

The Independent Review



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FOREWORD

On 1 April 2011 the Companies Act, No. 71 of 2008 (Act) will replace both the Companies Act of 1973 and Corporate Laws Amendment Act No 24 of 2006. In terms of this new Act all Public and State Owned must be audited. All other companies may be audited if, by regulations, it is desirable in the public interest to do so.

A company is exempted from any audit or independent review if it is owner managed (in other words if all the shareholders are directors and vice versa), and fails the Public Interest Test. A company can be voluntarily audited at the option of the company. All other companies must have an independent review, the nature, form and content will be governed by ISRE 2400 - Engagements to review financial statements. The purpose of this International Standard on Review Engagements (ISRE) is to establish standards and provide guidance on the practitioner's professional responsibilities when a practitioner, who is not the auditor of an entity, undertakes an engagement to review financial statements and on the form and content of the report that the practitioner issues in connection with such a review.

What is an Independent Review?

A review is an alternative assurance service situated in-between an audit and a compilation engagement. Moderate assurance is situated in-between reasonable assurance (derived from a higher investigative intensity audit), and no assurance, provided by a compilation engagement.

The level of assurance provided by a review is lower than an audit, so less work is required and less cost is incurred. However, less work obviously increases the risk of material misstatement, including undetected fraud, management bias, mistakes, omissions and incorrect disclosures. This risk factor is communicated to users of the financial statements through a negative assurance report as compared to the positive opinion provided in an audit.

In contrast to audits, where a reasonable level of assurance that the information subject to audit is free of material misstatement is provided, a review engagement provides a moderate level of assurance that the information subject to review is free of material misstatement.

In contrast to the objective of an audit of financial statements, which is to enable the auditor to express an opinion as to whether the financial statements have been prepared, in all material respects, in accordance with an applicable financial reporting framework, the objective of a review of financial statements is to enable a practitioner to reach a conclusion as to whether, on the basis of the performance of procedures which do not provide all the evidence that would be required in performing an audit, anything has come to the practitioner's attention that causes the practitioner to believe that the financial statements have not been



prepared, in all material respects, in accordance with an applicable financial reporting framework. In other words, the practitioner is required to give negative assurance.

The work effort in a review engagement is limited to inquiry, analytical procedures and discussions related to the information that the client supplies. Consequently, a review does not require the gathering of supporting or independent evidence or an assessment of internal control.

Management's responses to inquiries are acceptable as long as they appear plausible in the circumstances. The word plausible is often defined in terms such as the information being credible, appearing worthy of belief, or seemingly or apparently valid, likely or acceptable.

When aspects of financial statements do not appear plausible, additional inquiries should be made, which could even include procedures that would normally be performed in an audit. However, the use of these procedures does not convert the engagement into an audit.

Who Qualifies as an Independent Reviewer?

A registered Auditor in Terms of the Auditing Professions Act or a person qualified to be appointed as Accounting Officer of a Close Corporation in terms of the Close Corporations Act 69 of 1984. Both these must be independent of the Companies they will independently review.

Which Companies will be subject to Independent Review?

In terms of the new Companies Act, Audit is necessary only for Companies which are considered to be in public interest to do so. Therefore, all Companies (other than Public Companies and State Owned Enterprises) will be subject to a Public Interest Test, through a Point Scoring System.

The Public Interest Test

The public interest test is divided into two categories.

- 1) The first category is for those private companies that have an internal full time employee preparing financial statements in terms of financial reporting standards. This company would have to attain 300 points before an audit would be needed in terms of law.
- 2) The second category is for those private companies whose financial statements are independently compiled and reported. Independently Compiled and Reported financial statements means that the annual financial statements are prepared by an independent accounting professional on the basis of the financial records provided by the company and in accordance relevant financial reporting standards. This company would have to attain 750 points before an audit would be needed in terms of law.

The public interest score would not count if the company holds assets in a fiduciary capacity for others with a R5mil value. This company would automatically need an audit without the need to calculate the public interest score.

The Point Scoring System

For a company to pass the Public Interest Test, various factors are taken into account and these are:

- 1) The number of Employees
- 2) The level of unsecured debt
- 3) The level of Turnover,
- 4) The number of shareholders, and
- 5) The value of Assets it holds in a Fiduciary capacity.

The formula for allocating points is as follows:

- One point for each employee
- One point for every R1m – outstanding unsecured debt
- One point for every R1m – turnover
- One point for every individual who, at the end of the financial year, is known by the company:

For a profit company:
to directly or indirectly have a beneficial interest in any of the company's issued securities; or,

For a non profit company:
to be a member of the company, or a member of an association that is a member of the company.

Example 1:

Would a private company with a turnover of R300 million, with Unsecured Debt of R100 million, 250 employees and 50 shareholders be considered to be a Public Interest Company and therefore needs to be audited?

Financial Statement Item	Amount	Points
Turnover	R300 million	300
Unsecured Debt	R100 million	100
Number of employees	250	250
Number of Beneficial Owners	50	50
TOTAL		700

If this private company commissioned an external service provider to prepare its financial statements, it will not be required to be audited, **all it needs is An Independent Review** as the number of points are below the 750 threshold.

However, if this private company prepares its own financial statements, it will need to be audited as it will have exceeded the 300 points required before it gets audited.

Example 2:

Would a company with a Turnover of R50 million, with 50 employees and 1 shareholder with no Unsecured Debt require to be audited? This company offers gym benefits and receives gym membership fees in advance. Total fees in advance is R7million.

Answer

Even though the number of points to be scored by the company is less than 300 points, this company will be subject to audit as it holds more than R5million in a fiduciary capacity.



Summary of Differences between an Audit and an Independent Review

	Audit	Independent Review
Level of assurance	High – Reasonable	Limited - Moderate
Subject matter of report	Financial Statements	Financial Statements
Nature of assurance	Reasonable Assurance - Opinion – “the financial statements present fairly...”	Moderate Assurance - Negative assurance – “Nothing came to our attention to indicate”
Distribution of report	No restriction	No restriction
Understanding the entity	In-depth understanding	General understanding
Internal control	Evaluation of internal of internal control required	No requirements
Nature of procedures	Extensive, highly reliable	Primarily analytical procedures and inquiries
Relative cost	Most expensive	Less expensive than audit
Accounting framework	IFRS	IFRS for SME
IFAC standards	ISA – International Standards on Auditing	ISRE 2400 – International Standards for Review Engagements
Practitioner Registered	Auditor	Practitioner who qualifies for duties of Accounting Officer
Professional liability	Can be sued if auditor fails the objective standard/test of what the reasonable auditor would have done.	Can be sued if auditor fails the objective standard/test of what the reasonable independent reviewer would have done.
Liability protection	Section 46 of Auditing Professions Act – Limiting liability to third parties Section 58 (2) of Auditing Professions Act – application of Apportionment of Damages Act to auditor’s contracts with their clients	None
Regulation	Regulated by IRBA	No regulatory body
Applicability	- All public and state owned companies must be audited and - All other companies that pass the public interest test or - All companies opting for a voluntary audit.	All non owner managed companies (where the shareholders are not the same as the directors) who fail the public interest test and do not opt for a voluntary audit.

Steps Involved in a Review

1. Client acceptance or continuance

Before accepting a review engagement, the independent professional accountant should be satisfied that:

1. the subject matter is within the professional expertise of independent professional accountants.
2. there are appropriate criteria against which the subject matter can be evaluated.

2. Engagement planning

Planning starts with a basic understanding of the entity and its operations. This provides the foundation for identifying where review procedures should be performed. However, the information obtained about the entity would normally be a lot less detailed than that required in an audit.

Planning Considerations

External factors - Industry trends, laws and regulations, reporting and accountability requirements, government policies, taxation requirements, availability of financing, the applicable financial reporting framework, environmental matters, etc.

Internal factors - Business plans, personnel and governance, material assets and liabilities, accounting systems, operating issues, legal agreements and contracts, financing, etc.

Major changes during the period - Operations, personnel, financing, control systems or accounting principles followed.

Recent financial results and unusual events - The most recent financial results (if available) and explanations of major variances. Any events that have occurred during the period such as fraud, a critical government inspection or a control systems breakdown that would have a bearing on the nature or extent of the review engagement procedures to be performed.

What review engagement procedures are required?

- Timing of procedures, including who will perform the work, when it will be performed and any assistance required from client personnel;
- Results of work in previous years (where applicable); and
- The nature and extent of work required based on factors such as materiality and other potential risk factors identified.

3. Nature of review procedures

A review emphasizes enquiries of management. The practitioner is entitled to accept the responses received so long as they appear plausible. As a result, such procedures are not sufficient to provide reasonable assurance that material errors or fraud have been detected.

Review procedures consist of:

Analytical procedures - These include comparing the current and prior period information and considering the reasonableness of financial and other inter-relationships. Explanations for unusual relationships and items would be obtained by directing inquiries to appropriate personnel.

Inquiries - These would include questions of management and other knowledgeable personnel about financial, operating, contractual and other information. The responses could be oral or take the form of listings (such as receivables, inventory and payables), schedules, reconciliations or other relevant documents such as agreements and contracts.

Discussion - This could involve meetings with appropriate officials of the entity concerning the information received and the information being reported on.

4. Where plausibility is in doubt

If the independent professional accountant doubts the plausibility of a representation made by management, the independent professional accountant should perform sufficient additional or more extensive procedures so as to resolve such doubt or to confirm that a reservation is required in his or her review engagement report.

5. Management representations

The independent professional accountant should obtain management's written representations regarding matters that are important to support the content of his or her report. The written representations should be addressed to the independent professional accountant and would usually be in the form of a letter that comprises management's representations on matters that are:

1. Directly related to items that are material, either individually or in the aggregate, to the financial statements.
2. Not directly related to items that are material to the financial statements but are significant, either individually or in the aggregate, to the engagement, including:
 - a) Management's acknowledgment of its responsibility for the fair presentation of the financial statements in accordance with generally accepted accounting principles, or a disclosed basis of accounting described in the notes to the financial statements.
 - b) Management's belief that the financial statements are complete and presented fairly in accordance with generally accepted accounting principles, or a disclosed basis of accounting described in the notes to the financial statement.
 - c) Management's acknowledgment of its responsibility for the design and implementation of internal control to prevent and detect fraud and error.
 - d) The completeness and availability of all financial records and related data.
 - e) The fullness of management's response to all enquiries made by the independent professional accountant.
 - f) The completeness and availability of all minutes of meetings of shareholders, directors, and committees of directors.

- g) Management's knowledge of any known or probable instances of non-compliance with legislative or regulatory requirements, including financial reporting requirements.
- h) Relevant to management's judgments or estimates that are, either individually or in the aggregate, material to the financial statements.

6. Documentation

All matters judged by the practitioner to be important to support the content of the review engagement report should be documented.

Supporting working papers would typically include:

- Client acceptance / continuance procedures, including the independence assessment;
- The engagement letter;
- Planning information such as an understanding of the entity, assessment of materiality and other specific areas to address;
- Planned review procedures to be undertaken and members of the engagement team;
- The nature and results of analytical procedures performed and the explanations provided for unusual relationships and items identified;
- Listings of the major assets and liabilities, supporting schedules and reconciliations provided by the entity or prepared by the engagement team;
- Results of reviewing other relevant documents, such as contracts or minutes of meetings;
- Responses to questions raised and any follow-up procedures required;
- Any significant or unusual matters considered and their disposition; and
- The management representation letter.

7. Reporting on results

The final steps in a review engagement are to:

- Review the information obtained (including the financial statements) to ensure it is sufficient (a response has been received for questions asked and the financial statement disclosures are complete) and has been appropriately documented;
- Ensure additional steps have been taken to resolve or confirm any matters where the plausibility of information received was in doubt; and
- Form an appropriate conclusion based on the results and the applicable financial reporting framework.

Conclusion

According to the International Framework for Assurance Engagements the objective of any assurance engagement, be it an audit or a review, is to enhance the degree of confidence users of financial statements have in the statements. Therefore all professionals involved in providing an independent review should understand the professional obligation they carry towards the users of these financial statements on behalf of the profession.





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