceedings
At the year-end, the company had made disclosure of a contingent liability. However, subsequent to the year-end (29 October 2010), the court found the company liable for breach of contract. The legal proceedings were issued on 20 September 2010 (some 10 days before the year-end). This is, therefore, evidence of conditions that existed at the year-end. IAS 10 requires the result of a court case after the reporting date to be taken into consideration to determine whether a provision should be recognised in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* at the year-end. In this case, the financial statements will require adjusting because:

- the conditions existed at the year-end
- the recognition criteria for a provision in accordance with IAS 37 have been met.

3. Loss of customer
A customer ceasing to trade so soon after the reporting period indicates non-recoverability of a receivable at the reporting date and therefore represents an adjusting event under IAS 10, *Events After the Reporting Period*. Assets should not be carried in the statement of financial position at any more than their recoverable amount and, therefore, an allowance for receivables should be made.

Auditor's responsibilities
So far we have considered the financial reporting aspects relating to events after the reporting period. The second part of this article will now consider the auditor's responsibility in relation to ensuring all events occurring between the reporting date and the (expected) date of the auditor's report have been adequately taken into consideration, and sufficient appropriate audit evidence has been gathered to achieve the objective. It is important that where students have studied Paper F3, *Financial Accounting*, knowledge of accounting standards such as IAS 10 is not set aside or forgotten when it comes to papers such as Paper F8, *Audit and Assurance*. There is a very close relationship between accounting standards and auditing standards.

ISA 560, *Subsequent Events* outlines the auditor's responsibility in relation to subsequent events. For the purposes of ISA 560, subsequent events are those events that occur between the reporting date and the date of approval of the financial statements and the signing of the auditor's report.

The overall objective of ISA 560 is to ensure the auditor performs audit procedures that are designed to obtain sufficient appropriate audit evidence to give reasonable assurance that all events up to the (expected) date of the auditor's report have been identified, properly accounted for/r disclosed in the financial statements.

ISA 560 also covers events that are discovered by the auditor after the date of the auditor's report but before the financial statements are issued.

Audit procedures
In Example 1 above, we identified that fraud and the legal proceedings were *adjusting* events that gave rise to an adjustment within the financial statements as at 30 September 2010. We also identified that the loss of the customer was also an adjusting event, but as the value of the receivable was considered immaterial, no adjustment was made to the financial statements. Let us expand on the requirement in Example 1 as follows:

Required:
(b) Describe the audit procedures that should be performed to obtain sufficient appropriate evidence that the subsequent events have been appropriately treated in the financial statements.

Answer:
Candidates who are faced with scenarios such as those in Example 1 should think about the information needed that would prompt an accountant or finance director to go back to the year-end and retrospectively amend the financial statements. You could interpret the question as asking 'what information would I need in real-life to justify a provision or disclosure within the financial statements before making such provision or disclosure?' Where candidates have studied Paper F3 and have knowledge of IAS 10, thinking about the provisions contained in this IAS 10 will often lead you into thinking about the audit evidence you would need to satisfy yourself that the requirements in IAS 10 have been met, as well as offering ideas as to how you would go about obtaining this evidence for the audit file.

Fraud
Fraud risk factors are covered in ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*. The fact that fraud has occurred at Gabriella Enterprises Co will increase the risk of material misstatement due to fraud.

The audit procedures to be performed to ensure the fraud has been correctly accounted for in the financial statements may include:
- Recalculation of the amounts involved.
- Discussions with management as to how such a fraud occurred and why it took six months' to discover the fraud (controls should prevent, detect and correct material misstatements on a timely basis).
- Establishing how the bookkeeper discovered the fraud and what controls (if any) contain weaknesses to allow the employee to commit the fraud.

Note that employee fraud usually involves the manipulation of controls, whereas management fraud often involves the overriding of controls.
- Performing substantive procedures on journal entries (particularly those close to, or at, the year-end).
- Confirming directly with suppliers the account activity for the period under audit.
- Reviewing the purchase invoices and being on alert for any 'doctored' or 'copy' invoices and making enquiries as to their authenticity.
- A review of human resources files for evidence of disciplinary proceedings taken against the employee. This will also confirm compliance with laws and regulations, particularly in relation to employment legislation and the withholding of monies.
- Testing of other controls to identify other weaknesses that may indicate employee or management fraud.
- Obtaining written representations from management concerning the fraud.
- Test checking after-date cash for evidence of reimbursements by the employee, such as the withheld wages/salaries by the entity.
- Discussions with the entity's legal advisers as to the possibility of reimbursement of the balance of the misappropriated funds.

Legal proceedings
- Obtaining a copy of the court order or other correspondence confirming the company has been found liable to pay compensation to its customer.
- Test checking after-date cash to confirm payment to the customer.
- Ensuring a provision has been recognised as opposed to disclosure as a contingent liability to meet the requirements in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.
- Ensuring the provision is reasonable in relation to the outcome of the court case.
- Obtaining written representation from management to confirm the treatment of the provision.

Loss of customer
- Discuss with management the reason for not adjusting the irrecoverable receivable.
- The auditors have already agreed this amount is immaterial to the financial statements, so this amount would be put on an 'audit error schedule'. Provided this amount remains immaterial at the completion stage, both individually and when aggregated with other misstatements, the auditor can still express an unmodified opinion.

Financial statements amended *after* the date of the auditor's report, but *before* the financial statements are issued.

Circumstances may arise when the auditor becomes aware of facts that may materially affect the financial statements and, in such situations, the auditor will consider whether the financial statements need amending. The auditor is required to discuss with management how they intend to deal with events that will require the financial statements to be amended after the auditors have signed their report, but before the financial statements are issued.

Where the financial statements are amended, the auditor is required to carry out necessary audit procedures in light of the circumstances giving rise to the amendment. The auditor will also be required to issue a new auditor's report on the amended financial statements and, therefore, must extend their subsequent events testing up to the (expected) date of the new auditor's report. The revised auditor's report must not be dated any earlier than the date of the amended financial statements. In situations where management refuses to make amendments to the financial statements, the auditor must take all steps required to avoid reliance by third parties on the auditor's report. The auditor should also consider the need to resign from the audit.

Conclusion
Subsequent events are a key examinable area in auditing papers and it is crucial that students have an understanding of the types of audit evidence that the auditor should obtain to confirm that the accounting and disclosure requirements (particularly in IAS 10) have been applied correctly within the financial statements.

Candidates who simply write 'obtain a management representation' cannot expect to pass a question on subsequent events because written representations, on their own, are not a substitute for alternative audit evidence. Where candidates have knowledge of IAS 10 through studying Paper F3, you should not be afraid to think about the accounting requirements in order to help you consider how you will obtain sufficient appropriate audit evidence to achieve the auditing objectives. However, sticking to the question requirement is vital. If you are asked about the types of procedure(s) you should perform in determining whether the accounting treatment has been correctly applied, this is exactly what you must do.

Candidates should take care not to digress into irrelevant areas by writing everything they know about IAS 10, and instead should just answer the question set by the examiner.

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Reference
1. IAS 10, *Events After the Reporting Date*, Paragraph 3.