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Auditing of the Company Sigma after fundraising by issuing a synthetic financial instrument

A auditoria das demonstrações contábeis da Concessionária Sigma, após captação de recursos via instrumento financeiro sintético

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Keywords
Professional judgment of the auditor.
Professional skepticism.
Analysis of material misstatement.
Audit report.
Synthetic financial instrument.

Abstract

This teaching case presents a hypothetical situation of a highly leveraged public utility company in Brazil that needs to fulfill a contractual obligation to execute its capital budget – regulatory CAPEX[1].The company raises funds in the market through a tailor-made synthetic financial instrument and accounts for the transaction to avoid breaching covenants in debt contracts. At the time of the fundraising, the company is close to breaching its covenants. The independent auditor must perform professional judgments and apply the required auditing procedures, particularly regarding the assessment of inherent risk vis-à-vis the incentives from management to provide misleading information and assess the accounting policy that the management has created for the synthetic financial instrument. The auditor must work with skepticism and a questioning mindset to assure a faithful representation of accounting information.

[1]CAPEX, or "Capital Expenditure," are funds used to acquire and upgrade physical assets (infrastructure for public services) to ensure the company's capacity to provide services at a certain level and within a minimum quality standard, according to the sector regulator's requirements.

Palavras-chave
Julgamento profissional do auditor.
Ceticismo profissional.
Análise de distorção material.
Relatório de auditoria.
Instrumento financeiro sintético.

Resumo

O caso envolve uma situação hipotética de uma concessionária, que precisa cumprir com sua obrigação contratual de execução de seu orçamento de capital - CAPEX[2] regulatório, mas se encontra altamente endividada. Capta recursos no mercado por meio de um arranjo contratual sofisticado (um instrumento financeiro – IF sintético "tailor made") e contabiliza a transação de modo a evitar a quebra de "covenants" previstos em contratos de dívida. No momento da captação, a companhia encontra-se próxima do limite da quebra. O auditor independente precisa exercer uma série de julgamentos profissionais e adotar os procedimentos de auditoria requeridos. Em particular no tocante à avaliação de risco inerente vis-à-vis os incentivos da administração para informação enganosa e à avaliação da política contábil criada pela administração para o IF sintético, com ceticismo e mente questionadora, visando a assegurar uma representação fidedigna da informação contábil.

[2]*CAPEX – "Capital Expenditure" - são gastos (investimentos) a serem incorridos em bens de capital pela concessionária (infraestrutura de operação) de modo a assegurar a sua capacidade de prestar serviços no nível de oferta pré-estabelecida e dentro de um padrão de qualidade mínimo, conforme exigências do regulador setorial.*

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Pratical implications

The Sigma's case aims to develop the students' ability to judge (professional judgment of the independent auditor). It also explores auditor's attributes, such as skepticism and a questioning mindset. This case represents an exercise of professional judgment and an opportunity to apply the audit procedures required to assess inherent risk

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1 PROBLEM SITUATION AND OBJECTIVES OF THE AUDIT TEACHING CASE

The Sigma's case aims to develop the students' ability to judge (professional judgment of the independent auditor). It also explores auditor's attributes, such as skepticism and a questioning mindset.

This case represents an exercise of professional judgment and an opportunity to apply the audit procedures required to assess inherent risk (which is a component of audit risk), vis-à-vis incentives from the company's management for providing misleading information. It is also an opportunity to exercise audit procedures to assess the company's discretionary accounting policy, using skepticism and a questioning mindset to ensure a faithful representation of accounting information.

The teaching case presents a hypothetical situation of a public utility company (Sigma) in Brazil that, after raising funds in the market with a synthetic financial instrument in a complex contractual arrangement, develops its accounting policy to avoid breaching accounting covenants. Consequently, the company shows financial statements that are not a faithful representation of its economic reality.

At the end of the exercise proposed in this teaching case, the student will be able to understand the following themes:

1. Professional judgment of the auditor;

2. Professional skepticism;

3. Accounting presentation and disclosure with faithful representation;

4. Accounting treatment of a synthetic financial instrument;

5. Analysis of material misstatement in financial statements;

6. Issuance of an audit report with a modified opinion.

Before working on this case, students must learn the Brazilian standards set by the agency CPC (Comitê de Pronunciamentos Contábeis), and the International Standards on Auditing (ISAs) endorsed by the Brazilian Federal Accounting Council (CFC):

<u>Brazilian Accounting Standards set by CPC</u>

- CPC 18 – Investments in Associates, Subsidiaries, and Joint Ventures;

- CPC 23 – Accounting Policies, Change in Accounting Estimates and Error Correction, §§ 10-12;

- CPC 26 – Presentation of Financial Statements, §15;

- CPC 36 – Consolidated Statements;

- CPC 39 – Financial Instruments: Presentation, §§ 42, 49, and AG39;

- CPC 47 – Revenue from Contracts with Customers.

<u>International Standards on Auditing (ISAs) endorsed by CFC</u>

- NBC TA CONCEPTUAL STRUCTURE – Conceptual Framework for Assurance Engagements;

- NBC TA 315 (R1) – Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment;

- NBC TA 320 (R1) – Materiality in Planning and Performing an Audit;

- NBC TA 450 (R1) – Evaluation of Misstatements Identified during the Audit;

- NBC TA 700 – Forming an Opinion and Reporting on Financial Statements;

- NBC TA 701 – Communicating Key Audit Matters in the Independent Auditor's Report;

- NBC TA 705 – Modifications to the Opinion in the Independent Auditor's Report.

2 DESCRIPTION OF THE TEACHING CASE

2.1 Context

The professional in charge of an auditing process is planning the next job for a client, a company – Sigma – that controls a subsidiary engaged in an economic activity subject to government concession. This subsidiary is a public utility company offering essential services in infrastructure, adopting the legal form of special-purpose entity (SPE).

The SPE's business comprises building an infrastructure to provide public services, operate it, and perform periodic maintenance. At the end of the concession, the SPE must return the infrastructure to the granting authority in adequate operating conditions. The revenues come from fees charged to users and are recognized based on CPC 47 and the Interpretation of the CPC (ICPC) 01.

According to the pronouncement "Revenue from Contracts with Customers" (CPC 47) , the process the company uses to recognize revenues involves five critical steps, namely:

1) **Identify the contract with the customer** (§§ 9-21 of CPC 47), which implies verifying the existence of coercively enforceable rights and obligations to be fulfilled, with the possibility of combining contracts and contract modification. Contracts can be written, verbal, or implicit by the entity's usual business practices;

2) **Identify the performance obligations in the contract** (§§ 22-30 of CPC 47), which requires the separation of distinct goods and services in the contract. The distinction is an attribute that objectively shows the benefits a good or service provides, isolated or in combination with other resources, for the customer. The promise an entity makes of transferring a good or service to the customer is identifiable, separately, in the contract;

3) **Determine the transaction price** (§§ 46-72 of CPC 47), which involves evaluating the amount an entity expects to receive in exchange for goods or services. This evaluation must consider fixed and variable values established in the contract. Considerations about the agent and principal roles must be made since revenue is the resource the entity actually receives;

4) **Allocate the transaction price to the performance obligation in the contracts** (§§ 73-90 of CPC 47[1]), which is to be made on an individual price basis or by estimate. Variable discounts and payments must be submitted to the same allocation process;

5) **Recognize revenue when the entity satisfies a performance obligation** (§§ 31-45 of CPC 47), which can be observed either overtime or at a point in time.

The SPE has two performance obligations when recognizing revenues, namely: (a) obligation to build and promote improvements in the operations infrastructure (construction and upgrade) and (b) obligation to operate and periodically maintain the operating infrastructure (operation and maintenance).

As the endeavor analyzed refers to providing essential public service, the SPE has revenues based on users' fees, as established in the concession contract.

2.2 The concession contract

One of the concession contract items is to ensure the benefit and indiscriminate reach of public service users (principle of **universal service**) who, in exchange, must pay affordable fees (principle of **affordability**).

The SPE's parent company Sigma has to commit to expanding the service (expansion of infrastructure whenever necessary, following regulatory CAPEX[2]), observing the contract, and the quality standards required by the granting authority (principle of **service efficiency**).

[1]An updated version may be retrieved from the CPC's website: http://static.cpc.aatb.com.br/Documentos/527_CPC_47_Rev%2014.pdf

[2]CAPEX, or "Capital Expenditure," are funds used to acquire and upgrade physical assets (infrastructure for public services) to ensure the company's capacity to provide services at a certain level and within a minimum quality standard, according to the sector regulator's requirements.

According to the concession contract, the SPE is entitled to charge a fee to preserve its economic and financial balance while providing the public service. The contract considers the need for periodic review of fees when unmanageable costs are observed (due to exogenous events that the companies cannot control). Also, it allows a review of fees to update the weighted average cost of capital (market interest rate) and to incorporate the inflation in the fees charged.

A periodic review of fees is not applied when management **inefficiencies** are observed. This is the case, for example, with increases observed in manageable costs (events under the control of the company's management), which are not covered by periodic review of fees.

2.3 The Company's management of manageable costs

In the past few years, the controlling company (Sigma) has presented a high deficit in a post-employment benefits plan. It is a defined-benefit plan (DBP) that incorporates salary increases to active employees as part of the benefits and covers corporate health plan costs. The DBP is multi-sponsored and serves all the company's subsidiaries.

Sigma's management has been very generous with employees, recently offering several salary increases and career restructuring plans. Compared to competitors in the sector, Sigma's employees' salaries are 40% above the market average.

Sigma's management adopts a regular practice of hiring contractors to carry out construction works to improve operations infrastructure. These contracts have not been signed within the best market practices. It is possible to observe frequent CAPEX overruns from contractors, who transfer these costs to the prices Sigma is paying, i.e., the contractors' inefficiencies are incorporated into the construction cost.

Sigma has demonstrated severe deficiencies regarding governance, which explain the lack of alignment between management and the shareholders' best interests.

2.4 Planning the audit for the current fiscal year

In the auditing planning phase, the professional responsible for the process requested documents such as previous years' financial statements, main contracts signed (including the concession contract), and minutes of meetings (board of directors, executive committee, shareholders, debenture holders). Procedures of the analytical review were carried out to assess inherent risk, and interviews with the management of the parent company (Sigma) were conducted.

The professional planning the audit evaluated Sigma's organizational culture, control environment, ethical values, and management's integrity, concluding that the company presented a low level of governance. The main routine and non-routine accounting data were analyzed, and internal controls in the assessment of **control risk** were tested. The analysis of the fraud triangle (pressure or incentive to commit fraud, rationalization justifying dishonesty, and opportunity or ability to commit fraud) suggested a potential risk of misleading.

The company's level of indebtedness has been rising every year. During the interviews with Sigma's management, the professional responsible for planning the audit found a CAPEX budgeted and approved for the current fiscal year to comply with the obligation to expand the service offer. Due to the concession contract, compliance with the CAPEX is mandatory and requires additional funds to be raised.

The analysis of debt contracts revealed **accounting covenants** preventing Sigma from exceeding the level of fixed indebtedness. It was also observed an unusual **non-accounting** covenant preventing Sigma from having an audit report with a modified opinion. The breach of any covenants implies the early maturity of debts.

Chart 1 below shows the debt covenant (**accounting covenant**), which applies to both the individual and consolidated balance sheets:

Current	Contractual limit
$\frac{Liability}{Equity} = 2.12$	$\frac{Liability}{Equity} < 2.8$

Chart 1. Accounting covenant

Source: prepared by the author

The person responsible for the audit concludes that the current year's audit will offer high professional risk. They downward adjust the **overall materiality**[3] (uncorrected or undetected misstatements that, in the aggregate, affect the financial report as a whole) and the **performance materiality**[4] (thresholds determined when auditing transactions, accounting items, balances, and disclosures).

In addition, considering Sigma's covenants, the professional in charge decided to adopt one more level of materiality applied to transactions, balances, and disclosures closely associated with the debt covenant. Therefore, the use of **specific materiality** was added to the work plan[5].

The person responsible for the audit also believes that potential tensions and conflicts may arise in the fieldwork because of the **unusual non-accounting** covenant. Therefore, they allocate highly experienced auditors for the job, which increases the audit cost but helps to reduce professional risks.

All decisions, analyses, and red flags are duly documented in the working papers for the field team's knowledge.

2.5 Sigma's fundraising in the audited fiscal year by issuing a synthetic financial instrument

Sigma's management raised funds to execute its budgeted regulatory CAPEX in the fiscal year audited, using a highly sophisticated contractual arrangement involving an equity fund. The only shareholder of this equity fund is a bank.

According to the contract, Sigma offered 20% of its shares in the SPE to the equity fund. In addition, the equity fund and Sigma sign two swap contracts agreeing to a future sale, in the market, of the 20% of the SPE acquired by the equity fund. The contract establishes that Sigma will compensate the equity fund if this future sale results in a loss and that Sigma and the equity fund will share the returns if the sale results in profit.

The transaction where Sigma sells part of its shares in the SPE to the equity fund is made at a profit and is paid in cash at the equity interest's fair value. Thus, Sigma applies market participant assumptions to determine the sale transaction price, in line with CPC 46.

Sigma's operation income tax effect is null since the capital gain from the sale of its shares is offset by tax loss carryforward and unused negative bases of CSLL (social contribution on net profits, a Brazilian federal tax), both arising from **non-operating** earnings.

In turn, the equity fund intends to maintain the equity interest acquired in its portfolio for five years, after which it will place it on the market. If the sale in the market does not achieve the price established in the contract – the purchase price adjusted by the variation of the Brazilian CDI rate (interbank deposit certificates) of 4% p.a., plus a spread of 6% p.a. to offset Sigma's credit risk, discounting dividends received – Sigma must return the difference to the equity fund. This event will trigger a contractual swap. On the other hand, if the sale in the market results in returns superior to the price established in the contract, the profit will be shared between Sigma and the equity fund. This event will trigger another contractual swap.

Figure 1 below illustrates the transaction.

[3]NBC-TA320.10. When establishing the overall audit strategy, the auditor shall determine **materiality** for the **entire** financial report.

[4]NBC-TA320.11. The auditor shall determine the **performance materiality** for purposes of assessing the risks of material misstatement and to determining the nature, timing, and extent of additional audit procedures.

[5]NBC-TA320.10. If, in the specific circumstances of the entity, there is one or more specific classes of transactions, account balances or disclosure for which misstatements of **lesser amounts than materiality** for the entire financial report could reasonably be expected to influence the economic decisions of users taken on the basis of the financial report, the auditor shall also determine the **materiality level or levels** to be applied to these **specific classes** of transactions, account balances, and disclosures.

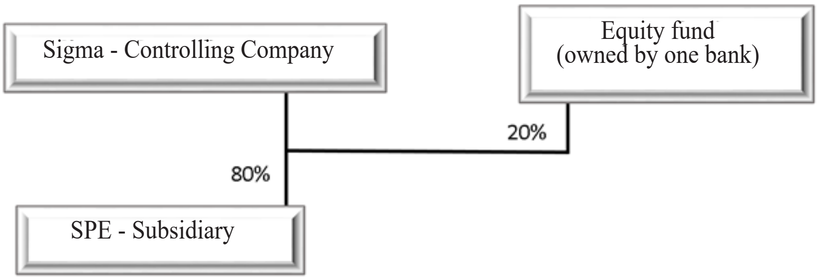


Figure 1. Contractual arrangement to raise funds via equity fund issuing a synthetic financial instrument
Source: prepared bu the author

2.6 Request of working paper prepared by the client

The person responsible for the audit asks the client to prepare a working paper to understand the transaction better. In this document, the client is requested to disclose financial statements and individual and consolidated balance sheets of the companies involved prior and after the effects of the transaction, following the accounting treatment provided by management.

The company's management establishes its own accounting policy to recognize the transaction given the lack of a specific provision in CPC 39 and 48. According to Sigma's management, this is a very specific transaction requiring a particular treatment to represent the economic reality faithfully.

Chart 2 shows the companies' equity (Sigma and its subsidiary SPE) before recognizing the transaction with the equity fund.

	Sigma	SPE	Debt	Credit	Consolidated
Cash	525,00	120,00			645,00
Fixed assets		350,00			350,00
Other assets	1.220,00	-			1.220,00
Investment SPE	470,00			470,00	-
Total	2.215,00	470,00			2.215,00
Post-Employment Benefit	855,00				855,00
Loans and financing	650,00				650,00
Equity					
Capital	710,00	470,00	470,00		710,00
Retained Earnings	-	-			-
Total	2.215,00	470,00	470,00	470,00	2.215,00
	-	-	-	-	-

	Covenant
Indiv. FS	2,12
Consol. FS	2,12

Chart 2. Balance sheets before the transaction with the equity fund
Source: prepared by the author

Chart 3 presents the companies' equity after recognizing the transaction with the equity fund.

	Sigma	SPE	Debt	Credit	Consolidated
Cash	644,10	172,88			816,98
Fixed assets	-	350,00	-		350,00
Other assets	1.220,00	-		-	1.220,00
Investment SPE	418,30	-		418,30	-
Total	2.282,40	522,88			2.386,98
Post-Employment Benefit	945,00				945,00
Loans and financing	702,00				702,00
Equity					-
Capital	710,00	470,00	470,00		710,00
Retained Earnings	- 74,60	52,88	52,88		- 74,60
Non-controlling interests				104,58	104,58
Total	2.282,40	522,88	522,88	522,88	2.386,98
	-	-	-	-	-

	Covenant
Indiv. FS	2,59
Consol. FS	2,59

Income Statement:	Sigma	SPE	Debt	Credit	Consolidated
Operations profit		70,50			70,50
Other revenues					-
Gain on disposal	11,00				11,00
Share of results of SPE	56,40		56,40		-
Expenses with interest	- 52,00				- 52,00
Post employment expenses	- 90,00				- 90,00
Profit before tax	- 74,60	70,50			- 60,50
Profit before tax - Equity fund interest					- 14,10
Profit before tax - Parent interest					- 74,60

Chart 3. Balance sheets and income statements after the transaction with the equity fund, at the end of the fiscal year
Source: prepared by the author

The events analyzed in the audit and occurred in the fiscal year are listed below:

a) A gain on disposal of $11 was recognized as a result of the sale of 20% of Sigma's shares of the SPE to the equity fund, at the fair value of $105;

b) The carrying amount basis of the SPE investment was partially written off in Sigma's balance sheet, representing $94 (20% of the equity method value);

c) The profit calculated on the SPE's operations was recognized. In order to simplify the exercise in this teaching case, the profit of $70.50 was realized in cash;

d) The distribution of 25% of the SPE's profit as dividends ($17.63) was registered;

e) The equity method result was recognized in the parent company's balance sheet, applying the due 80% on the profit obtained in the operations;

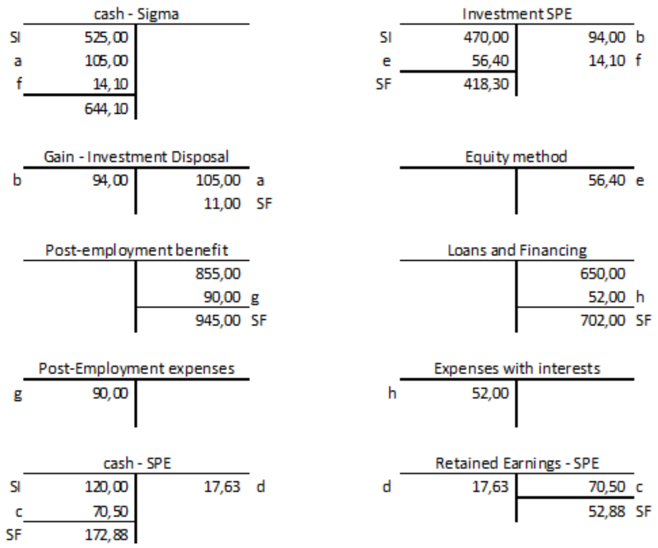
f) The dividends Sigma duly received were recognized. They summed $14.10 (80% of $17.63);

g) The current service cost of the post-employment benefits liability of $90 was recognized in the parent company Sigma;

h) Interest on loans and financing were recognized in the parent company, in the amount of $52 (rate of 8% per month);

i) To simplify the teaching case, tax effects and tax bookkeeping were ignored (e-Lalur – electronic book of taxable income; and e-Lacs – electronic book of CSLL)

The explanatory ledgers are presented below.



3 GUIDELINES FOR STUDENTS TO WORK ON THE TEACHING CASE

Based on the information above, the student is expected to meet the following requirements:

1) In the performance of your duties as an auditor, you shall exercise your judgment and conclude whether the synthetic financial instrument was recognized, evaluated, and presented appropriately to reflect a faithful representation of the economic reality.

2) When performing your duties as an auditor, you shall check whether there is a need to apply CPC 39 to the synthetic financial instrument issued and, if applicable, what would be the appropriate way to recognize the transaction, considering its economic essence. You shall develop an accounting policy and compare it with the policy adopted by the company's management.

3) After proceeding with the requirements above, you shall prepare the audit working paper summarizing the unadjusted misstatements.

4) After preparing the summary of unadjusted misstatements and observing the materialities defined in the stage of planning the audit, you shall assess – in case the transaction with the issuance of a synthetic financial instrument reveals material misstatements and adjustments are needed – what will be the decision in the audit report if the company's management decides not to adjust its financial statements.

5) The materialities defined when planning the audit are presented in Chart 4:

Information:	
Overall materiality – OM (2.5% company's net equ	17,75
Performance materiality – PM (50% of the PM)	8,88
Specific materiality – SM (0,5% of total liability)	7,53

Chart 4. Materialities
Source: prepared by the author

4 TEACHING NOTES

The following teaching notes must be of exclusive access to instructors. Their purpose is to guide the discussion with the students and stimulate debates based on auditing standards and procedures that shall be explored didactically. The aim is to facilitate the learning process, and the understanding of the concepts applied.

4.1 Data source

The case was developed and adapted from a concrete situation observed in the Brazilian capital market.

4.2 Recommended use

The case was developed to help instructors to teach the application of auditing standards and procedures. It emphasizes the themes explored and listed in the section Problem Situation and Objectives of the Audit Teaching Case. The main objective is to develop students' skepticism and their ability to make judgments.

Before introducing the teaching case, instructors must make sure that students read the work "Elevating Professional Judgment in Auditing and Accounting: The KPMG Professional Judgment Framework." This study is available on the platform Researchgate[6]: https://www.researchgate.net/publication/258340692_Elevating_Professional_Judgment_in_Auditing_and_Accounting_The_KPMG_Professional_Judgment_Framework

Students are also required to read the *Normas de Auditoria Independente de Informação Contábil Histórica* (standards of independent auditing of historical accounting information), which mirrors the International Standards on Auditing (ISAs), issued by The International Auditing and Assurance Standards Board (IAASB). Chart 5 lists these standards, retrieved from the Brazilian Federal Accounting Council's website:

Norm	Subject	Link
NBC TA CONCEPTUAL STRUCTURE	Conceptual Framework for Assurance Engagements	https://www1.cfc.org.br/sisweb/SRE/docs/NBCTAESTRUTURACONCEITUAL.pdf
NBC TA 315 (R1)	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment	https://www1.cfc.org.br/sisweb/SRE/docs/NBCTA315(R1).pdf
NBC TA 320 (R1)	Materiality in Planning and Performing an Audit	https://www1.cfc.org.br/sisweb/SRE/docs/NBCTA320(R1).pdf
NBC TA 450 (R1)	Evaluation of Misstatements Identified during the Audit	https://www1.cfc.org.br/sisweb/SRE/docs/NBCTA450(R1).pdf
NBC TA 700	Forming an Opinion and Reporting on Financial Statements	https://www1.cfc.org.br/sisweb/SRE/docs/NBCTA700.pdf
NBC TA 701	Communicating Key Audit Matters in the Independent Auditor's Report	https://www1.cfc.org.br/sisweb/SRE/docs/NBCTA701.pdf
NBC TA 705	Modifications to the Opinion in the Independent Auditor's Report	https://www1.cfc.org.br/sisweb/SRE/docs/NBCTA705.pdf

Chart 5. Standards adopted in this teaching case
Source: prepared by the author

4.3 Suggestions of questions to help instructors to stimulate the debate and guide the solution of the case

I - Questions related to the conceptual framework for assurance engagements:

Q1.Considering the rule NBC TA Conceptual Framework, §§ 51-55 (skepticism) and §§ 56-60 (professional judgment), what attitude should you adopt as a company auditor in obtaining audit evidence?

II - Questions related to Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment – NBC TA 315 (R1)

Q2. As the auditor, are you convinced that the company management's accounting policy to account, evaluate, and present the synthetic financial instrument is a faithful representation of the economic reality? Please answer this question considering the NBC TA 315 (R1), §11 "c," and the information in the Application Guideline §A36. Also, observe the conceptual framework for financial reporting, §§2.12-2.19 and CPC 26, §15.

[6]Alternatively, a professional judgment toolkit can be retrieved from Beasley, Mark S. *et al*. (2015), pp. 1-8, mentioned at the end of this teaching case as suggested reading.

Q3. As the auditor, should you challenge the company's management to convince you of the accounting policy adopted? What is the economic essence of the transaction? Develop your own accounting policy, considering the CPC 39, §49 "a," and compare the results with those obtained by the company's management.

Q4. Would the fact that the company is at the point of breaching its debt covenants and its management is under pressure be elements to consider when assessing the risk of material misstatement? As the auditor, should you demand from the management the disclosure of these facts? Answer this question considering the NBC TA 315 (R1), in Application Guideline §A135.

III – Questions related to materiality in planning and performing an audit – NBC TA 320 (R1)

Q5. As the auditor, when assessing the issue of covenants, indebtedness level, and the pressure to which management is subject, do you consider it appropriate to establish a specific materiality level for liabilities? Please answer this question considering the NBC TA 320 (R1), §10, and the Application Guideline §A11.

IV – Questions related to the evaluation of misstatements identified during the audit – NBC TA 450 (R1)

Q6. As the auditor, do you consider it appropriate to report misstatements deemed clearly trivial to the Fiscal Council? Should you put them together with other misstatements to offer a global assessment? Please answer this question considering the NBC TA 450 (R1), §§5, 8, 10-11, 15, and its Application Guidelines.

V – Questions related to forming an opinion and reporting on financial statements – NBC TA 700:

Q7. In your process of forming an opinion as auditor, do you think the company management's financial statements recognizing the transaction issuing the synthetic financial instrument are free from judgment bias? Please answer this question considering the NBC TA 700, §12.

Q8. As the auditor, would you issue a report expressing an unmodified opinion? Why? Please answer this question considering the NBC TA 700, §§16-19, and its Application Guidelines.

VI – Questions related to communicating key audit matters in the independent auditor's report – NBC TA 701

Q9. As the auditor, should accounting and non-accounting covenants included in debt contracts be disclosed in the audit report as a key audit matter? Please answer this question considering the NBC TA 701, §§9-17, and its Application Guideline.

Q10. As the auditor, do you understand that the transaction issuing the synthetic financial instrument should be disclosed in the audit report as a key audit matter? Please answer this question considering the NBC TA 701, §§9-17, and its Application Guideline.

VII – Questions related to modifications to the opinion in the independent auditor's report – NBC TA 705

Q11. As the auditor, when assessing material misstatements that have not been corrected by management, should you issue an audit report with a qualified opinion? Please answer this question considering the NBC TA 705, §§7-10, and its Application Guidelines.

Q12. As the auditor, when assessing material misstatements not corrected by management, should you issue an audit report with an adverse opinion? Please answer this question considering the NBC TA 705, §§7-10, and its Application Guidelines.

Q13. As the auditor, when assessing material misstatements not corrected by management, should you issue an audit report with a disclaimer of opinion? Please answer this question considering the NBC TA 705, §§7-10, and its Application Guidelines.

4.4 Case analysis and solution

The fundraising operation was formally recognized in Sigma's financial statements as partial disposal of an investment.

The faithful representation of the contractual arrangement indicates a financing transaction with an asset pledged as collateral (in this case, 20% equity interest of the SPE). First, this occurs because Sigma has continuous involvement, substantial risk retention, and benefits associated with holding shares of the SPE. These benefits are the dividends the SPE distributes – which are deducted from the interest the equity fund charges from Sigma – and the profit Sigma may share with the equity fund in the future sale of the SPE's equity interest. Second, the only risk the equity fund is exposed to is Sigma's credit risk (reflected in the spread practiced). The equity fund guarantee is, in this case, the 20% equity interest of the SPE, destined to be sold in the market in five years.

The specific case involves the accounting of a synthetic financial instrument , and its accounting treatment must comply with the CPC 39:

1. The offset presentation (CPC 39, §42) of the different effects generated by financial instruments that make up the synthetic financial instrument is usually inadequate (CPC 39, §49).

2. Because the parent company – Sigma – is exposed to various risk factors generated by the financial instruments that make up the synthetic financial instrument, these risks must be measured, recognized, and presented separately in the financial statements

There is, objectively, significant misstatement of economic reality. The following points in the audit's working papers stand out:

(i) The parent company (Sigma) fails to appropriately recognize the equity method result and equity interest held;

(ii) Sigma did not recognize the liability synthetic financial instrument[7] and its financial expense in the income statement. The parent company also did not recognize other financial instruments established in the contractual arrangement

(iii) Sigma unduly recognizes the gain or loss on disposal, with a future sale of 20% of the SPE's equity interest. Strictly speaking, what essentially is a loan, with 20% of the equity interest in the SPE put as collateral;

(iv) The accounting covenant is breached (which is the raison d'être of the operation). This implies in early maturity of debts with creditors.

(v) The non-accounting covenant – audit report with a modified opinion – may aggravate the company's situation with creditors.

Chart 6 shows the equity configuration, after recognizing the transaction with the equity fund, complying with the CPC 39, and reflecting a faithful representation of the economic reality, according to the auditors' understanding (working papers).

	Sigma	SPE	Debt	Credit	Consolidated
Cash	644,10	172,88			816,98
Asset swap	0,04				0,04
Fixed assets	-	350,00			350,00
Other assets	1.220,00	-			1.220,00
Investment SPE	522,88			522,88	-
Total	2.387,01	522,88			2.387,01
Liability swap	0,04				0,04
Syntetic financial instrument	115,50				115,50
Post-Employment Benefit	945,00				945,00
Loans and financing	702,00				702,00
Equity					
Capital	710,00	470,00	470,00		710,00
Retained Earnings	- 85,53	52,88	52,88		- 85,53
Total	2.387,01	522,88	522,88	522,88	2.387,01
	-	-	-	-	-

	Covenant
Indiv. FS	2,82
Consol. FS	2,82

Income statement	Sigma	SPE	Debt	Credit	Consolidated
Operations profit		70,50	3,53		66,98
Share of results of SPE	66,98		66,98		-
Expenses with interests	- 52,00				- 52,00
Post-Employment expenses	- 90,00				- 90,00
Interest - synthetic financial	- 10,50				- 10,50
FV liability swap	- 0,04				- 0,04
FV asset swap	0,04				0,04
Profit before tax	- 85,53	70,50			- 85,53

Chart 6. Balance sheets and income statements after the transaction with the equity fund, at the end of the fiscal year, according to the auditors' working papers
Source: prepared by the author

[7]When several different financial instruments are used to simulate the characteristics of a single financial instrument, they give rise to synthetic financial instruments (CPC 39, §49 "a").

The events occurred in the fiscal year (informed above in this teaching case) received the following accounting treatment in order to comply with CPC 39 and offer a faithful representation of the economic reality:

a) A loan in the amount of $105 was recognized in the parent company, according to the synthetic financial instrument contracted;

b) A profit of $70.50 was recognized in the subsidiary, which, for the simplification of this exercise, was paid in cash;

c) The distribution of 25% of the subsidiary's profit in dividends was recognized ($17.63);

d) The result of the equity method was recognized in the parent company, applying the percentage held of 100% on the profit obtained in the operations, in the amount of $70.50;

e) The amount of $17.63 (100%) was recognized in the parent company, regarding dividends received;

f) The gross debt charge with synthetic financial instrument (20% of the subsidiary's profit), in the amount of $14.10, was recognized in the parent company;

g) The cost of the current service of the post-employment benefit liability, in the amount of $90, was recognized in Sigma;

h) Interest on loans and financing, in the amount of $52, (rate of 8% p.m.) was recognized in Sigma;

i) Adjustment of the synthetic financial instrument's debt charge, in the amount of $3.53 (20% of the dividends distributed – $17.63), was recognized;

j) The adjustment of the debt charge of the synthetic financial instrument, in the amount of $0.07 (fair values of the swaps in the synthetic financial instrument) was recognized;

k) The liability swap for the equity fund was recognized at fair value, to exercise the right to 50% of the profits on the sale of 20% of the participation in the subsidiary, if the fund manages to sell the shares in the market with profit (the pricing on the date of the accounting statements reflects this event);

l) An asset swap against the equity fund was recognized at fair value, to exercise the right to 50% of the profits on the sale of 20% of the participation in the subsidiary, if the fund manages to sell the shares in the market with profit (the pricing on the date of the accounting statements reflects this event);

m) The result with equity method in the parent company was adjusted to reflect part of the subsidiary's profit destined for the equity fund, when dividends are paid, in the amount of $3.53;

n) For the purpose of measuring the fair values of swaps, the calculations were made based on residual values (after calculating the charges of the synthetic financial instruments), considering the value of the shares based on a market participant perspective, as $115.58 (an assumption of the teaching case)

o) To simplify the teaching case, tax effects and tax bookkeeping were ignored (e-Lalur – electronic book of taxable income; and e-Lacs – electronic book of CSLL).

Chart 7 shows the calculation of the synthetic financial instrument.

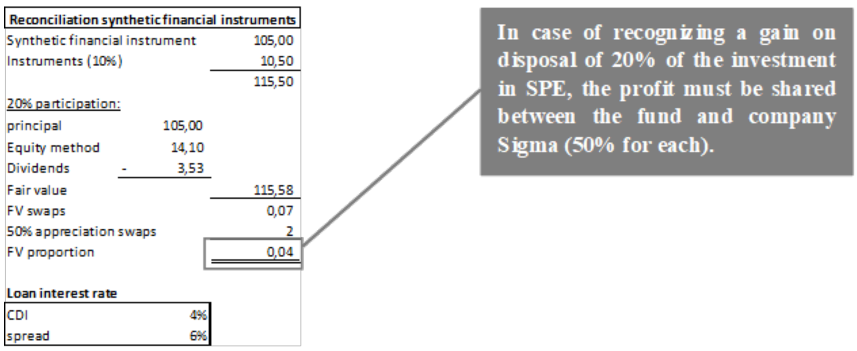


Chart 7. Synthetic financial instrument – reconciliation note
Source: prepared by the authorr

The explanatory ledgers are presented below.

	cash - Sigma		
SI	525,00	3,53	m
a	105,00		
e	17,63		
SF	644,10		

	Investment SPE		
SI	470,00	17,63	e
d	70,50		
SF	522,88		

	synthetic financial instrument		
i	3,53	105,00	a
j	0,07	14,10	f
		115,50	SF

	Equity Method		
m	3,53	70,50	d
		66,98	SF

	Post-employment benefit		
		855,00	
		90,00	g
		945,00	SF

	Synthetic interest		
f	14,10	3,53	i
		0,07	j
	10,50		

	Expenses with interests		
h	52,00		

	Post-Employment expenses		
g	90,00		

	cash - SPE		
SI	120,00	17,63	c
b	70,50		
SF	172,88		

	Loans and Financing		
		650,00	
		52,00	h
		702,00	SF

	liability swap		
		0,04	k

	Retained Earnings - SPE		
c	17,63	70,50	b
		52,88	SF

	asset swap		
l	0,04		

	FV swap (Income statement)		
k	0,04		

	FV swap (Income statement)		
		0,04	l

Based on the numbers assigned in their working papers, the auditor prepares the summary of unadjusted misstatements (Chart 8).

Working Paper: Summary of Unadjusted Misstatements

Unadjusted misstatements - current year	Overstated /Understated				
	Non current assets		Non current liabilities	Effect Income Statement	Effect Equity
	Receivable	Investments			
asset swap (*)	- 0,04			- 0,04	- 0,04
Investment subsidiary		- 104,58		- 0,43	- 0,43
liability swap (*)			0,04	0,04	0,04
Synthetic financial instrument			115,50	- 10,50	- 10,50
Total current year	- 0,04	- 104,58	115,54	- 10,93	- 10,93

Information:	
Overall materiality – OM (2.5% company's net equ	17,75
Performance materiality – PM (50% of the PM)	8,88
Specific materiality – SM (0,5% of total liability)	7,53

(*) Even though considered clearly trivial misstatements, the asset and liability swaps were included in the working papers based on the risks involved.

Chart 8. Summary of unadjusted misstatements
Source: prepared by the author

Evidence gathered and documented in the auditor's working papers indicate that there are material misstatements both for the balance sheet and the income statement as a whole (**overall materiality**) and for transactions, accounting items, and disclosures (**performance materiality**). The **specific materiality**, included to capture misstatements regarding the level of indebtedness, also revealed problems omitting the recognition liabilities arising from the synthetic financial instruments.

An aggravating factor related to the company's indebtedness level is the situation of debt contracts, whose covenants were breached when considering the figures demonstrated in the auditor's working papers. The company's management needs to provide the auditor with information about measures taken to renegotiate debt contracts and obtain creditors' waiver. Depending on these negotiations, the financial statements may undergo new modifications, reclassifying long-term liabilities as short term. In addition, the company's operational continuity may be subject to uncertainty.

The independent auditor may be required to issue an audit report with an adverse opinion[8], as the misstatements are material and widespread, or a report with a disclaimer of opinion[9], depending on the level of uncertainties involved with the renegotiation of debt contracts. The discussion of the audit report with the client will certainly be subject to a lot of tension, which is why the person responsible for the audit should recommend the presence of two experienced partners.

SUGGESTED READING

Johnstone, Karla M. *et al*. Auditing: A risk Based Approach to Conducting a Quality Audit. 10th edition. Boston: Cengage Learning, 2015

Hall, James A. Accounting Information Systems. 7th edition. Ohio: Thomson South-Western, 2011

Graham, Lynford. Internal Control Audit and Compliance. New Jersey: John Wiley & Sons, 2015.

Weirich, Thomas R. et al. Accounting and Auditing Research: Tools and Strategies. 8th edition. New Jersey: John Wiley & Sons, 2014

Beasley, Mark S. *et al*. Auditing Cases: An Interactive Learning Approach. 7th edition. Pearson Education, 2015.

[8]The auditor shall express an adverse opinion when they obtain sufficient appropriate audit evidence to conclude that, individually or in the aggregate, misstatements are material and pervasive to the financial statements. (NBC-TA-705, §8).

[9]The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, they concludes that, regardless of having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial report due to the possible interaction of uncertainties and their possible cumulative effect on the financial report (NBC-TA-705, §10).

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