case study 1.1 solution

Telecom Corporation of New Zealand Limited Auditors’ Report 2013

The following extract is taken from the Telecom Corporation of New Zealand Limited (Telecom NZ) Annual Report for the year ended 30 June 2013 (p. 69).



Questions

1 Does Telecom NZ provide a complete set of financial statements as required by NZ IAS 1?

NZ IAS 1.10: A complete set of financial statements comprises:

(a) a statement of financial position (Balance Sheet) as at the end of the period

(b) a statement of comprehensive income (Income Statement) for the period

(c) a statement of changes in equity for the period

(d) a statement of cash flows (Cash Flow Statement) for the period

(e) notes, comprising a summary of significant accounting policies and other explanatory information

(f) a statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively, or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

An entity may use titles for the statements other than those used in this standard.

The auditors assure that Telecom NZ provided:

• an income statement (fulfils (b) in the above list)

• a statement of changes in equity (fulfils (c) in the above list)

• a balance sheet (fulfils (a) in the above list)

• a cash flow statement (fulfils (d) in the above list)

• the notes (fulfils (e) in the above list).

We do not know from the information provided if Telecom NZ has applied an accounting policy retrospectively, or has made a retrospective restatement of items in its financial statements, or has reclassified items in its financial statements, hence is required to provide a comparative statement of financial position (balance sheet) as stipulated in NZ IAS 1.10 (f). We can therefore assume that they provide a complete set of financial statements as required by NZ IAS 1.

2 The auditors state that the financial statements provide information about the financial performance and financial position of the company and group. What is the difference between ‘company’ and ‘group’?

The group (here, Telecom NZ) refers to the aggregate (or consolidated) financial reports for the economic entity, being comprised of the parent or holding company, and all the subsidiary companies to which it is directly or indirectly connected. Subsidiary companies are those companies over which it has management control (normally through the ownership of the majority of voting shares). The company (here, Telecom Corporation of New Zealand Limited), refers to the legal accounts of the parent or holding company as a single entity.

3 The directors of Telecom Corporation of New Zealand Limited are responsible for the preparation of financial statements that give a true and fair view of the financial position of the company and group. How can ‘true’ and ‘fair’ be assessed in this context?

‘True’ and ‘fair’ have not been clearly defined, nor have these terms been tested in court. True and fair are normally closely linked with the provision of all material financial information that is necessary to facilitate the decision’s usefulness (in the allocation of scarce resources) and the accountability (stewardship) roles of accounting. It can also be linked with preparing financial statements to conform with the accounting standards and other generally accepted accounting principles. Today, these other accepted accounting principles are largely represented by the *New Zealand Equivalent to the IASB Framework for the Preparation and Presentation of Financial Statements (NZ Framework)*.

4 Give examples of the ‘estimates’ and ‘judgements’ directors have to assume in the preparation of the financial statements.

There are a multitude of incomplete transactions at the arbitrary end of each accounting period. The majority of these relate to:

• revenues and assets (uncollected credit sales, sales returns and allowances, constructions in progress)

• revenues and liabilities (unearned revenues, deposits received in advance)

• expenses and assets (depreciable assets, deferred expenses, prepayments, impaired assets, amortisation of identifiable intangibles)

• expenses and liabilities (accrued expenses, provisions for warranty).

Management are required to make estimates and judgements in relation to many incomplete transactions. Examples are:

• accounts receivable – the estimated amount for sales returns, early settlement discounts, warranty claims and bad debts

• inventory – the estimated losses through theft, damage and economic obsolescence

• Plant and equipment – the estimated fair value, useful life, pattern of consumption and residual value

• investments – the estimated fair value

• identifiable intangibles – the estimated recoverable amount, pattern of consumption, useful life and residual value

• goodwill – the estimated recoverable amount

• provision accounts (warranty, long-service leave, holiday pay) – the estimated amount and timing of the outlays.

5 The auditors seek reasonable assurance that the financial statements are free from material misstatements, whether caused by fraud or error. How can materiality be reasonably defined in this context?

Materiality is largely defined in terms of whether the information would impact on decision making related to the allocation of scarce resources, or the assessment of compliance with professional, industry and statutory requirements. If the inclusion or exclusion, misstatement, or non-disclosure will impact on the users’ assessment of the above, then it is said to be material.

6 What is the ‘New Zealand generally accepted accounting practice’ the auditors refer to in their unqualified opinion?

Accounting pronouncements issued by the New Zealand Institute of Chartered Accountants (NZICA) consist of:

• financial reporting standards

• statements of standard accounting practice

• guidance notes

• technical practice aids.

These accounting pronouncements represent Generally Accepted Accounting Practice (GAAP). In New Zealand, companies, issuers, most categories of public sector entities, and producer boards are required under legislation to comply with GAAP in the presentation of their external financial reports. In addition, NZICA requires members who are involved in preparing or reporting on the financial reports of entities to make best efforts to ensure that such financial reports comply with GAAP and to report any non-compliance if they do not.

Financial reporting standards are accounting pronouncements which have the greatest authority. Statements of standard accounting practice are older accounting standards that are yet to be revised to become financial reporting standards. Other accounting pronouncements have lower authority but are still authoritative as they will either provide interpretative guidance in applying the requirements of a financial reporting standard or will cover an area of financial reporting not covered by a financial reporting standard.

7 Why does New Zealand legislation require the independent audit of financial statements?

The New Zealand *Companies Act 1993* requires an independent financial audit to ensure an enhanced accuracy of the financial reporting process. An audit of financial statements is the review of the financial statements of a company or any other legal entity (including governments), resulting in the publication of an independent opinion on whether those financial statements are relevant, accurate, complete and fairly presented. Financial audits are typically performed by firms of practicing accountants due to the specialist financial reporting knowledge they require. The financial audit is one of many assurance or attestation functions provided by accounting and auditing firms, whereby the firm provides an independent opinion on published information.

Financial audits exist to add credibility to the implied assertion by an organisation’s management that its financial statements fairly represent the organisation’s position and performance to the firm’s stakeholders. The principal stakeholders of a company are typically its shareholders, but other parties such as the Inland Revenue Department (IRD), banks, regulatory agencies, suppliers, customers, and employees may also have an interest in ensuring that the financial statements are accurate.

8 Discuss whether the justification the auditors provide for their independence is sufficient.

KPMG, Telecom NZ’s elected auditor, has made the statement that ‘other than in our capacity as auditors we have no relationship with nor interest in the company. Partners and employees of our firm may also deal with the company and group on normal terms within the ordinary course of trading activities of the business of the company and group. These matters have not impaired our independence as auditors of the company and group.’ This has been a point of contention as proving audit independence can be difficult as there, as stated, may be relations between auditors and the organisation given the service Telecom provides. Students should critique the value of this independence in the light of recent corporate collapses (both within and external to New Zealand) and the role that the auditor had in relation to this.

9 What are the ‘New Zealand Auditing Standards’ the auditors’ reports are based on, and who is responsible for setting such standards?

New Zealand Auditing Standards refer to the International Standards on Auditing (New Zealand) (ISAs (NZ)), which are adapted from the International Standards on Auditing and house a set of standards that guide the audit process. This is coupled with a professional code of ethics. The New Zealand Institute of Chartered Accountants, through the Professional Standards Board, take responsibility for the implementation, review and development of these standards.

10 The auditors examined the amounts and disclosures in the financial statements only ‘on a test basis’. Do you believe that this method is sufficient?

It is important that the independent audit team collects sufficient and appropriate audit evidence to provide a valid audit opinion of the organisation. Audit evidence is the information used by the auditor in arriving at the conclusions on which the auditor’s opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. For purposes of the ISAs (NZ):

(a) 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.

(b) 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 risk – The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.

Misstatement – A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. Where the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor’s judgement, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

Detection risk – The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.