PROFESSIONAL STEAM

AUDITING

STUDY TEXTBOOK

2023

CPA (U)

PAPER 9

AUDITING

STUDY TEXT

This study text has been published in close consultation with lecturers and tutors with vast experience in teaching CPA(U) papers in particular Auditing, Ethics & Assurance (Paper 9) and has been updated to capture the new changes in the CPA(U) Syllabus that took effect in January 2023. Therefore, this study text contains all the information that you need to pass your exam.

The study text therefore;

- Highlights the most important elements in the CPA(U) Syllabus and the key skills you need
- Emphasizes how each chapter links to the CPA(U) Syllabus and the study guide
- Provide a lot of exam focus points demonstrating what is expected of you in the exam

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Introduction to Auditing

1.0

INTRODUCTION TO AUDITING

Definition of Auditing

Auditing can be defined as an (1) independent examination of the (2) books of accounts and (3) vouchers of a business, with a view of (4) Expressing an opinion as to whether these have been kept properly according to IASs & the companies' Act as to whether the (5) statement drawn there from portray (6) a true and fair view of the company's state of affairs as at a given date.

The above definition can be broken down as follows **:-**

1. **Independent Examination**

This is conducted by a qualified accountant; qualified according to the companies Act. The qualified accountant must be independent of all parts with an interest in the company e.g. management, directors and third parts .His independence is very crucial because of the following:

(a) This independence is a requirement of the companies Act.
(b) This independence is a requirement of institute of Certified Public Accountants of Uganda (ICPAU)-Professional bodies for ethical reasons.

The audit is conducted on behalf of (and protects interests of) the owners (shareholders).Owners meet at the Annual General Meeting and they hear the report from the auditors regarding the financial performance of their company.

2. **Books of Accounts**

According to the companies Act, of the laws of Uganda, a limited company must maintain:-

(1) A cash book
(2) Assets register
(3) Ledgers

(4) Shareholders.

The first three books are statutory books of accounts which must be kept by limited companies by their registered offices.

3. **Vouchers**

A voucher is a document in support of transactions in the boos of accounts e.g. an agreement, receipt, invoice debit or credit note, etc

The auditor will check a voucher for:-

(1) Authorization – i.e. whether it is authorized by rightful authority.

(2) Date i.e. whether it is for the current period under audit

(3) Recording i.e. in correct book of accounts.

(4) Whether it is for the business I.e. Whether is relates to the company's ordinary transactions.

4. **Opinion**

This is a personal expression of the auditor on financial statements of the organization.

This expressed is found in the opinion paragraph of an audit report submitted to the shareholders or owners of the company by the auditor. This can either be:-

(1) **A Positive opinion**- This is contained in an unqualified report (Good report) i.e. a report without a qualification –This is the best opinion formed by the auditor on any company's accounts.

(2) **A Negative opinion**- This is contained by a qualified report (bad report) which has qualification due to:-
   (a) **Disagreement on fundamental issues**, e.g. provisions which may be inadequate.
   (b) **Uncertainty on areas of fundamental issue** – (debtors) i.e. their realization may be uncertain to the auditor.

Consequences of Audit Report

(A qualified report i.e. a bad report from the auditor) will lead to:-

(1) Removal of all company's directors.

(2) A fall in the value of the company's shares in the stock exchange.

(3) Inability of the company to raise finance or credit.

(4) May lead to receivership in the extreme case as creditors may move in to protect interests in the company.

5. **Statements**

The auditor is supposed to form an opinion regarding the authenticity of:-

(1) The Statement of financial position.
(2) The statement of comprehensive income
(3) The statement of cash flows.

He the main emphasis is to find out whether the contents in the financial statements above are the same contents in the books of accounts from which they were drawn.

6. **True and fair view**

True refers to the profit and loss account items which must be true i.e. true as those in books of accounts from where P & L a/c is drawn.

Fair- refers to balance sheet items. Must be fair to all parties with financial stake in the company. I.e. the contents of the balance sheet should be fair to different parties. These parties are:-

(1) Lenders e.g. banks and other financial institutions who have given credit to such a company.
(2) Supplies of row materials or short term creditors.
(3) Debtors who obtain credit from the company.
(4) The government for tax purposes.
(5) Trustees – Those parties holding the company's assets in trust.
(6) Employees.
(7) Potential and actual investors.

True and fair is different from true and correct because today's audit is systems based and uses sampling tests. Samples of items are chosen to represent the entire population- hence true and fair .Just reasonable good enough to work with.

Objectives of an Audit (Aims of Audit)

(a) ***Primary* Objectives of an Audit:** (These are the requirements of the companies Act, the auditor's duties and obligations during an audit are:-

1. To prove the true and fair view of the company's state of affairs as at a given date. The proof of true and fair view will be cent red around the balance sheet, the profit and loss account, and the funds flow statements. This is the most important objective of an audit.

2. To find out whether the company has kept proper books of accounts e.g. Cash book, assets register, ledgers as required by the company's Act, 486 of the laws of Uganda

3. To write a report. This is the end- product of any audit. This report is addressed to the shareholders and it will contain the findings of the auditor during his examination and this report will contain his opinion. The report may, on the other hand, be positive which is technically known as an unqualified report, in all the report will cover one financial period and is always a prelude to the convention (holding) of the company's annual general meeting (AGM).

(b) **Secondary Objectives of an Audit:**

They are also known as incidents objects of an audit.

4. To provide advice to the management duty is (put) on the auditor's shoulders by professional bodies through auditing guidelines and standards. The advice is contained in a letter commonly known as "Management Letter or Letter of Internal weakness"

In this Management letter, (usually produced at the end of an audit) the auditor will highlight the following:-

(1) Shortcomings/weaknesses in internal control system e.g. in cash areas and other sensitive areas.
(2) Solutions to the problems highlighted.
(3) Will indicate impending dangers/ catastrophes to the business.
(4) It will contain areas where the auditor did not receive the necessary co-operation from the management of the company during the course of his audit work.

Areas where co-operation may be lacking are:-

(1) Stock counts – in identifying slow – moving stock, damaged stock,/ of fixed/ semi-fixed assets. The client's stuff may not co-operate with the auditor to identify these.
(2) Wages payment – the management may hide dummy/ ghost workers.

5. Detection of Errors and Frauds

This was the primary objective in early auditing and this was possible because the auditor could check each every entry since transactions were few as of then due to small size of businesses, however, in modern auditing this object is incidental to proving the true and fair view. It is even mentioned in the letter of engagement that the auditor will not be held responsible for any errors or frauds committed, but that if these are there, the auditor's tests will reveal them through audit checks.

Errors may be innocent or intentional – (innocent errors are usually immaterial). If immaterial, they are ignored in the report, If it is material and innocent, it is then mentioned in the Management Letter. Materiality can be assessed as follows:-

(i) Check the item and compare it with the whole to which its forms part.
(ii) Check and see whether the error has a reversing trend, e.g. if it can change a profit into a loss.

Innocent errors are commonly caused by lack of knowledge of accounting principles on the part of accounts staff.

Frauds (All frauds are Intentional)

Definition: A fraud is an intentional mis- representation of accounting information by one or more parties in a bid to defraud the company. However, if the auditor that fraud immaterial, then he should mention it I the report to the shareholders. If, on the other hand, the fraud is material, than he should qualify the report.

International Accounting Standards (IAS) defines fraud as an intention mi-representation of financial information by one or more individuals among the management, employees and in some causes, with third party collaboration in order to defraud the business of financial resources and assets.

Common Types of frauds

A fraud may take the following shapes:

(1) Manipulation, alteration of records or documents

(2) Misappropriation of goods – by all parties from management to employees.

(3) Misapplication of accounting policies leading to manipulation of accounts.

(4) Suppression or omission of effects of transactions from records or documents.

1. **Misappropriation of Cash:**

This is the most common type of fraud and this takes place in big companies, where owners do not have control over cash receipts. The client should be advised to institute a strong internal control system, in particular, a tight internal check to minimize the occurrence of the above fraud.

Cash can be misappropriated in the following way:-

(1) By omitting to enter received i.e. failure to debit cash received.
(2) By entering less cash than was received.
(3) By entering more cash on the payment side of the book than was paid.
(4) By making fictitious payment on the credit side of the cash book.

2. Misappropriation of Goods

This takes place in business which deal in small but valuable goods, e.g. watches, jewellery, etc this type of fraud takes place in situations where stock supervision is lacking and stock-taking is not carried out periodically. This type of fraud is usually perpetrated by clerks although in some cases the management maybe a party to it.

3. Fraudulent Manipulation of Accounts

This is usually perpetrated by the management or responsible officers in the business. It is usually committed for any of the following reasons:-

(1) So that the management retains their jobs by impressing shareholders that they are operating a profitable business (By directors- for their fees and commission reasons).
(2) To lean a high commission on profit if some senior stuff are paid commission on profits.
(3) If directors are the shareholders of the business, they may sell their shares at high price by showing high profits so as to influence the price of shares to increase in the stock ex-change.
(4) To obtain finance from creditors by showing better financial position of the company i.e. health liquidity position.

(5) To attract investors to subscribe to the company's share capital so ass to raise finance from the public.

Examples of situation or Events which indicate or Increase the Risks of Fraud or Errors in Business (Also Known as Indicators of weak Internal Control System in an Organization)

1. A business run by one person or a small group of people with no oversight board thus taking advantages of such a position to manipulate the company's assets.
2. Where there is a complex corporate structure whose complexity does not seem to be warranted or necessary.
3. Where there is continuing failure to correct major weaknesses in internal control system where these are practicable i.e. can be corrected.
4. Where there is high turnover in key accounting personnel (finance).
5. Where there is a significant under-staffing (prolonged) of the accounts department leading to a weak internal check system.
6. Where there are frequent changes in legal counselors' and auditors
7. Where the company's performance is persistently declining and failures are increasing for no apparent reason.
8. Where there is inadequate working- capital due to poor management or embezzlement of current assets.
9. Where the company needs a rising profit trend to support share market princes due to contemplated market takeover.
10. Where the company depends on one customer or a few products leading to collusion between such a party and the company stuff.
11. Where there is pressure exerted on accounting stuff to complete financial statements in an unusually shorter periods of time, leading to innocent errors.
12. Where there are unusual transactions at the end of the financial period.
13. Where there are transaction made between related parties leading to collusion.
14. Where the payment of services to lawyers, auditors, creditors, etc. is excessive in relation to the service given.
15. Where there are (a) inadequate records; (b) incomplete accounting records; (c) excessive adjustments in accounting books; (d) out-of balance accounts.
16. Where there is inadequate documentation and lack of proper authorization in transactions

17. Where there is an excessive number of a difference in accounting records, third-party confirmations, conflicting audit evidence, and unexplainable changes in operating ratios.
18. Where there are evasive or unreasonable answers by the management to audit questions e.g. dodging of audit questions by senior stuff of the client.

(19-21 are to do with computerized systems).

19. Where there are is inability to extract information from computer.

20. Where there are large numbers of program changes that are not documented, approved or tested.

21. Where there is inadequate overall balancing of computer transactions and data bases to financial accounts.

Prevention of frauds

Frauds can be prevented using such means as:-

1. Instituting a strong internal control system.
2. Careful selection of employees by requiring their references and checking for any career gaps; career gaps should be justified.
3. There should be routine checking and balancing of accounts.
4. The company should institute periodical comparison of budgets with actual performances and should get an explanation for unfavorable variances.
5. Allocation of person responsibility and accountability to a specific job, at a specified time.
6. There should be segregation of functions in preparation and interpretation of accounting information.
7. To give reasonable rewards in form of salaries, incentives and other benefits to employees commensurate with the sensitivity of their jobs, qualifications and experiences.
8. The company should institute a system of compulsory leave, in particular, to accounting stuff.
9. The company must appreciate apparent rise in the cost of living due to inflation and adjust salaries accordingly
10. Employment of machine devices, e.g. punched card machines, accounting machines, **NCR** franking machines, which reduce the possibilities of frauds.

11. The company should employ very qualified stuff in sensitive areas of its operations
12. The company should use rotation of duties as a means of cutting or interrupting the perpetration or continuity of a fraud.
13. There should be close supervision both by lower and high level of the management, to those under them.
14. Instituting an internal auditing function (where possible)which will constantly appraise when they are at their earlier stage of preparation- also its presence acts as deterrent measure against frauds.

General detection of frauds

1. Compare the company's present balance-sheet with previous 2 years balance- Sheets and obtain an explanation for any material differences.

2. Computer ratios and percentages to determine the changes in the company's

Financial performances, these changes must be explained, e.g. Debtors turnover,

3. Use the searching enquiry and posing intelligent questions to accountants.

4. By using audit in depth, i.e. the checking of all transactions from the initial stage to their final stages and checking each stage for consistency and authenticity

5. Collaborating evidence from third – parties and comparing such evidence with the

Company's accounts, records and obtaining an explanation for any difference.

6. Using surprise visits and checking the company's books, e.g. cash counts petty cash.

Stock counts and wages payment.

7. Using comparisons between budgets and actual situations.

There will reveal the variance which may be due to frauds, if it is an un favourable variance and cannot be explained or justified.

Location or detect Errors

Most of the errors will be detected during routine checks of vouchers but in case this does not helps the auditor could use:-

Steps to be used to detect Errors

1. Comparison of the previous year's figures with the current figures and ascertaining the changes, which must be explained.
2. To check the total of the trial balance. i.e. to add the trial balance again to prove the accuracy of its balances.
3. Check the names of the accounts in the ledger against the names of accounts as have been recorded in the trial balance. Pay particular attention to such items as cash –book entries, purchases, sales book, bills receivable and payable books as these stand high chances of having errors.
4. Compare the list of debtors and creditors from their respective ledgers with that in the trial balance and total such account and see whether their totals agree with those in the trial balance for any difference, the auditor should obtain an explanation to that effect from the management.
5. If accounts are kept on a self-balancing system. Ensure that the totals of those accounts with the balance as recorded in the trial balance. Otherwise, the differences will indicate the presence of errors.
6. Compare items (count them) in the trial balance of the current year with the item of the trial balance of the previous year and see whether an item was left out in any one trial balance, which can be traced to the ledger to find what exactly it is.
7. Whatever the difference is in the trial balance, halve it (half) and see if there is an item of this value in the ledger. This is done to ensure that a debit entry was not put on the credit side and vice versa.
8. Check the total in subsidiary books which may not have been entered in the trial balance, and then bring them in the trial balance, i.e. record them in the trial balance to assess their effect on trial balance.

Prevention of Errors

1. The company should employ a strong internal control system and in particular, efficient internal check system. An internal check is part of an internal control system which is a means by which the company employees, in particular clerks, are counter-checked by their fellow clerks or where the work of one officer is counter-checked or is complementary and independently checked by another. The aim of an internal check is to ensure that no single officer carries out a given transaction from the beginning to the end aloe, thus preventing errors and frauds.

2. Awarding employees reasonable salaries commensurate with their qualifications and experience which will raise their morale to work and reduce chances of errors.
3. Employment of qualified stuff – to prevent errors of principle.
4. Instituting an internal audit department where possible. This department is changed with the duty of constant review of the company's operations and controls
5. Encouraging clerks/ stuff to take their annual leave periodically so that their performance can be assessed in their absence, and any errors they had perpetrated revealed.
6. Encouraging inter-department transfers and rotation of duties at a surprise moment so as to cut down the continuity of any error.
7. There should be close supervision of duties, in particular, in sensitive areas of the business e.g. cash receipts and payments.
8. The management should us periodic reviews of what has taken place in any one given area. These should be surprise review s and should enquire into irregularities.
9. Using machines to record or man transactions, e.g. NCR adding machines, franking machines, cheque writing machines etc. – These will minimize innocent errors which are due to human fatigue or weakness.

Legal, Regulatory and Ethical Environment

Harvest Training and Consultancy Uganda Ltd.

2.0

LEGAL, REGULATORY AND ETHICAL ENVIRONMENT

Qualities of an Auditor (Traits / Features/Characteristics of an Auditor)

1. An auditor must be well versed with all branches of accounts e.g. Cost accounts, Management accounts, Financial and Income Tax accounts, and be a master of General Accepted Accounting Practices and principles and be conversant with GAAP. Are standards and principles developed through practice or established by an authoritative organization the latest developments in the accounting field such as new accounting standards and guidelines.
2. The auditor should never pass a transaction unless it is correct. This is possible if the auditor is conversant with all the principles of accounts so as to be able to certify their authenticities
3. The auditor should grasp quickly, the technical features of his client's business before commencement of the audit through visits to his client's acquaint himself with the client's technical features.
4. The auditor must seek clarification on technical matters and avoid pride which may occasion him liabilities for negligence.
5. He must be familiar with mercantile law and company law, and must also be a complete master of auditing principles so as to be able to apply these during the course of his audit work.
6. He must be tactful and honest, i.e. he must be a man/woman of un questionable integrity and should not certify what he does not be live to be true. Thus, he must have:-

(a) Tactic in applying tests
(b) Tactic in interviewing
(c) Tactic in observations.

7. He should not be influenced directly or indirectly by others in a bid to change his opinion which may lead to a compromise of his independence which in turn may lead to the violation of the Company's Acts call for this independence.
8. He should be courageous despite the situation in which the client may put him as he protected by the Companies Act.
9. He should be prepared to reign instead of signing a wrong balance sheet which will expose him to unwarranted liabilities.
10. He should never reveal the client's secrets except if the client consent to such.
11. He must be able to pose intelligent questions with tact to extract useful evidence from different parties.
12. He should never approach the audit work with suspicion because this may lead to a biased report which may expose him to a danger of liabilities for negligence.
13. He must be accurate, vigilant, cautious and methodical during the course of his audit work so as to do his audit work with some degree of professional competence.
14. He must be prepared to hear arguments as a source of audit evidence, known as hearsay evidence which will strengthen.

Who can be an Auditor (Qualification?)

An auditor in Uganda must meet the following conditions before he can be allowed to practice:-

1. He must be a member of one or more of the professional bodies which is specified in the first column of the Accountant Act, e.g. ICPAK, CPA ACCA, ICMA.
2. Anyone authorized by the Registrar of Companies to do so (should be a holder of a degree in accounting and have been in auditing environment.
    - ICPAU has refused to register the above parties as members and as such they are being phased out with time.
3. Must be registered with PAEB and thus must have passed the final part of their examinations i.e. his final part of CPA.
4. Must be a member of ICPAU (to ensure adherence to professional ethics)
5. Must have a post-graduate experience in an auditing environment of not less than two years.
6. Must hold a practicing certificate given by ICPAU Registration of Accountants ACT of the laws of Uganda.

Who cannot be an Auditor (Companies Act).

Parties who cannot be auditors:-

1. An officer or servant of the company – which means that an employee of a company cannot perform its own audit.
2. A person who is a partner or who is in employment of an officer of the company being audited.
3. Persons who are disqualified as auditors of the company's subsidiary or holding company or a subsidiary of a company are holding company.
4. Body corporate – These are in form of limited companies.
   These cannot be auditors because of the following reasons:

a. These have limited liabilities status and if allowed to become auditors, this will expose the clients to limited liabilities which may occasion him heavy losses.
b. Limited companies cannot express personal opinion, yet the Companies Act requires that the audit report contain an opinion paragraph which millions of Shareholders –owners of a limited company cannot express.

5. A person who is indebted to the company for quite large sum of money or has given guarantee or security in connection with indebtedness to any part who received or got such indebtedness.
6. Directors, shareholders, managing agents, secretaries and treasures of the company.
7. A person who is holding more than 5% of the company's authorized share capital.

Removal of an auditors section 160 companies act
An auditor can only be dismissed by shareholders in a properly convened G.M. This safeguards his independence. This removal is by ordinary resolution at the meeting with special notice (28 days) having been served.

Removal Procedure
Special notice is needed for a solution at the GM appointing another auditor or expressly stating that the retiring one shall not be reappointed. A copy of notice must be sent to the retiring auditor. Where a retiring auditor makes written representations regarding the resolution, the shareholders should be sent copies of representations. If representations are not sent, they should be read out in the meeting, unless the court has ruled it out. The auditor has a right to defend himself at the meeting.
NB: Removal procedures allow members to appoint auditors of their choice and it safeguards the auditors' independence by not allowing directors to remove auditors.

These procedures ensure that the auditor is not removed for improper reasons without the knowledge of the shareholders.

Reasons for removal

a) Incompatibility between management and auditors i.e. disagreements.
b) Incompetence of the auditor.
c) Change of ownership of the business.
d) Change of requirements of the client e.g. after expansion.

Resignation of auditors

An auditor may resign due to;

a) ill Health
b) Expansion of the client firm
c) Inadequate fees
d) Management fraud etc.

Revision Questions

Kent ltd was formed on 1st February 2000 in order to export roses to European markets. The directors are unsure as to their responsibilities, and the nature of their relationship with the external auditors. The audit partner has asked you to visit the client and explain to the directors the more fundamental aspects of accountability of the company and their relationship with the auditor.

Explain to the directors.

a) Why there is need for an audit?

How the auditor of a public co. may be appointed under the co.'s act. **ICPAU (ROLES OF ICPA (U)).**

- May adopt and implement ISAs possibly after modifying them to suit national standards
- Has powers to set own standards in line with the needs of the country.
- Enforces the implementation of auditing standards
- Has disciplinary powers to enforce quality of work
- Have rights to inspect audit files to monitor audit quality.

Eligibility to act as an auditor

- Membership of a recognized supervisory body is the major criteria for being eligible to act as an auditor e.g. ACCA, C.P.A.(U).CIMA etc and allowed by the rules of that body to be an auditor.
- Sufficient period of practical experience in an auditing field (about 10 years) under close supervision of qualified staff.
- Owning of recognized and appropriate overseas qualification
- Any one allowed by the state to act as an auditor.

Ineligibility to act as an Auditor:

Under C.A 1985, a person becomes ineligible for appointment if:

- He is an employee or officer of such a company.
- Partner/employee of any person working in such a company.
- In a partnership in which such a person is a partner.

In Uganda the RSB is called ICPAU is responsible for controlling and supervising the whole audit and accountancy profession. it was established by accountants statute of 1992 and it is still at its infantry stage. Its membership is after having sat and passed the final exams or by being a member of another recognized supervisory body.

APPOINTMENT, RESIGNATION AND REMOVAL OF AUDITORS

Generally, auditors are appointed in the office for one-year term but it can be extended. The C.A of 1985 requires auditors to be appointed by and therefore answerable to shareholders.

Appointment of the auditor

1. By shareholders
   Members/shareholders can appoint auditors at the end of each annual general meeting accounts are laid by positive resolution (re-appointment of the existing auditors not automatic.
2. Directors
   Can appoint auditors to fill a casual vacancy or in the first year of a company when the annual general meeting has not been held.
3. Registrar of companies

Can appoint auditors in case members or directors have failed to exercise their rights.

Resignation & removal of an auditor

Resignation of the auditor

Certain provisions of the CA 1985 are designed to ensure the auditors do not resign without any explanation of their action.

Resignation procedure entails the following:

- An auditor deposits a written note together with a statement of circumstances relevant to members.
- The company sends a notice of resignation to the registrar of companies.
- The company sends a statement of circumstances to everyone entitled to receive a copy of accounts
- Auditors ask directors to call an extraordinary general meeting to discuss the circumstances of the resignation. The directors must send out notice for the meeting within 21 days of having received the communication from the auditors.
- At the extraordinary general meeting, the auditors can speak to explain circumstances leading to their resignation.

Removal of an auditor

The authority of removal is the hands of members or shareholders in the annual general meeting.

Removal procedure entails the following:

- A special notice is written to the intender auditor within 28 days.
- The intended auditor can have a right to give explanation as to why he intends to stay in the office. He/she can further ask the directors to convene an extra-ordinary general.
- If resolution is passed, the company must notify the registrar of companies.

Rights of auditors

A right refers to an entitlement, which is given to an auditor to fulfill his duties comfortably and among which include:

- A right to exercise a lien over the clients books of accounts in case of failure to pay.
- A right to attend any annual general meeting.
- A right to seek audience/be heard in the annual general meeting

- A right to ask directors to convene an extra ordinary meeting
- A right to access all the books, reports, documents and account of a company at any time.
- A right to receive all the explanation, which are necessary for his work.
- A right to receive a copy of all resolution made in the annual general meeting.

Duties of an auditor

The duties under national legislations generally follow under:

- To report to the shareholders or directors on whether the accounts show a true and fair view.
- To leave a statement of circumstances when he ceases to hold office for any reason.
- To report on any company violation of laws.
- To consider whether the information's in the management report is consistent in the financial statements.

The auditor has to ensure that:

- Proper accounting records have been prepared in accordance with the companies Act.
- Proper returns have been received from branches not visited by the auditor
- The company's financial statements agree with the underlying accounting records
- Proper accounting records have been kept.
- All necessary information and explanations have been obtained.
- Information issued with the financial statements is consistent with the financial records.

Liabilities of an auditor

- **Liability of negligence**
  Negligence means acting carelessly or failing to perform a duty enjoyed upon a person. An auditor is expected to perform his duties as an agent of the shareholders by exercising care and diligence in the implementation of statutory requirements for the maintenance and presentation of the financial statement. Failure to perform this but will lead to the auditor being held liable.

- **Liability of liable:**
  In the report, the auditor may criticize any person. if it is based on fact, there is no liability of the auditor. In order to avoid this liability the auditor should take care that the report is based on facts and is prepare with good intention.
- **Liability of the Third party:**
  The auditor is an expert in finding out errors and frauds and is aware how to check the books of accounts. Many third parties i.e. shareholders, investors, tax authorities, creditors, etc. rely upon his reports. so if he makes any type of error or fraud, he is liable to pay the damages.
- **Breach of contract:**
  In the auditor fails to fulfill the term of the contract, liability arises. In case if he omits all or some conditions of contract, if he cannot make the secrecy, if fails to provide the true and fair view to the owner, he is liable to pay to the owner if sustain any financial loss.
- **Requirements of Reports:**
  If the auditor does not confirm to the requirement of audit reports he can be punished with fine.
- **Assistant to investigate:**
  Auditor has statutory duty to assist any investigator appointed by the government in collecting any information of the company otherwise; he shall be punished with imprisonment or with a fine or both.
- **Assistance to prosecute:**
  Based on the audit report, government may prosecute any officer. The auditor is to expect to assist in such prosecution otherwise; he is to be punished for contempt of court.
- **Return Books, papers property, etc:**
  At the time of winding up of a company, court may ask the auditor to return any property books or papers of the company otherwise he can be arrested.
- **Falsification of Books of Accounts:**
  Where the auditor is guilty of destruction, alteration, falsification of any books, papers, securities, he may be imprisoned and fined.
- **Prosecution of auditor:**
  Where auditor is found be guilty of any criminal offence by the liquidator of the company, he shall be prosecuted.

- **false statement:**
  In any return: where the auditor makes any false statements in any material respect in any return report, certifications ,balance sheet etc., he may be imprisoned and also be liable to fine.
- **Non-compliance:**
  In case when the auditor makes any report or signed against the legal requirement and the report may be not true, the auditor is liable to fine for if it is willful fault.
- **Audit report:**
  If the auditor make the report with the extent to profit himself and the third party for any loss for a material consideration, he is criminally liable.
- **False statement:**
  Whoever makes a statement false or incorrect or omits any material fact shall be punishable with imprisonment for a term, which may extend to three year and shall be liable to a fine.
- **Professional misconduct:**
  If the auditor fails to follow the rules of their own profession, he is criminally liable. For this default, ICPAU can with draw the certificate of practice. ICPAU can also go to the court of law for prosecuting the concerned auditor. The auditor can suffer the jail, fine, or both.

QUALITIES OF AN AUDITOR

- Must be well versed with all the branches of accounting. The cost A/C, Financial A/C, Management A/Chloral government A/C, Taxation(income tax accounting),and must be a mastery of GAAP as well as being conversant with the latest developments in, the accounting fields such as new accounting standards and guidelines.
- The auditor should never pass transaction unless he believes that it is correct. This is possible if the auditor is conversant with all the principles of accounting to certify their authenticity.
- The auditor should grasp easily the technical features of his client's business before commencement of audit, through visits to his clients to acquaint himself with client's technical features of the business.
- Must seek clarification on technical matters, and avoid pride, which may occasion him liabilities or negligence.

- He must be familiar with mercantile law and company law and should be a complete mastery of auditing principles so as to be able to apply these during the course of his audit work.
- He must be tactful and honest i.e. must be a person of unquestionable integrity and should not certify what he does not believe to be true. He must therefore have tactics in applying tests (audit tests).interviewing and observation.
- He should be courageous despite the situation in which the client may put him as he is protected by the companies act.
- He should be prepared to resign instead of signing a wrong balance sheet, which would expose him to unwarranted liabilities.
- He should not reveal the clients secrete except if the client consents.
- Must be able to pause intelligent questions with tactics to extract useful evidence from different parties.
- Should never approach the audit work with suspicion because this may lead to a braised report, which may expose him to danger of liabilities or negligence?
- He must be vigilant, accurate, and conscious of his audit work with some degree of professional competence.
- Must be prepared to hear arguments as a source of audit, which will strength his opinion.
- Must be able to write a good report characterized by correctness, charity and forcefulness and not a milled one.

THE CLIENT ACCEPTANCE PROCESS

Covers the procedures that auditors must undertake to ensure that their appointment is valid and clear to act.

Procedures before accepting nominations

There are intended to ensure that there are no independence or ethical issues likely to cause a conflict.

- Ensure you are professionally qualified to act, i.e membership of RSB e.g ICPAU, ACCA is vital.
- Ensure that the existing sources and logistics are adequate to handle given client (time, staff, technical expertise)
- Obtain references from independent sources about the integrity to directors or if not closely connected to you.

- Communicate with previous auditors and inquire whether there are reasons or circumstance behind the change, which the new auditor ought to know if it was for professional reasons or any other reasons.

Procedures after accepting nomination

- Ensure that the outgoing auditor's removal or resignation was properly conducted as per c.a.1985.
- Ensure that the new auditor's appointment is valid with a copy of resolution passed in the Annual General meeting appointing as company auditors.
- Design and submit a letter of engagement to the directors of the company.
- Ensure that the previous auditor's fees if still owing are settled.
- Obtain all books and papers which belong to the client from the old auditor unless if a lieu is being exercised.

PROFESSIONAL ETHICS & CODES OF CONDUCT

It covers ethical matters that auditors/accountants have to bear in mind when executing their duties.

FUNDAMENTAL PRINCIPLES

- Integrity: members should be straightforward and honest in all professional and business relationships.
- Objectivity: members should not allow bias, conflicts of interest or under due influence of others to override professional or business judgments.
- Professional competence and due care: members have a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives competent professional service base on current developments in practice, legislation and techniques.
- Confidentiality: members should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority or unless there is a legal or professional duty to disclose. Confidential information should not be used for the personal advantage of members or third parties.
- Professional behavior: members should comply with relevant laws and regulations and should avoid any action that discredits the profession.

THREATS/IMPAIRMENT TO FUNDAMENTAL PRINCIPLES

Self-interest threat

This is a threat of financial or other interests of members or their close family. For example:

- If the auditor or a member of their family owns shares in a client, they will want the client to do well in order for a dividend to be paid and for the share price to increase.
- Significant outstanding fees from a client may lead the auditor not to raise issues for fear that the fees will not be paid more so if they are going concern problems.
- Dependence on one client for significant proportion of the firms total fee income is a threat. An auditor cannot obtain more than 15% of his income from a single listed company or 10% from an unlisted company. If the firm raises more than these percentages of its total income, then the firm may not raise issues with the client for fear of losing them.
- The acceptance of gifts/hospitality is also a threat. The auditor should not accept gifts from the client unless they are 'modest 'otherwise it may be seen as a bribe.
- A firm quoting into any free arrangement for audit work under which the audit fee is dependent on the result of the audit work or on items that are the subject matter of the audit.

SELF REVIEW THREAT

It occurs when the auditor has to re-evaluate work completed by himself e.g. if the external auditor prepared the financial statements and the audited them. Other threats include:

- Recent service with the client (company) i.e. as director, officer or employee in a position to exert direct and significant influence over the subject matter information of the audit work in the previous or current period under review.
- Offering other service i.e. keeping the client's assets, supervising client employees, preparing etc.
- Preparation of accounting records and financial statements and then audit them.
- Provision of taxation services to the client i.e. compliance, planning, filing tax returns,etc.
- Provision of internal audit services.

ADVOCACY THREAT

It occurs when the auditor is asked to promote the client's position or represent them some way e.g. in a court of law. In this way the auditor would be biased in favor of the client and hence not objective.

FAMILIARITY THREAT

It occurs when as a result of close or long working relationship with the client. The auditor may be unable to review the work of the friend or relative due to the trust between the two or be too sympathetic to him. This may leave material errors go undetected in the financial statements.

INTIMIDATION THREAT

The client may harass or bully the auditor into giving an unqualified opinion when qualified opinion is appropriate.

For example if the auditor is dependent on fees from a client, the client may use this to their advantage and threaten to take their business elsewhere unless the auditor gives into their demands.

REMEDIES/SOLUTIONS TO ABOVE THREATS

- Should not audit if the client provides 15% and more of the firm's total income to the audit firm.
- Audit fee should be based upon predetermined level of work and not set too low so as to get more lucrative work.
- Not to accept loans or guarantees from client unless in normal course of business.
- Significant overdue fees are regarded as a loan hence not allowed.
- Gifts and hospitality should not be accepted unless modest i.e. available to all the company's staff at same terms.
- Audit work should not be conducted on a contingent basis.i.e where a commission is received or a percentage of fees is payable upon a specific event occurring like issuing a favorable audit opinion.
- Close business, family or personal relationships should be avoided between client and the audit firm. In cases of any such relationships.
  a. Dispose off the interest
  b. Remove the individual from the team
  c. Review of the audit by an independent partner.

- In case of offering other services to a client like accounting, taxation, advisory services, etc, A separate team and partners should be deployed.
- Must not take part in the audit if have been officer/employee in that period or in the last 2 years.
- An engagement partner-auditor in the charge of audit should act for a maximum of 5 years and have a break of 5 years before resuming role.
- Senior staff should not act for longer than 7 years.
- Should not offer legal services to a client and defend them in dispute, which is material to the financial statements.

Risk Assessment

3.0
RISK ASSESSMENT

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1.1 INTRODUCTION

ISA 315 'Understanding the Entity and it's environment, assessing the risk of material misstatements requires the auditor to perform risk assessment procedures to obtain an understanding of the entity its environment, including its internal controls.

Audit risk ISA 200 defines audit risk as the risk that the auditor will issue an in appropriate opinion when the financial statements are materially misstated. I.e. he qualifies the accounts yet he ought to have issued an un qualified report or vice versa.

1.2 OVERALL AUDIT RISK

Auditors usually follow a **risk-based approach to auditing** as required by ISAs. In this approach, auditors analyse the risks associated with the client's business, transactions and systems which could lead to misstatements in the financial statements, and direct their testing to risky areas.

This is in contrast to a procedural approach which is not in accordance with ISAs. In a procedural approach, the auditor would perform a set of standard tests regardless of the client and its business. The risk of the auditor providing an incorrect opinion on the truth and fairness of the financial statements might be higher if a procedural approach was adopted.

ISA 200: requires that the auditor plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit. Hence the auditor will attempt to reduce audit risk through the design and execution of the audit procedures.

1.3 ELEMNTS OF AUDIT RISK

Audit risk has 3 components namely;

(a) *Inherent risk*

(b) *Control risk*

(c) *Detection risk*

(a) Inherent risk

- It is the risk that there are materials errors in the financial statements arising from the characteristic of the client and his environment. (The possibility of material error regardless of internal controls)

- Inherent risk is assessed in to financial statements assertions. To decrease inherent risk much audit risk (substantive testing) must be done. For many organizations, inherent risk tends to be high i.e. 100%.

Factors to consider when assessing inherent risk

These are normally classified into two broad categories namely;

- **At the entity level**
- **At account balances and transaction level**

Examples of Inherent risk at entity level:

I. Integrity and attitude to risk of directors and management for instance dominance by a single person who may easily override the controls

II. Management experience, knowledge and changes in management during the accounting period. In experienced staff may result to errors and staff manipulating their ignorance.

III. Unusual pressure to directors or management for instance tight reporting deadlines, market expectations may force management to manipulate the figures.

IV. Small and new firms

With small firms segregation of duties is difficult and owners tend to override the controls in place.

V. Factors affecting the industry for instance the economic cycles and competition, regulatory requirements etc.

VI. The nature of the business for example technology obsolesce etc

Examples of inherent risks at accounts balances or transaction level:

I. Accounts likely to be misstated for example accounts which require adjustments in the past years or period (i.e. Inventory)
II. Complexity of the underlying transactions and other events which might require the use of an expert. Like Valuation of fuel in the underground tanks.
III. The degree of judgment involved in determining the account balance for example the provision for bad and doubtful debts.
IV. Areas experiencing major staff changes lead to morale, fear and chances for defrauding the company.
V. Susceptibility for some assets to loss or misappropriation like some but high value items, cash etc.
VI. Completion of unusual and complex transactions especially at or near the end of the period .
VII. The quality of the accounting system, the poor system may be a sign of high risk for example single entry accounting system.
VIII. Transactions not subject to ordinary processing for example purchases not tendered materials tend to inflated.

(b) Control risk

- Is the risk that, the controls in the entity's accounting system will fail to prevent or detect material errors or fraud.

- Control risk is normally assessed when evaluating the control environment later by performing tests of controls. However a preliminary assessment should be done at the planning stage.

- Where there are effective controls as confirmed by tests of controls, the controls risk will be low and normal substantive tests will be carried.

FACTORS TO CONSIDER IN ASSESSING CONTROL RISK

I. Quality and effectiveness of management for example degree of supervision, adoption of recommendations by external and internal auditors
II. Quality of internal controls for example poor segregation of duties, this is common in small firms.
III. Competence of accounts staff, their experience, turnover and remuneration.
IV. Existence and effectiveness of internal audit which provides a supervisory role as service to the organization.
V. Computerization which implies more or less error for example during the changeover season.

VI. Existence of an audit committee on the board.

(c) Detection risk

This is the risk that the auditors substantive procedures fail to detect a material misstatement and it may arise because of the following;

(a) The use of in appropriate audit procedures.
(b) Failure to draw proper conclusions in a particular audit evidence for example failure to detect teeming or lading or carryovers in the cash book and sales ledger and mistaken it as a clerical error.
(c) Failure to perform necessary audit work due to limited time or high costs for example missing stock and accepting inflated stock figure.

NB Auditor should therefore consider assessing inherent and control risk in the determining the nature, timing and extent of substantive procedures required to reduce detection risk thus audit risk should be reduced to acceptable levels.

When the assessed inherent and control risk change, the planned substantive procedures should be modified accordingly.

The combination of inherent and control risk is normally referred to as CLIENT risk. And if the auditor cannot reduce the detection risk to acceptable level, the he should qualify the opinion.

DETECTION RISK MAY BE REDUCED BY;

- Recruiting, training, and allocating staff properly during the audit.
- Planning audit work so as to handle audit risk and time progress.
- Encourage positive communication between the audit manager, audit staff and the client.
- Use appropriate audit manual and documentation.
- Ensure access to technical specialists (experts) in technical areas.

1.4 AUDIT RISK MODEL

Audit Risk (AR) = IR x CR x DR).

Audit risk can never be eliminated but the auditor should be cautious to minimize it. The auditor should use professional judgment to assess the component of the audit risk and design audit procedures that ensure that the risk is reduced to acceptable levels.

The level of the risk acceptable may be stated as 5% which means that 95% confidence level in the accuracy.

1.5 PLANNING MATERIALITY

Materiality is the expression of the importance or significance of a particular matter in the context of the financial statements as a whole.

A matter is material if its omissions or misstatements would reasonably influence the economic decision of users taken on the basis of financial statements.

Materiality is a relative factor and should be considered in relative terms e.g. shs 100 may be absolutely in material in accounts of a large company but in small companies or when aggregated.

IMPOTANCE OF MATERIALITY TO THE AUDITOR

a) It acknowledges the fact that accounts are not 100% accurate thus paving a way for sampling.

b) It determines the nature and size of the audit tests

c) It guides on the item on to be examined and whether to use a sample or not

d) Provides guidelines on necessary adjustments for errors

e) It determines whether the auditor should rely on work provided by internal auditor or carry out the work for himself.

ASSESSING MATERIALITY

This is done by the use of the balance sheet and income statement .An error is not material if it is 5% or less and it is material if it is 10% of either the profit before tax or the total assets of the company. If it's between 5-10% may or may not be material.

- **Materiality is viewed in terms of;**
  - Profit before tax of the entity
  - Turnover of the entity
  - Total assets of the entity

- **Available formulae to assess materiality**
  - Materiality =(misstatement /Profit before tax)*100%
  - Materiality =(misstatement/turnover)*100%
  - Materiality=(misstatement/total assets)*100%

NB In assessing materiality the auditor should ensure that there is total compliance with the reporting frame work and the company Act. Noncompliance would force the auditor to conclude that misstatement is material.

a. Materiality on the basis of profit and loss account (P&L a/c)

When assessing materiality on the basis of profit and loss account the auditor should consider the following;

- **Normal profit**
  Generally an error is material if it more than or equal to 10% of the profits before tax.

- **Critical points**
  If the effects of an error is to turn a profit into loss or vice versa then the error is material although its less than 10% of the normal profits

- **Degree of estimation**
  Any error in value of an item that can be measured precisely would normally be material. E.g. inventory.

- **Legal requirement**
  If an item required by law to treat in a particular way and it is not, then the item is material. E.g. Director's fees not being disclosed individually in the P&L a/c.

- **Trend**
  A small error reversing a trend in the profit may be regarded as material.

b. Assessing materiality on the basis of the Basis of the balance sheet

The principles are similar to those above in the P&L a/c with few differences here and there:

- **Accuracy in measurement**
  Items like cash, bank balance & share capital should be stated accurately and therefore no error may be acceptable any misstatement may be regarded material.

- **Reporting frame work**
  The company Act an item that is required to be disclosed by the companies Act should be disclosed, unless the item is very small. Share capital should be disclosed as authorized share capital, called up and failure to disclose this is considered to be violation of company law and its material.

- **Un certainties**
  An auditor should detect a large un certainty before this is considered material as warrant qualification in the audit report.

- **Accounting standards**
  There should always be compliance and non- compliance should be reported in the audit report.

Audit Planning and Documentation

4.0
AUDIT PLANNING & DOCUMENTATION

UNIT 4 OVERVIEW:
- Importance of Planning
- The overall audit strategy
- The audit plan
- Audit Documentation
- Audit files

1.1 IMPORTANCE OF PLANNING

An effective and efficient audit relies on proper planning procedures. The planning process is covered in general terms by ISA 300 Planning an audit of financial statements which states that the auditor shall plan the audit so that the engagement is performed in an effective manner.

Audits are planned to:

(i) Help the auditor devote appropriate attention to important areas of the audit.
(ii) Help the auditor identify and resolve potential problems on a timely basis.
(iii) Help the auditor properly organise and manage the audit so it is performed in an effective manner.
(iv) Assist in the selection of appropriate team members and assignment of work to them.
(v) Facilitate the direction, supervision and review of work.
(vi) Assist in coordination of work done by auditors of components and experts.

Audit procedures should be discussed with the client's management, staff and/or audit committee in order to co-ordinate audit work, including that of internal audit. However, all audit procedures remain the responsibility of the external auditors.

A structured approach to planning will include:
Step 1 Ensuring that ethical requirements are met, including independence
Step 2 Ensuring the terms of the engagement are understood
Step 3 Establishing the overall audit strategy that sets the scope, timing and direction of the audit and guides the development of the audit plan

- Identify the characteristics of the engagement that define its scope.
- Ascertain the reporting objectives to plan the timing of the audit and nature of communications required.
- Consider significant factors in directing the team's efforts.
- Consider results of preliminary engagement activities.
- Ascertain nature, timing and extent of resources necessary to perform the engagement.

Step 4 Developing an audit plan that includes the nature, timing and extent of planned risk assessment procedures and further audit procedures.

1.2 THE OVERALL AUDIT STRATEGY AND THE AUDIT PLAN

The overall audit strategy and audit plan shall be updated and changed as necessary during the course of the audit

1.2.1 Audit Strategy

The overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.

The matters the auditor may consider in establishing an overall audit strategy are set out in the table below.

THE OVERALL AUDIT STRATEGY: MATTERS TO CONSIDER	
Characteristics of the engagement	• Financial reporting framework • Industry-specific reporting requirements • Expected audit coverage Nature of business segments Availability of internal audit work Use of service organisations • Effect of information technology on audit procedures • Availability of client personnel and data
Reporting objectives, timing of the audit and nature of communications	• Entity's timetable for reporting • Organisation of meetings with management and those charged with governance • Discussions with management and those charged with governance • Expected communications with third parties
Significant factors, preliminary engagement activities, and knowledge gained on other engagements	• Determination of materiality • Areas identified with higher risk of material misstatement • Results of previous audits • Need to maintain professional scepticism • Evidence of management's commitment to design, implementation and maintenance of sound internal control • Volume of transactions • Significant business developments • Significant industry developments • Significant changes in financial reporting framework • Other significant recent developments
Nature, timing and extent of resources	• Selection of engagement team • Assignment of work to team members • Engagement budgeting

Examples of items to include in the overall audit strategy could be:

- Industry-specific financial reporting requirements
- Number of locations to be visited
- Audit client's timetable for reporting to its members
- Communication between the audit team and the client

1.2.2 The Audit Plan

The audit plan converts the audit strategy into a more detailed plan and includes the nature, timing and extent of audit procedures to be performed by engagement team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.

The audit plan shall include the following:

- A description of the nature, timing and extent of planned risk assessment procedures
- A description of the nature, timing and extent of planned further audit procedures at the assertion level
- Other planned audit procedures required to be carried out for the engagement to comply with ISAs The planning for these procedures occurs over the course of the audit as the audit plan develops.

Examples of items included in the audit plan could be:

- Timetable of planned audit work
- Allocation of work to audit team members
- Audit procedures for each major account area (eg inventory, receivables, cash etc)
- Materiality for the financial statements as a whole and performance materiality

Any changes made during the audit engagement to the overall audit strategy or audit plan, and the reasons for such changes, shall be included in the audit documentation.

1.2.3 Interim and Final Audit

Auditors usually carry out their audit work for a financial year in one or more sittings. These are referred to as the interim audit(s) and the final audit.

The interim audit visits are carried out during the period of review and work focuses on planning and risk assessment and tests of controls and systems, although substantive audit procedures may also be carried out. The final audit visit is at the year-end or shortly after and work focuses on the audit of the financial statements.

ISA 330 The auditor's responses to assessed risks states that the higher the risk of material misstatement, the more likely it is that the auditor will decide that it is more effective to undertake substantive procedures nearer to, or at, the period-end rather than earlier. However, performing audit procedures before the period-end can assist in identifying significant matters at an early stage of the audit and being able to resolve them with management's assistance or developing an effective audit approach to address them.

Auditors must obtain evidence that controls have operated effectively throughout the period. ISA 330 states that when the auditor obtains evidence about the operating effectiveness of controls during an interim audit visit, the auditor must determine what additional audit evidence should be obtained for the remaining period.

The ISA makes a similar observation with regard to substantive procedures: when substantive procedures are performed at an interim audit visit, the auditor shall perform further substantive procedures or substantive procedures combined with tests of controls to cover the remaining period that provide a reasonable basis for extending the audit conclusions from the interim date to the period-end.

Some audit procedures can only be performed at the final audit visit, such as agreeing the financial statements to the accounting records and examining adjustments made during the process of preparing the financial statements.

2 AUDIT DOCUMENTATION

It is important to document audit work performed in working papers to:

- Enable reporting partner to ensure all planned work has been completed adequately
- Provide details of work done for future reference
- Assist in planning and control of future audits
- Encourage a methodical approach

2.1 The objective of audit documentation

Audit documentation is the record of audit procedures performed, relevant audit evidence obtained and conclusions reached. The term 'working papers' or 'work papers' are also sometimes used.

All audit work must be documented: the working papers are the tangible evidence of the work done in support of the audit opinion. ISA 230 Audit documentation states that the auditor shall prepare audit documentation on a timely basis.

Audit documentation is necessary for the following reasons:

- It provides evidence of the auditor's basis for a conclusion about the achievement of the overall objective.
- It provides evidence that the audit was planned and performed in accordance with ISAs and other legal and regulatory requirements.
- It assists the engagement team to plan and perform the audit.
- It assists team members responsible for supervision to direct, supervise and review audit work. It enables the team to be accountable for its work.
- It allows a record of matters of continuing significance to be retained.
- It enables the conduct of quality control reviews and inspections (both internal and external).

2.2 Form and content of working papers

The ISA requires working papers to be sufficiently complete and detailed to provide an overall understanding of the audit. Auditors cannot record everything they consider. Therefore judgement must be used as to the extent of working papers, based on the following general rule:

What would be necessary to provide an experienced auditor, with no previous connection with the audit, with an understanding of the work performed, the results of audit procedures, audit evidence obtained, significant matters arising during the audit and conclusions reached:

The form and content of working papers are affected by matters such as:

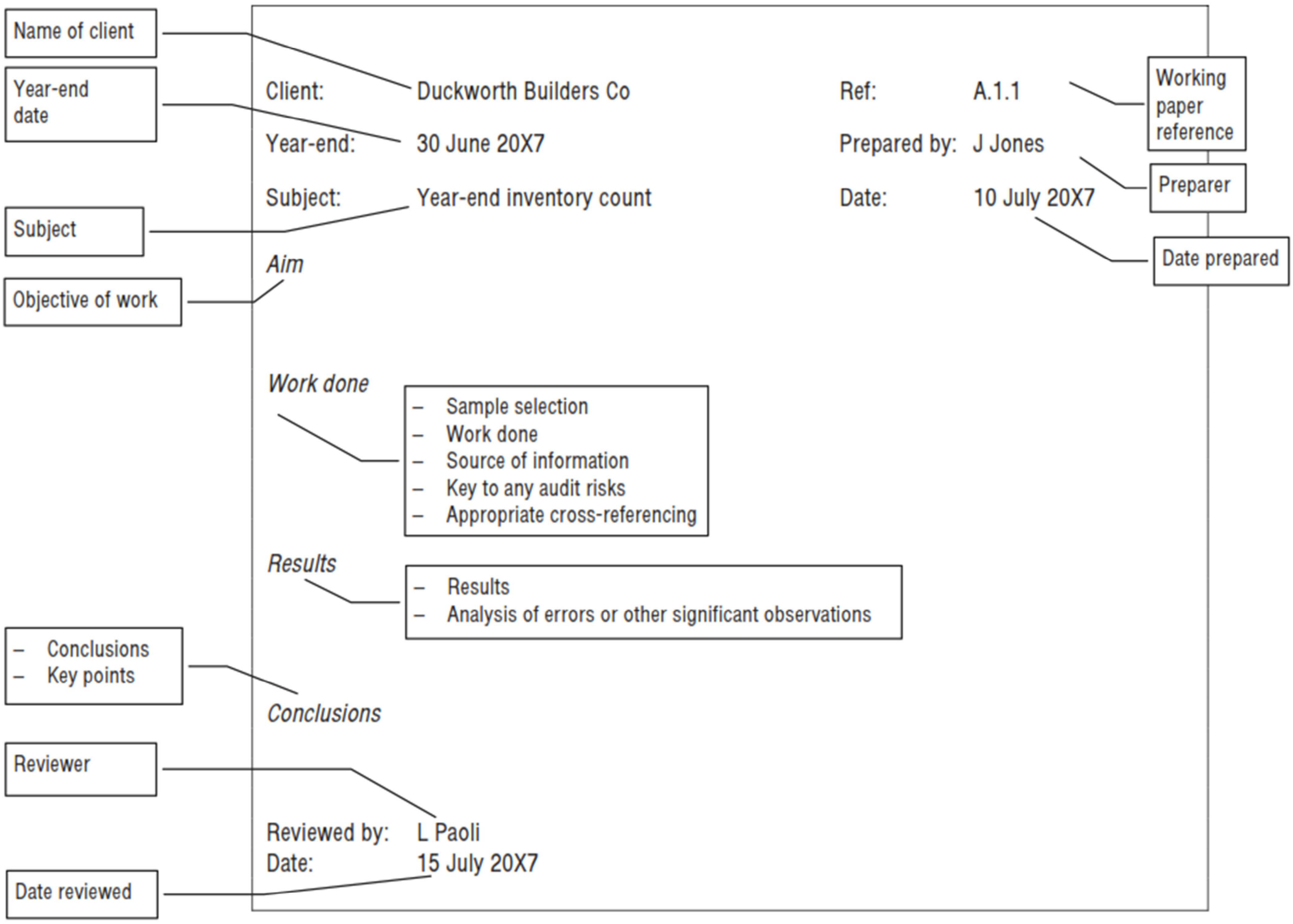
- The **size and complexity** of the entity
- The **nature** of the audit procedures to be performed
- The **identified risks** of material misstatement
- The **significance** of the audit evidence obtained
- The nature and extent of **exceptions** identified
- The need to document a **conclusion** or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained
- The audit **methodology and tools** used

2.2.1 Examples of working papers

a) Information obtained in understanding the entity and its environment, including its internal control, such as the following:
   (i) Information concerning the legal documents, agreements and minutes
   (ii) Extracts or copies of important legal documents, agreements and minutes
   (iii) Information concerning the industry, economic environment and legislative environment within which the entity operates.
   (iv) Extracts from the entity's internal control manual

b) Evidence of the planning process including audit programs and any changes thereto
c) Evidence of the auditor's consideration of the work of internal audit and conclusions reached
d) Analyses of transactions and balances
e) Analyses of significant ratios and trends
f) Identified and assessed risks of material misstatements
g) A record of the nature, timing, extent and results of audit procedures
h) Evidence that the work performed was supervised and reviewed
i) An indication as to who performed the audit procedures and when they were performed
j) Details of audit procedures applied regarding components whose financial statements are audited by another auditor
k) Copies of communications with other auditors, experts and other third parties
l) Copies of letters or notes concerning audit matters communicated to or discussed with management or those charged with governance, including the terms of the engagement and material weaknesses in internal control
m) Letters of representation received from the entity
n) Conclusions reached by the auditor concerning significant aspects of the audit, including how exceptions and unusual matters, if any, disclosed by the auditor's procedures were resolved or treated.
o) Copies of the financial statements and auditors' reports
p) Notes of discussions about significant matters with management and others
q) In exceptional circumstances, the reasons for departing from a basic principle or essential procedure of an ISA and how the alternative procedure performed achieve the audit objective

TYPICAL AUDIT WORKING PAPERS



The auditor should record the identifying characteristics of specific items or matters being tested. Firms should have standard referencing and filing procedures for working papers, to facilitate their review.

2.2.2 Audit files

For recurring audits, working papers may be split between:

Permanent audit files (containing information of continuing importance to the audit). These contain:

- Engagement letters
- New client questionnaire
- The memorandum and articles
- Other legal documents such as prospectuses, leases, sales agreement
- Details of the history of the client's business
- Board minutes of continuing relevance
- Previous years' signed accounts, analytical review and management letters
- Accounting systems notes, previous years' control questionnaires

Current audit files (containing information of relevance to the current year's audit). These should be compiled on a timely basis after the completion of the audit and should contain:

- Financial statements
- Accounts checklists
- Management accounts details
- Reconciliations of management and financial accounts
- A summary of unadjusted errors
- Report to partner including details of significant events and errors
- Review notes
- Audit planning memorandum
- Time budgets and summaries
- Representation letter Management letter
- Notes of board minutes
- Communications with third parties such as experts or other auditors

They also contain working papers covering each audit area. These should include the following:

- A lead schedule including details of the figures to be included in the accounts
- Problems encountered and conclusions drawn
- Audit programmes
- Risk assessments
- Sampling plans
- Analytical review
- Details of substantive tests and tests of control

If it is necessary to modify/add new audit documentation to a file after it has been assembled, the auditor should document:

- Who made the changes, and when, and by whom they were reviewed
- The reasons for making changes
- The effect of changes on the auditors' conclusions

If, in exceptional circumstances, changes are made to an audit file after the audit report has been signed, the auditor should document:

- The circumstances
- The audit procedures performed, evidence obtained, conclusions drawn
- When and by whom changes to audit documents were made and reviewed

2.3 Standardised and automated working papers

The use of **standardised** working papers, for example, checklists and specimen letters, may improve the efficiency of audit work but they can be dangerous because they may lead to auditors mechanically following an approach without using audit judgement.

Automated working paper packages have been developed which can make the documenting of audit work much easier. Such programs aid preparation of working papers, lead schedules, the trial balance and the financial statements themselves. These are automatically cross-referenced, adjusted and balanced by the computer.

The **advantages** of automated working papers are as follows.

- The risk of errors is reduced.
- The working papers will be neater and easier to review.
- The time saved will be substantial as adjustments can be made easily to all working papers, including those summarising the key analytical information.
- Standard forms do not have to be carried to audit locations.
- Audit working papers can be transmitted for review via a modem or fax facilities.

2.4 Safe custody and retention of working papers

Judgement may have to be used in deciding the length of holding working papers, and further consideration should be given to the matter before their destruction.

Working papers are the property of the auditors. They are not a substitute for, nor part of, the entity's accounting records.

Auditors must follow ethical guidance on the confidentiality of audit working papers. They may, at their discretion, release parts of or whole working papers to the entity, as long as disclosure does not undermine 'the independence or validity of the audit process'. Information should not be made available to third parties without the permission of the entity.

Audit Evidence

5.0
AUDIT EVIDENCE

UNIT 5 OVERVIEW:

- o The need for Audit Evidence
- o Sufficient appropriate audit evidence
- o Financial Statement Assertions
- o Audit Procedures to obtain evidence

1.0 INTRODUCTION TO AUDIT EVIDENCE

1.1 The need for Audit Evidence

Remember that the objective of an audit of financial statements is to enable the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. In this unit, we shall look at the audit evidence gathered, which enables the auditor to express his opinion.

Key term:
Audit evidence is all of the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based.

Audit evidence includes the information contained in the accounting records underlying the financial statements and other information gathered by the auditors, such as confirmations from third parties. Auditors are not expected to look at all the information that might exist. They will often select samples to conduct the audit tests.

1.2 Sufficient appropriate audit evidence

The **appropriateness of audit evidence** is the measure of the quality of it, that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

The **sufficiency of audit evidence** is the measure of the quantity of audit evidence. The quantity of audit evidence required is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

ISA 500 Audit evidence requires auditors to 'design and perform audit procedures that are appropriate in the circumstances for the purposes of obtaining sufficient appropriate audit evidence'. 'Sufficiency' and 'appropriateness' are interrelated and apply to both tests of controls and substantive procedures.

- **Sufficiency** is the measure of the **quantity** of audit evidence.
- **Appropriateness** is the measure of the **quality or reliability** of the audit evidence.

The **quantity** of audit evidence required is affected by the **level of risk** in the area being audited. It is also affected by the quality of evidence obtained. If the evidence is high quality, the auditor may need less than if it were poor quality. However, obtaining a high quantity of poor quality evidence will not cancel out its poor quality. The ISA requires auditors to consider the **relevance and reliability** of the information to be used as audit evidence when designing and performing audit procedures.

Relevance deals with the logical connection with the purpose of the audit procedure and the assertion under consideration. The relevance of information may be affected by the direction of testing.

Reliability is influenced by the source and nature of the information, including the controls over its preparation and maintenance. The following generalisations may help in assessing the **reliability** of audit evidence.

QUALITY OF EVIDENCE	
External	Audit evidence from **external sources** is more reliable than that obtained from the entity's records because it is from an independent source.
Auditor	Evidence obtained **directly by auditors** is more reliable than that obtained indirectly or by inference.
Entity	Evidence obtained from the entity's records is more reliable when the related **control system operates effectively.**
Written	Evidence in the form **of documents (paper or electronic) or written representations** are more reliable than oral representations, since oral representations can be retracted.
Originals	**Original documents** are more reliable than photocopies or facsimiles, which can easily be altered by the client.

1.2.1 Management's expert

A management's expert is an individual or organisation possessing expertise in a field other than auditing or accounting, whose work is used by the entity to assist in the preparation of the financial statements.

ISA 500 considers the use of a management's expert by management and states that if information to be used as audit evidence has been prepared by a management's expert, the auditor must evaluate the competence, capabilities and objectivity of the expert, obtain an understanding of the work done, and evaluate the appropriateness of the work done as audit evidence.

1.2.2 Information produced by the entity

If information produced by the entity is to be used by the auditor, the auditor needs to evaluate whether it is sufficiently reliable for the auditor's purposes, including obtaining audit evidence regarding its accuracy and completeness, and evaluating whether it is sufficiently precise and detailed.

1.2.3 Selecting items to test

ISA 500 states that the auditor must determine the means of selecting items for testing that are effective in meeting the purpose of the audit procedure. The auditor could either select all items, select specific items or use audit sampling.

1.2.4 Inconsistencies and doubts over reliability

If audit evidence from one source is inconsistent with that from another, or the auditor has doubts over the reliability of information, the auditor must determine what modifications or additions to audit procedures are necessary to resolve the issues and must consider the effect on other aspects of the audit.

2.0 FINANCIAL STATEMENT ASSERTIONS

2.1 Key terms

Financial statement assertions are the representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

ISA 315 states that the auditor must use assertions for classes of transactions (i.e. statement of profit or loss), account balances (i.e. statement of financial position), and presentation and disclosures in sufficient detail to form the basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. It gives examples of assertions in these areas which are set out in the table that follows.

Assertions used by the auditor	
Assertions about **classes of transactions and events** for the period under audit	• **Occurrence**: transactions and events that have been recorded have occurred and pertain to the entity. • **Completeness**: all transactions and events that should have been recorded have been recorded. • **Accuracy**: amounts and other data relating to recorded transactions and events have been recorded appropriately. • **Cut-off**: transactions and events have been recorded in the correct accounting period. • **Classification**: transactions and events have been recorded in the proper accounts.
Assertions about **account balances at the period-end**	• **Existence**: assets, liabilities, and equity interests exist. • **Rights and obligations**: the entity holds or controls the rights to assets, and liabilities are the obligations of the entity. • **Completeness**: all assets, liabilities and equity interests that should have been recorded have been recorded. • **Valuation and allocation**: assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Assertions about **presentation and disclosure**	2.0 **Occurrence and rights and obligations**: disclosed events, transactions and other matters have occurred and pertain to the entity. 3.0 **Completeness**: all disclosures that should have been included in the financial statements have been included. 4.0 **Classification and understandability**: financial information is appropriately presented and described, and disclosures are clearly expressed. 5.0 **Accuracy and valuation**: financial and other information are disclosed fairly and at appropriate amounts.

2.2 Audit procedures to obtain audit evidence

Audit evidence can be obtained by inspection, observation, inquiry and confirmation, recalculation, re-performance and analytical procedures**.**

The auditor obtains audit evidence by undertaking audit procedures to do the following:

- Obtain an understanding of the entity and its environment to assess the risks of material misstatement at the financial statement and assertion levels **(risk assessment procedures)**

- Test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level **(tests of controls)**

- Detect material misstatements at the assertion level **(substantive procedures)**

Tests of controls are necessary to test the controls to support the risk assessment, and also when substantive procedures alone do not provide sufficient appropriate audit evidence. Substantive procedures must always be carried out for material classes of transactions, account balances and disclosures.

The audit procedures described in the table below can be used as risk assessment procedures, tests of controls and substantive procedures.

Key Terms:

Tests of controls are performed to obtain audit evidence about the operating effectiveness of controls preventing, or detecting and correcting, material misstatements at the assertion level.

Substantive procedures are audit procedures performed to detect material misstatements at the assertion level.

They are generally of two types:

- Substantive analytical procedures
- Tests of detail of classes of transactions, account balances and disclosures.

Auditors obtain evidence by one or more of the following procedures.

PROCEDURES	
Inspection of tangible assets	Inspection of tangible assets that are recorded in the accounting records confirms existence, but does not necessarily confirm rights and obligations or valuation. Confirmation that assets seen are recorded in accounting records gives evidence of completeness.
Inspection of documents or records	This is the examination of documents and records, both internal and external, in paper, electronic or other forms. This procedure provides evidence of varying reliability, depending on the nature, source and effectiveness of controls over production (if internal). Inspection can provide evidence of existence (eg a document constituting a financial instrument), but not necessarily about ownership or value.
Observation	Observation This involves watching a procedure or process being performed (for example, post opening). It is of limited use, as it only confirms the procedure took place when the auditor was watching, and because the act of being observed could affect how the procedure or process was performed.
Inquiry	This involves seeking information from client staff or external sources. Strength of evidence depends on the knowledge and integrity of source of information. Inquiry alone does not provide sufficient audit evidence to detect a material misstatement at assertion level nor is it sufficient to test the operating effectiveness of controls.
Confirmation	This is the process of obtaining a representation of information or of an existing condition directly from a third party e.g. confirmation from bank of bank balances.
Recalculation	This consists of checking the mathematical accuracy of documents or records and can be performed through the use of IT.
Reperformance	This is the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.
Analytical procedures	Evaluating and comparing financial and/or non-financial data for plausible relationships. Also include the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

Internal Control System

6.0 INTERNALCONTROLS

UNIT 6 OVERVIEW:

- The control environment
- Use of internal controls
- Evaluating internal controls
- The computerised environment

The auditors must **understand** the **accounting system** and **control environment** in order to determine their audit approach.

Internal control is the process designed and effected by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the **nature, timing and extent** of further audit procedures.

Initially, gaining an understanding of internal control helps auditors' to determine which are **relevant to the audit**. ISA 315 (Revised) *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* points out that there is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. Many of these controls will relate to financial reporting, operations and compliance, but not all of the entity's objectives and controls will be relevant to the auditor's risk assessment.

Having determined which controls are relevant, and are adequately designed to aid in the prevention of material misstatements in the financial statements, the auditor can then decide whether it is more efficient to seek reliance on those controls and perform tests of controls in that area, or more efficient to perform substantive testing over that area.

If the controls are not adequately designed, the auditor needs to perform sufficient substantive testing over that financial statement area in light of the apparent lack of control and increased risk. Any deficiencies are noted and, where appropriate, these will be communicated to management.

ISA 315 (Revised) *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* deals with the whole area of controls.

Internal control has **five components**:

- The control environment
- The entity's risk assessment process
- The information system relevant to financial reporting
- Control activities
- Monitoring of controls

In obtaining an understanding of internal control, the auditor must understand the **design** of the internal control and the **implementation** of that control. In the following sub-sections, we look at each of the elements of internal control in turn.

1.1 Control environment

The control environment is the framework within which controls operate. The control environment is very much determined by the management of a business.

Control environment includes the governance and management functions and the attitudes, awareness and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity.

A strong control environment does not, by itself, ensure the effectiveness of the overall internal control system, but can be a positive factor when assessing the risks of material misstatement. A weak control environment can undermine the effectiveness of controls.

Aspects of the control environment (such as management attitudes towards control) will nevertheless be a significant factor in determining how controls operate. Controls are more likely to operate well in an environment where they are treated as being important. In addition consideration of the control environment will mean determining whether certain controls (internal auditors, budgets) actually exist.

ISA 315 states that auditors shall have an understanding of the control environment. As part of this understanding, the auditor shall evaluate whether:

- Management has created and maintained a culture of honesty and ethical behaviour
- The strengths in the control environment provide an appropriate foundation for the other components of internal control and whether those components are not undermined by deficiencies in the control environment

The following table illustrates the elements of the control environment that may be relevant when obtaining an understanding of the control environment.

CONTROL ENVIRONMENT	
Communication and enforcement of integrity and ethical values	Essential elements which influence the effectiveness of the design, administration and monitoring of controls
Commitment to competence	Management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge
Participation by those charged with governance	• Independence from management • Experience and stature • Extent of involvement and scrutiny of activities • Appropriateness of actions and interaction with internal and external auditors
Management's philosophy and operating style	• Approach to taking and managing business risks • Attitudes and actions towards financial reporting • Attitudes towards information processing and accounting functions and personnel
Organisational structure	The framework within which an entity's activities for achieving its objectives are planned, executed, controlled and reviewed
Assignment of authority and responsibility	How authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established
Human resource policies and practices	Recruitment, orientation, training, evaluating, counselling, promoting, compensation and remedial actions

The auditor shall assess whether these elements of the control environment have been implemented using a combination of **inquiries of management** and **observation** and **inspection**.

1.2 Entity's risk assessment process

ISA 315 says the auditor shall obtain an understanding of whether the entity has a process for:

- Identifying business risks relevant to financial reporting objectives
- Estimating the significance of the risks
- Assessing the likelihood of their occurrence
- Deciding upon actions to address those risks

If the entity has established such a process, the auditor shall obtain an understanding of it. If there is not a process, the auditor shall discuss with management whether relevant business risks have been identified and how they have been addressed.

1.3 Information system relevant to financial reporting

The **information system relevant to financial reporting** is a component of internal control that includes the financial reporting system, and consists of the procedures and records established to initiate, record, process and report entity transactions and to maintain accountability for the related assets, liabilities and equity.

The auditor shall obtain an understanding of the information system relevant to financial reporting objectives, including the following areas:

- The classes of transactions in the entity's operations that are significant to the financial statements
- The procedures, within both IT and manual systems, by which those transactions are initiated, recorded, processed, corrected, transferred to the general ledger and reported in the financial statements
- The related accounting records, supporting information, and specific accounts in the financial statements, in respect of initiating, recording, processing and reporting transactions
- How the information system captures events and conditions, other than transactions, that are significant to the financial statements
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures
- Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments

The auditor shall obtain an understanding of how the entity **communicates** financial reporting roles and responsibilities and significant matters relating to financial reporting.

1.4 Control activities

Control activities are those policies and procedures that help ensure that management directives are carried out.

ISA 315 states that the auditor shall obtain an understanding of control activities relevant to the audit and how the entity has responded to risks arising from IT.

Control activities include those activities designed to **prevent** or to **detect** and **correct errors**. Examples include activities relating to authorisation, performance reviews, information processing, physical controls and segregation of duties.

Examples of control activities	
Approval and control of documents	Transactions should be approved by an appropriate person. For example, overtime should be approved by departmental managers.
Controls over computerised applications	We shall look at computer controls later in this chapter.
Checking the arithmetical accuracy of records	For example, checking to see if individual invoices have been added up correctly.
Maintaining and reviewing control accounts and trial balances	Control accounts bring together transactions in individual ledgers. Trial balances bring together unusual transactions for the organisation as a whole. Preparing these can highlight unusual transactions or accounts.
Reconciliations	Reconciliations involve comparison of a specific balance in the accounting records with what another source says the balance should be, for example, a bank reconciliation. Differences between the two figures should only be reconciling items.
Comparing the results of cash, security and inventory counts with accounting records	For example, in a physical count of petty cash, the balance shown in the cash book should be the same as the amount held.
Comparing internal data with external sources of information	For example, comparing records of goods despatched to customers with customers' acknowledgement of goods that have been received.
Limiting physical access to assets and records	Only authorised personnel should have access to certain assets (particularly valuable or portable ones) eg ensuring that the inventory stores locked are unless store personnel are there.

1.4.1 Segregation of duties

Segregation implies a **number of people** being involved in the accounting process. This makes it more difficult for fraudulent transactions to be processed (since a number of people would have to collude in the fraud), and it is also more difficult for accidental errors to be processed (since the more people are involved, the more checking there can be). Segregation should take place in various ways:

(a) **Segregation of function.** The key functions that should be segregated are the **carrying out** of a transaction, **recording** that transaction in the accounting records and **maintaining custody** of assets that arise from the transaction.

(b) The various **steps** in carrying out the transaction should also be segregated. We shall see how this works in practice when we look at the major transaction cycles in Chapter 10.

(c) The **carrying out** of various **accounting operations** should be segregated. For example, the same staff should not record transactions and carry out the reconciliations at the period-end.

1.5 Monitoring of controls

Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It includes assessing the design and operation of controls on a timely basis and taking necessary corrective actions modified for changes in conditions.

The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates corrective actions to deficiencies in its controls.

If the entity has an **internal audit function**, the auditor shall obtain an understanding of the **nature of its responsibilities,** its organisational status, and the **activities** performed/to be performed.

The auditor shall also obtain an understanding of the **sources of the information** used in the monitoring activities and the **basis** on which management considers it reliable.

1.6 Small companies – the problem of control

Many of the controls which would be relevant to a large entity are neither practical nor appropriate for a small company which often have simple internal control systems. For a small company the most important form of internal control is generally the **close involvement** of the **directors or proprietors**.

However it is also important to note that close involvement by management will enable them to **override controls** and, if they wish, to **exclude transactions** from the records.

Auditors can also have difficulties not because there is a general lack of controls but because the **evidence** available as to their operation and the completeness of the records is **insufficient**. For example, an owner manager may well perform an independent review of payroll records, but will not sign and date to indicate the review has taken place, and may not document the investigation of anomalies or how problems were resolved. Therefore it is very difficult for the auditor to obtain evidence that a control is operating effectively, even if it is.

Segregation of duties will often appear inadequate in enterprises having a small number of staff. Similarly, because of the scale of the operation, organisation and management controls are likely to be rudimentary at best.

As discussed above, the onus is on the proprietor, by virtue of his day-to-day involvement, to compensate for this lack. This involvement should encompass physical, authorisation, arithmetical and accounting controls as well as supervision.

Where the manager of a small business is not the owner, the manager may not possess the same degree of commitment to the running of it as an owner-manager would. In such cases, the auditors will have to consider the adequacy of controls exercised by the shareholders over the manager in assessing internal control.

1.6.1 Evidence available in relation to internal control in small companies

We discussed above the fact that audit evidence for elements of the control environment in smaller entities may not be available in documentary form, in particular where communication between management and other personnel may be informal but effective. However, although not documented, small companies may develop a culture that emphasises the importance of integrity and ethical behaviour through verbal communication and where management sets a good example. As a result the attitudes, awareness and actions of management are very important to the auditor's understanding of a smaller entity's control environment.

Although size and economic considerations in smaller entities often reduce the opportunity for formal control activities there is still likely to be some evidence available in relation to internal controls. Some basic control activities are likely to exist for the main transaction cycles such as revenues, purchases and payroll costs.

In a small company, often management's sole authority for approval of, for example, purchases and payments can provide strong control over important account balances and the auditor can seek to test and rely on these controls. These key controls lessen or remove the need for more detailed control activities and if the auditor can gain enough evidence that these key controls are operating effectively substantive testing can be reduced.

However, because of the factors discussed in the preceding section, the auditor will often choose or be forced to turn to substantive procedures to gain sufficient appropriate audit evidence when auditing a smaller entity. This can often mean use of:

- Confirmations
- Agreeing samples related to different financial statement areas to source documents
- Analytical procedures where these are considered suitable

1.7 Limitations of accounting and control systems

Any internal control system can only provide the directors with **reasonable assurance** that their objectives are reached, because of **inherent limitations**. These include:

- The **costs** of control **not outweighing** their **benefits**
- The potential for **human error**
- **Collusion** between employees
- The possibility of **controls** being **by-passed** or **overridden** by management
- Controls being **designed to cope** with **routine** and **not non-routine transactions**

These factors demonstrate why auditors cannot obtain all their evidence from tests of the systems of internal control. The key factors in the limitations of controls system are **human error** and **potential for fraud**.

The safeguard of segregation of duties can help deter fraud. However, if employees decide to perpetrate frauds by collusion, or management commit fraud by overriding systems, the accounting system will not be able to prevent such frauds.

This is one of the reasons that auditors always need to be alert to the possibility of fraud, the subject of ISA 240, which was discussed in Chapter 6.

Question — Internal control systems

An internal control system has been described as comprising 'the control environment and control activities. It includes all the policies and procedures (internal controls) adopted by the directors and management of an entity to assist in achieving their objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to internal policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information'.

Explain the meaning and relevance to the auditors giving an opinion on financial statements of each of the management objectives above.

Answer

The auditors' objective in evaluating and testing internal controls is to determine the degree of reliance which they may place on the information contained in the accounting records. If they obtain reasonable assurance by means of tests of controls that the internal control system is effective in ensuring the completeness and accuracy of the accounting records, they may limit their substantive procedures.

(a) *'The orderly and efficient conduct of its business'*

An organisation which is efficient and conducts its affairs in an orderly manner is much more likely to be able to supply the auditors with sufficient appropriate audit evidence on which to base their audit opinion. More importantly, the level of inherent and control risk will be lower, giving extra assurance that the financial statements do not contain material errors.

(b) *'Adherence to internal policies'*

Management is responsible for setting up an effective system of internal control and management policy provides the broad framework within which internal controls have to operate. Unless management does have a pre-determined set of policies, then it is very difficult to imagine how the company could be expected to operate efficiently. Management policy will cover all aspects of the company's activities, ranging from broad corporate objectives to specific areas such as wage rates.

Given that the auditors must have a sound understanding of the company's affairs generally, and of specific areas of control in particular, then the fact that management policies are followed will make the task of the auditors easier in that they will be able to rely more readily on the information produced by the systems established by management.

(c) '*Safeguarding of assets*'

This objective may relate to the physical protection of assets (for example locking cash in a safe at night) or to less direct safeguarding (for example ensuring that there is adequate insurance cover for all assets). It can also be seen as relating to the maintenance of proper records in respect of all assets.

The auditors will be concerned with ensuring that the company has properly safeguarded its assets so that they can form an opinion on the existence of specific assets and whether the company's records can be taken as a reliable basis for the preparation of financial statements. Reliance on the underlying records will be particularly significant where the figures in the financial statements are derived from such records rather than as the result of physical inspection.

(d) *'Prevention and detection of fraud and error'*

The directors are responsible for taking reasonable steps to prevent and detect fraud. They are also responsible for preparing financial statements which give a true and fair view of the entity's affairs. However, the auditors must plan and perform their audit procedures and evaluate and report the results of these, recognising that fraud or error may materially affect the financial statements. A strong system of internal control will give the auditors some assurance that frauds and errors are not occurring, unless management are colluding to overcome that system.

(e) *'Accuracy and completeness of the accounting records'/'timely preparation of reliable financial information'*

This objective is most clearly related to statutory requirements relating to both management and auditors. The company generally has legal obligations to maintain proper accounting records. The auditors must form an opinion on whether the company has fulfilled these obligations and also conclude whether the financial statements agree with the underlying records.

2 The use of internal control systems by auditors

The auditors shall assess the **adequacy** of the systems as a basis for the financial statements and shall identify **risks** of material misstatements to provide a basis for designing and performing further audit procedures.

Auditors are only concerned with assessing policies and procedures which are relevant to the financial statements. Auditors shall:

- **Assess the adequacy** of the accounting system as a basis for preparing the accounts
- **Identify** the types of **potential misstatements** that could occur in the accounts
- **Consider factors** that affect the **risk of misstatements**
- **Design appropriate audit procedures**

We have discussed the process of assessing the risks of material misstatement in Chapter 6. The assessment of the controls of an entity will have an impact on that risk assessment.

Risks arising from **poor control environments** are unlikely to be confined to particular assertions in the financial statements, and, if severe, may even raise questions about whether the financial statements are capable of being audited, that is, if control risk is so high that audit risk cannot be reduced to an acceptable level.

On the other hand, some **control procedures** may be closely connected to an assertion in financial statements, for example, controls over the inventory count are closely connected with the existence and completeness of inventory in the financial statements.

There may be occasions where substantive procedures alone are not sufficient to address the risks arising. Where such risks exist, auditors shall **evaluate the design** and **determine the implementation** of the controls, that is by **controls testing**. This is most likely to be the case in a system which is highly computerised and which does not require much manual intervention.

2.1 Recording accounting and control systems

The auditors must keep a record of the client's systems which must be updated each year. This can be done through the use of narrative notes, flowcharts, questionnaires or checklists.

There are several techniques for recording the assessment of control risk, that is, the system. One or more of the following may be used depending on the complexity of the system.

- Narrative notes
- Flowcharts
- Questionnaires
- Checklists

We look at each of these methods throughout the rest of Section 2, including the benefits and limitations of each.

In respect of questionnaires, you should note that there are two types, each with a different purpose.

- **Internal Control Questionnaires (ICQs)** are used to ask whether controls exist which meet specific control objectives.
- **Internal Control Evaluation Questionnaires (ICEQs)** are used to determine whether there are controls which prevent or detect specified errors or omissions.

The specific controls for each major transaction system (sales, purchases, inventory, cash, payroll, revenue and capital expenditure) are examined in detail in Chapter 10. However some are also included in the examples included in 2.1.3 and 2.1.4 for the purposes of illustrating how IQCs and ICEQs are used to record internal control systems. Whatever method of recording is used, the record will usually be retained on the permanent file and updated each year.

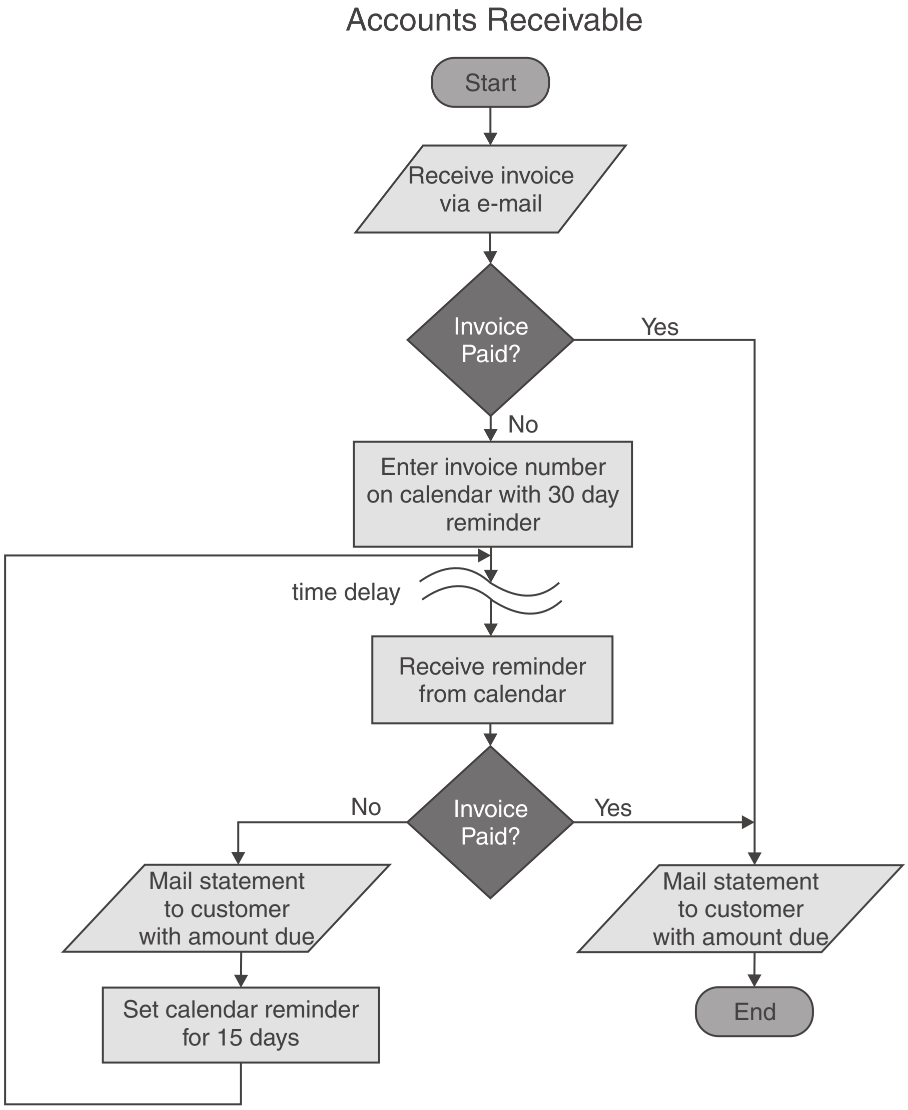
2.1.1 Narrative notes

The purpose of narrative notes is to **describe** and **explain** the **system**, at the same time as making any comments or criticisms which will help to demonstrate an intelligent understanding of the system.

Narrative notes	
Advantages	**Disadvantages**
They are relatively simple to record and can facilitate understanding by all audit team members.	Describing something in narrative notes can be a lot more time consuming than, say, representing it as a simple flowchart, particularly where the system follows a logical flow.
They can be used for any system due to the method's flexibility.	They are awkward to update if written manually.
Editing in future years can be relatively easy if they are computerised.	It can be difficult to identify missing internal controls because notes record the detail of systems but may not identify control exceptions clearly.

2.1.2 Flowcharts

Flowcharts can take many forms, but in general are graphic illustrations of the physical flow of information through the accounting system. Flowlines represent the sequences of processes, and other symbols represent the inputs and outputs to a process. An example of an accounts receivable flowchart follows.



Source: http://www.rff.com/flowchart_samples.htm

Flowcharts have certain advantages and disadvantages.

Advantages
After a little experience they can be prepared quickly.
As the information is presented in a standard form, they are fairly easy to follow and to review.
They generally ensure that the system is recorded in its entirety, as all document flows have to be traced from beginning to end. Any 'loose ends' will be apparent from a cursory examination.
They eliminate the need for extensive narrative and can be of considerable help in highlighting the salient points of control and any deficiencies in the system.

Disadvantages
They are most suitable for describing standard systems. Procedures for dealing with unusual transactions will normally have to be recorded using narrative notes.
Major amendment is difficult without redrawing.
Time can sometimes be wasted by charting areas that are of no audit significance.

2.1.3 Internal Control Questionnaires (ICQs)

The major question which internal control questionnaires are designed to answer is 'How good is the system of controls?'

Although there are many different forms of ICQ in practice, they all conform to the following basic principles:

(a) They **comprise a list of questions** designed to determine whether desirable controls are present (possible desirable controls are considered for each major transaction cycle in Chapter 10).

(b) They are formulated so that there is one list of questions to **cover each of the major transaction cycles**.

One of the most effective ways of designing the questionnaire is to phrase the questions so that all the answers can be given as 'YES' or 'NO' and a 'NO' answer indicates a deficiency in the system. An example would be:

Are purchase invoices checked to goods received notes before being passed for payment?	YES/NO/Comments

The ICQ questions below dealing with goods inward provide additional illustrations of the ICQ approach.

Goods inward

(a) Are supplies examined on arrival as to quantity and quality?

(b) Is such an examination evidenced in some way?

(c) Is the receipt of supplies recorded, perhaps by means of goods inwards notes?

(d) Are receipt records prepared by a person independent of those responsible for:

- (i) Ordering functions?
- (ii) The processing and recording of invoices?

(e) Are goods inwards records controlled to ensure that invoices are obtained for all goods received and to enable the liability for unbilled goods to be determined (by pre-numbering the records and accounting for all serial numbers)?

(f) (i) Are goods inward records regularly reviewed for items for which no invoices have been received?

(ii) Are any such items investigated?

(g) Are these records reviewed by a person independent of those responsible for the receipt and control of goods?

2.1.4 Internal Control Evaluation Questionnaires (ICEQs)

In recent years, many auditing firms have developed and implemented an evaluation technique more concerned with assessing whether specific errors (or frauds) are possible, rather than establishing whether certain desirable controls are present. This is achieved by reducing the control criteria for each transaction stream down to a handful of **key questions** (or control questions). The characteristic of these questions is that they concentrate on the significant errors or omissions that could occur at each phase of the appropriate cycle if controls are weak.

The nature of the key questions may best be understood by reference to the example below relating to the purchases (expenditure) cycle.

Internal control evaluation questionnaire: control questions

The purchases (expenditure) cycle

Is there reasonable assurance that:

(a) Goods or services could not be received without a liability being recorded?

(b) Receipt of goods or services is required in order to establish a liability?

(c) A liability will be recorded:

  (i) Only for authorised items?
  (ii) At the proper amount?

(d) All payments are properly authorised?

(e) All credits due from suppliers are received?

(f) All transactions are properly accounted for?

(g) At the period end liabilities are neither overstated nor understated by the system?

(h) The balance at the bank is properly recorded at all times?

(i) Unauthorised cash payments could not be made and that the balance of petty cash is correctly stated at all times?

Each key control question is supported by detailed control points to be considered. For example, the detailed control points to be considered in relation to key control question (b) for the expenditure cycle (Is there reasonable assurance that receipt of goods or services is required to establish a liability?) are as follows.

(1) Is segregation of duties satisfactory?

(2) Are controls over relevant master files satisfactory?

(3) Is there a record that all goods received have been checked for:

- Weight or number?
- Quality and damage?

(4) Are all goods received taken on charge in the detailed inventory ledgers:

- By means of the goods received note?
- Or by means of purchase invoices?
- Are there, in a computerised system, sensible control totals (hash totals, money values and so on) to reconcile the inventory system input with the payables system?

(5) Are all invoices initialled to show that:

- Receipt of goods has been checked against the goods received records?
- Receipt of services has been verified by the person using it?
- Quality of goods has been checked against the inspection?

(6) In a computerised invoice approval system are there print-outs (examined by a responsible person) of:

- Cases where order, GRN and invoice are present but they are not equal ('equal' within predetermined tolerances of minor discrepancies)?
- Cases where invoices have been input but there is no corresponding GRN?

(7) Is there adequate control over direct purchases?

(8) Are receiving documents effectively cancelled (for example cross-referenced) to prevent their supporting two invoices?

Alternatively, ICEQ questions can be phrased so that the deficiency which should be prevented by a key control is highlighted, such as the following.

Question	*Answer*	*Comments or explanation of 'yes' answer*
Can goods be sent to unauthorised suppliers?		

In these cases a 'yes' answer would require an explanation, rather than a 'no' answer.

2.1.5 Advantages and disadvantages of ICQs and ICEQs

ICQs and ICEQs	
Advantages	**Disadvantages**
If drafted thoroughly, they can ensure **all controls** are **considered**	The principal disadvantage is that they can be **drafted vaguely**, hence **misunderstood** and important controls not identified
They are **quick** to **prepare**	They may contain a large number of **irrelevant controls**
They are **easy** to **use** and **control**	They may not include **unusual controls**, which are nevertheless effective in particular circumstances
Because they are drafted in terms of **objectives** rather than specific controls, **ICEQs** are easier to apply to a variety of systems than **ICQs**	They can give the impression that all controls are of **equal** weight. In many systems one NO answer (for example lack of segregation of duties) will cancel out a string of YES answers
Answering ICEQs should enable auditors to **identify the key controls** which they are most likely to test during control testing	The client may be able to **overstate controls**
ICEQs can **highlight deficiencies** where extensive substantive testing will be required	

2.1.6 Checklists

Checklists may be used instead of questionnaires to document and evaluate the internal control system. The subtle difference with these is that, instead of asking questions, statements are made to 'mark off' and tick boxes are used to indicate where the statement holds true. For example a checklist may state 'Supplies are examined on arrival as to quantity and quality' which would be ticked if this does actually occur, or crossed if not. Checklists share many of the same advantages and disadvantages of IQCs and ICEQs.

3 The evaluation of internal control components

If the auditors believe the system of controls is strong, they may choose to test controls to assess whether they can rely on the controls having operated effectively.

3.1 Confirming understanding

In order to confirm their understanding of the control systems, auditors will often carry out **walk-through tests**. This is where they pick up a transaction and follow it through the system to see whether all the controls they anticipate should be in existence were in operation with regard to that transaction.

3.2 Tests of control

Tests of control are tests performed to obtain audit evidence about the effectiveness of the:

- Design of the accounting and internal control systems, ie whether they are suitably designed to prevent, or detect and correct, material misstatement at the assertion level; and
- Operation of the internal controls throughout the period.

Tests of control are distinguished from substantive tests which are designed to detect material misstatements in the financial statements.

Tests of control may include the following.

(a) **Inspection of documents** supporting controls or events to gain audit evidence that internal controls have operated properly, eg verifying that a transaction has been authorised

(b) **Inquiries about internal controls** which leave no audit trail, eg determining who actually performs each function not merely who is supposed to perform it

(c) **Reperformance of control procedures**, eg reconciliation of bank accounts, to ensure they were correctly performed by the entity

(d) **Examination of evidence of management views**, eg minutes of management meetings

(e) Testing of internal controls operating on **computerised systems** or over the overall IT function, eg access controls

(f) **Observation of controls** to consider the manner in which the control is being operated

Auditors should consider:

- **How** controls were applied
- The **consistency** with which they were applied during the period
- **By whom** they were applied

Deviations in the operation of controls (caused by change of staff etc) may increase control risk and tests of control may need to be modified to confirm effective operation during and after any change.

The use of **computer-assisted audit techniques** (CAATs) may be appropriate and these are discussed in detail in Chapter 11.

In a continuing engagement, the auditor will be aware of the accounting and internal control systems through work carried out previously but will need to update the knowledge gained and consider the need to obtain further audit evidence of any changes in control.

3.3 Revision of risk assessment, audit strategy and audit plan

The auditors may find that the evidence they obtain from controls testing indicates that controls did not operate as well as they expected. If the evidence contradicts the original risk assessment, the auditors will have to amend the further procedures they have planned to carry out.

In particular, if controls testing reveals that controls have not operated effectively throughout the year, the auditor may have to extend substantive testing.

Revising the risk assessment and audit procedures will necessitate an update of the audit strategy, which sets out the scope, timing and direction of the audit. For example, if tests of controls highlight that many controls are not operating as expected, this may lead to an increase in the strategy's emphasis on substantive procedures.

The new or changed procedures will need to be reflected on the audit plan, which as we saw in Chapter 7, details the nature, timing and extent of audit procedures to be performed.

3.4 Communication of deficiencies in internal control

Significant deficiencies in internal controls shall be communicated in writing to those charged with governance in a **report to management** in accordance with ISA 265 *Communicating deficiencies in internal control to those charged with governance and management* which states that the objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control identified during the audit which the auditor considers are of sufficient importance to warrant their attention.

We will look at an example report to management in more detail in Chapter 19, but in this section we will discuss the requirements of ISA 265.

A **deficiency in internal control** exists when a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis, or a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

A **significant deficiency in internal control** is a deficiency or combination of deficiencies in internal control that, in the auditor's professional judgement, is of sufficient importance to merit the attention of those charged with governance.

ISA 265 requires the auditor to determine whether one or more deficiencies in internal control have been identified and if so, whether these constitute significant deficiencies in internal control. The significance of a deficiency depends on whether a misstatement has occurred and also on the likelihood of a misstatement occurring and its potential magnitude, ISA 265 includes examples of matters to consider when determining whether a deficiency in internal control is a significant deficiency:

- The **likelihood** of the deficiencies resulting in material misstatements in the financial statements in the future
- The **susceptibility to loss or fraud** of the related asset or liability
- The **subjectivity and complexity** of determining estimated amounts
- The **amounts** exposed to the deficiencies
- The **volume of activity** that has occurred or could occur
- The **importance of the controls** to the financial reporting process
- The **cause and frequency** of the exceptions identified as a result of the deficiencies
- The **interaction** of the deficiency with other deficiencies in internal control

The ISA also lists examples of indicators of significant deficiencies in internal control, which include the following:

- Evidence of **ineffective aspects** of the control environment
- Absence of a **risk assessment process**
- Evidence of an **ineffective entity risk assessment process**
- Evidence of an **ineffective response to identified significant risks**
- **Misstatements** detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control
- **Restatement** of previously issued financial statements that were corrected for a material misstatement due to fraud or error

Evidence of **management's inability to oversee** the preparation of the financial statements.

The auditor shall communicate any significant deficiencies in internal control to **those charged with governance** on a timely basis. The auditor shall also communicate in writing to **management** on a timely basis significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance and other deficiencies in internal control that have not been communicated to management by other parties and that the auditor considers are of sufficient importance to warrant management's attention. The communication to management of other deficiencies in internal control can be done orally.

The auditor shall include the following in the written communication:

- A **description** of the deficiencies and an explanation of their **potential effects** (but there is no need to quantify the effects).
- **Sufficient information** to enable those charged with governance and management to understand the context of the communication, in particular that:
  - The purpose of the audit was for the auditor to express an opinion on the financial statements.
  - The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures appropriate in the circumstances, but not to express an opinion on the effectiveness of internal control.
  - The matters being reported are limited to those deficiencies identified during the audit and which the auditor has concluded are sufficiently important to merit being reported to those charged with governance.

The auditor may also include suggestions for remedial action on the deficiencies, management's actual or proposed responses and a statement as to whether or not the auditor has undertaken any steps to verify whether management's responses have been implemented. In addition, the auditor may also include the following additional information:

- A statement that if the auditor had undertaken more extensive procedures on internal control, more deficiencies might have been identified or some of the reported deficiencies need not have been reported.
- The written communication is for the purpose of those charged with governance and may not be suitable for other purposes.

3.4.1 Impact of deficiencies on the auditor's reliance on internal control

As we discussed in Section 1, if the controls are not adequately designed or not operating effectively, the auditor needs to re-visit the risk assessment and design sufficient substantive testing over that financial statement area. Therefore, where significant deficiencies are identified, unless there are robust compensating controls, the auditor will have no choice but to use purely substantive procedures to obtain sufficient appropriate audit evidence. The auditor will not seek to place reliance on internal controls.

It may be that the deficiencies were not identified during planning and risk assessment, but only become apparent later in the audit process. If this is the case, and the original audit plan was based on a reliance on internal controls, that audit plan will need to be amended, with the likely result that further audit procedures will need to be performed.

4 Internal controls in a computerised environment

There are special considerations for auditors when a system is computerised. IT controls comprise **general** and **application** controls.

The internal controls in a computerised environment include both manual procedures and procedures designed into computer programs. Such control procedures comprise two types of control, **general controls** and **application controls**.

General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. They commonly include controls over data centre and network operations, system software acquisition, change and maintenance, access security, and application system acquisition, development and maintenance.

Application controls are manual or automated procedures that typically operate at a business process level. They can be preventative or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, they relate to procedures used to initiate, record, process and report transactions or other financial data.

4.1 General controls

GENERAL CONTROLS	EXAMPLES
Development of computer applications	**Standards** over systems design, programming and documentation Full **testing procedures** using test data **Approval** by computer users and management **Segregation of duties** so that those responsible for design are not responsible for testing **Installation procedures** so that data is not corrupted in transition **Training** of staff in new procedures and availability of adequate **documentation**
Prevention or detection of unauthorised changes to programs	**Segregation of duties** **Full records** of program changes **Password protection** of programs so that access is limited to computer operations staff **Restricted access** to central computer by locked doors, keypads Maintenance of **programs logs** **Virus checks** on software: use of anti-virus software and policy prohibiting use of non-authorised programs or files **Back-up copies** of programs being taken and stored in other locations **Control copies** of programs being preserved and regularly compared with actual programs **Stricter controls** over certain programs (utility programs) by use of **read-only memory**
Testing and documentation of program changes	Complete **testing procedures** **Documentation standards** **Approval** of changes by computer users and management **Training** of staff using programs
Controls to prevent wrong programs or files being used	**Operation controls** over programs **Libraries** of programs **Proper job scheduling**
Controls to prevent unauthorised amendments to data files	**Password protection** **Restricted access** to authorised users only
Controls to ensure continuity of operation	Storing **extra copies** of programs and data files off-site **Protection of equipment** against fire and other hazards **Back-up power sources** **Disaster recovery procedures** eg availability of back-up computer facilities **Maintenance agreements** and **insurance**

The auditors will wish to test some or all of the above general IT controls, having considered how they affect the computer applications significant to the audit.

General IT controls that relate to some or all applications are usually interdependent controls, ie their operation is often essential to the effectiveness of application controls. As application controls may be useless when general controls are ineffective, it will be more efficient to review the design of general IT controls first, before reviewing the application controls.

4.2 Application controls

The purpose of application controls is to establish **specific control procedures** over the accounting applications in order to provide reasonable assurance that all transactions are authorised and recorded, and are processed completely, accurately and on a timely basis.

Application controls include the following.

APPLICATION CONTROLS	EXAMPLES
Controls over **input**: **completeness**	Manual or programmed agreement of **control totals** **Document counts** **One-for-one checking** of processed output to source documents **Programmed matching** of input to an expected input control file **Procedures** over resubmission of rejected controls
Controls over **input: accuracy**	**Programmes to check data** fields (for example value, reference number, date) on input transactions for plausibility: • Digit verification (eg reference numbers are as expected) • Reasonableness test (eg sales tax to total value) • Existence checks (eg customer name) • Character checks (no unexpected characters used in reference) • Necessary information (no transaction passed with gaps) • Permitted range (no transaction processed over a certain value) **Manual scrutiny** of output and reconciliation to source Agreement of **control totals** (manual/programmed)
Controls over **input authorisation:**	**Manual checks** to ensure information input was: • Authorised • Input by authorised personnel
Controls over **processing**	Similar controls to input must be in place when input is completed, for example, **batch reconciliations** **Screen warnings** can prevent people logging out before processing is complete
Controls over **master files and standing data**	**One-to-one checking** **Cyclical reviews** of all master files and standing data **Record counts** (number of documents processed) and **hash totals** (for example, the total of all the payroll numbers) used when master files are used to ensure no deletions **Controls** over the deletion of accounts that have no current balance

Controls over input, processing, data files and output may be carried out by IT personnel, users of the system, a separate control group and may be programmed into application software. The auditors may wish to test the following application controls.

TESTING OF APPLICATION CONTROLS	
Manual controls exercised by the user	If manual controls exercised by the user of the application system are capable of providing reasonable assurance that the system's output is complete, accurate and authorised, the auditors may decide to limit tests of control to these manual controls.
Controls over system output	If, in addition to manual controls exercised by the user, the controls to be tested use information produced by the computer or are contained within computer programs, such controls may be tested by examining the system's output using either manual procedures or computers. Such output may be in the form of magnetic media, microfilm or printouts. Alternatively, the auditor may test the control by performing it with the use of computers.
Programmed control procedures	In the case of certain computer systems, the auditor may find that it is not possible or, in some cases, not practical to test controls by examining only user controls or the system's output. The auditor may consider performing tests of control by using computers, reprocessing transaction data or, in unusual situations, examining the coding of the application program.

As we have already noted, general IT controls may have a pervasive effect on the processing of transactions in application systems. If these general controls are not effective, there may be a risk that misstatements occur and go undetected in the application systems. Although weaknesses in general IT controls may preclude testing certain IT application controls, it is possible that manual procedures exercised by users may provide effective control at the **application level**.

Tests of Control

7.0
TESTS OF CONTROL

UNIT 7 OVERVIEW:

- The Sales System
- The Purchases System
- The Inventory System
- The Bank and Cash System
- The Payroll System
- Revenue and Capital Expenditure

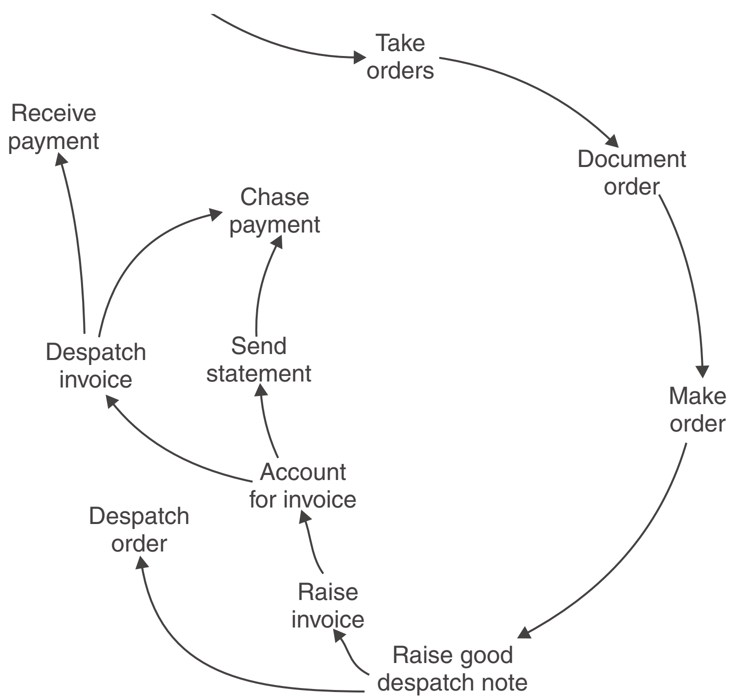
1 The Sales System

The tests of control in the sales system will be based around:

1. Selling (**Athourisation**)
2. Good outwards (**Custody**)
3. Accounting (**Recording**)

The following diagram illustrates the sales system.

The sales system



1.1 Sales system: Control objectives, controls and tests of controls

Assertion	Control objectives	Controls	Tests of controls
Occurrence and existence	• To ensure that one person is not responsible for taking orders, recording sales and receiving payment.	• Segregation of duties.	• Observe and evaluate whether proper segregation of duties is operating.
	• To ensure that recorded sales transactions represent goods or services provided.	• Sales are only recorded if there is an approved sales order form and shipping/despatch documentation.	• For a sample of sales invoices ensure there is a related sales order form that has been authorised and shipping documentation. • Examine application controls for authorisation.
		• Accounting for numerical sequences of invoices.	• Review and test entity's procedures for accounting for numerical sequences of invoices.
		• Monthly customer statements sent out and customer queries and complaints handled independently.	• Review entity's procedures for sending out monthly statements and dealing with customer queries and complaints.

Assertion	Control objectives	Controls	Tests of controls
Occurrence and existence	• To ensure that goods and services are only supplied to customers with good credit ratings.	• Authorisation of credit terms to customers (senior staff authorisation, references/credit checks for new customers, regular review of credit limits). • Authorisation by senior staff required for changes in other customer data such as address etc. • Orders not accepted unless credit limits reviewed first.	• Review entity's procedures for granting credit to customers. • Examine a sample of sales orders for evidence of proper credit approval by the appropriate senior staff member. • Examine application controls for credit limits. • Review all new customer files to ensure satisfactory credit references have been obtained.
	• To ensure that goods and services are provided at authorised prices and on authorised terms. • To ensure that customers are encouraged to pay promptly.	• Authorised price lists and specified terms of trade in place.	• Verify that price lists and terms of trade are properly documented, authorised and communicated. • Examine application controls for authorised prices and terms.
Completeness	• To ensure that all revenue relating to goods dispatched is recorded.	• Accounting for numerical sequences of invoices.	• Review and test entity's procedures for accounting for numerical sequences of invoices.
	• To ensure that all goods and services sold are correctly invoiced.	• Shipping/despatch documentation is matched to sales invoices. • Sales invoices are reconciled to the daily sales report. • An open-order file is maintained and reviewed regularly.	• For a sample of shipping/despatch documents, ensure each has been matched to a related sales invoice that was subsequently recorded. • Review a sample of reconciliations performed. • Inspect the open-order file for unfilled orders.

Assertion	Control objectives	Controls	Tests of controls
Accuracy	• To ensure that all sales and adjustments are correctly journalised, summarised and posted to the correct accounts.	• Sales invoices and matching documents required for all entries and the date and reference of the entry are written on each document.	• Review supporting documents for a sample of sales entries to ensure they contain the written details that indicate they were referred to when entered.
Cut-off	• To ensure that transactions have been recorded in the correct period.	• All shipping documentation is forwarded to the invoicing section on a daily basis. • Daily invoicing of goods shipped.	• Compare dates on sales invoices with dates of corresponding shipping documentation. • Compare dates on sales invoices with dates recorded in the sales ledger.
Classification	• To ensure that all transactions are properly classified in accounts.	• Chart of accounts (COA) in place and is regularly reviewed for appropriateness and updated where necessary. • Codes in place for different types of products or services.	• Inspect any documentary evidence of review (such as e-mails requesting update to COA as a result of review). • Test application controls for proper codes.

Question

Sales system

You are the auditor of Arcidiacono Stationery, and you have been asked to suggest how audit work should be carried out on the sales system.

Arcidiacono Stationery Ltd sells stationery to shops. Most sales are to small customers who do not have a sales ledger account. They can collect their purchases and pay by cash. For cash sales:

(i) The customer orders the stationery from the sales department, which raises a pre-numbered multi-copy order form.

(ii) The dispatch department make up the order and give it to the customer with a copy of the order form.

(iii) The customer gives the order form to the cashier who prepares a hand-written sales invoice.

(iv) The customer pays the cashier for the goods by cheque or in cash.

(v) The cashier records and banks the cash.

Required

(a) State the deficiencies in the cash sales system.
(b) Describe the systems-based tests you would carry out to audit the controls over the system.

Answer

(a) **Deficiencies in the cash sales system**

(i) The physical location of the dispatch department and the cashier are not mentioned here, but there is a risk of the customer taking the goods without paying. The customer should pay the cashier on the advice note and return for the goods, which should only be released on sight of the paid invoice.

(ii) There is a failure in segregation of duties in allowing the cashier to both complete the sales invoice and receive the cash as he could perpetrate a fraud by replacing the original invoice with one of lower value and keeping the difference.

(iii) No-one checks the invoices to make sure that the cashier has completed them correctly, for example by using the correct prices and performing calculations correctly.

(iv) The completeness of the sequence of sales invoices cannot be checked unless they are pre-numbered sequentially and the presence of all the invoices is checked by another person. The order forms should also be pre-numbered sequentially.

(v) There is no check that the cashier banks all cash received, and this is a further failure of segregation of duties.

If the sales department prepared and posted the invoices and also posted the cash for cash sales to a sundry sales account, this would solve some of the internal control problems mentioned above. In addition, the sales department could run a weekly check on the account to look for invoices for which no cash had been received. These could then be investigated.

All of these deficiencies, and possible remedies, should be reported to management.

(b) **Tests**

(i) Select a sample of order forms issued to customers during the year. Trace the related sales invoice and check that the details correlate (date, unit amounts etc). The customer should have signed for the goods and this copy should be retained by the dispatch department.

(ii) For the sales invoices discovered in the above test, I would check that the correct order form number is recorded on the invoice, that the prices used are correct (by reference to the prevailing price list).

(iii) I would then trace the value of the sales invoices to the cash book and from the cash book that the total receipts for the day have been banked and appear promptly on the bank statement.

(iv) I would check that the sales invoices have been correctly posted to a cash or sundry sales account. For any sales invoices missing from this account (assuming they are sequentially numbered), I would trace the cancelled invoice and check that the cancelled invoice was initialled by the customer and replaced by the next invoice in sequence.

(v) Because of the weaknesses in the system I would carry out the following sequence checks on large blocks of order forms/invoices, eg four blocks of 100 order forms/invoices.

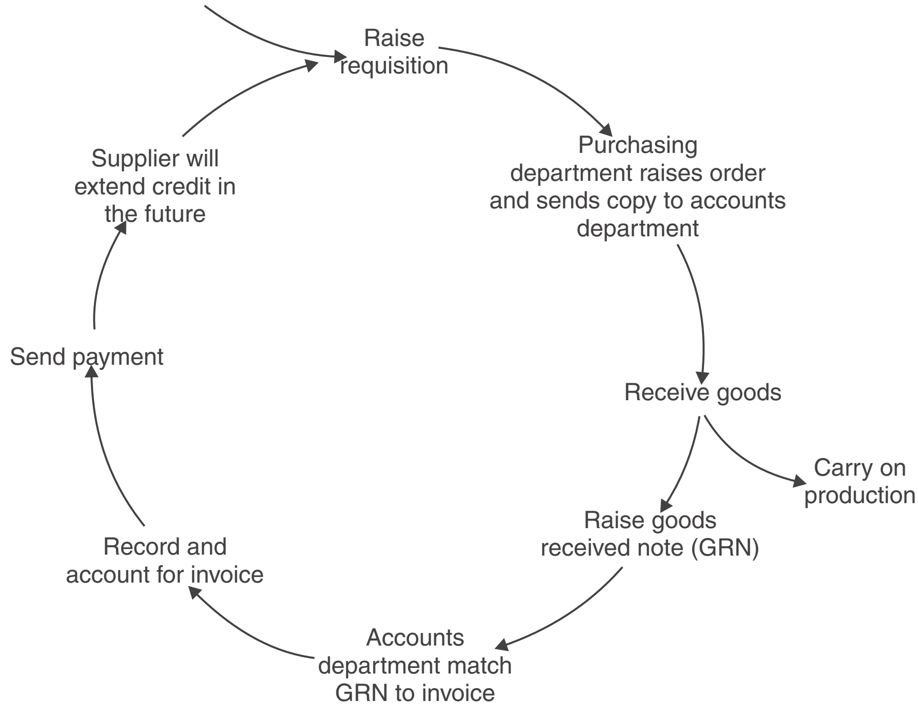
(1) Inspect all order forms to ensure all present; investigate those missing
(2) Match sales invoices to order forms
(3) Check all sales invoices in a sequence have been used; investigate any missing
(4) Cash for each sales invoice has been entered into the cash book

Using the results of the above tests I would decide whether the system for cash sales has operated without material fraud or error. If I am not satisfied that it has then this may impact on the audit report.

2 The purchases system

The tests of controls in the **purchases system** will be based around:

- **Buying** (authorisation)
- **Goods inwards** (custody)
- **Accounting** (recording)



2.1 Control objectives, controls and tests of controls

Assertion	Control objectives	Controls	Tests of controls
Occurrence and existence	• To ensure that recorded purchases represent goods and services received.	• Authorisation procedures and policies in place for ordering goods and services. • Segregation of duties. • Purchase orders raised for each purchase and authorised by appropriate senior personnel. • Approved purchase order for each receipt of goods.	• Inspect policies and procedures and inquire about them. • Observe and evaluate segregation of duties. • Examine a sample of purchase orders to ensure they have been appropriately authorised. • Review the delegated list of authority for purchases. • For a sample of GRNs, ensure there is a related purchase order that it has been properly approved.

Assertion	Control objectives	Controls	Tests of controls
Occurrence and existence		• Staff receiving goods check them to the purchase order. • Stores clerks sign for goods received. • Purchase orders and GRNs are matched with the suppliers' invoices.	• Observe receipt of goods by staff to confirm whether the check is done. • Inspect a sample to confirm whether stores staff undertake this check. • Examine supporting documentation to ensure it has been matched for a sample of invoices.
Completeness	• To ensure that all purchase transactions that occurred have been recorded.	• Purchase orders and GRNs are matched with the suppliers' invoices. • Periodic accounting for prenumbered GRNs and purchase orders. • Independent check of amount recorded in the purchase journal.	• For a sample of purchase orders in the year ensure each has been matched to a related invoice that was subsequently recorded. • Review entity's procedures for accounting for prenumbered documents. • Examine application controls. • Examine documentation for evidence of this check.
Rights and obligations	• To ensure that recorded purchases represent the liabilities of the entity.	• Purchase orders and GRNs are matched with the suppliers' invoices.	• Examine supporting documentation to ensure it has been matched for a sample of invoices.
Accuracy, classification and valuation	• To ensure that purchase transactions are correctly recorded in the accounting system.	• Purchase orders and GRNs are matched with the suppliers' invoices. • Mathematical accuracy of the supplier's invoice is verified. • Amount posted to general ledger is reconciled to the purchases ledger.	• Examine supporting documentation for a sample of invoices. • Review a sample of invoices for evidence the accuracy has been verified (eg signature or initials) and re-perform the check. • Review reconciliations for evidence of this check.

Assertion	Control objectives	Controls	Tests of controls
Accuracy, classification and valuation		• Chart of accounts in place.	• Review purchases journal and general ledger for reasonableness.
Cut-off	• To ensure that purchase transactions are recorded in the correct accounting period.	• All goods received reports forwarded to accounts payable department daily. • Procedures in place that require recording of purchases as soon as possible after goods/services received.	• Compare dates on reports to dates on relevant vouchers. • Compare dates on vouchers with dates they were recorded in the purchases journal.

Question

Purchase controls

Derek, a limited liability company, operates a computerised purchase system. Invoices and credit notes are posted to the purchases ledger by the purchases ledger department. The computer subsequently raises a cheque when the invoice has to be paid.

Required

List the controls that should be in operation:

(a) Over the addition, amendment and deletion of suppliers, ensuring that the standing data only includes suppliers from the company's list of authorised suppliers

(b) Over purchase invoices and credit notes, to ensure only authorised purchase invoices and credit notes are posted to the purchase ledger

Answer

(a) Controls over the standing data file containing suppliers' details will include the following.

(i) All amendments/additions/deletions to the data should be authorised by a responsible official. A standard form should be used for such changes.

(ii) The amendment forms should be input in batches (with different types of change in different batches), sequentially numbered and recorded in a batch control book so that any gaps in the batch numbers can be investigated. The output produced by the computer should be checked to the input.

(iii) A listing of all such adjustments should automatically be produced by the computer and reviewed by a responsible official, who should also check authorisation.

(iv) A listing of suppliers' accounts on which there has been no movement for a specified period should be produced to allow decisions to be made about possible deletions, thus ensuring that the standing data is current. The buying department manager might also recommend account closures on a periodic basis.

(v) Users should be controlled by use of passwords. This can also be used as a method of controlling those who can amend data.

(vi) Periodic listings of standing data should be produced in order to verify details (for example addresses) with suppliers' documents (invoices/statements).

(b) The input of authorised purchase invoices and credit notes should be controlled in the following ways.

   (i) Authorisation should be evidenced by the signature of the responsible official such as the Chief Accountant. In addition, the invoice or credit note should show initials to demonstrate that the details have been agreed: to a signed GRN; to a purchase order; to a price list; for additions and extensions.

   (ii) There should be adequate segregation of responsibilities between the posting function, inventory custody and receipt, payment of suppliers and changes to standing data.

   (iii) Input should be restricted by use of passwords linked to the relevant site number.

   (iv) A batch control book should be maintained, recording batches in number sequence. Invoices should be input in batches using pre-numbered batch control sheets. The manually produced invoice total on the batch control sheet should be agreed to the computer generated total. Credit notes and invoices should be input in separate batches to avoid one being posted as the other.

   (v) A program should check calculation of sales tax at standard rate and total of invoice. Non-standard sales tax rates should be highlighted.

   (vi) The input of the supplier code should bring up the supplier name for checking by the operator against the invoice.

   (vii) Invoices for suppliers which do not have an account should be prevented from being input. Any sundry suppliers account should be very tightly controlled and all entries reviewed in full each month.

   (viii) An exception report showing unusual expense allocation (by size or account) should be produced and reviewed by a responsible official. Expenses should be compared to budget and previous years.

   (ix) There should be monthly reconciliations of purchase ledger balances to suppliers' statements by someone outside the purchasing (accounting) function.

3 The inventory system

Inventory controls are designed to ensure safe custody. Such controls include restriction of access, documentation and authorisation of movements, regular **independent inventory counting** and **review of inventory condition**.

3.1 Introduction

The inventory system can be very important in an audit because of the high value of inventory or the complexity of its audit. It is closely connected with the sales and purchases systems covered in the previous sections.

There are three possible approaches to the audit of inventory and the approach chosen depends on the control system in place over inventory.

(a) If the entity has a perpetual inventory system in place where inventory is counted continuously throughout the year, and therefore a year-end count is not undertaken, a controls-based approach can be taken if control risk has been assessed as low.

(b) If an inventory count is to be undertaken near the year-end and adjusted by perpetual inventory records for the year-end value, this approach also requires control risk to be assessed as low.

(c) If inventory quantities will be determined by an inventory count at the year-end date, a largely substantive approach is taken. This approach is covered in Chapter 13.

3.2 Control objectives, controls and tests of controls

Most of the controls testing relating to inventory has been covered in the purchase and sales testing outlined in Sections 1 and 2. Auditors will primarily be concerned at this stage with ensuring that the business keeps track of inventory. To confirm this, tests must be undertaken on how inventory **movements** are **recorded** and how **inventory** is **secured**. Auditors will carry out extensive tests on the **valuation** of inventory at the substantive testing stage (see Chapter 13).

Assertion	Control objectives	Controls	Tests of controls
Occurrence and existence	• To ensure that all inventory movements are authorised and recorded.	• Prenumbered documentation such as GDNs and GRNs in use. • Reconciliations of inventory records with general ledger. • Segregation of duties.	• Review documentation in use. • Review a sample of reconciliations to confirm they are performed and then reviewed by an independent person. • Observe and evaluate proper segregation of duties.
	• To ensure that Inventory included on the statement of financial position physically exists.	• Physical safeguards in place to ensure inventory is not stolen. • Separate responsibilities for maintenance of records and custodianship. • Inventory counted regularly.	• Review security systems in place (eg locked warehouses, CCTV etc). • Review policies and procedures in place; discuss procedures with relevant staff. • Review procedures for counting inventory. • Attend inventory count.
Completeness	• To ensure that all purchases and sales of inventory have been recorded in the accounting system.	• Procedures in place to include inventory held at third parties and exclude inventory held on consignment for third parties. • Reconciliations of accounting records with physical inventory.	• Review entity's procedures relating to consignment inventory. • Review reconciliations performed and whether reviewed by independent person.

Assertion	Control objectives	Controls	Tests of controls
Rights and obligations	• To ensure that inventory records only include items that belong to the entity.	• Procedures in place to include inventory held at third parties and exclude inventory held on consignment for third parties.	• Review entity's procedures relating to consignment inventory.
Accuracy, classification and valuation	• To ensure that Inventory quantities have been accurately determined.	• Periodic or annual comparison of inventory with amounts shown in continuous (perpetual) inventory records.	• Review and test entity's procedures for taking physical inventory.
	• To ensure that Inventory is properly stated at the lower of cost and net realisable value.	• Standard costs reviewed by management. • Review of cost accumulation and variance reports. • Inventory managers review inventory regularly to identify slow-moving, obsolete and excess inventory.	• Review and test entity's procedures for developing standard costs. • Inspect variance reports produced. • Discuss with inventory managers how this is done. • Observe the procedure being performed.
Cut-off	• To ensure that all purchases and sales of inventory are recorded in the correct accounting period.	• All dispatch documents processed daily to record the dispatch of finished goods. • All goods inwards reports processed daily to record the receipt of inventory. • Reconciliations of inventory records with general ledger.	• Inspect documentation to confirm daily processing. • Inspect documentation to confirm daily processing. • Review reconciliations performed.
Presentation and disclosure assertions	• To ensure that inventory transactions and balances are properly identified and classified in the financial statements.	• Orders for materials and production data forms used to process goods through manufacturing.	• Review entity's procedures and documentation used to classify inventory.
	• To ensure that disclosures relating to classification and valuation are sufficient.	• Approval by Finance Director.	• Review entity's working papers for evidence of review.

4 The bank and cash system

Controls over cash receipts and payments should prevent fraud or theft.

4.1 Control objectives, controls and tests of controls

The following table sets out the control objectives, controls and possible tests of controls over **cash payments**.

Assertion	Control objectives	Controls	Tests of controls
Occurrence	• To ensure that only valid cash payments are made.	• Segregation of duties. • Supplier statements independently reviewed and reconciled to trade payable records. • Monthly bank reconciliations prepared and reviewed. • Only authorised staff can make electronic cash payments and issue cheques. • Electronic cash payments and cheques prepared only after all source documents have been independently approved.	• Observe and evaluate proper segregation of duties. • Review procedures for reconciling supplier statements. • Review reconciliations to confirm whether undertaken and reviewed. • Review delegated list of authority for cash payments. • Inspect relevant documentation for evidence of approval by senior personnel.
Completeness	• To ensure that all cash payments that occurred are recorded.	• Segregation of duties. • Supplier statements independently reviewed and reconciled to trade payable records. • Monthly bank reconciliations prepared and reviewed.	• Observe and evaluate proper segregation of duties. • Review procedures for reconciling supplier statements. • Review reconciliations to confirm whether undertaken and independently reviewed.

Assertion	Control objectives	Controls	Tests of controls
Completeness		• Review of cash payments by manager before release. • Daily cash payments reconciled to posting to payable accounts. • Use of prenumbered cheques.	• Inspect sample of listings for evidence of senior review. • Review a sample of reconciliations for evidence that they have been done. • Examine evidence of use of prenumbered cheques.
Accuracy, classification and valuation	• to ensure that cash payments are recorded correctly in the ledger.	• Reconciliation of daily payments report to electronic cash payment transfers and cheques issued. • Supplier statements reconciled to payable accounts regularly. • Monthly bank reconciliations of bank statements to ledger account.	• Review reconciliation, to ensure performed, reviewed and any discrepancies followed up on a timely basis. • Review reconciliations for a sample of accounts. • Review bank reconciliation for evidence it was done and independently reviewed.
	• To ensure that cash payments are posted to the correct payable accounts and to the general ledger.	• Supplier statements reconciled to payable accounts regularly. • Agreement of monthly cash payments journal to general ledger posting. • Payable accounts reconciled to general ledger control account.	• Review reconciliations for a sample of accounts. • Review postings from journal to general ledger. • Review reconciliation, to ensure performed, reviewed and any discrepancies followed up on a timely basis.

Assertion	Control objectives	Controls	Tests of controls
Cut-off	• To ensure that cash payments are recorded in the correct accounting period.	• Reconciliation of electronic funds transfers and cheques issued with postings to cash payments journal and payable accounts.	• Review reconciliation and check it is carried out regularly.
Presentation and disclosure assertions	• To ensure that cash payments are charged to the correct accounts.	• Chart of accounts. • Independent approval and review of general ledger account assignment.	• Review cash payments journal to assess reasonableness of charging of accounts. • Review assignment of general ledger account.

The following table sets out the control objectives, controls and possible tests of controls over **cash receipts**.

Assertion	Control objectives	Controls	Tests of controls
Occurrence	• To ensure that all valid cash receipts are received and deposited.	• Segregation of duties. • Use of electronic cash receipts transfer not received or deposited. • Monthly bank reconciliations performed and independently reviewed. • Use of cash registers or point-of-sale devices. • Periodic inspections of cash sales procedures. • Restrictive endorsement of cheques immediately on receipt. • Mail opened by two staff members. • Immediate preparation of cash book or list of mail receipts.	• Observe and evaluate proper segregation of duties. • Examine application controls for electronic cash receipts transfer. • Review monthly bank reconciliations to confirm performed and reviewed. • Observe cash sales procedures. • Inquire of managers about results of inspections. • Observe mail opening, including endorsement of cheques. • Observe mail opening procedures. • Observe preparation of cash receipts' records.

Assertion	Control objectives	Controls	Tests of controls
Occurrence		• Independent check of agreement of cash/cheques to be deposited at bank with register totals and receipts listing. • Independent check of agreement of bank deposit slip with daily cash summary.	• Review documentation for evidence of independent check. • Review documentation for evidence of independent check.
Completeness	• To ensure that all cash receipts are recorded.	• Segregation of duties. • Use of electronic cash receipts transfer not received or deposited. • Monthly bank reconciliations performed and independently reviewed. • Daily cash receipts listing reconciled with posting to customer accounts. • Customer statements prepared and sent out on a regular basis.	• Observe and evaluate proper segregation of duties. • Examine application controls for electronic cash receipts transfer. • Review monthly bank reconciliations to confirm performed and reviewed. • Review reconciliation. • Inquire of management about handling of customer statements. • Examine a sample of customers and note frequency of statements.

Assertion	Control objectives	Controls	Tests of controls
Accuracy, classification and valuation	• To ensure that cash receipts are recorded at correct amounts.	• Daily remittance report reconciled to control listing of remittance advices. • Monthly bank statement performed and reviewed independently.	• Review reconciliations. • Review reconciliations for evidence they were performed and independently reviewed.
	• To ensure that cash receipts are posted to correct receivables accounts and to the general ledger.	• Daily remittance report reconciled daily with postings to cash receipts journal and customer accounts. • Monthly customer statements sent out. • Monthly cash receipts journal agreed to general ledger posting. • Receivables' ledger reconciled to control account.	• Review reconciliations. • Review entity's procedures for sending out statements. • Review journal and posting to general ledger. • Review reconciliations.
Cut-off	• To ensure that cash receipts are recorded in the correct accounting period.	• Bank reconciliation at period-end.	• Review and test reconciliation.
Presentation and disclosure assertions	• To ensure that cash receipts are charged to the correct accounts.	• Chart of accounts (COA) in place and is regularly reviewed for appropriateness and updated where necessary. • Codes in place for different types of receipts.	• Inspect any documentary evidence of review (such as emails requesting update to COA as a result of review). • Test application controls for proper codes.

5 The payroll system

Key controls over **payroll** cover:

- **Documentation** and **authorisation** of staff changes
- **Calculation** of wages and salaries
- **Payment** of wages
- **Authorisation** of **deductions**

5.1 Control objectives, controls and tests of controls

Assertion	Control objectives	Controls	Tests of controls
Occurrence and existence	• To ensure that payment is made only to bona fide employees of the entity.	• Segregation of duties between HR and payroll functions.	• Observe and evaluate proper segregation of duties.
		• Personnel files held for all employees.	• Review a sample of starters and leavers in the year to ensure correct documentation is in place.
		• Authorisation procedures for hiring, terminating, time worked, wage rates, overtime, benefits etc.	• Review and test authorisation procedures in place.
		• Any changes in employment status of employees (eg maternity, special leave etc) informed to Human Resources department.	• Review policies and procedures in place for changing status and consider whether adequate. • Review personnel files for a sample of employees whose status changed in the year.
		• Use of time clocks to record time worked.	• Observe employees' use of time clocks.
		• Clock cards approved by supervisor.	• Inspect a sample of clock cards for evidence of approval by appropriate level of management.
		• Only employees with valid employee numbers are paid.	• Review and test procedures for entering and removing employee numbers from the payroll master file.

Assertion	Control objectives	Controls	Tests of controls
Occurrence and existence		• Payroll budgets in place and reviewed by management.	• Review budgeting procedures.
Completeness	• To ensure that all payroll costs are recorded for work done by employees.	• Prenumbered clock cards in use. • Segregation of duties. • Regular reconciliations carried out of payroll records and employee costs recorded in the general ledger. • Comparison of cheques and bank transfer list with payroll to ensure all employees paid have been recorded via payroll. • Preparation and authorisation of cheques and bank transfer lists.	• Review numerical sequence of clock cards. • Observe and evaluate proper segregation of duties. • Review a sample of reconciliations to ensure they are properly carried out. • Inquire whether comparisons are being made between payment records and payroll and inspect any documentary evidence of the review. • Examine paid cheques or a certified copy of the bank list for employees paid by cheque or bank transfer to ensure proper authorisation.
Accuracy, classification and valuation	• To ensure that all benefits and deductions (tax, pension etc) are computed correctly.	• Re-performance of a sample of payroll benefit and deduction calculations. • Payroll budgets in place and reviewed by management. • Agreement of gross earnings and total tax deducted with taxation returns.	• Review documentary evidence that recalculation occurred (eg spreadsheet print out). • Review budgeting procedures. • Inspect documentation for evidence of management's review.
	• To ensure that payroll transactions are correctly recorded in the accounting system.	• Changes to master payroll file verified through 'before and after' reports.	• Review reconciliation 'before and after' reports to payroll master file.

Assertion	Control objectives	Controls	Tests of controls
Accuracy, classification and valuation		• Payroll master file reconciled to general ledger.	• Review reconciliation payroll master file to general ledger. Confirm whether discrepancies are followed-up promptly and resolved.
Cut-off	• To ensure that payroll transactions are recorded in the correct accounting period.	• All starters, leavers, changes to salaries and deductions are reported promptly to payroll department and changes are updated to the payroll master file promptly.	• Review entity's procedures for reporting changes to the payroll department. • Verify sample of starters and leavers.
Presentation and disclosure assertions	• To ensure that payroll transactions are properly classified in the financial statements.	• Chart of accounts. • Independent approval and review of accounts charged to payroll. • Payroll budgets in place and reviewed by management.	• Review chart of accounts. • Review procedures for classifying payroll costs. • Review budgeting procedures.

The following question aims to link the aspects we looked at in the Chapter 9 with the control objectives and tests of control we have just looked at.

The audit of wages, particularly the internal controls around wages, are discussed in detail in an article in the Student Accountant in August 2013 called 'The Audit of Wages.' This article can be accessed via the Technical Articles link on the ACCA website: http://www.accaglobal.com/gb/en/student/acca-qual-student-journey/qual-resource/acca-qualification/f8/technical-articles.html.

Question — Payroll controls

A good understanding of internal controls is essential to auditors. This helps them to understand the business and allows the auditor to effectively plan and execute tests of controls together with an appropriate level of substantive procedures.

A small manufacturing company, Westfield, pays its staff in cash and by bank transfer, and the payroll department consists of a payroll clerk who maintains its payroll on a stand-alone lap-top computer. The payroll clerk is supervised by the chief accountant, who in turn reports to the managing director. You are Westfield's auditor.

Required

(a) For the *payroll department* at Westfield, describe the internal control *objectives* that should be in place

(b) Describe the internal control *environment* and internal control *activities* that should be in place to achieve the internal control objectives in (a)

(c) Using your answer above, suggest a control the auditor may seek to rely on when obtaining evidence over 'occurrence and existence' in relation to payroll, and explain why. State ONE test of control the auditor might carry out to test the operating effectiveness of that control.

Answer

(a) **Internal control objectives**

To ensure that:

- Only genuine staff are paid for work performed
- Gross pay has been calculated correctly
- Deductions from gross pay are calculated and recorded accurately
- The correct employees are paid what they are entitled to
- Wages and salaries paid are accurately recorded in the bank and cash records
- The right amounts due in respect of tax and national insurance are paid to the relevant authority on a timely basis

(b) **Internal control environment and control activities**

Internal control environment

The control environment includes the governance and management functions and the attitudes, awareness and actions of management and those charged with governance in terms of the importance of internal control within the business. More specifically it would include the following:

- The way in which management **communicate** to staff the need for integrity and enforce it.
- The consideration which management gives to ensure that the payroll staff have the **requisite skills** and **knowledge** through proper recruitment and training.
- Management's **philosophy** and **operating style,** including the way in which the importance of internal control in the processing of payroll is translated into positive action, for example providing sufficient resources to address security risks regarding access to the computer.
- The way that **authority** and **responsibility** is assigned. For example the chief accountant might act in a supervisory role whilst the payroll clerk is responsible for the detailed calculations and processing.

Internal control activities

- Responsibility for the preparation of the payroll should be delegated to a responsible, adequately trained member of staff.
- For hourly paid employees, the payroll should be prepared on the basis of timesheets/clockcards authorised by a factory supervisor.
- Standing data used by the computerised payroll system should be checked on a regular basis eg gross pay to personnel records.
- Any changes should be authorised by the chief accountant eg change in pay rates, overtime, joiners and leavers.
- For a sample of employees calculations for gross pay, net pay and deductions should be reperformed by the chief accountant.
- The payroll software should include computerised controls eg hierarchical password access and range checks. Exception reports should be produced and investigated.
- The managing director should review the payroll by comparing the total monthly cost with the budget and previous months actual figures.
- The bank transfer list and wage cheque should be authorised by the managing director.
- Cash should be kept securely in the company safe until it is distributed.

- There should be segregation of duties between the member of staff responsible for processing the payroll and the individual handling the cash.
- The chief accountant should maintain and reconcile a wages and salaries control account.

(c) **Occurrence and existence**

The segregation of duties between the member of staff responsible for processing the payroll and the individual making the bank transfers or cash payments is a key control in preventing the setting up of bogus employees and diverting funds to a private bank account.

This therefore helps fulfil the control objective that only genuine employees are paid and is one control the auditor may seek to test and rely on, to gain evidence in relation to 'occurrence and existence'.

The test of control would simply be to observe and evaluate proper segregation of duties.

6 Revenue and capital expenditure

Most of the key controls over capital and revenue expenditure are the general purchase controls.

The nature of a statement of financial position and statement of profit or loss means that it is important to classify capital and revenue expenditure correctly, or profit will be over or understated. You should know the distinction between them from your financial reporting studies.

The controls and tests outlined below are often considered and performed during the audit of non-current assets (see Chapter 12) as this is where the main issue of capitalisation occurs.

6.1 Controls and tests of controls

Assertion	Control objectives	Controls	Tests of control
Authorisation	• To ensure that expenditure is properly authorised.	• Orders for capital items should be authorised by appropriate levels of management. • Order should be requisitioned on appropriate (different to revenue) documentation. • Invoices should be approved by the person who authorised the order. • Invoices should be marked with the appropriate general ledger code.	• Review policies and procedures in place. • Examine a sample of orders for appropriate authorisation. • Inspect invoices to verify the invoice has been appropriately approved. • Inspect invoices to verify the invoice has the correct general ledger code marked on it.
Classification	• To ensure that expenditure is classified correctly in the financial statements as capital or revenue expenditure.	• All the standard controls over purchases are relevant here (see Section 2).	• See Section 2.

Assertion	Control objectives	Controls	Tests of control
Completeness	• To ensure that all non-current assets are correctly recorded in the accounting system.	• Capital items should be written up in the non-current asset register. • The non-current asset register should be reconciled regularly to the general ledger and any differences investigated and resolved promptly.	• Review reconciliation to ensure it is regularly carried out, reviewed by a more senior person, and that all discrepancies are followed up and resolved on a timely basis.

6.2 Tests of controls and substantive testing

If the ordering documentation is different for capital purchases, all the standard purchase control tests should be carried out. If the documentation is not different, the auditor should also enquire as to the client's system for recording and filing capital invoices.

It is likely that the number of capital purchases in the year will be less than the number of standard purchases in the year and if the invoices are not segregated it may not be cost-efficient to test the controls over this area in which case substantive testing would have to be undertaken.

These substantive tests are often carried out as part of the substantive audit of non-current assets, which is covered in Chapter 12.

The auditor should be aware of the risks attaching to the audit of this area. As tests of controls might not be cost-effective, control risk in this area is higher than it would have been if they were tested.

Inherent risk can also be high in this area. Capital and revenue expenditure is treated differently for the purposes of tax, and if the client is sensitive to the tax bill, there may be an incentive to account creatively.

Question — System control deficiencies

Jonathan is the sole shareholder of Furry Lion Stores, a company which owns five stores in the west of England. The stores sell mainly food and groceries.

Each store is run by a full-time manager and three or four part-time assistants. Jonathan spends on average ½ a day a week at each store, and spends the rest of his time at home, dealing with his other business interests.

All sales are for cash and are recorded on till rolls which the manager retains. Shop managers' wages are paid monthly by cheque by Jonathan. Wages of shop assistants are paid in cash out of the takings.

Most purchases are made from local wholesalers and are paid for in cash out of the takings. Large purchases (over $250) must be made by cheques signed by the shop manager and countersigned by Jonathan.

Shop managers bank surplus cash once a week, apart from a float in the till.

All accounting records including the cash book, wages and sales tax records are maintained by the manager. Jonathan reviews the weekly bank statements when he visits the shops. He also has a look at inventory to see if inventory levels appear to be about right. All invoices are also kept in a drawer by a manager and marked with a cash book reference, and where appropriate a cheque number when paid.

Required

Discuss the deficiencies in the control systems of Furry Lion Stores, and how the weaknesses can be remedied.

Answer

Deficiencies in the system, and their remedies, are as follows.

Inventory

The shops do not appear to have any inventory movement records. Jonathan has also only a very approximate indication of inventory levels. Hence it will be difficult to detect whether inventory levels are too high, or too low with a risk of running out of inventory. Theft of inventory would also be difficult to detect. The company should therefore introduce inventory movement records, detailing values and volumes.

In addition regular inventory counts should be made either by Jonathan or by staff from another shop. Discrepancies between the inventory records and the actual inventory counted should be investigated.

Cash controls

Too much cash appears to be held on site. In addition the fact that most payments appear to be for cash may mean inadequate documentation is kept. The level of cash on site can be decreased by daily rather than weekly bankings. In addition the need for cash on site can be decreased by paying wages by cheque, and by paying all but the smallest payments by cheque.

The cash book should obviously still be maintained but cheque stubs should also show details of amounts paid. The cash book should be supported by invoices and other supporting documentation, and should be cross-referenced to the general ledger (see below).

Cash reconciliations

There is no indication of the till rolls that are kept being reconciled to cash takings.

There should be a daily reconciliation of cash takings and till rolls; this should be reviewed if not performed by the shop manager.

Bank reconciliations

There is no mention of bank reconciliations taking place.

Bank reconciliations should be carried out at least monthly by the shop manager, and reviewed by the owner.

Purchases

There is no formal system for recording purchases. Invoices do not appear to be filed in any particular way. It would be difficult to see whether accounting records were complete, and hence it would be difficult to prepare a set of accounts from the accounting records available.

In addition the way records are maintained means that accounts would have to be prepared on a cash basis, and not on an accruals basis.

A purchase day book should be introduced. Invoices should be recorded in the purchase day book, and filed in a logical order, either by date received or by supplier.

General ledger

There is no general ledger, and again this means that annual accounts cannot easily be prepared (and also management accounts).

A general ledger should be maintained with entries made from the cash book, wages records and purchase day book. This will enable accounts to be prepared on an accruals basis.

Supervision

Jonathan does not take a very active part in the business, only signing cheques over $250, and visiting the shops only half a day each week. This may mean that assets can easily go missing, and Jonathan cannot readily see whether the business is performing as he would wish.

Jonathan should review wage/sales tax/cash book reconciliations. Management accounts should also be prepared by shop managers for Jonathan.

Tutorial note. This question deals with controls that are possible given the circumstances of the business. Greater segregation of duties does not appear to be possible as the shops are small, and Jonathan cannot spend more time at the shops (although he can use his time more productively by reviewing reconciliations).

In the exam you may be asked for deficiencies in a system, and the consequences of those deficiencies, or you could be asked for tests of controls.

If you are asked about appropriate controls or deficiencies, remember the **control objectives** for the accounting area. Controls should be in place to **fulfil** the **objectives** given, deficiencies will mean that the objectives are not fulfilled. You should give enough detail about the controls you suggest to enable a non-accountant to implement the controls.

You should use a similar thought process when deciding how to test the controls. Think of the **objectives** of the system; assess how the controls given **fulfil** those **objectives**; and set out tests which demonstrate whether the controls are working. Remember that different types of test can be used to test different controls. For example, inspection can be used to test whether different documents are being compared or documents are being properly authorised. Recalculation and reperformance can be used to test that invoices have been properly completed or reconciliations correctly performed.

Internal Audit

8.0

INTERNAL AUDIT

INTERNAL AUDITING

Internal audit can be defined as an independent appraisal function established by the management of an organization for the review of the internal control system as a service to the organization. Internal audit is an element of the internal control system set up by the management of an enterprise to examine, evaluate and report accounting and other controls on operations.

Scope and objectives of IA

1. Review of accounting system and related internal controls

2. Examining the financial and operating information for management. This may include review of the means used to identify measure, classify and report such information.

3. Reviewing the economy, efficiency and effectiveness of operations and of the functioning of non-financial controls. This can be done through routine and automatic checks, periodic reviews and surprise checks.

- Routine and automatic checks- are checks on the procedures and items prone to misuse or misappropriation. stock, petty cash, wages payment etc.
- Periodic reviews are conducted on company activities that are subject to abrupt change. The review is to ensure that they conform to the laid down procedure policies e.g. budgets.
- Surprise checks are on sensitive assets that are desirable, portable and viable to prevent their misuse through unauthorized access.

4. Review of the implementation of corporate policies, plans and procedures.

5. Special investigations.

Functions of Internal Auditors

An internal Auditor ensures the following:

1. Detection of errors and fraud

2. An effective system of internal control systems.

3. Continuous effective operation of internal control systems

4. Adequate management of information flow

5. Asset safeguarding

6. Adequate accounting system in place

7. Compliance with statutory and regulatory requirements.

Functions of Internal Auditing

1. It acts as a consultant department on matters of controls e.g. financial controls, personal controls etc.

2. It ensures that the organization has strong ICS, which will enhance efficient and orderly running of the organization.

3. It served as a preventive measure against errors and frauds, and as such ensured safety of the company's resources.

4. Internal audit safeguards the company's assets through strong controls and as such it ensures that the company's assets are used by authorized persons and for the right purpose.

5. This function conducts special investigations in such areas:

- Where frauds and errors are suspected.
- Where profit margins have fallen for no apparent reasons etc.

7. The department performs routine duties such as verification of assets and liability, surprise checks etc.
8. Internal audit performs executive duties such as designing of policies and execution or supervision of board directors, all of which are aimed at ensuring efficient organization of policies.

Limitations to setting up an Internal Auditing Function

1. Size of the organization may be too small to warrant the function.
2. The cost installing and maintaining the internal auditing function may be too high.
3. If operations are few, the function may not be necessary
4. Staff (qualified and competent) may be unavailable to operate the function.
5. Lack of cooperation on the part of the management
6. The company's technical aspects.

Areas/ ways which Internal Auditors can assist External Auditors

1. Identify areas in which the ICS's are weak. This will enable the external auditor to plan his/ her audit to concentrate his effort in these areas.
2. The internal auditor will pinpoint technical matters 0verwhich the external auditor may not have sufficient knowledge e.g. technical assets.
3. The internal auditor will pinpoint areas where there are fundaments changes in management and ICS.
4. He undertakes routine duties on behalf of the external auditor such as branch visits, stocktaking, wage payment, etc all of which will assist the external auditor.
5. The internal auditor may prepare schedules for the external auditor e.g., creditors, debtors and assets schedules, which are useful for comparison purposes and for final review.
6. He makes any inquiries and undertakes observation over operations on the behalf of the external auditor.
7. The presence of an IA boosts the morale of the accounts staff thereby keeping their accounts to date.

Factors to consider before the external auditor's can rely on the internal auditors work

Before placing reliance on the work of an internal audit, function. The criteria for making this assessment should include the following:

1. **Degree of independence**: The external auditor should evaluate the organization status and reporting responsibility of the internal auditor and consider any restrictions placed on him. Although an IA ie an employee of the organization, he should be able to organize his work and have access to the highest level of management. An internal auditor should also be at liberty to communicate freely with the external auditor.

2. **The scope and objectives of the IA functions**. The external auditor should ascertain the scope and objectives of internal audit assignments. This enables him to consider the relevant assignments.
3. **Due professional care**: To be useful to an external auditor, the internal auditor's work must be done in a professional manner. It must be properly planned, controlled, supervised, recorded and reviewed. Examples of the exercise of due professional care by an internal auditor are: existence of an audit manual, general internal audit plans etc.
4. **Technical competence**: The external auditor should ascertain whether persons having adequate training perform the work of the internal audit. Indications of technical competence may be membership of an appropriate professional body or the possession of relevant practical experience.
5. **Reporting standards**: The external auditor should consider the quality of reports issued by the internal auditor and ascertain whether management acts upon the reports.
6. **Resources available**: The external auditor should consider whether the internal auditor has adequate resources. e.g. in terms of staff and computer facilities.

7. **Supervision**
   - Supervisors are people of integrity and thus will reveal frauds perpetrated to avoid being victimized.
   - Managerial views, out of balance budget/balance forecasts will give a clue to frauds
   - Where procedures are not adhered to due to relaxation of a supervisor, will give room to frauds
8. **Personnel**
   - Qualified people will not normally allow frauds to pass their way
   - Properly remunerated personnel will reveal frauds committed by lower level employees under them.
   - High turnover of qualified personnel will serve as an indication of frauds.
9. **Rotation of duties and vacations**
   - Once a person has been rotated, the incoming person will be able to detect any fraud if any. This also applies for a person gone for leave.
   - Reluctance to be rotated or go for leave may indicate presence of frauds

10. Routine and automatic checks

- Perpetrators of fraud are normally caught unwares with surprise checks.
- Periodic, routine and automatic checks will detect errors and frauds perpetrated.

11. Control over documents

- Missing pre-numbered and serialized documents will reveal frauds.
- Unauthorized documents or forged documents will also reveal frauds

Differences between an Internal Auditor and an External Auditor

Internal Auditor	**External Auditor**
1.Does not have to be a certified accountant	1.should be a certified accountant
2.An employee of the organization	2.An independent contractor
3.Is paid a salary for service	3.paid fees
4.Appointment by management	4. Appointment as per the companies Act.
5.Report addressed to the management	5. Report addressed not only to the management but also to shareholders and other stakeholders.
6.main objective is strengthening controls	6.Main objective is to prove the true and fair view
7.Removal of the auditor is by the board	7.Removal is as per the company Acts 160
8.Not liable to third parties	8.Liable to third parties
9.Does not have to attend the AGM	9.Has a right to attend the AGM
10.Report if bad has no effect on the company	10.Report if bad may be very disastrous to the company
11.NotLiable to professional misconduct unless certified	11.Liable for professional misconduct
12.Scope is limited	12.Scope is open
13.Has no obligations	13. Bound by the company Act.

Ascertaining the system

This involves getting information on the accounting and internal control systems. The following methods are used to ascertain the system:

a) Examine the previous audit work (except if it is a new audit).Audit files contain record of the system of the previous period

b) Examine the client's documentation of the system e.g. examine the accounting manuals.

c) Interview client's staff for example you ask the purchasing manager how the system works etc.

d) Trace few transactions (walk through checks)

e) Examine the client's documents.

f) Observe the client's procedure e.g. attend the wages payout to see how it is organized.

Recording the system

These are four techniques, namely narrative notes, flow charts, internal control, questionnaires or checklists and the organization charts.

(see techniques used to assess the strength of the internal control system below)

Confirming the system

Confirming the system is usually done through inquiries and walk through tests. Walk through tests are performed to get knowledge on the design and operation of the systems.(see techniques used to assess the strength of the internal control system below).

Techniques Used to Assess the Strength of the Internal Control System

1. **Internal control questionnaire (ICQ)**

This is a pre-printed document containing various questions. The answers to questions describe the system in place. Questions cover various controls. These questions require short answers like Yes or No, e.g. "was local purchase order authorized"? Yes answers show the strength of ICS, whereas No indicates of ICS. It is usually used for evaluating rather than recording the system.

Illustration of an ICQ

Question Nos.	Questions	Answers	Remarks
1.	Who raised the LPO	None	Weak ICS
2.	Was it authorized?	No	Weak ics
3.	Was it recorded?	No	Weak ics
4.	If so, who recorded it?	N/A	Weak ics

2. **Use of systems Notes/narrative notes**
   These are notes made by the auditor on the system in place describing accounting routine. They are also a record of ICS, which describes operations of entire ICS and outlines where the ICS is weak and how serious the weaknesses are. They include information on:
   - Function done and who does them
   - Documents used
   - Source and destination of documents
   - Sequence of filling retained copies
   - Books kept and where

3. **Use of third party confirmation (circularization)**
   An auditor uses this source to gain valuable and reliable information from debtors, creditors, bankers, lawyers, etc. Any difference between the third party evidence and evidence from the company's own records is a sign of weak ICS.

4. **Use of compliance tests.**

These are tests that analyze the client's records and recording system to ascertain whether they are working as expected under ICS. The question is 'do they comply with the company's laid down policies? If the results of these tests indicate a strong control system then the auditor reduces the volume of substantive tests.

5. Observation

This technique reveals deviations from usual conduct of operations. These observations are made in areas such as wage payments, stock taking, cash counts, etc. Any deviations from laid down policies are an indication of weak ICS.

6. Flow charts

These are diagrammatical representations of the company's procedures designed to show movement of documents within the organization. Any destruction in the flow lines or blocked flow line is assumed to be an indication of weak ICS

7. Analytical Reviews

These are trend measurements aimed at analyzing a company's performance, say, by use of ratios to determine normal changes of the deviations are not justified, it could indicate weakness in the ICS.

8. Use of walk through tests.

These involve tracing one or more transactions through the accounting system and observing the application of the relevant aspects of the control system on these transactions. These are limited tests aimed at ascertaining the strength or otherwise of an Issuing order to follow a particular sequence relating to a single transaction, it may be best to follow through a few typical or similar transactions.

Differences between Internal control systems (ICS) and Internal checks (ICS)

An internal check is part of internal control system where his colleagues independently check duties or functions of an individual. The essence of IC is to ensure that any given function is counter checked to avoid possibility of frauds and errors. The differences between ICS and IC include the following:

1. An internal control system is a broad spectrum of controls aiming at ensuring that the organization is run efficiently whereas an internal check is aimed at preventing errors and frauds.
2. The internal control is necessary for all businesses regardless of their size whereas an internal check is ideal for large companies, which require strong segregation of duties.
3. A weak ICS may lead to a qualified report whereas an internal check may not lead to qualified report.

Actions to be taken by the Auditor if the ICS is weak;

1. He should bring such weaknesses to the attention of the management immediately and requests foe corrective measures to this effect.

2. The auditor should increase substantive tests. The volume of the tests should also be increased to ensure that the gathers sufficient audit evidence.
3. The auditor should change his audit approach in areas where the ICS is weak, e.g. from system-based audit to vouching audit and auditing in depth.
4. If the weaknesses persist year after year, the auditor should bring this to the attention of the shareholders so as to take appropriate action.
5. If ICS are too weak to allow testing, the auditor should qualify his report on the strength of the fact that he is unable to get all the information and explanations he considers necessary for the purpose of his opinion.

Internal Audit

1 Substantive procedures

Auditors need to obtain **sufficient appropriate audit evidence** to support the financial statement assertions. Substantive procedures can be used to obtain that evidence.

1.1 Types of audit tests

To recap, **substantive procedures** are tests to obtain audit evidence to detect material misstatements in the financial statements. They are generally of two types:

- Analytical procedures
- Tests of detail of transactions, account balances and disclosures

The types of substantive tests carried out to obtain evidence about various financial statement assertions are outlined in the table below.

Audit assertion	Type of assertion	Typical audit tests
Completeness	Classes of transactions Account balances Presentation and disclosure	(a) Review of post year-end items (b) Cut-off testing (c) Analytical review (d) Confirmations (e) Reconciliations to control accounts
Rights and obligations	Account balances Presentation and disclosure	(a) Reviewing invoices for proof that item belongs to the company (b) Confirmations with third parties
Valuation and allocation	Account balances Presentation and disclosure	(a) Matching amounts to invoices (b) Recalculation (c) Confirming accounting policy is consistent and reasonable (d) Review of post year-end payments and invoices (e) Expert valuation
Existence	Account balances	(a) Physical verification (b) Third party confirmations (c) Cut-off testing
Occurrence	Classes of transactions Presentation and disclosure	(a) Inspection of supporting documentation (b) Confirmation from directors that transactions relate to business (c) Inspection of items purchased
Accuracy	Classes of transactions Presentation and disclosure	(a) Recalculation of correct amounts (b) Third party confirmation (c) Analytical review

Audit assertion	Type of assertion	Typical audit tests
Classification and understandability	Classes of transactions Presentation and disclosure	(a) Confirming compliance with law and accounting standards (b) Reviewing notes for understandability
Cut-off	Classes of transactions	(a) Cut-off testing (b) Analytical review

Use the following model for drawing up an audit plan:

- **Agree opening balances** with **previous year's working papers**
- **Review general ledger** for unusual records
- **Agree client schedules to/from accounting records** to ensure completeness
- Carry out **analytical review**
- **Test transactions in detail**
- **Test balances in detail**
- **Review presentation** and **disclosure** in accounts

1.2 Directional testing

Substantive tests are designed to discover errors or omissions.

Broadly speaking, substantive procedures can be said to fall into two categories:

- Tests to discover **errors** (resulting in over or understatement)
- Tests to discover **omissions** (resulting in understatement)

1.2.1 Tests designed to discover errors

These tests will start with the **accounting records** in which the transactions are recorded to supporting documents or other evidence. Such tests should detect any overstatement and also any understatement through causes other than omission. For example, if a test is designed to ensure that sales are priced correctly, it would begin with a sales invoice selected from the sales ledger. Prices would then be checked to the official price list.

1.2.2 Tests designed to discover omissions

These tests must start from **outside the accounting records** and then matched back to those records. Understatements through omission will never be revealed by starting with the account itself as there is clearly no chance of selecting items that have been omitted from the account. For example, if a test is designed to discover whether all raw material purchases have been properly processed, it would start with goods received notes to be agreed to the inventory records or purchase ledger.

1.2.3 Directional testing

For most systems auditors would include tests designed to discover both errors and omissions. The type of test, and direction of the test, should be recognised before selecting the test sample. If the sample which tested the accuracy and validity of the sales ledger were chosen from a file of sales invoices then it would not substantiate the fact that there were no errors in the sales ledger.

Directional testing is particularly appropriate when testing the financial statement assertions of existence, completeness, rights and obligations, and valuation.

The concept of directional testing derives from the principle of double-entry bookkeeping, in that for every **debit** there should be a **corresponding credit**. Therefore, any **misstatement** of a **debit entry** will result in either a corresponding **misstatement** of a **credit entry** or a **misstatement** in the opposite direction, of **another debit entry**.

By designing audit tests carefully the auditors are able to use this principle in drawing audit conclusions, not only about the debit or credit entries that they have directly tested, but also about the corresponding credit or debit entries that are necessary to balance the books.

Tests are therefore designed in the following way.

Test item	Example
Test **debit items** (expenditure or assets) for overstatement by selecting debit entries recorded in the nominal ledger and checking value, existence and ownership	If a non-current asset entry in the nominal ledger of $1,000 is selected, it would be overstated if it should have been recorded at anything less than $1,000 or if the company did not own it, or indeed if it did not exist (eg it had been sold or the amount of $1,000 in fact represented a revenue expense).
Test **credit items** (income or liabilities) for understatement by selecting items from appropriate sources independent of the nominal ledger and ensuring that they result in the correct nominal ledger entry	Select a goods dispatched note and agree that the resultant sale has been recorded in the nominal ledger sales account. Sales would be understated if the nominal ledger did not reflect the transaction at all (completeness) or reflected it at less than full value (say if goods valued at $1,000 were recorded in the sales account at $900, there would be an understatement of $100).

A test for the overstatement of an asset simultaneously gives comfort on understatement of other assets, overstatement of liabilities, overstatement of income and understatement of expenses.

So, by performing the primary tests, the auditors obtain audit assurance in other audit areas. Successful completion of the primary tests will therefore result in them having tested all account areas both for overstatement and understatement.

1.3 Analytical procedures

Analytical procedures are used at all stages of the audit, including as substantive procedures. When using analytical procedures as **substantive tests**, auditors must consider the information available, assessing its **availability, relevance** and **comparability**.

We introduced analytical procedures in Chapter 6 where they were used at the planning stage of an audit. They can also be used as substantive procedures to obtain audit evidence directly.

ISA 520 *Analytical procedures* provides guidance to auditors on the use of analytical procedures as substantive procedures. Remember from Chapter 6 that analytical procedures include:

(a) The consideration of comparisons with:

- **Comparable information** for prior periods
- **Anticipated results** of the entity, from budgets or forecasts
- **Expectations** prepared by the auditors (eg estimation of depreciation)
- **Industry information**

(b) Those between elements of financial information that are expected to conform to a predicted pattern based on the entity's experience, such as the relationship of gross profit to sales

(c) Those between financial information and relevant non-financial information, such as the relationship of payroll costs to number of employees

ISA 520 states that when using analytical procedures as substantive tests, the auditor must:

- Determine the **suitability** of particular analytical procedures for given assertions.
- Evaluate the **reliability of data** from which the auditor's expectation of recorded amounts or ratios is developed.

- **Develop an expectation** of recorded amounts or ratios and evaluate whether this is **sufficiently precise** to identify a misstatement that may cause the financial statements to be materially misstated.
- Determine the amount of any difference that is **acceptable** without further investigation.

1.3.1 Suitability of analytical procedures

Substantive analytical procedures are usually more applicable to large volumes of transactions that tend to be predictable over time. The suitability of a particular analytical procedure will depend on the auditor's assessment of how effective it will be in detecting material misstatements. Determining the suitability will be influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement.

1.3.2 Reliability of data

The ISA sets out factors which influence the reliability of data which are set out in the following table, with examples.

Reliability factors	Example
Source of the information	Information may be more reliable when obtained from independent sources outside the entity.
Comparability of information available	Broad industry data may need to be supplemented so it is comparable to that of an entity that produces and sells specialised products.
Nature and relevance of the information available	Whether budgets have been set up as results to be expected rather than goals to be achieved
Controls over the preparation of the information to ensure its **completeness, accuracy and validity**	Controls over the preparation, review and maintenance of budgets

The auditor will need to consider testing the controls, if any, over the **preparation** of **information** used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and therefore in the results of analytical procedures.

The **controls** over **non-financial information** can often be tested in conjunction with tests of **accounting-related controls**. For example, in establishing controls over the processing of sales invoices, a business may include controls over unit sales recording. The auditor could therefore test the controls over the recording of unit sales in conjunction with tests of controls over the processing of sales invoices.

Alternatively the auditor may consider whether the information was subjected to audit testing. ISA 500 contains guidance in determining the audit procedures to be performed on information to be used for substantive analytical procedures.

1.3.3 Evaluation of whether the expectation is sufficiently precise

The factors to consider when evaluating whether the expectation can be developed sufficiently precisely to identify a misstatement that may cause the financial statements to be materially misstated are set out in the following table.

Factors to consider	Example
The **accuracy** with which the expected results of analytical procedures can be predicted	The auditor may expect greater consistency in comparing the relationship of gross profit to sales from one period to another than in comparing discretionary expenses, such as research or advertising.
The **degree to which information can be disaggregated**	Analytical procedures may be more effective when applied to financial information on individual sections of an operation or to the financial statements of components of a diversified entity than when applied to the financial statements as a whole.

Factors to consider	Example
The **availability** of the information	The auditor may consider whether financial information (eg budgets or forecasts) and non-financial information (eg number of units produced or sold) is available.

1.3.4 Acceptable differences

The amount of the difference of recorded amounts from the expected value that is acceptable depends on **materiality** and **consistency with the desired level of assurance**, having taken into account that a misstatement may cause the financial statements to be materially misstated. Therefore as the **assessed risk increases**, the **amount of the difference that is acceptable** without further investigation **decreases**.

1.3.5 Practical techniques

Analytical procedures can be performed using various techniques, ranging from simple comparisons to complex analyses using advanced statistical techniques. In this section we look at some of the techniques that can be used to carry out analytical procedures.

Ratio analysis can be a useful technique. However ratios mean very little when used in isolation. They should be calculated for previous periods and for comparable companies. This may involve a certain amount of initial research, but subsequently it is just a matter of adding new statistics to the existing information each year. The permanent file should contain a section with summarised accounts and the chosen ratios for prior years.

In addition to looking at the more usual ratios the auditors should consider examining other ratios that may be relevant to the particular clients' business. Other analytical techniques include:

(a) **Examining related accounts** in conjunction with each other. Often revenue and expense accounts are related to accounts in the statement of financial position and comparisons should be made to ensure relationships are reasonable.

(b) **Trend analysis**. Sophisticated statistical techniques can be used to compare this period with previous periods.

(c) **Reasonableness test**. This involves calculating the **expected value** of an item and comparing it with its actual value, for example, for straight-line depreciation.

(Cost + Additions – Disposals) × Depreciation % = Charge in statement of comprehensive income

Important accounting ratios	• Gross profit margins, in total and by product, area and months/quarter (if possible) • Operating profit margin • Receivables collection period (average collection period in days) • Payables payment period (average payment period in days) • Inventory holding period (average number of days inventory is held) • Inventory revenue ratio (revenue divided into cost of sales) • Current ratio (current assets to current liabilities) • Quick or acid test ratio (liquid assets to current liabilities) • Gearing ratio (debt capital to equity capital) • Return on capital employed (profit before tax to total assets less current liabilities)
Related items	• Payables and purchases • Inventories and cost of sales • Non-current assets and depreciation, repairs and maintenance expense • Intangible assets and amortisation • Loans and interest expense • Investments and investment income • Receivables and bad debt expense • Receivables and sales

Other areas for consideration
• **Examine changes** in **products, customers and levels** of **returns**
• **Assess** the effect of **price and mix changes** on the cost of sales
• **Consider** the effect of **inflation, industrial disputes, changes in production methods** and **changes in activity** on the charge for wages
• **Obtain explanations** for all **major variances** analysed using a standard costing system. Particular attention should be paid to those relating to the over or under absorption of overheads since these may, inter alia, affect inventory valuations
• **Compare trends in production and sales** and assess the effect on any provisions for obsolete inventory
• **Ensure** that **changes in the percentage labour or overhead content** of production costs are also reflected in the inventory valuation
• **Review other expenditure**, comparing: – Rent with annual rent per rental agreement – Rates with previous year and known rates increases – Interest payable on loans with outstanding balance and interest rate per loan agreement – Hire or leasing charges with annual rate per agreements – Vehicle running expenses with those expected for the company's vehicles – Other items related to activity level with general price increase and change in relevant level of activity (for example telephone expenditure will increase disproportionately if export or import business increases) – Other items not related to activity level with general price increases (or specific increases if known)
• **Review** statement of comprehensive income for **items** which may have been **omitted** (eg scrap sales, training levy, special contributions to pension fund, provisions for dilapidation etc)
• **Ensure expected variations** arising from the following have occurred: – Industry or local trends – Known disturbances of the trading pattern (for example strikes, depot closures, failure of suppliers)

Some comparisons and ratios measuring liquidity and longer-term capital structure will assist in evaluating whether the company is a going concern, in addition to contributing to the overall view of the accounts. We shall see in Chapter 18 however, that there are factors other than declining ratios that may indicate going concern problems.

The working papers must contain the completed results of analytical procedures. They should include:

- The outline **programme** of the work
- The summary of **significant figures** and relationships for the period
- A summary of **comparisons** made with budgets and with previous years
- Details of all **significant fluctuations** or **unexpected relationships** considered
- Details of the **results of investigations** into such fluctuations/relationships
- The audit **conclusions** reached
- **Information considered** necessary for assisting in the **planning** of subsequent audits

1.3.6 Investigating the results of analytical procedures

ISA 520 states that where analytical procedures identify fluctuations or relationships that are inconsistent with other relevant information or that differ significantly from the expected results, the auditor shall investigate by:

- **Inquiries of management** and obtaining appropriate audit evidence relevant to **management's responses**

- Performing **other audit procedures** if necessary (eg if management cannot provide an explanation or the explanation is not adequate)

Question

Analytical procedures

You are part of the audit team auditing the financial statements of Sweep Co, a small office supplies business, for the year ended 31 March 20X9. The company employed the following staff at the start of the financial year: 7 office and warehouse managers, 20 warehouse staff and 25 office staff.

The pay ranges for each category of staff is shown below:

Office and warehouse managers:	\$35-\$50k per year
Warehouse and office staff:	\$18-\$25k per year

You have been asked to audit the wages and salaries expense for the year. All staff were given a 4% pay rise in the year, backdated to the start of the year. One of the office managers left the company half-way through the year. Two new members of warehouse staff and three new members of office staff joined half-way through the year.

The expense for the year is shown in the draft statement of profit or loss as \$1,249,450.

Required

Using analytical procedures, perform a proof in total on the wages and salaries expense for the year.

Answer

An expectation of the charge for the year can be developed using the information provided and compared to the charge in the draft statement of profit or loss to assess its reasonableness.

Managers

Based on salary range, average annual salary:	\$42,500
Applying the 4% rise:	\$44,200
Total average salary for year (ie × 7):	\$309,400
Leaver left half-way through year:	(\$22,100)
Total for managers:	**\$287,300**

Office and warehouse staff

Based on salary range, average annual salary:	\$21,500
Applying the 4% rise:	\$22,360
Total average salary for year (ie × 45, exclude starters):	\$1,006,200
Starters started half-way through year:	\$55,900
Total for office and warehouse staff:	**\$1,062,100**
Expected total expense for wages and salaries:	**\$1,349,400**
Expense per draft statement of profit or loss:	**\$1,249,450**
Difference:	**8%**

The difference between the expected total and the expense in the draft statement of profit or loss is 8%. The auditor needs to consider whether this is acceptable in light of materiality for the financial statements as a whole and performance materiality and the risk of material misstatement and whether further explanations from management may be necessary.

2 Accounting estimates

When auditing **accounting estimates** auditors must:

- Test the management process
- Use an independent estimate
- Review subsequent events

In order to assess whether the estimates are reasonable.

2.1 The nature of accounting estimates

ISA 540 *Auditing accounting estimates, including fair value accounting estimates, and related disclosures* provides guidance on the audit of accounting estimates contained in financial statements. The auditor's objective is to obtain sufficient appropriate audit evidence about whether accounting estimates are reasonable and related disclosures are adequate.

An **accounting estimate** is an approximation of a monetary amount in the absence of a precise means of measurement.

Estimation uncertainty is the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

Management's point estimate is the amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

Auditor's point estimate or **auditor's range** is the amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate.

Examples of accounting estimates include:

- Allowance for doubtful accounts
- Inventory obsolescence
- Warranty obligations
- Depreciation method or asset useful life
- Outcome of long-term contracts
- Costs arising from litigation settlements and judgements
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability

Some financial statement items cannot be measured precisely, only estimated. The **nature and reliability** of information available to management to support accounting estimates can vary enormously and this therefore affects the **degree of uncertainty** associated with accounting estimates, which in turn affects the **risk of material misstatement** of accounting estimates.

Management use their discretion when arriving at accounting estimates. Balances and transactions related to accounting estimates are therefore more susceptible to management bias, especially where management has an incentive to manipulate trading results (eg their remuneration is linked to the profit for the year).

Unless the actual outcome of an issue that has given rise to an accounting estimate is known at the time of the audit (eg settlement has occurred post year end), it is often difficult for auditors to obtain conclusive evidence over the reliability of estimates.

In particular it may be difficult for an auditor to arrive at his or her own point estimate due to the uncertainties and assumptions involved. For example there may be a warranty provision included in the financial statements relating to a relatively new product, for which there is little data available on the level of returns.

Even it the auditor can formulate a reasonable estimate, it will be difficult for auditors to challenge managements' estimate on the basis the auditor's point estimate is different. Management will often argue they are better placed to make estimates due to their ongoing involvement with the business and its environment. However, despite any resistance from management, the auditor has a responsibility to assess and, if necessary, challenge managements' estimates.

2.2 Risk assessment procedures

ISA 540 states that the auditor shall obtain an understanding of the following to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:

- The requirements of the applicable financial reporting framework
- How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates
- How management makes the accounting estimates and an understanding of the data on which they are based including:
  - Method
  - Relevant controls
  - Assumptions
  - Whether change from prior period in method used
  - Whether management has assessed the effect of estimation uncertainty

The ISA also states that the auditor shall review the **outcome** of accounting estimates included in the **prior period**.

2.3 Risk identification and assessment

The auditor shall also evaluate the degree of **estimation uncertainty** associated with an accounting estimate. Where estimation uncertainty is assessed as high, the auditor shall determine whether these give rise to **significant risks**.

2.4 Responding to the assessed risks

The ISA requires the auditor to perform one or more of the following:

- Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.
- Test how management made the accounting estimate and the data on which it is based.
- Test the operating effectiveness of controls over how the accounting estimate was made.
- Develop a point estimate or a range to evaluate management's point estimate.

2.5 Substantive procedures in response to significant risks

Where the auditor judges that the accounting estimate gives rise to a significant risk, he shall evaluate the following in accordance with ISA 540:

- How management has considered alternative assumptions and why these have been rejected
- Whether the assumptions used are reasonable
- Management's intent to carry out specific courses of action and its ability to do so

If the auditor considers that management has not adequately addressed the effects of estimation uncertainty on accounting estimates that give rise to significant risks, he shall, if necessary, develop a **range** with which to evaluate the reasonableness of the accounting estimate.

2.6 Other audit procedures

ISA 540 requires the auditor to do the following:

- Evaluate whether the accounting estimates are either **reasonable or misstated**.
- Obtain sufficient appropriate audit evidence about whether **disclosures** are correct.
- For accounting estimates that give rise to significant risks, evaluate the adequacy of **disclosure of their estimation uncertainty**.
- Review the judgements and decisions of management in making the accounting estimates to identify if there are indications of **possible management bias**.
- Obtain **written representations** from management whether management believes significant assumptions used are reasonable.

3 Audit sampling

Auditors usually seek evidence from less than 100% of items of the balance or transaction being tested by using **sampling techniques**.

3.1 Introduction to audit sampling

Audit sampling is the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection. This will enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population. Audit sampling can be applied using either statistical or non-statistical approaches.

The **population** is the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

Auditors do not normally examine all the information available to them as it would be impractical to do so and using audit sampling will produce valid conclusions. ISA 530 *Audit sampling provides guidance to auditors.*

Some testing procedures do **not** involve sampling, such as:

- **Testing 100%** of items in a population
- Testing all items with a **certain characteristic** as selection is not representative

Auditors are unlikely to test 100% of items when carrying out tests of controls, but 100% testing may be appropriate for certain substantive procedures. For example, if the population is made up of a small number of high value items, there is a high risk of material misstatement and other means do not provide sufficient appropriate audit evidence, then 100% examination may be appropriate.

Audit sampling can be done using either **statistical sampling** or **non-statistical sampling** methods.

Statistical sampling is an approach to sampling that involves random selection of the sample items, and the use of probability theory to evaluate sample results, including measurement of sampling risk.

Non-statistical sampling is a sampling approach that does not have these characteristics.

So, bearing in mind the definitions above, sampling is non-statistical when it does not meet the criteria required of statistical sampling. If each item of the population does not have an equal chance of selection, the sampling technique is non-statistical.

The difference between the two types of sampling is that, with statistical sampling, the sampling risk can be measured and controlled (we look at sampling risk in Section 3.2). With non-statistical sampling it cannot be measured.

Although the audit procedures performed on the items in the sample will be the same, whether a statistical or non-statistical approach is used, meaningful extrapolation can only occur from a statistical sample which has been selected randomly.

The auditor may alternatively select certain items from a population because of specific characteristics they possess. The results of items selected in this non-statistical way cannot be projected onto the whole population but may be used in conjunction with other audit evidence concerning the rest of the population.

- **High value or key items.** The auditor may select high value items or items that are suspicious, unusual or prone to error.
- **All items over a certain amount**. Selecting items this way may mean a large proportion of the population can be verified by testing a few items.
- **Items to obtain information** about the client's business, the nature of transactions, or the client's accounting and control systems.
- **Items to test procedures,** to see whether particular procedures are being performed.

In September 2013, the *Student Accountant* published an article by the F8 examining team on audit sampling which considers the various sampling methods in the context of Paper F8. You should read this as part of your studies. The article can be accessed via the Technical Articles link on the ACCA's website: http://www.accaglobal.com/gb/en/student/acca-qual-student-journey/qual-resource/acca-qualification/f8/technical-articles.html.

3.2 Design of the sample

Sampling risk arises from the possibility that the auditor's conclusion, based on a sample of a certain size, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.

Non-sampling risk arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample. For example, the use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognise a misstatement or deviation.

Sampling unit is the individual items constituting a population. It may be a physical item (eg credit entries on bank statements, sales invoices, receivables' balances) or a monetary unit.

Stratification is the process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics, often monetary value.

The auditor must consider the **purpose** of the audit procedure when designing an audit sample. The auditor must also consider the **characteristics of the population**. When considering the characteristics of the population, the auditor might determine that **stratification** or **value-weighted selection** is appropriate.

The auditor must design a sample size sufficient to reduce sampling risk to an **acceptably low level**. Sampling risk can lead to two types of erroneous conclusions: for tests of controls, that they are more effective that they actually are or for tests of details, that a material misstatement does not exist when it actually does; and for tests of controls, that controls are less effective than they actually are or for tests of details, that a material misstatement exists when it actually does not. The lower the risk the auditor is willing to accept, the greater the sample size will need to be. Sample size can be determined using a statistically-based formula or through the use of judgement.

ISA 530 also requires the auditor to select items for the sample in such a way that each sampling unit in the population has a chance of selection. When statistical sampling is used, each sampling unit has a **known probability** of being selected. When non-statistical sampling is used, judgement is applied. However, it is important that the auditor selects a **representative sample**, free from bias, by choosing sample items that have **characteristics typical** of the population. The main methods of selecting samples are **random selection, systematic selection** and **haphazard selection**. We discuss these and other methods below.

(a) **Random selection** ensures that all items in the population have an equal chance of selection, eg by use of random number tables or random number generators.

(b) **Systematic selection** involves selecting items using a constant interval between selections, the first interval having a random start. When using systematic selection auditors must ensure that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population.

(c) **Haphazard selection** may be an alternative to random selection provided auditors are satisfied that the sample is representative of the entire population. This method requires care to guard against making a selection which is biased, for example towards items which are easily located, as they may not be representative. It should not be used if auditors are carrying out statistical sampling.

(d) **Block selection** may be used to check whether certain items have particular characteristics. For example an auditor may use a sample of 50 consecutive cheques to test whether cheques are signed by authorised signatories rather than picking 50 single cheques throughout the year. Block sampling may however produce samples that are not representative of the population as a whole, particularly if errors only occurred during a certain part of the period, and hence the errors found cannot be projected onto the rest of the population.

(e) **Monetary Unit Sampling** is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

3.3 Performing audit procedures

Once the sample has been selected, the auditor must perform **appropriate audit procedures** on each item in the sample. If the audit procedure is not applicable to the selected item, the test must be performed on a **replacement item**. This could happen if, for example, a voided check is selected when testing for evidence of authorisation of payment.

If the auditor cannot apply the designed audit procedures (eg if documentation relating to the item has been lost), or suitable alternative audit procedures, to the selected item, that item must be treated as a **deviation** from the prescribed control (for tests of controls) or a **misstatement** (for tests of details).

3.4 Deviations and misstatements

An **anomaly** is a misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

Once the sample has been tested, the auditor must investigate the nature and cause of any deviations or misstatements found and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit.

In rare cases, a deviation or misstatement may be considered an **anomaly**, in which case the auditor must obtain a high degree of certainty that this is not representative of the population, by carrying out additional audit procedures.

3.5 Projection of misstatements

For **tests of details**, the auditor shall **project** misstatements found in the sample to the population to obtain a broad view of the scale of the misstatement but this may not be enough to determine an amount to be recorded.

Misstatements established as **anomalies** can be excluded when projecting sample errors to the population. However, note that the effect of any uncorrected anomalies still needs to be considered. Projected errors and anomalies are combined together when considering the possible effect of errors on the total class of transactions or account balance. Where the audited entity has corrected specific errors found in the sample, the projected error may be reduced by the amount of these corrections.

ISA 530 states that for **tests of controls**, no explicit projection of errors is necessary because the sample deviation rate is also the projected deviation rate for the population as a whole. So for example, if in sample of 75, four errors are discovered, the projected deviation rate is 4/75, ie 5%.

3.6 Evaluating the results

Tolerable misstatement is a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

Tolerable rate of deviation is a rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

ISA 530 requires the auditor to evaluate the results of the sample.

For tests of controls, an unexpectedly high deviation rate in the sample may result in an increase in the assessed risk of material misstatement, unless further audit evidence to substantiate the initial assessment of risk is obtained.

For tests of details, an unexpectedly high misstatement amount in the sample may lead the auditor to conclude that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no misstatement exists.

For tests of details, the total of the projected misstatement and anomalous misstatement is the auditor's best estimate of misstatement in the population. If the total exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population. The closer the total figure is to tolerable misstatement, the more likely it is that actual misstatement in the population could exceed tolerable misstatement. The auditor must therefore also consider the results of other audit procedures to assist in determining the risk that actual misstatement in the population exceeds tolerable misstatement. The risk may be reduced if additional audit evidence is obtained.

The auditor must also evaluate whether the use of sampling has provided a reasonable basis for conclusions about the population from which the sample was drawn. If the conclusion is that sampling has not provided this, the auditor may request management to investigate misstatements that have been identified and make any necessary adjustments, or tailor the nature, timing and extent of further audit procedures to best achieve the assurance required.

3.7 Summary

Key stages in the sampling process are as follows.

- Determining **objectives and characteristics of the population**
- Determining **sample size**
- Choosing method of **sample selection**
- **Projecting errors** and **evaluating** the **results**

4 Computer-assisted audit techniques

CAATs are the use of computers for audit work. The two most commonly used CAATs are **audit software** and **test data**.

Computer-assisted audit techniques (CAATs) are the applications of auditing procedures using the computer as an audit tool.

The overall objectives and scope of an audit do not change when an audit is conducted in a computerised environment. However, the application of auditing procedures may require auditors to consider techniques that use the computer as an audit tool. These uses of the computer for audit work are known as **computer-assisted audit techniques** (CAATs).

CAATs may be used in performing various auditing procedures, including the following.

- **Tests of details** of transactions and balances
- **Analytical review procedures**
- **Tests of computer information system controls**

The advantages of using CAATs are:

- Auditors can test programme controls as well as general internal controls associated with computers.
- Auditors can test a greater number of items more quickly and accurately than would be the case otherwise.
- Auditors can test transactions rather than paper records of transactions that could be incorrect.
- CAATs are cost-effective in the long-term if the client does not change its systems.
- Results from CAATs can be compared with results from traditional testing – if the results correlate, overall confidence is increased.

The disadvantages associated with using CAATs include:

- Setting up the software needed for CAATs can be time consuming and expensive
- Audit staff will need to be trained so they have a sufficient level of IT knowledge to apply CAATs
- Not all client systems will be compatible with the software used with CAATs
- There is a risk that live client data is corrupted and lost during the use of CAATs

The major steps to be undertaken by the auditors in the application of a CAAT are as follows.

- **Set the objective** of the CAAT application
- **Determine** the **content** and **accessibility** of the entity's files
- **Define** the **transaction types** to be tested
- **Define** the **procedures** to be performed on the data
- **Define** the **output requirements**
- **Identify** the audit and computer **personnel** who may participate in the design and application of the CAAT
- **Refine** the estimates of **costs** and **benefits**
- Ensure that the **use of the CAAT is properly controlled** and **documented**
- Arrange the **administrative activities**, including the necessary skills and computer facilities
- Execute the **CAAT application**
- **Evaluate the results**

There are two particularly common types of CAAT, **audit software** and **test data**.

4.1 Audit software

Audit software consists of computer programs used by the auditors, as part of their auditing procedures, to process data of audit significance from the entity's accounting system. It may consist of generalised audit software or custom audit software. Audit software is used for substantive procedures.

Generalised audit software allows auditors to perform tests on computer files and databases, such as reading and extracting data from a client's systems for further testing, selecting data that meets certain criteria, performing arithmetic calculations on data, facilitating audit sampling and producing documents and reports. Examples of generalised audit software are ACT and IDEA.

Custom audit software is written by auditors for specific tasks when generalised audit software cannot be used.

The following table provides some examples of the use of audit software in the course of an audit.

Audit software: examples of use
• Perform calculations and comparisons in analytical procedures
• Sampling programs to extract data for audit testing, eg select a sample of receivables for confirmation
• Scan a file to ensure that all documents in a series have been accounted for or to search for large and unusual items
• Compare data elements in different files for agreement (eg prices on sales invoices to authorised prices in master file)
• Reperform calculations eg totalling sales ledger
• Prepare documents and reports eg produce receivables' confirmation letters and monthly statements

Earlier we looked at the advantages and disadvantages of CAATs in general and, although some may be similar, we will now look specifically at the benefits of audit software along with the potential difficulties of using audit software.

Benefits of using audit software

(a) Audit software can perform calculations and comparisons more quickly than those done manually.

(b) Audit software makes it possible to test more transactions than when simply manually scanning print outs. For example audit software may facilitate searches for exceptions, such as negative or very high quantities when auditing inventory listings. The additional information will give the auditor increased comfort that the figure being audited is reasonably stated.

(c) Audit software may allow the actual computer files (the source files) to be tested from the originating programme, rather than print outs from spool or previewed files which are dependent on other software (and therefore could contain errors or could have been tampered with following export).

(d) Using audit software is likely to be **cost-effective in the long-term** if the client does not change its systems.

Difficulties of using audit software

(a) The **costs** of designing tests using audit software can be substantial as a great deal of planning time will be needed in order to gain an in-depth understanding of the client's systems so that appropriate software can be produced.

(b) The **audit costs in general may increase** because experienced and specially trained staff will be required to design the software, perform the testing and review the results of the testing.

(c) If errors are made in the design of the audit software, **audit time, and hence costs, can be wasted** in investigating anomalies that have arisen because of flaws in how the software was put together rather than by errors in the client's processing.

(d) If audit software has been designed to carry out procedures during live running of the client's system, there is a risk that this **disrupts** the client's systems. If the procedures are to be run when the system is not live, extra costs will be incurred by carrying out procedures to verify that the version of the system being tested is identical to that used by the client in live situations.

4.2 Test data

Test data techniques are used in conducting audit procedures by entering data (eg a sample of transactions) into an entity's computer system, and comparing the results obtained with pre-determined results. Test data is used for tests of controls.

Examples include:

(a) Test data used to test **specific controls** in computer programs such as on-line password and data access controls.

(b) Test transactions selected from previously processed transactions or created by the auditors to test **specific processing characteristics** of an entity's computer system. Such transactions are generally processed separately from the entity's normal processing. Test data can for example be used to check the controls that prevent the processing of **invalid data** by entering data with say a non-existent customer code or worth an unreasonable amount, or a transaction which may if processed break customer credit limits.

(c) Test transactions used in an **integrated test facility**. This is where a 'dummy' unit (eg a department or employee) is established, and to which test transactions are posted during the normal processing cycle.

Bearing the examples above in mind we can see the main **benefits of using test data techniques** are:

(a) Test data provides evidence that the software or computer system used by the client are working effectively by testing the program controls and in some cases there may be no other way to test some program controls.

(b) Once the basic test data have been designed, the level of ongoing time needed and costs incurred is likely to be relatively low until the client's systems change.

However, there are some **problems with using test data**:

(a) A significant problem with test data is that any **resulting corruption of data files** has to be corrected. This is difficult with modern real-time systems, which often have built-in (and highly desirable) controls to ensure that data entered **cannot** be easily removed without leaving a mark.

(b) Test data only tests the operation of the system at a **single point of time** and therefore the results do not prove that the program was in use throughout the period under review.

(c) **Initial computer time and costs can be high** and the client may change their programs in subsequent years.

5 Using the work of others

External auditors may make use of the work of an **auditor's expert**, **internal auditors** and **service organisations** and their auditors when carrying out audit procedures.

5.1 Using the work of an expert

An **auditor's expert** is an individual or organisation who has expertise in a field other than auditing or accounting, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be an auditor's internal expert (partner or staff, including temporary staff, of the auditor's firm or network firm) or an auditor's external expert.

Management's expert is an individual or organisation having expertise in a field other than auditing or accounting, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

Professional audit staff are highly trained and educated, but their experience and training is limited to accountancy and audit matters. In certain situations it will therefore be necessary to employ an **auditor's expert**.

Examples of areas in which an auditor’s expert may be needed to help gain audit evidence include:

- Valuations of land and buildings
- Valuation of inventory or work in progress, including the determination of the physical condition of inventory
- Legal opinions, including expert opinions on the possible outcomes of litigation or disputes

Guidance on this area is provided by ISA 620 *Using the work of an auditor's expert*. An auditor's expert could be employed by the auditor to assist in:

- Obtaining an understanding of the entity and its environment, including its internal control
- Identifying and assessing the risks of material misstatement
- Determining and implementing overall responses to assessed risks at the financial statement level
- Designing and performing further audit procedures to respond to assessed risks at the assertion level
- Evaluating the sufficiency and appropriateness of audit evidence obtained in forming an opinion on the financial statements

5.1.1 Competence, capabilities and objectivity of the auditor's expert

ISA 620 requires the auditor to evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity. Where the auditor's expert is external, the evaluation of objectivity will include inquiry of interests and relationships that could create a threat to objectivity.

Information on these areas may come from the following sources:

- **Personal experience** with previous work done by the expert
- **Discussions with the expert**
- **Discussions with other people** who are familiar with the expert's work
- Knowledge of the expert's **qualifications, membership of a professional body or industry association, licence to practise** etc
- **Published papers or books** by the expert
- The auditor's firm's **quality control policies and procedures**

5.1.2 Obtaining an understanding of the field of expertise

The auditor shall obtain a sufficient understanding of the auditor's expert's field of expertise to allow the auditor to determine the nature, scope and objectives of the work and to evaluate the adequacy of the work done.

5.1.3 Agreement

ISA 620 requires the auditor to agree in writing the following with the auditor's expert:

- **Nature, scope and objectives** of the work
- Respective **roles and responsibilities** of the auditor and the auditor's expert
- **Nature, timing and extent of communication** between auditor and auditor's expert, including the **form of any report**
- **Confidentiality requirements**

The agreement between the auditor and the auditor's expert is often in the form of an engagement letter. The Appendix to ISA 620 lists matters to consider for inclusion in the engagement letter.

5.1.4 Evaluating the work of the auditor's expert

The auditor shall evaluate the adequacy of the auditor's expert's work, which will include the following:

- The **relevance and reasonableness** of the expert's work and **consistency** with other audit evidence
- The relevance and reasonableness of any **assumptions and methods** used
- The relevance, completeness and accuracy of any **source data** used

If the auditor's evaluation results in a conclusion that the expert's work is not adequate, the auditor must agree on the nature and extent of further work to be done by the expert, and perform additional audit procedures that may be necessary in the circumstances.

5.1.5 Reference to the auditor's expert in the auditor's report

The auditor must not refer to the work of an auditor's expert in the auditor's report containing an unmodified opinion (unless required by law or regulation). If the auditor makes reference to the work of an auditor's expert in the auditor's report because it is relevant to understanding a modification to the opinion, the auditor must state in the auditor's report that this reference does not reduce the auditor's responsibility for the opinion.

5.2 Using the work of internal audit

> This is a topical issue that has prompted a recent revision of ISA 610 in 2013. You should make sure that you are familiar with the content in this section. In the past, those areas that have been recently revised or updated have often come up in the exam.

ISA 610 (Revised) *Using the work of internal auditors* provides guidance to the external auditor when the external auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor.

The objectives of the auditor (as stated in ISA 610) are:

- To determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent;
- If using the work of the internal audit function, to determine whether that work is appropriate for the purposes of the audit; and
- If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.

Internal audit function is defined in the ISAs as a function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.

Direct assistance refers to the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

Although the work of internal audit may be used for the purposes of the external audit, it is important to note that the external auditor has **sole responsibility** for the audit opinion expressed on the financial statements.

The current ISA 610 was revised in March 2013 (effective for audits of financial statements for periods ending on or after 15 December 2014). In 2012, amendments were made to strengthen the framework for the evaluation and use of the internal audit function when obtaining audit evidence. The latest revision tackled the question of direct assistance, an ambiguous and contentious area on which the IAASB felt it could no longer remain silent.

5.2.1 Scope and objectives of internal audit

As we discussed in Chapter 5, the scope and objectives of internal audit vary widely. Normally however, internal audit operates in one or more of the following broad areas.

- Monitoring of internal control
- Examination of financial and operating information
- Review of operating activities
- Review of compliance with laws and regulations
- Risk management
- Governance

5.2.2 When can the work of the internal audit function be used?

An effective internal audit function may reduce, modify or alter the timing of external audit procedures, but it can **never** eliminate them entirely. Even where the internal audit function is deemed ineffective, it may still be useful to be aware of the conclusions formed. The effectiveness of internal audit will have a great impact on how the external auditors assess the whole control system and the assessment of audit risk.

The external auditor will need to determine whether the work of the internal audit function can be used for the audit and if so, establish the **nature and extent** of work that can be used.

Determining whether the work of the internal audit function can be used

The following criteria must first be considered by the external auditors when determining **whether the work of the internal audit function can be used**.

EVALUATING THE INTERNAL AUDIT FUNCTION	
CRITERIA	**RELEVANT CONSIDERATIONS**
The extent to which its **objectivity** is supported by its organisational status, relevant policies and procedures	Consider the **status** of the internal audit function, to whom it **reports**, any **conflicting responsibilities**, any **constraints or restrictions**, whether those charged with governance oversee **employment decisions** regarding internal auditors, whether management acts on **recommendations** made, whether internal auditors are members of professional bodies and obligated to comply with their requirements for objectivity.
The level of **competence** of the function	Consider whether the internal audit function is **adequately resourced**, whether internal auditors are **members of relevant professional bodies**, have adequate **technical training and proficiency**, whether there are **established policies for hiring and training,** whether internal auditors possess the **required knowledge** of financial reporting/the applicable financial reporting framework.

EVALUATING THE INTERNAL AUDIT FUNCTION	
Whether the internal audit function applies a **systematic and disciplined approach** (including quality control)	Consider whether internal audit activities include a systematic and disciplined approach to **planning, supervising, reviewing and documenting** assignments, whether the function has **appropriate quality control procedures**, the **existence of audit manuals**, **work programs** and **internal audit documentation.**

If the internal audit function is found to be lacking in **any** of the preceding areas, ISA 610 (Revised) states that the auditor shall **not** use the work of the internal auditor.

Determining the nature and extent of internal audit work that can be used

When determining the **areas and the extent** to which the work of the internal audit function can be used, the auditor must consider:

- The **nature and scope** of specific work performed or to be performed
- The **relevance** of that work to the audit strategy and audit plan
- The **degree of judgement** involved in evaluation of audit evidence gathered by internal auditors

The external auditor is responsible for the audit opinion and must make all significant judgements in the audit. Therefore, the external auditor must plan to use the work of the internal audit function less (and therefore perform more of the work directly) in any areas which might involve significant judgements being made. These will be areas where:

- More judgement is needed in planning/performing procedures and evaluating evidence
- The risk of material misstatement is high, including where risks are assessed as significant
- The internal audit function's organisational status and relevant policies/procedures are not as robust in supporting the internal audit function's objectivity
- The internal audit function is less competent

The external auditor must also take a 'step back' and consider whether the planned extent of internal auditors' involvement will still result in the external auditor being involved enough, in light of the fact the external auditor is solely responsible for the audit opinion.

5.2.3 Communicating with those charged with governance and the internal audit function regarding the use of its work

If the auditor intends to use internal audit work to obtain evidence, then how the external auditor intends to use this work **must** be communicated to those charged with governance when the auditor communicates the planned scope and timing of the audit. It is therefore important the auditor has made the assessment above before this communication takes place.

The auditor must also discuss the planned use of the work with the internal audit function so both parties' activities can be coordinated.

5.2.4 Using the work of internal audit

ISA 610 (Revised) requires the external auditor to read the reports of the internal audit function relating to the work the external auditor plans to use. This is to obtain an understanding of the nature and extent of audit procedures the internal audit function performed, as well as understanding the related findings.

Before using the work of internal audit, the external auditors need to **evaluate** and **perform audit procedures** on the entirety of the work that they plan to use, in order to determine its adequacy for the purposes of the audit.

The evaluation includes the following:

- Whether the work was **properly planned, performed, supervised, reviewed** and **documented**
- Whether **sufficient appropriate evidence** was obtained to allow the internal auditors to draw reasonable conclusions

- Whether the **conclusions** reached are **appropriate** in the circumstances and the reports prepared are **consistent** with the results of the work done

As we have already seen above, the **nature and extent** of the audit procedures performed on specific work of the internal auditors will depend upon the external auditor's assessment of:

- The amount of **judgement involved**
- The assessed **risk** of material misstatement
- How well the audit function's organisational status and relevant policies and procedures support the **objectivity of the internal auditors**
- The level of **competence** of the function

Note that ISA 610 (Revised) requires the external auditor's procedures to include **reperformance** of some of the internal audit work used.

Audit procedures might include:

- Examination of items **already examined** by the internal auditors
- Examination of **other similar items**
- **Observation of procedures** performed by the internal auditors

As the work of internal audit is reviewed, the external auditor must consider whether the initial conclusions reached when deciding whether to use (and to what extent to use) internal audit work in the first place are still valid, and should tailor audit procedures accordingly.

5.2.5 Using direct assistance from internal auditors

Requirements relating to the use of direct assistance from internal auditors for the purposes of the external audit (ie external auditors assigning the performance of specific audit procedures to the entity's internal auditors) were introduced in the latest revision to ISA 610, in 2013.

Previously, the ISAs have remained silent on the subject of whether, and how, external auditors should involve the entity's internal auditors in obtaining and evaluating audit evidence. While some jurisdictions categorically prohibit direct assistance, the IAASB notes that the use of direct assistance, where it is allowed, does not appear to compromise audit quality. Given appropriate planning, direction, supervision and review from the external audit team, the use of internal auditors could lead to savings both in terms of time and cost for the audit client.

> As ISA 610 (Revised) is an examinable document, you should ensure that you familiarise yourself with the requirements around direct assistance. Recent changes to the ISAs are often examined.

5.2.6 When can direct assistance from internal auditors be used?

The approach for determining when, in which areas, and to what extent internal auditors can be used to provide direct assistance mirrors the requirements we have already seen in relation to using the work of the internal audit function. The external auditors must first consider **whether direct assistance can be obtained** at all, before **determining the nature and the extent of the work** that can be assigned to internal auditors.

Determining whether internal auditors can be used to provide direct assistance

If external auditors are prohibited by law or regulation from obtaining direct assistance from internal auditors then it should not be used.

If direct assistance is not prohibited by law, the external auditor should evaluate the following:

- The internal auditors' **objectivity** (existence and significance of any threats)
- The internal auditors' **competence**

If either of these are lacking, then the external auditor must **not** use direct assistance.

Determining the nature and extent of work that can be assigned to internal auditors

The external auditor will need to determine the nature and extent of the work that may be assigned to internal auditors. As part of this, it will be necessary to consider the direction, supervision and review that would be needed.

Three key areas must be considered:

(1) The amount of **judgement** involved in **planning** and **performing** the relevant audit procedures, and in **evaluating** the audit evidence gathered

(2) The assessed **risk** of material misstatement

(3) The external auditor's evaluation of the existence and significance of threats to the **objectivity** and the level of **competence** of the internal auditors

ISA 610 (Revised) **prohibits** the use of internal auditors to provide direct assistance to perform procedures that:

- Involve making **significant judgments** in the audit.
- Relate to **higher assessed risks of material misstatement** where more than a limited degree of **judgment** is required: For example, in assessing the valuation of accounts receivable, internal auditors may be assigned to check the accuracy of receivables ageing, but they must not be involved in evaluating the adequacy of the provision for irrecoverable receivables).
- Relate to work with which the **internal auditors have been involved**.
- Relate to **decisions** the external auditor makes **regarding the internal audit function** and the use of its work or direct assistance.

As we have already seen, ISA 610 (Revised) emphasises the fact that the sole responsibility for the audit opinion rests with the external auditors. The external auditor must therefore evaluate whether the combination of using the internal auditors to provide direct assistance, **and** the use of the work of the internal audit function, will allow the external auditor to be sufficiently involved in the audit to express an audit opinion.

5.2.7 Communicating with those charged with governance regarding the use of direct assistance

Once the external auditors have evaluated the extent to which internal auditors can be used to provide direct assistance, they must **communicate the nature and extent of the planned use of direct assistance** to those charged with governance.

The external auditors and those charged with governance must reach a **mutual understanding** that the use of direct assistance is not excessive in the circumstances of the audit engagement.

5.2.8 Using internal auditors to provide direct assistance

Before using internal auditors to provide direct assistance, **written agreement must be obtained**:

- From an **authorised representative** of the entity (confirming that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work that the internal auditor performs for the external auditor)
- From the **internal auditors** (confirming that they will keep specific matters confidential as instructed by the external auditor, and inform the external auditor of any threat to their objectivity)

It is especially important that the external auditor directs, supervises and reviews the work performed by the internal auditors, bearing in mind that the internal auditors are not independent of the entity.

ISA 610 (Revised) requires the external auditor to check back to the underlying audit evidence for at least some of the work performed by the internal auditors.

Throughout the process, the external auditor must consider the degree of judgement involved in, and the assessed risk of material misstatement associated with, the work assigned to the internal auditor, as we have already seen above. They should also remain alert for indications that the internal auditors lack the required **competence**, and **objectivity**, to perform the work.

5.2.9 Documentation

Where **the work of the internal audit function has been used**, ISA 610 (Revised) requires the external auditors to document:

- The evaluation of whether the function's organisational status and relevant policies/procedures support its independence adequately, the level of competence of the function and whether it is disciplined and systematic in its approach.
- The nature and extent of the work used and the reasons for deciding on that approach.
- The audit procedures performed by the external auditor to evaluate the adequacy of the internal audit function's work.

Where the **external auditors have used direct assistance from the internal auditors**, ISA 610 (Revised) requires the following to be documented:

- The evaluation of the **existence** and **significance** of **threats to the objectivity** of the internal auditors, and the level of **competence** of the internal auditors used
- The **basis for the decision** regarding the **nature and extent** of the work performed by the internal auditors
- **Who reviewed** the work performed and the **date** and **extent** of that review

In addition, the written agreements obtained from the authorised representative of the entity and the internal auditors (see section 5.2.8 above) should also be included in the audit documentation. The working papers prepared by the internal auditors who provided direct assistance should be filed.

5.3 Service organisations

A **service organisation** provides services to user entities. There may be special considerations for the auditor of a user entity when that entity makes use of a service organisation.

A **service organisation** is a third party organisation that provides services to user entities that are part of those entities' information systems relevant to financial reporting.

A **user entity** is an entity that uses a service organisation and whose financial statements are being audited.

A **user auditor** is an auditor who audits and reports on the financial statements of a user entity.

A **service auditor** is an auditor who, at the request of the service organisation, provides an assurance report on the controls of a service organisation.

ISA 402 *Audit considerations relating to an entity using a service organisation* provides guidance to auditors whose clients uses such an organisation. It expands on how the user auditor obtains an understanding of the user entity, including internal control sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.

A client may use a service organisation such as one that executes transactions and maintains related accountability or records transactions and processes related data. Many companies now outsource some aspects of their business activities to external service organisations. Examples relevant to the independent auditors include:

- Payroll processing
- Maintenance of accounting records

5.3.1 Understanding the services provided

User auditors must obtain an understanding of the services provided by the service organisation in accordance with ISA 315. This understanding must include the following:

- Nature of services provided and the significance of these to the user entity, including effect on user entity's internal control
- Nature and materiality of transactions processed or financial reporting processes affected
- Degree of interaction
- Nature of relationship including contractual terms

When obtaining an understanding of the internal control relevant to the audit, the user auditor must evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organisation.

The user auditor needs to determine whether a sufficient understanding of the nature and significance of the services provided and their effect on internal control has been obtained to allow for the identification and assessment of risks of material misstatement in the financial statements.

If the user auditor cannot get this understanding from the user entity, the understanding needs to be obtained from one or more of the following procedures:

- Obtaining a type 1 report (report on description and design of controls at a service organisation) or type 2 report (report on the description, design and operating effectiveness of controls at a service organisation) from a service auditor, if available
- Contacting the service organisation through the user entity
- Visiting the service organisation and performing necessary procedures
- Using another auditor to perform necessary procedures

If the user auditor uses a type 1 or type 2 report to obtain an understanding of the services, the auditor must be satisfied as to the service auditor's professional competence and independence, and the adequacy of standards used.

5.3.2 Responding to the assessed risks of material misstatement

In responding to the assessed risks in accordance with ISA 330, the user auditor must:

(a) Determine whether **sufficient appropriate audit evidence** concerning the relevant financial statement assertions is available from records held at the user entity; and if not

(b) Perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organisation on the user auditor's behalf.

5.3.3 Reporting by the user auditor

The user auditor is always **solely responsible** for the auditor's opinion. He must be assured that he has gained sufficient appropriate audit evidence to form an opinion on the financial statements and he must then express his opinion in the auditor's report. The user auditor must therefore not refer to the work of a service auditor in the user auditor's report if it contains an unmodified opinion (unless required by law or regulation). If the user auditor makes reference to the work of a service auditor in the user auditor's report because it is relevant to understanding a modification to the opinion, the user auditor must state in the user auditor's report that this reference does not reduce the user auditor's responsibility for the opinion.

Auditing Elements of Financial Statements

1 Tangible non-current assets

Key areas when testing **tangible non-current assets** are:

- **Confirmation** of ownership
- **Inspection** of non-current assets
- **Valuation** by third parties
- **Adequacy** of **depreciation** rates

1.1 Audit objectives for tangible non-current assets

Financial statement assertion	Audit objective
Existence and occurrence	– Additions represent assets acquired in the year and disposal represent assets sold or scrapped in the year – Recorded assets represent those in use at the year-end
Completeness	– All additions and disposals that occurred in the year have been recorded – Balances represent assets in use at the year-end
Rights and obligations	– The entity has rights to the assets purchased and those recorded at the year-end
Accuracy, classification and valuation	– Non-current assets are correctly stated at cost less accumulated depreciation – Additions and disposals are correctly recorded

Financial statement assertion	
Assertions relating to presentation and disclosure (occurrence and rights and obligations, completeness, classification and understandability, accuracy and valuation)	– Disclosures relating to cost, additions and disposals, depreciation policies, useful lives and assets held under finance leases are adequate and in accordance with accounting standards

1.2 Internal control considerations

The **non-current asset register** is a very important aspect of the internal control system. It enables assets to be identified, and comparisons between the general ledger, non-current asset register and the assets themselves provide **evidence** that the assets are **completely recorded**.

Another significant control is procedures over acquisitions and disposals, that acquisitions are properly **authorised**, **disposals** are **authorised** and **proceeds accounted for**. The controls and tests outlined in Chapter 10 (Section 6) are often considered and performed during the audit of non-current assets, as this is where the main issue of capitalisation occurs.

Other significant aspects are whether:

- **Security arrangements** over non-current assets are **sufficient**.
- **Non-current assets** are **maintained properly**.
- **Depreciation** is **reviewed every year**.
- **All income** is **collected** from **income-yielding assets**.

1.3 Audit procedures for tangible non-current assets

The plan below contains procedures for non-current assets in the statement of financial position and the related statement of profit or loss and other comprehensive income items (such as the depreciation charge and profits or losses on disposals).

AUDIT PLAN: TANGIBLE NON-CURRENT ASSETS	
COMPLETENESS	• **Obtain** or **prepare** a **summary** of tangible non-current assets showing how: – **Gross book value** – **Accumulated depreciation** – **Net book value** **Reconcile** with the **opening position**. • **Compare non-current assets** in the general ledger with the **non-current assets register** and **obtain explanations** for **differences**. • For a sample of assets which physically exist agree that they are **recorded** in the **non-current asset register**. • If a non-current asset register is not kept, **obtain** a **schedule** showing the original costs and present depreciated value of major non-current assets. • **Reconcile** the **schedule** of non-current assets with the **general ledger**.
EXISTENCE	• **Confirm** that the **company physically inspects** all items in the non-current asset register each year. • **Inspect assets**, concentrating on high value items and additions in-year. Confirm that items inspected: – Exist – Are in use – Are in good condition – Have correct serial numbers • **Review records** of **income-yielding assets**. • **Reconcile** opening and closing **vehicles** by numbers as well as amounts.

AUDIT PLAN: TANGIBLE NON-CURRENT ASSETS	
VALUATION	• **Verify valuation** to valuation certificate. • **Consider reasonableness** of **valuation**, reviewing: – Experience of valuer – Scope of work – Methods and assumptions used – Valuation bases are in line with accounting standards
VALUATION	• **Reperform** calculation of revaluation surplus. • Confirm whether valuations of all assets that have been revalued have been **updated regularly** (full valuation every five years and an interim valuation in year three generally) by asking the Finance Director and inspecting the previous financial statements. • **Inspect** draft accounts to check that client has recognised in the statement of profit or loss revaluation losses unless there is a credit balance in respect of that asset in equity, in which case it should be debited to equity to cancel the credit. All revaluation gains should be credited to equity. • **Review insurance policies** in force for all categories of tangible non-current assets and consider the adequacy of their insured values and check expiry dates.
DEPRECIATION	• **Review depreciation** rates applied in relation to: – Asset lives – Residual values – Replacement policy – Past experience of gains and losses on disposal – Consistency with prior years and accounting policy – Possible obsolescence • **Review** non-current assets register to ensure that **depreciation** has been **charged on all assets** with a limited useful life. • For **revalued assets**, ensure that the charge for **depreciation** is based on the revalued amount by recalculating it for a sample of revalued assets. • **Reperform calculation** of depreciation rates to ensure it is correct. • **Compare ratios** of depreciation to non-current assets (by category) with: – Previous years – Depreciation policy rates • **Scrutinise** draft accounts to ensure that **depreciation policies** and rates are **disclosed** in the accounts.
RIGHTS AND OBLIGATIONS	• **Verify title** to land and buildings by inspection of: – Title deeds – Land registry certificates – Leases • Obtain a certificate from solicitors/bankers: – **Stating purpose** for which the deeds are being held (custody only) – **Stating deeds** are **free** from **mortgage** or **lien** • **Inspect registration documents** for vehicles held, confirming that they are in client's name. • **Confirm** all vehicles are used for the **client's business**. • **Examine documents** of **title** for other assets (including purchase invoices, architects' certificates, contracts, hire purchase or lease agreements). • **Review for evidence** of charges in statutory books and by company search.

AUDIT PLAN: TANGIBLE NON-CURRENT ASSETS	
RIGHTS AND OBLIGATIONS	• **Review leases** of leasehold properties to ensure that company has fulfilled covenants therein. • **Examine invoices received after year-end, orders** and **minutes** for evidence of capital commitments.
ADDITIONS	These tests are to confirm **rights and obligations**, **valuation** and **completeness**. • Verify additions by inspection of architects' certificates, solicitors' completion statements, suppliers' invoices etc. • **Review** capitalisation of expenditure by examining for non-current assets additions and items in relevant expense categories (repairs, motor expenses, sundry expenses) to ensure that: – Capital/revenue distinction is correctly drawn – Capitalisation is in line with consistently applied company policy • **Inspect** non-current asset accounts for a sample of purchases to ensure they have been **properly allocated**. • Ensure that appropriate **claims** have been made for **grants**, and grants received and receivable have been received, by **inspecting** claims documentations and bank statements. • Verify that **additions** have been **recorded** by **scrutinising** the non-current asset register and general ledger.
SELF-CONSTRUCTED ASSETS	These tests are to confirm **valuation** and **completeness**. • **Verify material** and **labour** costs and **overheads** to invoices, wage records etc. • Ensure expenditure has been **analysed correctly** and **properly charged** to capital. • Expenditure should be capitalised if it: – **Enhances** the **economic benefits** of the asset in excess of its previously assessed standard of performance – **Replaces or restores a component** of the asset that has been treated separately for depreciation purposes, and depreciated over its useful economic life – Relates to a **major inspection** or **overhaul** that restores the economic benefits of the asset that have been consumed by the entity, and have already been reflected in depreciation • **Review** costs to ensure that no profit element has been included. • **Review** accounts to ensure that **finance costs** have been **capitalised** or not capitalised on a consistent basis, and costs capitalised in period do not exceed total finance costs for period.
DISPOSALS	These tests are to confirm **rights and obligations**, **completeness**, **occurrence** and **accuracy**. • **Verify disposals** with supporting documentation, checking transfer of title, sales price and dates of completion and payment. • **Recalculate** profit or loss on disposal. • **Consider** whether **proceeds** are **reasonable**. • If the asset was **used as security**, ensure **release from security** has been correctly made.
CLASSIFICATION AND UNDERSTAND-ABILITY	• **Review** non-current asset disclosures in the financial statements to ensure they meet IAS 16 criteria. • For a sample of **fully depreciated assets**, inspect the register to ensure no further depreciation is charged.

Question

You are the manager in charge of the audit of Puppy, a building and construction company, and you are reviewing the non-current asset section of the current audit file for the year ended 30 September 20X5. You find the following five matters which the audit senior has identified as problem areas. He is reviewing the company's proposed treatment of the five transactions in the accounts and is not sure that he has yet carried out sufficient audit work.

(i) During the year Puppy built a new canteen for its own staff at a cost of $450,000. This amount has been included in buildings as at 30 September 20X5.

(ii) Loose tools included in the financial statements at a total cost of $166,000 are tools used on two of the construction sites on which Puppy operates. They are classified as non-current assets and depreciated over two years.

(iii) A dumper truck, previously written-off in the company's accounting records has been refurbished at a cost of $46,000 and this amount included in plant and machinery as at 30 September 20X5.

(iv) The company's main office block has been revalued from $216,000 to $266,000 and this amount included in the statement of financial position as at 30 September 20X5.

(v) A deposit of $20,000 for new equipment has been included under the heading 'plant and machinery' although the final instalment of $35,000 was not paid over until 31 October 20X5, which was the date of delivery of the plant.

You are required, for each of the above matters, to:

(a) Comment on the acceptability of the accounting treatment and disclosure as indicated above.
(b) Outline the audit work and evidence required to substantiate the assets.

Answer

(a) *Acceptability of accounting treatment and disclosure*

(i) *New staff canteen*. The costs of building a new staff canteen can quite properly be capitalised and treated as part of buildings in the statement of financial position as work has produced future economic benefits (IAS 16). The company's normal depreciation policy should be applied, subject only to the canteen being completed and in use at the year-end.

(ii) *Loose tools*. Loose tools tend to have a very limited life and to be immaterial in value individually. For these reasons any capitalisation policy must be extremely prudent. The acceptability of this accounting treatment would depend on the policy in previous years and normal practice within the industry.

(iii) *Dumper truck*. The refurbishment costs have obviously extended the useful life of this asset and it therefore seems reasonable to capitalise the expenditure. Depreciation should be charged on the refurbishment costs over the estimated remaining useful life.

(iv) *Revaluation of office block.* The revaluation of property is acceptable, but the auditors will need to ensure that the company complies with a number of disclosure requirements. A note to the accounts should give details of the revaluation and the name of the valuer. The surplus on revaluation should be transferred to a separate non-distributable reserve in the statement of financial position as part of shareholders' funds. Furthermore, any other assets of a similar nature to this should also be revalued.

(v) *Deposit for new equipment.* As the equipment was not actually in the company's possession and use at the year-end, the deposit should not have been shown as plant and machinery, but rather as a payment on account. If the amount was considered to be material a note to the accounts should give details of this prepayment.

(b) The audit work and evidence required to substantiate each of the assets referred to in (a) above would be as follows.

(i) *New staff canteen*

(1) Physically confirm existence of the asset.

(2) Confirm title to building by reference to central registry certificate.

(3) Ascertain and confirm the details of any security granted over the asset, ensuring that this is properly recorded and disclosed.

(4) Review the detailed costings of the building and obtain explanations for any material variances from the original budget. Particular care should be taken in assessing the reasonableness of any overheads included as an element of cost.

(5) Review the depreciation policy for adequacy and consistency.

(ii) *Loose tools*

(1) Visit the two sites where the loose tools are used to confirm the existence and condition of a sample of them.

(2) Vouch the cost and ownership of the loose tools to purchase invoices and the company's asset register.

(3) Confirm the company's estimate of a two year life for these assets.

(4) Review control procedures for safe custody of the loose tools.

(5) Review the company's policy with regard to scrapping and/or sale of tools no longer required to ensure that any proceeds are properly recorded and the assets register appropriately updated and tools are completely recorded.

(iii) *Dumper truck*

(1) Inspect the truck to confirm its existence and to gain evidence of its valuation by reviewing its condition and the fact that it is still being used.

(2) If the vehicle is used at all on public roads then the vehicle registration document should be inspected as some evidence of title.

(3) Inspect the insurance policy for the truck as evidence of valuation.

(4) Vouch the expenditure on refurbishment to suppliers' invoices or company's payroll records where any of the work has been done by the client's own staff.

(5) Review the depreciation policy and assess for reasonableness by discussion with management and past experience of similar vehicles.

(iv) *Revaluation of office block*

(1) Inspect the building to confirm its existence and state of repair.

(2) Examine documents of title to confirm ownership.

(3) Enquire about any charges on the building and confirm that these have been properly recorded and disclosed.

(4) Review the valuer's certificate and agree to the amount used in the financial statements, with consideration also being given to his qualifications, experience and reputation.

(5) Assess the reasonableness of the valuation by comparison with any similar properties which may have recently changed hands on the open market.

(v) *Deposit for new equipment*

(1) Agree the payment of the deposit to the contract for purchase of the equipment.

(2) Confirm the existence of the plant following its delivery on 31 October 20X5 as it is unlikely that the audit work will have been completed by that date.

Note that inspection of a building's title deeds does **not** give audit evidence about **existence** and if there is doubt that a building actually exists, the auditors should physically inspect it.

2 Intangible non-current assets

Key assertions for intangible non-current assets are **existence** and **valuation**.

The key assertions relating to intangibles are **existence** (not so much 'do they exist?', but 'are they genuinely assets?') and **valuation**. They will therefore be audited with reference to criteria laid down in the financial reporting standards. As only purchased goodwill or intangibles with a readily ascertainable market value can be capitalised, **audit evidence should be available** (purchase invoices or specialist valuations). The audit of **amortisation** will be similar to the audit of depreciation.

AUDIT PLAN: OTHER NON-CURRENT ASSETS	
Goodwill	• Agree the consideration to sales agreement by **inspection**. • Consider whether asset valuation is reasonable. • Agree that the calculation is correct by **recalculation**. • **Review** the impairment review and **discuss** with management. • Ensure valuation of goodwill is reasonable/there has been no impairment not adjusted through **discussion** with management.
Research and development costs	• Confirm that capitalised development costs conform to IAS 38 criteria by **inspecting** details of projects and **discussions** with technical managers. • Confirm feasibility and viability by **inspection** of budgets. • **Recalculate** amortisation calculation, to ensure it commences with production/is reasonable. • **Inspect** invoices to verify expenditure incurred on R&D projects.
Other intangibles	• Agree purchased intangibles to purchase documentation agreement by **inspection**. • **Inspect** specialist valuation of intangibles and ensure it is reasonable. • Review amortisation calculations and ensure they are correct by **recalculation**.

1 Auditing inventory

The key assertions relating to inventory are:

- **Existence**
- **Completeness**
- **Rights and obligations**
- **Valuation**
- **Cut-off**

The audit of inventory can pose problems for auditors as a result of its nature and potential material value on the statement of financial position. The audit approach taken depends on the auditor's assessment of the controls in place. In this chapter we focus on the **substantive** audit of inventory.

The following table demonstrates the audit objectives for inventory and the related financial statement assertions. The audit procedures described in the remainder of this chapter are undertaken to provide audit evidence to support these assertions.

AUDIT PLAN: FOLLOWING UP THE INVENTORY COUNT
• **Review replies** from **third parties** about inventory held by or for them.
• **Confirm** the client's final **valuation** of inventory has been calculated correctly.
• **Follow up queries** and **notify problems** to management.

4.5 Inventory held by third parties

Where the entity has inventory that is held by third parties and which is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence by performing one or both of the following:

- **Direct confirmation** from the third party regarding quantities and condition (in accordance with ISA 505 *External confirmations*)
- **Inspection** or other **appropriate audit procedures** (if third party's integrity and objectivity are doubtful, for example)

The other appropriate audit procedures referred to above could include the following:

- Attending, or arranging for another auditor to attend, the third party's inventory count
- Obtaining another auditor's report on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded
- Inspecting documentation in respect of third party inventory (eg warehouse receipts)
- Requesting confirmation from other parties when inventory has been pledged as collateral

Question

Inventory count

In connection with your examination of the financial statements of Camry Products Co, a limited liability company, for the year ended 31 March 20X9, you are reviewing the plans for a physical inventory count at the company's warehouse on 31 March 20X9. The company assembles domestic appliances, and inventory of finished appliances, unassembled parts and sundry inventory are stored in the warehouse which is adjacent to the company's assembly plant. The plant will continue to produce goods during the inventory count until 5pm on 31 March 20X9. On 30 March 20X9, the warehouse staff will deliver the estimated quantities of unassembled parts and sundry inventory which will be required for production for 31 March 20X9; however, emergency requisitions by the factory will be filled on 31 March. During the inventory count, the warehouse staff will continue to receive parts and sundry inventory, and to dispatch finished appliances. Appliances which are completed on 31 March 20X9 will remain in the assembly plant until after the count has been completed.

Required

(a) List the principal procedures which the auditors should carry out when planning attendance at a company's physical inventory count.

(b) Describe the procedures which Camry Products should establish in order to ensure that all inventory items are counted and that no item is counted twice.

Answer

(a) In planning attendance at a physical inventory count the auditors should:

(i) Review previous year's audit working papers and discuss any developments during the year with management.

(ii) Obtain and review a copy of the company's count instructions.

(iii) Arrange attendance at count planning meetings, with the consent of management.

(iv) Gain an understanding of the nature of the inventory and of any special problems this is likely to present, for example liquid in tanks, scrap in piles.

(v) Consider whether expert involvement is likely to be required as a result of any circumstances noted in (iv) above.

(vi) Obtain a full list of all locations at which inventories are held, including an estimate of the amount and value of inventories held at different locations.

(vii) Using the results of the above steps, plan for audit attendance by appropriately experienced audit staff at all locations where material inventories are held, subject to other factors (for example rotational auditing, reliance on internal controls).

(viii) Consider the impact of internal controls upon the nature and timing of attendance at the count.

(ix) Ascertain whether inventories are held by third parties and if so make arrangements to obtain written confirmation of them or, if necessary, to attend the count.

(b) Procedures to ensure a complete count and to prevent double-counting are particularly important in this case because movements will continue throughout the count.

(i) Clear instructions should be given as to procedures, and an official, preferably not someone normally responsible for inventories, should be given responsibility for organising the count and dealing with queries.

(ii) Before the count, all locations should be tidied and inventory should be laid out in an orderly manner.

(iii) All inventory should be clearly identified and should be marked after being counted by a tag or indelible mark, so that it is evident that it has been counted.

(iv) Pre-numbered sheets should be issued to counters and should be accounted for at the end of the count.

(v) Counters should be given responsibility for specific areas of the warehouse. Each area should be subject to a recount.

(vi) A separate record should be kept of all goods received or issued during the day (for example by noting the goods received note or dispatch note numbers involved).

(vii) Goods received on the day should be physically segregated until the count has been completed.

(viii) Similarly, goods due to be dispatched on the day should be identified in advance and moved to a special area or clearly marked so that they are not inadvertently counted in inventory as well as being included in sales.

You **must** have a thorough knowledge of audit procedures before, during and after the physical inventory count.

5 Cut-off

Auditors should test **cut-off** by noting the **serial numbers** of GDNs and GRNs received and dispatched just before and after the year-end, and subsequently testing that they have been included in the **correct period**.

5.1 The importance of cut-off

Cut-off is most critical to the accurate recording of transactions in a manufacturing enterprise at particular points in the accounting cycle as follows:

- The **point** of **purchase** and **receipt** of **goods** and **services**
- The **requisitioning** of **raw materials** for production
- The **transfer** of **completed work-in-progress** to finished goods
- The **sale** and **dispatch** of **finished goods**

5.2 Audit procedures

The auditors should consider whether management has implemented adequate cut-off procedures: procedures intended to ensure that movements into, within and out of inventories are properly identified and reflected in the accounting records.

Purchase invoices should be recorded as liabilities only if the goods were received prior to the count. A schedule of 'goods received not invoiced' should be prepared, and items on the list should be accrued for in the accounts.

Sales cut-off is generally more straightforward to achieve correctly than purchases cut-off. Invoices for goods dispatched after the count should not appear in the income statement for the period.

Prior to the physical inventory count, management should make arrangements for cut-off to be properly applied.

(a) Appropriate systems of recording of receipts and dispatches of goods are in place, and also a system for documenting materials requisitions. Goods received notes (GRNs) and goods dispatched notes (GDNs) should be sequentially pre-numbered.

(b) Final GRN and GDN and materials requisition numbers are noted. These numbers can then be used to subsequently check that purchases and sales have been recorded in the current period.

(c) Arrangements should be made to ensure that the cut-off arrangement for inventories held by third parties are satisfactory.

There should ideally be no movement of inventory during the count. Preferably, receipts and dispatches should be suspended for the full period of the count. It may not be practicable to suspend all deliveries, in which case any deliveries which are received during the count should be segregated from other inventory and carefully documented.

6 Valuation

Auditing the **valuation** of inventory includes:

- Testing the **allocation of overheads** is appropriate
- Confirming inventory is carried at the **lower** of **cost** and **net realisable value**

6.1 Assessment of cost and net realisable value

Auditors must understand how the company determines the cost of an item for inventory valuation purposes. Cost should include an appropriate proportion of overheads, in accordance with IAS 2.

There are several ways of determining cost. Auditors must ensure that the company is **applying** the method **consistently** and that each year the method used gives a **fair approximation** to cost. They may need to support this by additional procedures:

- **Reviewing price** changes near the year-end
- **Ageing the inventory** held
- **Checking gross profit** margins to reliable management accounts

The requirement to consider valuation of inventory is a topic which is regularly examined. If asked for procedures in this area, then restrict your answer to only those procedures related to valuation. The examining team has noted that in previous exams, some candidates provided procedures related to other assertions, therefore wasting valuable time.

6.1.1 Valuation of raw materials and brought-in components

The auditors should perform work to test whether the correct prices have been used to value raw materials and brought-in components valued at actual costs by **referring** to **suppliers' invoices**. The valuation may include unrealised profit if inventory is valued at the latest invoice price. Reference to suppliers' invoice will also provide the auditors with assurance as regards ownership.

If standard costs are used, auditors should **check** the **basis** of the **standards**, **compare standard costs** with **actual costs** and **confirm** that **variances** are being **treated appropriately**.

6.1.2 Valuation of work-in-progress and finished goods

'Cost' comprises the cost of purchase plus the costs of conversion. The cost of conversion comprises:

- Costs specifically attributable to units of production
- Production overheads
- Other overheads attributable to bringing the product or service to its present location and condition

(Work-in-progress relating to construction contracts is outside the scope of the F8 syllabus.)

6.2 Audit procedures

The audit procedures will depend on the methods used by the client to value work-in-progress and finished goods, and on the adequacy of the system of internal control.

The auditors should consider what tests they can carry out to check the reasonableness of the valuation of finished goods and work-in-progress. **Analytical procedures** may assist comparisons being made with items and categories from the previous year's summaries. If the client has a computerised accounting system, the auditors may be able to request an exception report listing, for example, all items whose value has changed by more than a specified amount. A reasonableness check will also provide the auditors with assurance regarding completeness.

6.2.1 Cost

The auditors should ensure that the client includes a proportion of overheads **appropriate** to **bringing** the **inventory** to its **present location and condition**. The basis of overhead allocation should be:

- Consistent with prior years
- Calculated on the normal level of production activity

Thus, overheads arising from **reduced levels of activity**, **idle time** or **inefficient production** should be written-off to the income statement, rather than being included in inventory.

Difficulty may be experienced if the client operates a system of total overhead absorption. It will be necessary for those overheads that are of a general, non-productive nature to be identified and excluded from the valuation.

6.2.2 Cost vs NRV

Auditors should **compare cost and net realisable value** for each item of inventory. Where this is impracticable, the comparison may be done by group or category.

Net realisable value is likely to be less than cost when there has been:

- An **increase in costs** or a fall in selling price
- **Physical deterioration**
- **Obsolescence** of products
- A **marketing decision** to manufacture and sell products at a loss
- Errors in production or purchasing

For work-in-progress, the **ultimate selling price** should be **compared** with the **carrying value** at the year-end plus **costs** to be **incurred** after the year-end to bring work-in-progress to a finished state.

Question

Your firm is the auditor of Arnold Electrical, a limited liability company, and you have been asked to audit the valuation of the company's inventory at 31 May 20X1 in accordance with IAS 2. Arnold Electrical operates from a single store and purchases domestic electrical equipment from wholesalers and manufacturers and sells them to the general public. These products include video and audio equipment, washing machines, refrigerators and freezers. In addition, it sells small items such as electrical plugs, tapes for video recorders, records and compact discs.

A full physical inventory count was carried out at the year-end, and you are satisfied that the inventory was counted accurately and there are no cut-off errors. Because of the limited time available between the year-end and the completion of the audit, the company has valued the inventory at cost by recording the selling price and deducting the normal gross profit margin.

Inventory which the company believes to be worth less than cost has been valued at net realisable value. The selling price used is that on the item in the store when it was counted.

The inventory has been divided into three categories.

(a) Video and audio equipment: televisions, video recorders, video cameras and audio equipment
(b) Domestic equipment: washing machines, refrigerators and freezers
(c) Sundry inventory: electrical plugs, magnetic tapes and compact discs

The normal gross profit margin for each of these categories has been determined and this figure has been used to calculate the cost of the inventory (by deducting the gross profit margin from the selling price). In answering the question you should assume there are no sales taxes.

Required

(a) List and describe the audit work you will carry out to check that inventory has been correctly valued at cost.

(b) List and describe the audit work you will carry out to:

  (i) Find inventory which should be valued at net realisable value
  (ii) Check that the net realisable value is correct

(c) List and describe the other work you will perform to check that the inventory value is accurate.

Note. In answering the question you are only required to check that the price per unit of the inventory is correct. You should assume that the inventory quantities are accurate and there are no purchases or sales cut-off errors.

Answer

(a) This method of valuation at cost is permitted by IAS 2, but it is usually applied to large retail concerns which inventory thousands of low value items, for example supermarket chains. This method is only permitted when it can be shown that it gives a reasonable approximation of the actual cost.

The following tests should be performed to ensure that the inventory is correctly valued at cost.

  (i) Obtain a schedule of the client's calculations of the gross profit margins. Check the mathematical accuracy and consider the reliability of all sources of information used in the calculation.
  (ii) Where the normal overall gross margin has been used, check the reasonableness of the figure by comparing it to the monthly management accounts for the year and last year's published accounts.
  (iii) Test a sample of items to make sure that gross profit does not vary too much across all items of inventory (which is unlikely for Arnold Electrical). The test will compare selling price to purchase price.

(iv) If a weighted average gross margin has been used, check that the weighting is correct in terms of the proportion of each type of product in closing inventory.

(v) Select a sample of high value lines and check the reasonableness of the gross profit estimate by calculating the gross profit for each of those lines. Sales price will be compared to inventory sheets and to sales prices in the shop at the year-end. Cost will be checked by examining purchase invoices. The weighted average profit margin for the selected lines can then be calculated and compared to the gross margin applied to the whole inventory.

(vi) Overvaluation of slow moving inventory is possible when the prices of those items are affected by inflation. To check this, examine the inventory sheets for any slow moving items (or ask the management of the company or use own observation). Compare the value of the inventory at the end of the accounting period to cost according to purchase invoices. If an overvaluation has occurred it should be quantified.

(vii) Check whether any goods were being offered for sale at reduced prices at the year-end. If the reduced price is greater than cost, the use of an average gross profit percentage will cause inventory to be undervalued. This undervaluation must be quantified. If full selling price was used in the calculation then the problem will not arise. Check a sample of inventory items to sales invoices issued around the year-end to make sure that the correct price was used in the costing calculation.

(b) (i) Inventory which may be worth less than cost will include:

- Slow moving inventory
- Obsolete or superseded inventory
- Seconds and items that have been damaged
- Inventories which are being, or are soon likely to be, sold at reduced prices
- Discontinued lines

Finished goods where the selling price is less than cost will be valued at net realisable value. This is defined as the actual or estimated selling price less costs to completion and marketing, selling and distribution expenses.

To identify inventories which may be worth less than cost the following work will be carried out.

- Examine the computerised inventory control system and list items showing an unacceptably low turnover rate. An unacceptable rate of turnover may be different for different items, but inventory representing more than six months' sales is likely to qualify.
- Review the inventory printout for items already described as seconds or recorded as damaged.
- Discuss with management the current position regarding slow moving inventories and their plans and expectations in respect of products that may be discontinued. The standard system must be carefully considered and estimates obtained of the likely selling price of existing inventories. The most likely outcome regarding the use and value of discontinued components must be decided.
- At the physical inventory count, look for inventory which is dusty, inaccessible and in general not moving and mark on the inventory sheets.
- Find out whether any lines are unreliable and therefore frequently returned for repairs as these may be unpopular.
- Review the trade press or other sources to see whether any of the equipment is out of date.

(ii) Determining the net realisable value of inventory involves management judging how much inventory can be sold and at what price, together with deciding whether to sell off raw materials and components separately or to assemble them into finished products. Each separate type of inventory item should be considered individually in deciding on the level of prudent provision.

The following tests should be carried out.

- Find the actual selling prices from the latest sales invoice. For items still selling, invoices will be very recent, but for slow moving and obsolete items the invoiced prices will be out of date and allowance will have to be made for this.
- Estimate the value of marketing, selling and distribution expenses using past figures for the types of finished goods concerned as a base. Update and review for reasonableness against the most recent accounting records.
- Discuss with management what selling prices are likely to be where there is little past evidence. Costs to completion will be questioned where these are difficult to estimate and where there are any unusual assembly, selling or distribution problems.

(c) The following procedures would also be performed to check the value of inventory at the year-end.

(i) Compare current results with prior year(s). This would include gross profit margins, sales and turnover. Marked variations from the current year's results should be investigated.

(ii) Consider the effects of new technology and new fashions. The electrical appliance business will be exposed to obsolescence problems. Quantify any necessary write-down.

(iii) Compare selling prices to those charged elsewhere. If the prices elsewhere are lower, than the distortion in selling price might affect the value of the inventory of Arnold Electrical. Alternatively, if prices elsewhere are higher, then the company's prices may occasionally fall below cost. Again, any adjustment discovered to be necessary must be quantified.

(iv) Compare the valuation of inventory this year to that at the end of last year. This will be particularly useful for lines held at both dates. If the values are comparable, taking account of inflation, then the current valuation is more likely to be correct.

(v) Sale prices should be monitored as long after the year-end as possible, to make sure that prices were not kept artificially high over the year-end and then reduced at a later date. Inventory turnover should also be examined on the same basis.

1 Receivables

Receivables are usually audited using a combination of **tests of details** and **analytical procedures**.

The audit of receivables is important as this is likely to be a material area. A combination of analytical procedures and tests of details are used, with sales also being tested in conjunction with trade receivables.

The following table sets out the assertions that apply to receivables. The audit procedures in the remainder of this chapter are used to provide evidence for these assertions.

Assertions about classes of transactions	– All sales transactions recorded have occurred and relate to the entity **(occurrence)** – All sales transactions that should have been recorded have been recorded **(completeness)** – Amounts relating to transactions have been recorded appropriately **(accuracy)** – All transactions have been recorded in the correct period **(cut-off)** – All transactions are recorded properly **(classification)**
Assertions about account balances at the period-end	– Recorded receivables exist **(existence)** – The entity controls the rights to receivables and related accounts **(rights and obligations)** – All receivables that should have been recorded have been recorded **(completeness)** – Receivables are included in the accounts at the correct amounts **(valuation and allocation)**
Assertions about presentation and disclosure	– All disclosed events and transactions relating to receivables have occurred and pertain to the entity **(occurrence, rights and obligations)** – All disclosures required have been included **(completeness)** – Financial information is appropriately presented and described and disclosures clearly expressed **(classification and understandability)** – Financial and other information is disclosed fairly and at appropriate amounts **(accuracy and valuation)**

1.1 Internal control considerations

The audit of receivables and sales is closely linked to the objectives we looked at when we considered controls over the sales system in Chapter 10.

Segregating responsibilities in this area is a very important control. One person should not be responsible for taking orders, raising sales invoices and receiving and recording monies from customers. The failure to segregate these duties could lead to a fraud such as teeming and lading (explained in Chapter 10) which would overstate receivables balances.

From the company's point of view, the reconciliation of the aged receivables accounts with the receivables control account on a regular basis is a key control to highlight anomalies. However, as with a bank reconciliation, the auditor will usually only focus on the year end reconciliation and listings, as this is often the most efficient way to obtain audit evidence.

As we saw in Chapter 10, a common control over the sales system is having numerically sequenced invoices which are matched to shipping documentation or goods despatched notes (GDNs).

One area the auditor may be able to make use of client controls is over the completeness of sales, where the client performs a reconciliation between sales records outside of the accounting system and the sales in the financial statements. However if they are unable to test and rely on such controls, the auditor often uses samples of documents outside of the accounting system as a starting point for substantive tests of completeness. This might include testing completeness of sales by checking there is an invoice for a sample of GDNs.

Note that the direction of testing is important, depending on what the auditor's objective is. For instance, starting with invoices and agreeing them to GDNs would not provide evidence on completeness.

2 Audit procedures for receivables

Existence, completeness and **valuation** are key assertions relating to the audit of receivables.

Audit procedures for receivables are set out in the table below. This covers the audit of sales and prepayments as well as trade receivables. Receivables are often tested in conjunction with sales. The key assertions for sales are occurrence, completeness and accuracy. The receivables' confirmation is used as an audit procedure in the table below and is described in more detail in Section 3. Section 4 contains additional information on the audit of sales.

AUDIT PLAN: RECEIVABLES	
Completeness	• **Agree** the balance from the individual sales ledger accounts to the aged receivables' listing and vice versa. • **Match** the total of the aged receivables' listing to the sales ledger control account. • **Cast and cross-cast** the aged trial balance before selecting any samples to test. • **Trace** a sample of shipping documentation to sales invoices and into the sales and receivables' ledger. • Complete the **disclosure checklist** to ensure that all the disclosures relevant to receivables have been made. • **Compare** the gross profit % by product line with the previous year and industry data. • **Compare** the level of prepayments to the previous year to ensure the figure is materially correct and complete. • **Review detailed statement of financial position** to ensure all likely prepayments have been included.

AUDIT PLAN: RECEIVABLES	
Existence	• Perform a **receivables' circularisation** on a sample of year-end trade receivables (see Section 3 for details of how to undertake the receivables' circularisation). • **Follow up** all balance disagreements and non-replies to the receivables' confirmation. • **Perform alternative procedures** for any exceptions and non-replies to the receivables' confirmation, such as: • **Review after-date cash receipts** by inspecting bank statements and cash receipts documentation. • Examine the **customer's account and customer correspondence** to assess whether the balance outstanding represents specific invoices and confirm their validity. • Examine the **underlying documentation** (purchase order, dispatch documentation, duplicate sales invoice etc). • **Inquire from management** explanations for invoices remaining unpaid after subsequent ones have been paid. • **Observe** whether the balance on the account is growing and if so, find out why by discussing with management.
Rights and obligations	• Review **bank confirmation** for any liens on receivables. • Make **inquiries of management, review** loan agreements and review board minutes for any evidence of receivables being sold (eg to factors).
Valuation and allocation	• **Compare** receivables' turnover and receivables' days to the previous year and/or to industry data. • **Compare** the aged analysis of receivables from the aged trial balance to the previous year. • **Review** the adequacy of the allowance for uncollectable accounts through discussion with management. • **Compare** the bad debt expense as a % of sales to the previous year and/or to industry data. • **Compare** the allowance for uncollectable accounts as a % of receivables or credit sales to the previous year and/or to industry data. • Confirm adequacy of allowance by **reviewing correspondence** with customers and solicitors. • **Examine credit notes** issued after year-end for allowances that should be made against current period balances. • **Examine** large customer accounts individually and compare to the previous year's balances. • For a sample of old debts on the aged trial balance, obtain further information regarding their recoverability by **discussions** with management and **review** of customer correspondence. • For a sample of prepayments from the prepayments' listing, **recalculate** the amount prepaid to ensure that it has been accurately calculated.
Cut-off	• For a sample of sales invoices around the year-end, **inspect the dates** and compare with the dates of dispatch and the dates recorded in the ledger for application of correct cut-off. • For **sales returns**, select a sample of returns documentation around the year-end and trace to the related credit entries.

AUDIT PLAN: RECEIVABLES	
Cut-off	• Perform **analytical procedures** on sales returns, comparing the ratio of sales returns to sales. • **Review material** after-date invoices, credit notes and adjustments and ensure that they are recorded correctly in the relevant financial period.
Classification	• Take a sample of sales invoices and examine for proper **classification** into revenue accounts.
Accuracy	• For a sample of sales invoices, **compare** the prices and terms to the authorised price list and terms of trade documentation. • Test whether **discounts** have been properly applied by **recalculating** them for a sample of invoices. • Test the correct calculation of **tax** on a sample of invoices.
Occurrence	• For a sample of sales transactions recorded in the ledger, **vouch** the sales invoice back to customer orders and dispatch documentation.
Occurrence and rights and obligations	• Determine, through **discussion** with management, whether any receivables have been pledged, assigned or discounted and whether such items require disclosure in the financial statements.
Classification and understandability	• **Review** the aged analysis of receivables for any large credits, non-trade receivables and long-term receivables and consider whether such items require separate disclosure. • **Read** the disclosure notes relevant to receivables in the draft financial statements and review for understandability.
Accuracy and valuation	• **Read** the disclosure notes to ensure the information is accurate and properly presented at the appropriate amounts.

3 The receivables' confirmation

A **confirmation of receivables** is a major procedure, usually achieved by **direct contact** with customers. There are two methods of confirmation: **positive** and **negative**.

3.1 Objectives of confirmation

External confirmations are audit evidence obtained as a direct written response to the auditor from a third party in paper form or by electronic or other medium.

ISA 505 *External confirmations* covers the confirmation of amounts by third parties, including the confirmation of amounts by receivables.

The verification of trade receivables by direct confirmation is the normal means of providing audit evidence to satisfy the objective of testing whether customers exist and owe *bona fide* amounts to the company (**existence** and **rights and obligations**).

Confirmation will produce for the current audit file a written statement from each respondent that the amount owed at the date of the confirmation is correct. This is, *prima facie*, reliable audit evidence, being from an **independent source** and in **documentary** form. The confirmation of receivables on a test basis should not be regarded as replacing other normal audit tests, such as the testing in-depth of sales transactions, but the results may influence the scope of such tests.

3.2 Client's mandate

Confirmation is essentially an act of the **client**, who alone can authorise third parties to divulge information to the auditors.

The ISA outlines what the auditors' response should be when management refuses permission for the auditors to contact third parties for evidence. If management asks the auditor not to seek the confirmation, the auditor shall inquire about management's reasons for the refusal and seek audit evidence regarding the validity and reasonableness of the reasons. They shall also evaluate the implications of the refusal on the assessment of the risk of material misstatement and on the nature, timing and extent of other audit procedures. The auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence. If the auditor concludes that the refusal is unreasonable, or the auditor cannot obtain relevant and reliable audit evidence elsewhere, the auditor shall communicate with those charged with governance in accordance with ISA 260 and consider the implications for the auditor's report.

3.3 Positive v negative confirmation

A **positive confirmation request** is one in which the confirming party responds directly to the auditor indicating whether they agree or disagree with the information in the request or provides the requested information.

A **negative confirmation request** is one in which the confirming party responds directly to the auditor only if they disagree with the information in the request.

When confirmation is undertaken the method of requesting information from the customer may be either **positive** or **negative**.

- Under the **positive** method the customer is requested to confirm the accuracy of the balance shown or state in what respect he is in disagreement.
- Under the **negative** method the customer is requested to reply only if the amount stated is disputed.

The positive method is generally preferable as it is designed to encourage definite replies from those contacted.

The negative method provides less persuasive audit evidence and shall not be used as the sole substantive procedure to audit receivables unless all of the following are present:

- The **risk** of material misstatement has been assessed as **low**.
- The auditor has obtained sufficient appropriate audit evidence on the operating effectiveness of relevant **controls**.
- The population consists of a **large number of small, homogeneous account balances**.
- A **very low exception rate** is expected.
- The auditor is not aware of circumstances or conditions that would cause customers to **disregard the requests**.

A specimen 'positive' confirmation letter is shown below.

The statements will normally be prepared by the client's staff, from which point the auditors, as a safeguard against the possibility of fraudulent manipulation, must maintain **strict control** over the preparation and dispatch of the statements.

Precautions must also be taken to ensure that undelivered items are returned, not to the client, but to the auditors' own office for follow-up by them.

MANUFACTURING CO LIMITED
15 South Street
London

Date

Messrs (customer)

In accordance with the request of our auditors, ABC Co, we ask that you kindly confirm to them directly your indebtedness to us at [insert date] which, according to our records, amounted to $.......... as shown by the enclosed statement.

If the above amount is in agreement with your records, please sign in the space provided below and return this letter direct to our auditors in the enclosed stamped addressed envelope.

If the amount is not in agreement with your records, please notify our auditors directly of the amount shown by your records, and if possible detail on the reverse of this letter full particulars of the difference.

Yours faithfully,

For Manufacturing Co Limited

Reference No: ....

....

(Tear-off slip)

The amount shown above is/is not * in agreement with our records as at

Account No	....	Signature	....
Date	....	Title or position	....

* The position according to our records is shown overleaf.

Notes

- The letter is on the client's paper, signed by the client.
- A copy of the statement is attached.
- The reply is sent directly to the auditor in a pre-paid envelope.

3.4 Sample selection

Auditors will normally only contact a **sample** of accounts receivable. If this sample is to yield a meaningful result it must be based upon a **complete list** of all accounts receivable. In addition, when constructing the sample, the following classes of account should receive special attention:

- **Old, unpaid** accounts
- Accounts **written-off** during the period under review
- Accounts with **credit balances**
- Accounts settled by **round sum payments**
- Accounts with **nil balances**
- Accounts which have been **paid** by the date of the examination

3.5 Follow-up procedures

ISA 505 states that the auditor may send an additional confirmation request when a reply to a previous request has not been received within a **reasonable time**. For example, the auditor may send an additional or follow-up request having rechecked the accuracy of the original address. Also with the client’s permission the auditor can phone the customer to request a reply to the original request.

3.5.1 Exceptions and non-responses

An **exception** is a response that shows a difference between the information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.
A **non-response** is a failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

Auditors will have to carry out further work in relation to those receivables who:

- **Disagree** with the **balance stated** (positive and negative confirmation), resulting in **exceptions**
- **Do not respond**, resulting in **non-responses**

In the case of disagreements, the customer response should have identified specific amounts which are disputed. These give rise to exceptions and may indicate misstatements or potential misstatements in the financial statements. When a misstatement is identified, the auditor must evaluate whether this is indicative of fraud (in accordance with ISA 240). Exceptions might also indicate a deficiency in internal control. Some exceptions of course do not represent misstatements, as they may be due to timing, measurement or clerical errors in the confirmation procedures. The table below outlines some reasons for exceptions occurring.

REASONS FOR EXCEPTIONS
There is a **dispute** between the client and the customer. The reasons for the dispute would have to be identified, and provision made if appropriate against the debt.
Cut-off problems exist, because the client records the following year's sales in the current year or because goods returned by the customer in the current year are not recorded in the current year. Cut-off testing may have to be extended (see below).
The customer may have sent the **monies before** the year-end, but the monies were **not recorded** by the client as receipts until **after** the year-end. Detailed cut-off work may be required on receipts.
Monies received may have been posted to the **wrong account** or a cash-in-transit account. Auditors should check if there is evidence of other mis-posting. If the monies have been posted to a cash-in-transit account, auditors should ensure this account has been cleared promptly.
Customers who are also suppliers may **net-off balances** owed and owing. Auditors should check that this is allowed.
Teeming and lading, stealing monies and **incorrectly posting** other receipts so that no particular customer is seriously in debt is a **fraud** that can arise in this area. Teeming and lading involves an employee first stealing the cash receipts from a receivable (receivable 1) and not recording the receipt against the customer account. Then the employee receives more cash from another receivable (receivable 2) and allocates it against receivable 1 in order to conceal the stolen funds. Similarly, he or she then allocates monies from receivable 3 against amounts owed from receivable 2, and so on. By allocating the funds in this way, there is only an apparent time lag on posting the receipt of cash, rather than an obvious uncollected debt. If auditors suspect teeming and lading has occurred, detailed testing will be required on cash receipts, particularly on prompt posting of cash receipts.

In the case of **non-responses**, the ISA states that the auditor shall perform **alternative audit procedures** to obtain relevant and reliable audit evidence. These could include reviewing subsequent cash receipts, shipping documentation and sales near the period-end.

3.6 Reliability of responses

The ISA states that the auditor shall obtain further audit evidence to resolve any **doubts about the reliability** of a response to a confirmation request. This could include contacting the confirming party.

If the auditor concludes that a response to a request is **not reliable**, he shall evaluate the impact of this on the assessment of the risk of material misstatement (including the risk of fraud), and on the related nature, timing and extent of other audit procedures.

4 Sales

Sales comprise a material figure in the statement of profit or loss that is often audited by analytical review as it should have predictable relationships with other figures in the financial statements.

Accounts' receivable will often be tested in conjunction with sales. Auditors are seeking to obtain evidence that sales pertain to the entity (occurrence), and are **completely** and **accurately recorded**. This will involve carrying out certain procedures to test for **completeness** of sales and also testing **cut-off.** We already looked at some audit procedures relating to sales earlier in this chapter (in the table in Section 2). However, we will now look in detail at some important procedures used when testing completeness and occurrence of sales.

4.1 Completeness and occurrence of sales

Analytical review is important when testing completeness. A client is likely to have a great deal of information about company sales and should be able to explain any fluctuations and variances. Auditors should consider the following.

- The **level of sales** over the year, compared on a month-by-month basis with the previous year
- The effect on sales value of **changes in quantities** sold
- The effect on sales value of **changes in products** or **prices**
- The level of **goods returned, sales allowances** and **discounts**
- The **efficiency of labour** as expressed in sales or profit per tax per employee

In addition auditors must record reasons for changes in the **gross profit margin**. Analysis of the gross profit margin should be as detailed as possible, ideally broken down by **product area** and **month or quarter**.

As well as analytical review, auditors may feel that they need to carry out a directional test on **completeness of recording** of individual sales in the accounting records. To do this, auditors should start with the documents that first record sales (**goods dispatched notes** or **till rolls** for example), and trace sales recorded in these through intermediate documents such as sales summaries to the **sales ledger**.

Auditors must ensure that the population of documents from which the sample is originally taken is itself complete, by checking for example the **completeness** of the **sequence** of goods dispatched notes.

You must remember the direction of this test. Since we are checking the completeness of recording of sales in the sales ledger, we cannot take a sample from the ledger because the sample would not include what has not been recorded.

Question — Receivables

Sherwood Textiles, a listed company, manufactures knitted clothes and dyes these clothes and other textiles. You are carrying out the audit of the accounts of the company for the year ended 30 September 20X6 which show a revenue of about $10 million and a profit before tax of about $800,000.

You are attending the final audit in December 20X6 and are commencing the audit of trade accounts receivables, which are shown in the draft accounts at $2,060,000.

The interim audit (tests of control) was carried out in July 20X6 and it showed that there was a good system of internal control in the sales system and no serious errors were found in the audit tests. The company's sales ledger is maintained on a computer, which produces at the end of each month:

(i) A list of transactions for the month

(ii) An aged list of balances

(iii) Open item statements which are sent to customers. (Open item statements show all items which are outstanding on each account, irrespective of their age)

Required

(a) List and briefly describe the audit tests you would carry out to verify trade accounts receivable at the year-end. You are not required to describe how you would carry out a direct confirmation of receivables.

(b) Describe the audit work you would carry out on the following replies to a receivables' circularisation:

(i) Balance agreed by customer

(ii) Balance not agreed by customer

(iii) Customer is unable to confirm the balance because of the form of records kept by the customer

(iv) Customer does not reply to the confirmation letter

Answer

(a) The auditors will carry out the following tests on the list of balances:

(i) Agree the balances from the individual sales ledger accounts to the list of balances and vice versa.

(ii) Agree the total of the list to the sales ledger control account.

(iii) Cast the list of balances and the sales ledger control account.

Other general tests auditors will carry out will be to:

(i) Agree the opening balance on the sales ledger control account to ensure that last year's audit adjustments were recorded.

(ii) Inspect ledger balances for unusual entries.

(iii) Perform analytical procedures on trade receivables as follows:

– Compare receivables' turnover and receivables' days to the prior year and/or to industry data.
– Perform an age analysis on trade receivables and compare this to the prior year.
– Compare the bad debt expense as a % of sales to the prior year and/or to industry data.
– Examine large customer accounts individually and compare them to the prior year.

The determination of whether the company has made reasonable provision for bad and doubtful debts will be facilitated as the company produces an aged listing of balances.

Auditors will carry out the following procedures to audit the allowance for receivables.

(i) Debts against which specific allowance has been made (and debts written-off) should be examined in conjunction with correspondence, lawyers'/debt collection agencies' letters, liquidators' statements and so on, and their necessity or adequacy confirmed.

(ii) A general review of relevant correspondence may reveal debts where an allowance is warranted, but has not been made.

(iii) Where specific and/or general allowances have been determined using the aged analysis, the auditors should ensure that the analysis has been properly prepared by comparing it with the dates on invoices and matching cash receipts against outstanding invoices. They should check the reasonableness and consistency of any formula used to calculate general allowances.

(iv) Additional tests that should be carried out on individual balances will include ascertaining the subsequent receipt of cash, paying particular attention to round sum payments on account, examination of specific invoices and, where appropriate, goods received notes, and enquiry into any invoices that have not been paid when subsequent invoices have been paid.

(v) Excessive discounts should be examined, as should journal entries transferring balances from one account to another and journal entries that clear customer balances after the year-end.

(vi) Credit notes issued after the year-end should be reviewed and allowances checked where they refer to current period sales.

In order to audit cut-off and hence completeness, the auditors should, during the physical inventory count, have obtained details of the last serial numbers of goods outwards issued before the commencement of the count. The following substantive procedures are designed to test that goods taken into inventory are not also treated as sales in the year under review and, conversely, goods dispatched are treated as sales in the year under review and not also treated as inventory.

(i) Review goods outwards and returns inwards notes around year-end to ensure that:

(1) Invoices and credit notes are dated in the correct period.

(2) Invoices and credit notes are posted to the sales ledger and nominal ledger in the correct period.

(ii) Reconcile entries in the sales ledger control around the year-end to daily batch invoice totals ensuring batches are posted in correct year.

(iii) Review sales ledger control account around year end for unusual items.

(iv) Review material after-date invoices and ensure that they are properly treated as following year's sales.

(b) The verification of trade receivables by direct confirmation is the normal means of providing audit evidence to prove that receivables represent *bona fide* amounts due to the company (existence and rights and obligations).

The audit work required on the various replies to a receivables' circularisation would be as follows.

(i) *Balances agreed by customer*

All that is required would be to ensure that the debt does appear to be collectable, by reviewing cash received after-date or considering the adequacy of any allowance made for a long outstanding amount.

(ii) *Balances not agreed by customer*

All balance disagreements must be followed up and their effect on total receivables evaluated. Differences arising that merely represent invoices or cash-in-transit generally do not require adjustment, but disputed amounts, and errors by the client, may indicate that further substantive work is necessary to determine whether material adjustments are required.

(iii) *Customer is unable to confirm the balance because of the form of records maintained*

Certain companies, often computerised, operate systems which make it impossible for them to confirm the balance on their account. Typically in these circumstances their purchase ledger is merely a list of unpaid invoices. However, with sufficient information the customer will be able to confirm that any given invoice is outstanding. Hence the auditors can circularise such enterprises successfully, but they will need to break down the total on the account into its constituent outstanding invoices.

(iv) *Customer does not reply to confirmation letter*

When the positive request method is used the auditors must follow up by all practicable means those customers who fail to respond. Second requests should be sent out in the event of no reply being received within two or three weeks and if necessary this may be followed by telephoning the customer with the client's permission.

After two, or even three attempts to obtain confirmation, a list of the outstanding items will normally be passed to a responsible independent company official who will arrange for them to be investigated.

Alternative audit procedures might include the following.

(1) Check receipt of cash after-date by reviewing post year-end bank statements.

(2) Verify valid purchase orders, if any.

(3) Examine the account to see if the balance represents specific outstanding invoices.

(4) Obtain explanations for invoices remaining unpaid after subsequent ones have been paid.

(5) Observe whether the balance on the account is growing, and if so, find out why by discussions with management.

(6) Test the company's control over the issue of credit notes and the write-off of irrecoverable debts.

The receivables' confirmation provides good audit evidence of the existence of receivables, but not necessarily of their valuation. Therefore, in a question on the audit of receivables, remember to include other audit procedures such as analytical procedures.

1 Cash and Bank

'Cash' in the financial statements represents cash in-hand and cash on deposit in bank accounts. Most accounting transactions pass through the cash account so cash is affected by all of the entity's business processes, and is particularly impacted by the sales and purchases processes. We looked at the controls relating to cash in Chapter 10. In this chapter, we will consider the substantive audit testing applied to the year-end cash figure.

1.1 Audit objectives for cash

The following table demonstrates the audit objectives for cash balances and how these are related to the financial statement assertions relevant to this account area. The audit procedures described in the remainder of this chapter are undertaken to provide audit evidence to support these financial statement assertions.

Financial statement assertion	Audit objective
Existence	Recorded cash balances exist at the period-end
Completeness	Recorded cash balances include the effects of all transactions that have occurred
Rights and obligations	The entity has legal title to all cash balances shown at the period-end
Valuation	Recorded cash balances are realisable at the amounts stated
Assertions relating to presentation and disclosure (classification and understandability, occurrence and rights and obligations, accuracy and valuation, completeness)	Disclosures relating to cash are adequate and in accordance with accounting standards and legislation

1.2 Internal control considerations

We covered internal control over the cash system in Section 4 of Chapter 10. The bank reconciliation is a key control for the company in this area and should be prepared frequently and routinely. However, the auditor is concerned with obtaining sufficient appropriate audit evidence on the year end bank balance, so they will focus on the year end reconciliation (in conjunction with other substantive procedures set out in this chapter) when auditing the bank balance included on the statement of financial position.

2 Bank

Bank balances are usually **confirmed directly** with the bank in question.

2.1 Bank confirmation procedures

The audit of bank balances will need to cover **completeness**, **existence**, **rights and obligations and valuation**. All of these assertions can be audited directly by obtaining third party confirmations from the client's banks and reconciling these with the accounting records, having regard to **cut-off**.

The audit objectives linking these assertions are as follows:

- Recorded cash balances exist at the year-end **(existence)**
- Recorded cash balances include the effects of all transactions that occurred **(completeness)**
- Year-end transfers are recorded in the correct period **(cut-off)**
- Recorded balances are realisable at the amounts stated **(valuation and allocation)**
- The entity has legal title to all cash balances shown at the year-end **(rights and obligations)**

This type of audit evidence is valuable because it comes directly from an **independent source** and, therefore, provides greater assurance of reliability than that obtained solely from the client's own records. The bank letter is mentioned as a source of external third party evidence in ISA 505 *External confirmations*.

2.2 Confirmation requests

The **bank confirmation letter** can be used to ask a variety of questions, including queries about outstanding interests, contingent liabilities and guarantees.

The auditors should decide from which bank or banks to request confirmation, having regard to such matters as **size of balance**, **volume of activity**, **degree of reliance** on **internal control**, and **materiality** within the context of the financial statements.

The auditors should determine which of the following approaches is the most appropriate in seeking confirmation of balances or other information from the bank:

- **Listing balances** and other information, and requesting confirmation of their accuracy and completeness, or
- **Requesting details of balances** and other information, which can then be compared with the requesting client's records

In determining which of the above approaches is the most appropriate, the auditors should weigh the **quality** of **audit evidence** they require in the particular circumstances against the **practicality** of obtaining a reply from the confirming bank.

Difficulty may be encountered in obtaining a satisfactory response even where the client company submits information for confirmation to the confirming bank. It is important that a response is sought for **all** confirmation requests. Auditors should not usually request a response only if the information submitted is incorrect or incomplete.

2.2.1 Preparation and dispatch of requests and receipt of replies

Control over the content and dispatch of confirmation requests is the responsibility of the auditors. However, it will be necessary for the request to be **authorised** by the client entity. Replies should be returned directly to the auditors and to facilitate such a reply, a pre-addressed envelope should be enclosed with the request.

2.2.2 Content of confirmation requests

The form and content of a confirmation request letter will depend on the purpose for which it is required and on local practices.

The most commonly requested information is in respect of balances due to or from the client entity on **current, deposit, loan and other accounts**. The request letter should provide the account description number and the type of currency for the account.

It may also be advisable to request information about **nil balances** on accounts, and accounts which were **closed** in the 12 months prior to the chosen confirmation date. The client entity may ask for confirmation not only of the balances on accounts but also, where it may be helpful, other information, such as the maturity and interest terms on loans and overdrafts, unused facilities, lines of credit/standby facilities, any offset or other rights or encumbrances, and details of any collateral given or received.

The client entity and its auditors are likely to request confirmation of **contingent liabilities**, such as those arising on guarantees, comfort letter, bills and so on.

Banks often hold **securities** and other items in safe custody on behalf of customers. A request letter may thus ask for confirmation of such items held by the bank.

The procedure is simple but important, and outlined below.

(a) The banks will require **explicit written authority** from their client to disclose the information requested.

(b) The **auditors' request** must **refer** to the **client's letter** of authority and the date thereof. Alternatively it may be countersigned by the client or it may be accompanied by a specific letter of authority.

(c) In the case of joint accounts, **letters of authority** signed by all **parties** will be necessary.

(d) Such **letters of authority** may either **give permission** to the bank to disclose information for a specific request or grant permission for an indeterminate length of time.

(e) The request should **reach** the **branch manager** at least **one month in advance** of the client's **year-end** and should state both that year-end date and the previous year-end date.

(f) The **auditors** should themselves **check** that the bank response covers all the information in the standard and other responses.

2.3 Cut-off

Care must be taken to ensure that there is no **window dressing**, by auditing **cut-off** carefully. Window dressing in this context is usually manifested as an attempt to overstate the liquidity of the company by:

(a) Keeping the cash book open to take credit for **remittances actually received** after the year-end, thus enhancing the balance at bank and reducing receivables

(b) **Recording cheques paid in** the period under review which are not actually dispatched until after the year-end, thus decreasing the balance at bank and reducing liabilities

A combination of (a) and (b) can contrive to present an artificially healthy looking current ratio.

With the possibility of (a) above in mind, where lodgements have not been cleared by the bank until the new period, the auditors should **examine the paying-in slip** to ensure that the amounts were actually paid into the bank on or before the period-end date.

As regards (b) above, where there appears to be a particularly **large number of outstanding cheques** at the year-end, the auditors should check whether these were **cleared within a reasonable time** in the new period. If not, this may indicate that dispatch occurred after the year-end.

2.4 Audit plan for bank

AUDIT PLAN: BANK (to confirm completeness, valuation, existence, cut-off and assertions related to disclosure)
• **Obtain standard bank confirmations** from each bank with which the client conducted business during the audit period. • **Reperform** arithmetic of bank reconciliation. • **Trace cheques shown as outstanding** from the bank reconciliation to the cash book prior to the year-end and to the **after-date bank statements** and **obtain explanations** for any **large or unusual items** not cleared at the time of the audit. • **Compare cash book(s)** and **bank statements** in detail for the last month of the year, and **match items outstanding** at the reconciliation date to bank statements. • **Review bank reconciliation** previous to the year-end bank reconciliation and test whether **all items** are **cleared** in the last period or **taken forward** to the year-end bank reconciliation. • Obtain satisfactory explanations for **all items** in the **cash book** for which there are **no corresponding entries** in the **bank statement** and vice versa by **discussion** with finance staff. • **Verify contra items** appearing in the cash books or bank statements with original entry. • Verify by **inspecting** paying-in slips that **uncleared bankings** are **paid in** prior to the year-end. • **Examine all lodgements** in respect of which payment has been refused by the bank; ensure that they are cleared on representation or that other appropriate steps have been taken to effect recovery of the amount due. • Verify balances per the cash book according to the bank reconciliation by **inspecting** cash book, bank statements and general ledger. • **Verify** the **bank balances** with reply to **standard bank letter** and with the **bank statements**. • **Inspect** the cash book and bank statements before and after the year-end for **exceptional entries** or **transfers** which have a material effect on the balance shown to be in-hand. • Identify whether any **accounts** are **secured** on the **assets** of the company by **discussion** with management. • **Consider** whether there is a **legal right** of **set-off** of overdrafts against positive bank balances. • Determine whether the bank accounts are **subject** to any **restrictions** by **inquiries** with management. • **Review draft accounts** to ensure that disclosures for bank are complete and accurate and in accordance with accounting standards.

Remember that the bank confirmation letter contains the balance held by the client at the bank **per the bank's records**. This must be **reconciled** to the balance held with the bank **per the client's records.** When suggesting audit procedures for verifying bank balances , although the bank confirmation letter is important, do **not forget to suggest other procedures** related to the year-end bank reconciliation. Previous candidates have lost out on marks for not focusing enough on these procedures.

Question

(a) Explain the importance of the bank letter and describe the procedures used to obtain confirmations from the bank.

(b) Describe how you would test the bank reconciliation shown below.

Another Co
Bank Reconciliation 31 December 20X1

	$	$
Balance per bank statement 31 December 20X1		35,111.91
Add: deposits outstanding		
30 December (ref 1122)	10,222.00	
31 December (ref 1123)	25,000.00	35,222.00
		70,333.91
Less: outstanding cheques		
2411	10,250.00	
2721	2,300.40	
2722	5,000.00	
2723	1,345.25	
2724	1,900.00	
2726	2,200.00	
2728	1,005.50	
2729	1,576.75	
2730	1,255.65	26,833.55
Balance per bank in the general ledger 31 December 20X1		43,500.36

(c) Describe other procedures that should be carried out in respect of bank balances shown in the financial statements.

Answer

(a) The bank letter is important because it is independent confirmation of a number of significant matters in the client's financial statements. It confirms cash and bank balances which may well be a significant asset. It also provides confirmation of customers' assets held as security, customers' other assets held (as custodian) and contingent liabilities. Auditors also ask the bank to give details of other banks and branches that the respondent bank is aware have a relationship with the client.

Audit procedures

(i) Obtain written authority from the client to the bank to disclose the necessary information.

(ii) Send a bank letter in standard form to the bank in sufficient time for it to arrive at least a month before the year-end. The letter should state both the year-end date and the previous year-end date, and should refer to the client's granting of authority.

(iii) If additional information over and above what is in the standard letter is requested, send a separate letter requesting that information.

(iv) When confirmation is received from the bank, check that the bank has answered all the questions in the letter.

(v) Follow up all points disclosed in the bank letter.

(b) The following procedures should be carried out on the bank reconciliation.

(i) Agree the balance per bank statement at 31 December 20X1 as shown on the reconciliation ($35,111.91) to the bank statement and to the amount for that account shown on the bank letter.

(ii) Test arithmetic of bank reconciliation by recasting it.

(iii) Review the bank reconciliation previous to the year-end bank reconciliation (30 November reconciliation if carried out monthly) and test whether items shown on it cleared in the last period or have been taken forward to the bank reconciliation at 31 December.

(iv) Trace the cheques shown as outstanding on the bank reconciliation to the cash book prior to the year-end and ensure they have cleared the bank by looking at the after-date bank statements. Obtain explanations for any that have not cleared at the time of the audit. In particular the outstanding cheque for $10,250 has a reference (2411) which appears to suggest it was raised much earlier in the year than the others and the fact it has not cleared is unusual. Enquiries should be made in respect of this outstanding cheque.

(v) Verify by checking paying-in slips that the uncleared bankings (deposits outstanding – ref 1122 and 1123) were paid in prior to the year-end, and review whether they cleared quickly after the year-end. Any that have not cleared soon after the year end should be investigated.

(vi) Verify the year end balance per the general ledger according to the reconciliation ($43,500.36) agrees with the general ledger account balance at 31 December 20X1 and that this has been properly reflected in the financial statements.

(c) (i) Obtain standard bank confirmations from each bank with which the client conducted business during the period.

(ii) Verify the bank balances with reply to standard bank letter and with the bank statements.

(iii) Scrutinise the cash book and bank statements before and after the period-end for exceptional entries or transfers which have a material effect on the balance shown to be in hand.

(iv) Identify whether any accounts are secured on the assets of the company.

(v) Consider whether there is a legal right to set-off overdrafts against positive bank balances.

(vi) Determine whether the bank accounts are subject to any restrictions.

(vii) Review disclosures related to the cash at bank figure included in the financial statements and ensure they are in accordance with International Financial Reporting Standards.

3 Cash

Cash balances should be verified if they are **material** or **irregularities** are suspected.

Cash balances/floats are often individually immaterial but they may require some audit emphasis because of the opportunities for fraud that could exist where internal control is weak and because they may be material in total.

However in enterprises such as hotels and retail organisations, the amount of cash-in-hand at the period-end could be considerable. Cash counts may be important for internal auditors, who have a role in fraud prevention.

Auditors will be concerned that the cash **exists**, is **complete**, and belongs to the company (**rights and obligations**) and is stated at the correct **value**.

Where the auditors determine that cash balances are potentially material they may conduct a **cash count**, ideally at the period-end. Rather like attendance at an inventory count, the conduct of the count falls into three phases: planning, the count itself, and follow-up procedures.

3.1 Planning the cash count

Planning is an essential element, as it is important that all cash balances are counted at the same time as far as possible. Cash in this context may include unbanked cheques received, IOUs and credit card slips, in addition to notes and coins.

As part of their planning procedures the auditors will need to determine the **locations** where cash is held and which of these locations warrant a count.

Planning decisions will need to be recorded on the current audit file including:

- The **precise time** of the count(s) and location(s)
- The **names** of the **audit staff** conducting the counts
- The **names** of the **client staff** intending to be present at each location

Where a location is not visited it may be appropriate to obtain a letter from the client confirming the balance.

3.2 Cash count

The following matters apply to the count itself.

- All cash/petty cash **books** should be **written up** to date in **ink** (or other permanent form) at the time of the count.
- All **balances** must be **counted** at the **same time**.
- All **negotiable securities** must be **available** and **counted** at the time the cash balances are counted.
- At **no time** should the **auditors** be **left alone** with the cash and negotiable securities.
- **All cash** and securities **counted** must be **recorded** on working papers subsequently filed on the current audit file. **Reconciliations** should be prepared where applicable (for example, impress petty cash float).

AUDIT PLAN: CASH COUNT (to confirm completeness, valuation, existence and disclosure)
• **Count cash balances** held and agree to petty cash book or other record: – Count all balances simultaneously – All counting to be done in the presence of the individuals responsible – Enquire into any IOUs or cashed cheques outstanding for a long period of time • **Obtain certificates** of cash-in-hand from responsible officials. • **Confirm** that bank and cash **balances** as reconciled above are **correctly stated** in the financial statements
Follow up • Obtain **certificates of cash-in-hand** as appropriate. • Verify **unbanked cheques/cash receipts** have subsequently been **paid in** and agree to the bank reconciliation by **inspection** of the relevant documentation. • Ensure **IOUs** and cheques cashed for employees have been **reimbursed**. • Review whether **IOUs or cashed cheques outstanding** for **unreasonable periods** of time have been provided for. • Verify the **balances** as counted are reflected in the accounts (subject to any agreed amendments because of shortages and so on) by **inspection** of draft financial statements.

1 LIABILITIES

In this chapter we will examine the substantive audit of trade payables and accruals, long-term liabilities and provisions and end with a look at share capital, reserves and directors' emoluments. Purchases are often tested in conjunction with the audit of trade payables and so are included in the section on trade payables. The following table sets out the financial statement assertions to which audit testing is directed.

Assertions about classes of transactions	– All purchase transactions recorded have occurred and relate to the entity **(occurrence)** – All purchase transactions that should have been recorded have been recorded **(completeness)** – Amounts relating to transactions have been recorded appropriately **(accuracy)** – Purchase transactions have been recorded in the correct period **(cut-off)** – Purchase transactions are recorded properly in the accounts **(classification)**

Assertions about period-end account balances	– Trade payables and accrued expenses are valid liabilities (**existence**) – Trade payables and accrued expenses are the obligations of the entity **(rights and obligations)** – All liabilities have been recorded **(completeness)** – All liabilities are included in the accounts at appropriate amounts **(valuation and allocation)**
Assertions about presentation and disclosure	– All disclosed events and transactions relating to liabilities have occurred and relate to the entity **(occurrence and rights and obligations)** – All disclosures required have been included **(completeness)** – Financial information is appropriately presented and described and disclosures clearly expressed **(classification and understandability)** – Financial information is disclosed fairly and at appropriate amounts **(accuracy and valuation)**

1.1 Internal control considerations for payables

The audit of payables is closely linked to the purchases system. We looked at controls over the purchases system in Section 2 of Chapter 10, where we saw that they were based around ensuring purchases were authorised, the segregation of duties, matching GRNs with invoices, and prompt recording to minimise cut-off issues.

A specific control often operated by clients over the completeness of trade payables balances is the reconciliation of month end balances to supplier statements. If the client has carried out this reconciliation at the year end for all suppliers, the auditor can review these reconciliations.

However if the client has not carried out these reconciliations, the auditor will need to compare supplier statements with year end payables balances and investigate differences, so this becomes a substantive procedure that the auditor must undertake.

We look at supplier statement reconciliations and other substantive procedures in Section 2.

2 Procedures for trade payables, accruals and expenses

The largest figure in **current liabilities** will normally be **trade accounts payable** which are generally audited by comparison of **suppliers' statements** with **purchase ledger accounts.**

2.1 Audit procedures

As with accounts receivable, accounts payable are likely to be a material figure in the statement of financial position of most enterprises. The tests of controls on the purchases cycle (Chapter 10) will have provided the auditors with some assurance as to the completeness of liabilities.

Auditors should however be particularly aware, when conducting their work on the statement of financial position, of the possibility of **understatement** of **liabilities** to improve liquidity and profits (by understating the corresponding purchases). The primary objective of their work will therefore be to ascertain whether **liabilities** existing at the year-end have been **completely** and **accurately recorded**.

As regards **trade accounts payable**, this primary objective can be subdivided into two detailed objectives.

- Is there a **satisfactory cut-off** between goods received and invoices received, so that purchases and trade accounts payable are recognised in the correct year?
- Do trade accounts payable represent the ***bona fide*** amounts due by the company?

Before we ascertain how the auditors design and conduct their tests with these objectives in mind, we need to establish the importance of the list of balances.

The following table sets out audit procedures to test trade accounts payables and accruals. Many of the procedures in the table below are applicable to the related statement of profit or loss items, since the figures in that statement constitute the movement between the current and previous year's statement of financial position balances. Some are also procedures relating to statement of profit or loss figures which indirectly give evidence over the year end balances. For example the payroll proof in total is an estimate of the employee costs charge for the year but also provides evidence over the adequacy of any related accrual for payroll costs (eg for unpaid wages).

AUDIT PLAN: ACCOUNTS PAYABLES AND ACCRUALS	
Completeness	• Obtain a listing of trade accounts payables and **agree** the total to the general ledger by casting and cross-casting. • Test for unrecorded liabilities by **inquiries of management** on how unrecorded liabilities and accruals are identified and examining post year-end transactions. • Obtain selected suppliers' statements and **reconcile** these to the relevant suppliers' accounts (see Section 2.3 for details of suppliers' statements). • Examine files of unmatched purchase orders and supplier invoices for any **unrecorded liabilities**. • Perform a **confirmation of accounts payables** for a sample (see Section 2.2 for details of the accounts payables' confirmation). • Complete the **disclosure checklist** to ensure that all the disclosures relevant to liabilities have been made. • **Compare** the current year balances for trade accounts payables and accruals to the previous year. • **Compare** the amounts owed to a sample of individual suppliers in the trade accounts payables listing to amounts owed to these suppliers in the previous year. • **Compare** the payables' turnover and payables' days to the previous year and industry data. • **Reperform casts** of **payroll records** to confirm completeness and accuracy. • **Confirm** payment of net pay per payroll records to cheque or bank transfer summary. • **Agree** net pay per cashbook to payroll. • **Inspect** payroll for **unusual items** and **investigate** them further by **discussion** with management. • Perform **proof-in-total (analytical procedures)** on payroll and compare to figure in draft financial statements to assess reasonableness.
Existence	• **Vouch** selected amounts from the trade accounts payables listing and accruals listing to supporting documentation such as purchase orders and suppliers' invoices. • Obtain selected suppliers' statements and **reconcile** these to the relevant suppliers' accounts. • Perform a **confirmation of accounts payables** for a sample. • Perform **analytical procedures** comparing current year balances to the previous year to confirm reasonableness, and also calculating payables' turnover and comparing to the previous year.
Rights and obligations	• **Vouch** a sample of balances to supporting documentation such as purchase orders and suppliers' invoices to obtain audit evidence regarding rights and obligations.

AUDIT PLAN: ACCOUNTS PAYABLES AND ACCRUALS	
Valuation and allocation	• **Trace** selected samples from the trade accounts payables listing and accruals listing to the supporting documentation (purchase orders, minutes authorising expenditure, suppliers' invoices etc). • Obtain selected suppliers' statements and **reconcile** these to the relevant suppliers' accounts. • For a sample of **accruals, recalculate** the amount of the accrual to ensure the amount accrued is correct. • **Compare** the current year balances for trade accounts payables and accruals to the previous year. • **Compare** the amounts owed to a sample of individual suppliers in the trade accounts payables listing to amounts owed to these suppliers in the previous year. • **Compare** the payables' turnover and payables' days to the previous year and industry data.
Cut-off	• For a sample of vouchers, **compare the dates** with the dates they were recorded in the ledger for application of correct cut-off. • **Test transactions** around the year-end to determine whether amounts have been recognised in the correct financial period. • **Perform analytical procedures** on purchase returns, comparing the purchase returns as a % of sales or cost of sales to the previous year.
Accuracy	• **Recalculate** the mathematical accuracy of a sample of suppliers' invoices to confirm the amounts are correct. • **Recast** calculation of **remuneration.** • **Reperform** calculation of **statutory deductions** to confirm whether correct. • Confirm validity of **other deductions** by **agreeing** to supporting documentation. • **Recast** calculation of **other deductions**.
Occurrence	• For a sample of vouchers, **inspect** supporting documentation such as authorised purchase orders. • **Agree individual remuneration** per payroll to personnel records, records of hours worked, salary agreements etc. • Confirm **existence** of employees on payroll by meeting them, attending wages payout, inspecting personnel and tax records, and confirmation from managers. • **Agree benefits** on payroll to supporting correspondence.
Classification and understandability	• **Review** the trade accounts payables listing to identify any large debits (which should be reclassified as receivables or deposits) or long-term liabilities which should be disclosed separately. • **Read** the disclosure notes relevant to liabilities in the draft financial statements and review for understandability.
Accuracy and valuation	• **Read** the disclosure notes to ensure the information is accurate and properly presented at the appropriate amounts.

2.1.1 Audit procedures in relation to purchases, other expenses and wages costs

Although the table above includes details of some procedures which give evidence over items in the statement of profit or loss, the following are procedures specifically related to the audit of purchases and other expenses:

(a) Inspect a sample of purchase invoices to ensure they agree to the amount posted to the general ledger.

(b) Compare expenses making up administrative expenses to the prior year charge and to expectations on a line by line basis. Where differences from expectations are discovered they should be investigated.

(c) Inquire of management whether there are any unsettled claims or obligations arising before the year end and ensure these are provided for (to give evidence over the completeness of the charge in the related expense category in the statement of profit or loss)

(d) Recalculate accruals and prepayments to gain evidence that other expenses are not over or understated.

(e) Compare gross profit margin with the previous year, the gross margin per the budget and expectations. Investigate any unexpected fluctuations.

One expense that may make up a significant proportion of expenses is the wages cost included in statement of profit or loss. It is important you know procedures that can be used when auditing this area. Although a number of these are included in the table on the previous page as they are related to the SOFP balances, they are reproduced here for clarity along with other relevant procedures:

(a) Reconcile the gross costs on the payroll to the wages cost in the financial statements.

(b) Reperform casts of payroll records to confirm completeness and accuracy of costs used as a basis for the journals to the financial statements

(c) Confirm payment of net pay per payroll records to cheque or bank transfer summary.

(d) Inspect payroll for unusual items and investigate them further by discussion with management.

(e) Perform proof-in-total (analytical procedures) on payroll by multiplying estimated average wage (using last year's figures plus expected increases) by average number of employees (therefore incorporating starters and leavers) and compare to figure in draft financial statements to assess reasonableness.

(f) Reperform calculations of statutory deductions to establish whether valid deductions have been included in the payroll expense.

2.2 Confirmation of trade payables

We have already discussed the receivables' confirmation procedure in Chapter 14. It is also possible to undertake confirmation of trade payables, although this is not used a great deal in practice because the auditor can test trade payables by examining **reliable, independent evidence** in the form of suppliers' invoices and suppliers' statements. However, where an entity's internal controls are weak, suppliers' statements may not be available and in this situation, it may be relevant to undertake confirmation procedures. Confirmation of trade payables provides evidence primarily for the **completeness** assertion.

Where the entity has **strong controls** in place to ensure that all liabilities are recorded, the confirmation will focus on **large balances**.

Where the auditor is **concerned** about the presence of **unrecorded liabilities**, regular suppliers with **small or zero balances** on their accounts and a sample of **other accounts** will be confirmed as well as **large balances**.

Auditors use a **positive confirmation** referred to as a **blank or zero-balance confirmation**. This confirmation **does not state** the balance owed but requires the supplier to declare the amount owed at the year-end and to provide a detailed statement of the account. When the confirmation is received back, the amount must be **reconciled** with the entity's records.

The selection and sending out of accounts payables' confirmations should be controlled using the same procedures as for the receivables' confirmation that we discussed in Chapter 14.

2.3 Reconciliations of accounts payables with suppliers' statements

Many suppliers provide **monthly statements** to their customers. These may therefore be available in the entity for examination. Because they are a source of documentary evidence originating outside of the entity, they are a **reliable** source of evidence to support suppliers' balances and provide evidence as to the **existence, completeness** and **valuation** of balances.

Having said this, auditors do still need to be **cautious** when using them as they may have been **tampered** with by the entity. The auditor should not rely on **photocopies or faxed statements**. If there is any doubt, the auditor should request a copy **directly** from the supplier or confirm the balance with the supplier (see above).

When selecting accounts for testing, the auditor should consider the **volume of business** during the year, not the balance outstanding at the year-end, because the risk is understatement of balances. Most differences between balances on suppliers' statements and the year-end accounts payables' listing are likely to be due to goods and cash-in-transit and disputed amounts, however all differences need to be investigated thoroughly.

Question — Trade payables and accruals

You have been assigned to the audit of Carter Brandon Co (CBC), and you are drafting the audit programme for payables and accruals for the year ended 31 December 20X7.

The company operates from a site in West Wendon. All raw materials are received in the stores and all deliveries are checked to the delivery note and purchase order. The stores supervisor raises a goods received note and is also responsible for raising credit requests if there are any problems with the raw materials delivered.

When the purchase ledger department staff receive the purchase invoices, they match them to the relevant goods received notes and purchase orders, and post them to the computerised purchase ledger. Suppliers are paid on the last day of each month.

Other payables and accruals consist of tax, wages and other statutory deductions, accruals and time-apportioned expenses such as electricity and telephone.

Required

Describe the audit work you will carry out:

(a) To compare suppliers' statements with balances recorded on the purchase ledger
(b) To check that purchases cut-off has been applied correctly
(c) To confirm that other payables and accruals have been accurately stated.

Answer

(a) Comparing suppliers' statements with balances recorded

(i) Select a sample of balances and **compare suppliers' statements with purchase ledger balances**. The extent of the sample will depend on the results of tests of controls and assessment of the effectiveness of controls within the purchases system.

(ii) **Select** the **sample on a random basis**. Selection of only large balances or those with many transactions will not yield an appropriate sample as understatement of liabilities is being tested for. Nil and negative balances will also need to be included in the sample.

(iii) If **no statement** was **available** for the supplier, **confirmation** of the balance **from the supplier** should be requested.

If the balance **agrees exactly**, no further work needs to be carried out.

Where differences arise these need to be categorised as either in-transit items or other (including disputed) items. In-transit items will be either goods or cash.

(iv) If the difference relates to goods-in-transit, **ascertain** whether the **goods** were **received** before the year-end by reference to the GRN and that they are included in year-end inventory and purchase accruals. If not, a cut-off error has occurred and should be investigated. If the goods were received after the year-end, the difference with the suppliers' accounts is correct.

(v) Similarly, cash-in-transit would arise where the payment to the supplier was made by cheque before the year-end but was not received by him until after the year-end. The **date** the **cheque** was **raised** and its subsequent **clearing** through the bank account after the year-end should be **verified by inspecting the cash book** and the post year-end bank statements.

(vi) However, if the cheque clears after the year-end date, it may indicate that the cheque, though raised before the year-end was not sent to the supplier until after the year-end. The relevant amount should be added back to year-end accounts payable and to the end of year bank balance.

(vii) Differences which do not arise from in-transit items need to be investigated and **appropriate adjustments** made where necessary.

These differences may have arisen due to **disputed invoices**, where for example the client is demanding credit against an invoice which the supplier is not willing to agree.

The client may decide not to post the invoice to the supplier account as he does not consider it to be a liability of the company. However, differences may also arise because **invoices** have been **held back** in order to reduce the level of year-end accounts payable.

(viii) If significant unexplained differences are discovered it may be necessary to **extend** my **testing**. There may also be a problem if sufficient suppliers' statements are not available. Alternative procedures, eg a circularisation may then be required.

(b) Correct purchases cut-off

(i) From the inventory count working papers, the **number** of the **last GRN** that was issued before the year-end will have been noted. **Select a sample** of **GRNs** issued in the period immediately before and immediately after the year-end. The period to be covered would be at least two weeks either side of the year-end.

(ii) **Concentrate** the sample on **high value items**, and more on those GRNs from before the year-end as these represent the greatest risk of cut-off error.

(iii) Check that the **GRNs** have a **correct number**, according to the last GRN issued in the year and whether the **goods** were **received before or after the year-end**.

(iv) For **GRNs** issued **before the year-end**, check whether the **inventory** has been included in the year-end inventory total. Also check whether the **payable** is either **included** in **trade payables** or **purchase accruals** by **inspecting** the relevant documentation.

(v) For **GRNs** issued **after the year-end**, to ensure that the **inventory** is **included** in the inventory records **after the year-end**. In addition, review the **purchase ledger** to ensure that the relevant **invoice** has been **posted** to the supplier account after the year-end.

(c) Other payables and accruals

(i) **Assess the system of control** instituted by management to identify and quantify accruals and accounts payable.

(ii) From the client's sundry payables and accruals listing, check that **accruals** are **calculated correctly** and verify them by reference to subsequent payments. Check that **all time apportionments** have been made correctly (for example, for electricity) by **recalculation**.

(iii) **Taxation balances**

(1) Check the **amount paid to the tax authorities** by inspecting relevant documentation. The balance at the year-end would normally represent one month's deductions and can be verified to the payroll records. The payment should be traced from the cash book to the payment book (if used) and subsequent bank statements.

(2) For the sales tax balance, **review** for **reasonableness** to the **next return**. **Ensure** that the **payment** for the **previous return** was for the **correct** amount and has cleared through the bank.

(iv) **Review the statement of financial position** and **prior year figures** (for any accruals which have not appeared this year or which did not appear last year) and consider liabilities inherent in the trade (eg weekly wages) to ensure that all likely accruals have been provided.

(v) **Scrutinise payments** made after the year-end to ascertain whether any payments made should be accrued. This will include consideration of any payments relating to the current year which are made a long time after the year-end.

(vi) **Consider and document** the basis for **round sum accruals** and ensure it is consistent with prior years.

(vii) **Ascertain** why any **payments on account** are being made and **ensure** that the full **liability** is **provided**.

(viii) **Accrued interest** and basic **charges on loans** or overdrafts can be **agreed** to the **bank letter** received for audit purposes.

3 Non-current liabilities

Non-current liabilities are usually authorised by the board and should be well documented.

We are concerned here with non-current liabilities comprising debentures, loan inventory and other loans **repayable** at a date **more than one year after the year-end**.

Auditors will primarily try and determine:

- **Completeness**: whether all non-current liabilities have been disclosed
- **Accuracy**: whether interest payable has been calculated correctly and included in the correct accounting period
- **Classification and understandability**: whether long-term loans and interest have been correctly disclosed in the financial statements

The major complication for the auditors is that debenture and loan agreements frequently contain conditions with which the company must comply, including restrictions on the company's total borrowings and adherence to specific borrowing ratios.

The plan that follows contains procedures for non-current liabilities in the statement of financial position and the related interest charge in the statement of profit or loss.

AUDIT PLAN: NON-CURRENT LIABILITIES

- **Obtain/prepare schedule of loans** outstanding at the year-end date showing, for each loan: name of lender, date of loan, maturity date, interest date, interest rate, balance at the end of the period and security.
- **Compare opening balances** to previous year's papers.
- **Test the clerical accuracy** of the analysis.
- **Compare balances** to the **general ledger**.

AUDIT PLAN: NON-CURRENT LIABILITIES
• **Agree name** of **lender** etc, to **register** of **debenture holders** or equivalent (if kept). • **Trace additions** and **repayments** to **entries** in the **cash book**. • **Confirm repayments** are in accordance with **loan agreement**. • **Examine cancelled cheques** and **memoranda of satisfaction** for **loans repaid**. • **Verify** that **borrowing limits** imposed by agreements are **not exceeded**. • **Examine signed Board minutes** relating to **new borrowings/repayments**. • **Obtain direct confirmation** from **lenders** of the amounts outstanding, accrued interest and what security they hold. • **Verify interest charged** for the period is in accordance with statements and supporting agreements, and consistent with known interest rates. Consider the adequacy of accrued interest. • **Confirm assets charged** have been **entered** in the **register of charges** and **notified** to the **Registrar**. • **Review restrictive covenants** and provisions relating to default: – **Review** any **correspondence** relating to the loan – **Review confirmation** replies for non-compliance – If a **default** appears to exist, determine its **effect**, and schedule findings • **Review minutes, cash book** to confirm that all **loans have been recorded**. • **Review draft accounts** to ensure that **disclosures** for non-current liabilities are correct and in accordance with accounting standards. Any elements repayable within one year should be classified under current liabilities.

4 Provisions and contingencies

The accounting treatments for provisions and contingencies are complex and involve judgement and this can make them difficult to audit.

4.1 Accounting issues

A **provision** is a liability of uncertain timing or amount.

A **liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

An **obligating event** is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

A **legal obligation** is an obligation that derives from:

(a) A contract (through its explicit or implicit terms),
(b) Legislation, or
(c) Other operation of law

A **constructive obligation** is an obligation that derives from an entity's actions where:

(a) By an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities, and
(b) As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

A **contingent liability** is:

(a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity, or

(b) A present obligation that arises from past events but is not recognised because:

   (i) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or

   (ii) The amount of the obligation cannot be measured with sufficient reliability.

A **contingent asset** is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Under IAS 37 *Provisions, contingent liabilities and contingent assets*, an entity should not recognise a contingent asset or a contingent liability. However if it becomes probable that an outflow of future economic benefits will be required for a previous contingent liability, a provision should be recognised. A contingent asset should not be accounted for unless its realisation is virtually certain; if an inflow of economic benefits has become probable, the asset should be disclosed.

Examples of the principal types of contingencies disclosed by companies are:

- **Guarantees** (for group companies, of staff pension schemes, of completion of contracts)
- **Discounted bills of exchange**
- **Uncalled liabilities** on shares or loan inventory
- **Lawsuits** or claims pending
- **Options** to purchase assets

4.2 Obtaining audit evidence of contingencies

Part of ISA 501 *Audit evidence – specific considerations for selected items* covers contingencies relating to litigation and legal claims, which will represent the major part of audit work on contingencies. Litigation and claims involving the entity may have a material effect on the financial statements, and so will require adjustment to/disclosure in those financial statements.

The auditor shall design and perform procedures in order to identify any litigation and claims involving the entity which may give rise to a risk of material misstatement. Such procedures would include the following.

- **Make appropriate inquiries of management** and others including in-house legal advisers.
- **Review minutes of meetings** of those charged with governance and **correspondence** between the entity and its external legal advisers.
- **Review legal expense** accounts.
- **Use any information** obtained regarding the entity's business including information obtained from discussions with any in-house legal department.

When litigation or claims have been identified or when the auditor believes they may exist, the auditor shall seek **direct communication** with the entity's external legal advisers through a **letter of inquiry** that is prepared by management and sent by the auditor, requesting the legal adviser to communicate directly with the auditor. This assists the auditor in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are reasonable.

The letter may be one of **general inquiry** or one of **specific inquiry**.

A letter of **general inquiry** requests the entity's external legal advisers to inform the auditor of any litigation and claims that they are aware of, together with an assessment of the outcome of the litigation and claims, and an estimate of the financial implications, including costs involved.

However, if it is considered **unlikely** that the entity's external legal advisers will respond appropriately to a letter of general inquiry, the auditor may seek direct communication through a letter of **specific inquiry**. This will include:

- A **list** of litigation and claims
- Where available, **management's assessment** of the outcome of each of the identified litigation and claims and its **estimate** of the financial implications, including costs involved
- A request that the entity's external legal advisers **confirm the reasonableness** of management's assessments and provide the auditor with **further information** if they consider the list to be incomplete or incorrect

In certain circumstances (the matter is a significant risk, the matter is complex, there is disagreement between management and legal advisers), the auditor also may judge it necessary to **meet** with the entity's external legal advisers to discuss the likely outcome of the litigation or claims. These meetings require management's permission and a member of management will be present at the meeting.

If management **refuses** to give the auditor permission to communicate or meet with the entity's external legal advisers, or the entity's external legal advisers refuse to respond appropriately to the letter of inquiry, or are prohibited from responding, and the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures, the auditor shall modify the opinion in the auditor's report in accordance with ISA 705 *Modifications to the opinion in the independent auditor's report*.

The auditor shall request management and, where appropriate, those charged with governance to provide **written representations** that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework.

4.3 The audit of provisions

The following audit plan can be used in the audit of provisions.

AUDIT PLAN: PROVISIONS/CONTINGENCIES
• **Obtain details** of all **provisions** which have been included in the **accounts** and all **contingencies** that have been disclosed. • **Obtain** a **detailed analysis** of all **provisions** showing opening balances, movements and closing balances. • **Determine** for each material provision whether the company has a **present obligation** as a result of past events by: – **Review** of **correspondence** relating to the item – **Discussion** with the **directors**. Have they created a valid expectation in other parties that they will discharge the obligation? • **Determine** for each material provision **whether** it is **probable** that a **transfer of economic benefits** will be required to settle the obligation by: – Checking whether any **payments** have been made in the post year-end period in respect of the item by reviewing after-date cash – **Review of correspondence** with solicitors, banks, customers, insurance company and suppliers both pre and post year-end – **Sending** a **letter** to the **solicitor** to obtain his views (where relevant) – **Discussing** the **position** of similar **past provisions** with the directors. Were these provisions eventually settled? – **Considering** the **likelihood** of **reimbursement** • **Recalculate** all provisions made. • **Compare** the **amount provided** with any post year-end payments and with any amount paid in the past for similar items.

AUDIT PLAN: PROVISIONS/CONTINGENCIES
• In the event that it is not possible to estimate the amount of the provision, check that a **contingent liability** is **disclosed** in the accounts. • **Consider** the **nature** of the **client's business**. Would you expect to see any other provisions eg warranties? • Consider the adequacy of **disclosure** of provisions, contingent assets and contingent liabilities in accordance with IAS 37.

The audit of provisions is notoriously complex because of the degree of judgement used and the availability of sufficient appropriate audit evidence. This is likely to be tested in a mini scenario type question so you must be able to apply your knowledge to the circumstances in the question.

5 Capital and other issues

The main concern with **share capital and reserves** is that the company has complied with the law.

The issued share capital as stated in the accounts must be **agreed** in total with the **share register**. An examination of transfers on a test basis should be made in those cases where a company handles its own registration work. Where the registration work is dealt with by independent registrars, auditors will normally examine the reports submitted by them to the company, and obtain from them at the year-end a certificate of the share capital in issue.

Auditors should check carefully whether clients have complied with local legislation about share issues or purchase of own shares. Auditors should take particular care if there are any movements in reserves that cannot be distributed, and should confirm that these movements are **valid**.

AUDIT PLAN: CAPITAL AND RELATED ISSUES	
SHARE EQUITY CAPITAL	• **Agree** the **authorised share capital** with the statutory documents governing the company's constitution. • **Agree changes** to **authorised share capital** with **properly authorised resolutions**.
ISSUE OF SHARES	• **Verify any issue** of share capital or other changes during the year with general and **board minutes**. • **Ensure issue or change** is within the **terms** of the **constitution**, and directors possess appropriate **authority** to issue shares. • **Confirm** that **cash** or **other consideration** has been **received** or **receivable(s) is included** as called-up share capital not paid.
TRANSFER OF SHARES	• **Verify transfers of shares** by reference to: – Correspondence – Completed and stamped transfer forms – Cancelled share certificates – Minutes of directors' meeting • **Review the balances** on **shareholders' accounts** in the register of members and the total list with the amount of issued share capital in the general ledger.
DIVIDENDS	• **Agree dividends** paid and declared pre year-end to **authority** in minute books and **reperform calculation** with **total share capital** issued to ascertain whether there are any outstanding or unclaimed dividends. • **Agree dividend payments** to **documentary evidence** (say, the returned dividend warrants). • Test that **dividends do not contravene** distribution provisions by reviewing the legislation.

AUDIT PLAN: CAPITAL AND RELATED ISSUES	
RESERVES	• Agree **movements on reserves** to supporting authority. • **Ensure that movements on reserves do not contravene** the **legislation** and the company's constitution by reviewing the legislation. • **Confirm** that the **company** can **distinguish distributable** reserves from those that are **non-distributable**. • **Ensure appropriate disclosures** of movements on reserves are made in the company's accounts by **inspection** of the financial statements.

6 Directors' emoluments

The auditor will be need to make sure the disclosure of **directors' emoluments** is complete, accurate, and compliant with both applicable accounting standards and local legislation.

The term 'directors' emoluments' is most likely to appear in local legislation. For example, under UK legislation director's emoluments must be disclosed in the financial statements. Emoluments include salaries, fees, bonuses, pension contributions and retirement benefits, non-cash benefits and any compensation for loss of office.

The shareholders and other users of the financial statements will be very interested in how much of the company's wealth is being paid out to the directors and this area will always be a material one. The area of directors' emoluments is said to be **material by nature**.

Companies listed in the UK have to disclose details of directors' emoluments as part of their Directors' Remuneration report. The part of this report which discloses directors' emoluments must be audited, and if the disclosure is inadequate (in the auditors opinion), the auditor is required by UK law to highlight this in their auditor's report.

The requirement to disclose directors' emoluments can also be linked to International Financial Reporting Standards because they require compensation payments to **key management personnel** to be disclosed. Although IAS 24 *Related party disclosures* is outside of the syllabus, it is useful to look at its requirements here to illustrate the sorts of payments and benefits a company needs to disclose in respect of management and the board.

IAS 24 requires that the financial statements of a company disclose **key management personnel** compensation details in total. Key management will include the board of directors and compensation will include:

(a) Short-term employee benefits, such as wages, salaries and social security contributions, paid annual leave and paid sick leave, profit-sharing and bonuses and non-monetary benefits for current employees

(b) Post-employment benefits such as pensions, other retirement benefits, post-employment life insurance and post-employment medical care

(c) Other long-term employee benefits, including long-service benefits, and deferred compensation

(d) Termination benefits

(e) Share-based payments

The auditor must therefore ensure that he or she is comfortable with the requirements of International accounting standards **and** any local legislation. Then procedures adopted must ensure related disclosure is accurate, complete and covers all areas required by local legislation.

The table below lists some valid audit procedures when auditing directors' emoluments:

AUDIT PLAN: DIRECTORS' EMOLUMENTS
• For each director, obtain a schedule of emoluments for the year, split between wages, bonuses, benefits, pension contributions and other emoluments. • Check the addition of the schedule and ensure the totals are in agreement with the disclosure in the financial statements. • Ask each individual director to confirm the emoluments listed are complete and in line with their expectations. • Compare the emoluments with both the previous year's emoluments and with expectations, taking into account the knowledge obtained during the audit (for example if you know a director has left during the year, is there any compensation for loss of office expected?). • Agree salaries, fees, bonuses and pension contributions **to payroll records** for the individual directors and check the amounts paid on the bank statements agree with the payroll records. • Review the **directors' contracts** and ensure emoluments are consistent with the terms of these contracts. • Review **board meeting minutes** and meetings of any remuneration committee for evidence of any bonuses, fees or other emoluments not disclosed. • Review the cash book for any unusual transactions which suggest undisclosed directors emoluments. • Obtain and review **returns to tax authorities** made on behalf of the directors by the company which detail non cash benefits. Ensure these are consistent with the benefits disclosed in the financial statements. • Consider the adequacy of **disclosure** of directors' emoluments in accordance with applicable accounting standards and local legislation, including the separate disclosure of amounts due to or from directors in respect of director's emoluments.

Review and Finalisation

1 Subsequent events

Subsequent events are events occurring between the period-end and the date of the auditor's report and also include facts discovered after the auditor's report has been issued. Auditors shall consider the effect of such events on the financial statements and on their audit opinion.

Subsequent events are events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

IAS 10 *Events after the reporting period* deals with the treatment in the financial statements of events, both favourable and unfavourable, occurring after the period-end. There are two types of event defined by IAS 10:

- Those that provide evidence of conditions that existed at the year-end date (**adjusting events**)
- Those that are indicative of conditions that arose after the year-end date (**non-adjusting events**)

You should be familiar with adjusting and non-adjusting events from your financial reporting studies. Here are some examples.

Adjusting events	Non-adjusting events
Settlement of a court case	Dividends declared after the year-end
Sale of inventory after year-end providing evidence of its NRV at year-end	Fire causing destruction of major plant
Fraud or error showing the accounts are incorrect	Announcement of a major restructuring

ISA 560 *Subsequent events* provides guidance to auditors in this area. The objectives of the auditor are:

- To obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that need adjustment or disclosure in the financial statements are properly reflected in the financial statements
- To respond appropriately to facts that become known to the auditor after the date of the auditor's report which may have caused the auditor to amend the auditor's report if they were known to the auditor at the date of the report

An article published in April 2011 considers how subsequent events can affect an entity's financial statements, and discusses the auditing requirements Paper F8 candidates need to know. You should read this as part of your F8 study as it makes some very important observations such as stressing the importance of being able to differentiate between an adjusting and a non-adjusting event.

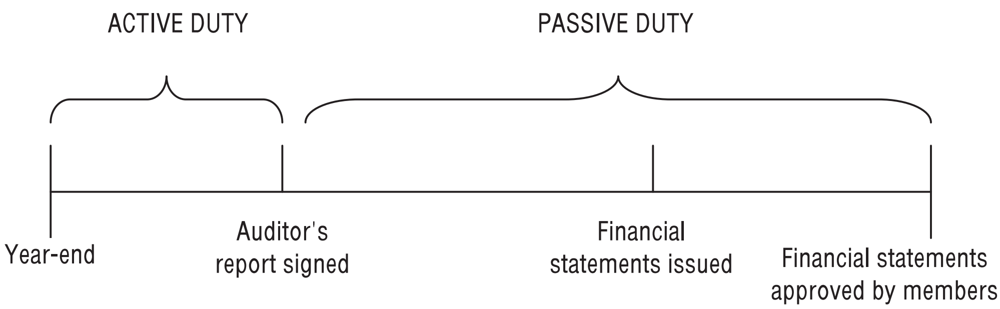
The F8 assessor has also written an article in September 2013 entitled 'Subsequent Events.' This article considers the financial reporting aspects of subsequent events using a case study scenario, and discusses in concrete detail how you should approach a scenario-based question on subsequent events in the exam. Please make sure that you read this article.

Both articles can be found on the ACCA's website: http://www.accaglobal.com/gb/en/student/acca-qual-student-journey/qual-resource/acca-qualification/f8/technical-articles.html.

1.1 Procedures

Auditors have a **responsibility** to **review subsequent events** before they sign the auditor's report, and may have to take action if they become aware of subsequent events between the date they sign the auditor's report and the date the financial statements are issued.

The following time line is helpful when considering subsequent events and the auditor's responsibilities concerning them.



1.1.1 Events occurring up to the date of the auditor's report

The auditor shall perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified.

These procedures should be applied to any matters examined during the audit which may be susceptible to change after the year-end. They are in addition to tests on specific transactions after the period end, eg cut-off tests.

ISA 560 lists procedures to identify subsequent events which may require adjustment or disclosure. They should be performed as near as possible to the date of the auditors' report.

AUDIT PROCEDURES TO TEST SUBSEQUENT EVENTS	
Inquiries of management	Status of items involving **subjective judgement** Status of items accounted for using **preliminary or inconclusive** data Whether there are any new **commitments, borrowings or guarantees** Whether there have been any: • **Sales** or destruction of **assets** • **Issues** of **shares/debentures** or changes in business structure • **Developments** involving **risk areas, provisions** and **contingencies** • **Unusual accounting adjustments** • **Major events** (eg going concern problems) affecting appropriateness of accounting policies for estimates • Litigations or claims
Other procedures	**Review** management procedures for identifying subsequent events to ensure that such events are identified. **Read minutes** of general board/committee meetings and enquire about unusual items. **Review latest available interim financial statements** and budgets, cash flow forecasts and other management reports. **Obtain evidence** concerning any litigation or claims from the company's solicitors (only with client permission). Obtain **written representation** that all events occurring subsequent to the period-end which need adjustment or disclosure have been adjusted or disclosed.

1.1.2 Facts discovered after the date of the auditor's report but before the financial statements are issued

The financial statements are the management's responsibility. They should therefore inform the auditors of any material subsequent events between the date of the auditors' report and the date the financial statements are issued. The auditor does **not** have any obligation to perform procedures, or make enquires regarding the financial statements, **after** the date of the report.

However if the auditor becomes aware of a fact that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- **Discuss** the matter with management and those charged with governance.
- **Determine** whether the financial statements need amendment.
- If amendment is required, **inquire** how management intends to address the matter in the financial statements.

If amendment is required to the financial statements and management makes the necessary changes, the auditor must carry out a number of procedures:

- Undertake any **necessary audit procedures** on the changes made.
- **Extend audit procedures** for identifying subsequent events that may require adjustment of or disclosure in the financial statements to the date of the new auditor's report.
- Provide a **new auditor's report** on the amended financial statements.

If management does not amend the financial statements:

- If the auditor's report has not yet been provided to the entity, the auditor shall **modify the opinion** and then provide the auditor's report.
- If the auditor's report has already been provided to the entity, the auditor shall notify management and those charged with governance **not to issue** the financial statements before the amendments are made; but if the financial statements are issued anyway, the auditor shall take action to seek to **prevent reliance** on the auditor's report.

1.1.3 Facts discovered after the financial statements have been issued

Auditors have **no obligations** to perform procedures or make enquiries regarding the financial statements **after** they have been issued.

However if the auditor becomes aware of a fact that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- **Discuss** the matter with management and those charged with governance.
- **Determine** whether the financial statements need amendment.
- If amendment is required, **inquire** how management intends to address the matter in the financial statements.

If management amends the financial statements, the auditor shall carry out any necessary procedures on the amendment and review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements is **informed**.

The auditor shall also issue a **new or amended auditor's report,** which will include an **explanatory paragraph** (known as an **emphasis of matter paragraph** or **other matter paragraph** – we discuss these further in Chapter 19) that refers to a note in the financial statements that discusses the reason for the amendment. Audit procedures will be extended up to the date of the new report.

If management does not take the necessary steps, the auditor shall **notify** management and those charged with governance that the auditor will **seek to prevent future reliance** on the report. If management still does not act, the auditor shall take appropriate action to **seek to prevent reliance** on the auditor's report.

2 Going concern

If the entity has inappropriately used the going concern assumption or a material uncertainty exists, this may impact on the auditor's report.

Under the **going concern assumption**, an entity is viewed as continuing in business for the foreseeable future. When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business.

The financial statements should be prepared on the going concern basis unless management either intends to liquidate the entity or has no realistic alternative but to do so. Therefore, as we discuss in section 2.1, the going concern assumption is a fundamental principle in the preparation of the financial statements and IAS 1 *Presentation of financial statements* therefore requires management to assess whether the entity is a going concern.

It is vital that the going concern assumption is considered since it affects the value of many areas of the financial statements, how account balances are presented and the financial statement disclosures.

If the going concern basis is not appropriate the financial statements are prepared using on a **break-up basis**.

Using the break-up basis is likely to result in non-current assets and liabilities being reclassified as current. Asset values will need to be stated at their realisable value as they are no longer to be used in an ongoing business. More liabilities may also arise as a result of closing down operations, and extra provisions may be necessary (for example over inventories to be sold at a reduced price). Management will also need to disclose the fact the going concern assumption has not been used and explain why.

Since the going concern assumption has such significance in the preparation of the financial statements, the going concern review is a very important part of the audit. As we will see in Section 2.5, this outcome of this review can have a direct impact on the auditor's report. Its importance means it is allocated its own International Standard on Auditing, ISA 570 *Going concern*.

ISA 570 *Going concern* provides guidance to auditors in this area. The objectives of the auditor are:

- To obtain sufficient appropriate audit evidence regarding the **appropriateness** of management's use of the going concern assumption
- To conclude whether a **material uncertainty** exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern
- To determine the **implications** for the auditor's report

ISA 570 includes examples of events or conditions that may cast doubt about the going concern assumption. These are sometimes referred to as **going concern indicators** and fall under three headings: 'financial', 'operating' and 'other', and are shown in the table below.

Events or conditions that may cast doubt about the going concern assumption (potential indicators that an entity is not a going concern).	
Financial	• Net liability or net current liability position • Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment • Indications of withdrawal of financial support by creditors • Negative operating cash flows (historical or prospective) • Adverse key financial ratios • Substantial operating losses or significant deterioration in the value of assets used to generate cash flows • Arrears or discontinuance of dividends

Events or conditions that may cast doubt about the going concern assumption (potential indicators that an entity is not a going concern).	
Financial (continued)	• Inability to pay creditors on due dates • Inability to comply with terms of loan agreements • Change from credit to cash-on-delivery transactions with suppliers • Inability to obtain financing for essential new product development or other essential investments
Operating	• Management intentions to liquidate or cease operations • Loss of key management without replacement • Loss of a major market, key customers, licence, or principal suppliers • Labour difficulties • Shortages of important supplies • Emergence of a highly successful competitor
Other	• Non-compliance with capital or other statutory requirements • Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy • Changes in laws/regulations/government policy expected to adversely affect the entity • Uninsured or underinsured catastrophes when they occur

'Identify and explain potential indicators that an entity is not a going concern' was an addition to the syllabus for exams in 2012. You should make sure you study the above indicators carefully and bear them in mind when you are faced with identifying going concern problems from scenarios in the F8 exam.

The F8 examining team has written an article, 'Going Concern,' discussing the respective responsibilities of auditors and management regarding going concern. This is an important topic for the paper. Please read the article by accessing the technical articles link on the ACCA's website:
http://www.accaglobal.com/gb/en/student/acca-qual-student-journey/qual-resource/acca-qualification/f8/technical-articles.html.

2.1 Management's responsibilities for going concern

Management has specific responsibilities relating to going concern that may be set out in law or regulation and in the financial reporting framework. IAS 1 *Presentation of financial statements* contains a specific requirement that management makes an assessment of an entity's ability to continue as a going concern.

Because general purpose financial statements are prepared on a going concern basis, the going concern assumption is a **fundamental principle** in the preparation of financial statements. Therefore management's responsibility for the preparation and presentation of the financial statements also encompasses a responsibility to assess the entity's ability to continue as a going concern even if there is no explicit requirement to do so in the financial reporting framework.

Management's assessment involves making a **judgement** about inherently uncertain future outcomes of events or conditions. This judgement is affected by the following:

- **Degree of uncertainty** which increases the further into the future an event/condition/outcome occurs
- **Size and complexity** of the entity
- **Nature and condition** of the business
- Judgement about the future is based on **information available** at the time the judgement is made but **subsequent events** may result in **inconsistent outcomes**

If, during their assessment, management becomes aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, then those **uncertainties must be disclosed** in the financial statements.

As discussed earlier in the chapter, if management conclude the going concern assumption is not appropriate they will need to prepare the accounts on a different basis. When this happens they must disclose the fact the going concern assumption has not been used and explain why.

This section highlights why audit work on going concern is crucial – because of the **judgements** used by management in making its assessment of going concern.

2.2 Management's assessment

Management may have performed a **preliminary assessment** of whether the entity can continue as a going concern. If it has, the auditor shall discuss it with management. If the assessment has not been performed, the auditor shall discuss with management the basis for the intended use of the going concern assumption.

2.2.1 Auditors' responsibilities in relation to management's assessment

Don't get these responsibilities mixed up with the auditors' reporting responsibilities in relation to going concern (which we look at later). It is important you look at what is being asked for in questions on going concern. In a previous exam, the examining team noted that when asked for auditor's **reporting** responsibilities in relation to going concern issues, students often focused on general responsibilities or directors' responsibilites. They therefore wasted time writing on a subject there were no marks available for.

The auditor must **remain alert** throughout the audit for evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. However the auditor also has specific responsibilities in relation to management's assessment.

The auditor shall **evaluate** management's assessment of the entity's ability to continue as a going concern. However, if this assessment covers less than 12 months from the date of the financial statements, the auditor shall ask management to extend its assessment period to **at least 12 months** from that date. The auditor shall also inquire of management its knowledge of events or conditions beyond the period of the assessment that may cast significant doubt on the entity's ability to continue as a going concern.

2.3 Events or conditions identified

If events or conditions are identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether a material uncertainty exists by:

- Requesting management to make its **assessment** where this has not been done
- Evaluating management's **plans for future action**
- Evaluating the **reliability of underlying data** used to prepare a cash flow forecast and considering the **assumptions** used to make the forecast
- Considering whether any **additional facts or information** have become available since the date management made its assessment
- Requesting **written representations** from management and those charged with governance about plans for future action and the feasibility of these plans

2.4 Audit procedures applied in performing going concern reviews

Specific audit procedures the auditor might carry out could include the following:

- **Analyse and discuss cash flow**, profit and other relevant forecasts with management

- **Analyse and discuss** the entity's latest available **interim financial statements** (or management accounts)
- **Review the terms of debentures and loan agreements** and determine whether they have been breached
- **Read minutes** of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties
- **Inquire** of the entity's lawyer regarding **litigation and claims**
- **Confirm the existence, legality and enforceability** of arrangements to provide or maintain financial support with related and third parties
- **Assess** the **financial ability** of such parties to **provide additional funds**
- **Consider the entity's position** concerning unfulfilled customer orders
- **Review events after the period-end** for items affecting the entity's ability to continue as a going concern
- Confirm the existence, terms and **adequacy of borrowing facilities**
- Obtaining and **reviewing reports of regulatory actions**
- Determining the **adequacy of support for any planned disposals** of assets

2.5 Audit reporting

It is very important that you are aware of the reporting implications when faced with scenarios in which a company has going concern problems. This is an area where students have struggled in the past and this has been highlighted in recent examiner's reports. Don't forget to take into account any information you are given in the scenario. For example, if you know a material uncertainty exists and management has provided disclosures, the audit report issued will depend on the adequacy of those disclosures.

The auditor shall consider whether a **material uncertainty** exists related to events or conditions which may cast doubt on the entity's ability to continue as a going concern, as this will have an impact on the opinion issued in the auditor's report because the uncertainty must be disclosed.

The following table summarises the possible scenarios that could arise following the auditor's review of going concern. We discuss audit reporting in detail in Chapter 19, so you may wish to revisit this section again after having studied Chapter 19. ISA 570 does provide example extracts in respect of the following scenarios and these are presented in the following table.

Scenario	Impact on auditor's report
1 Going concern assumption appropriate but material uncertainty which is adequately disclosed	Unmodified opinion and explanatory emphasis of matter paragraph
2 Going concern assumption appropriate but material uncertainty which is not adequately disclosed	Qualified or adverse opinion (ie modified opinion)
3 Use of going concern assumption inappropriate	Adverse opinion (ie modified opinion)
4 Management unwilling to make or extend its assessment	Qualified or disclaimer of opinion (ie modified opinion)

Scenario 1: Going concern assumption appropriate but material uncertainty which is adequately disclosed

In this situation, the opinion on the financial statements will be **unmodified** but the auditor's report will include an **emphasis of matter paragraph** which is an explanatory paragraph detailing the uncertainty. The ISA contains an example of such an extract from the auditor's report:

Emphasis of Matter

Without qualifying our opinion, we draw attention to Note X in the financial statements which indicates that the Company incurred a net loss of ZZZ during the year ended December 31, 20X1 and, as of that date, the company's current liabilities exceeded its total assets by YYY. These conditions, along with other matters as set forth in Note X, indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern.

Scenario 2: Going concern assumption appropriate but material uncertainty which is not adequately disclosed

In this situation, as inadequate disclosure has been made of the material uncertainty, the auditor's opinion will be modified – either a qualified or adverse opinion will be issued depending on the magnitude of the uncertainty. An extract from the auditor's report where a qualified opinion is issued is provided by the ISA follows.

Basis for Qualified Opinion

The Company's financing arrangements expire and amounts outstanding are payable on March 19, 20X1. The Company has been unable to re-negotiate or obtain replacement financing. This situation indicates the existence of a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore the Company may be unable to realise its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not fully disclose this fact.

Qualified Opinion

In our opinion, except for the incomplete disclosure of the information referred to in the Basis for Qualified Opinion paragraph, the financial statements present fairly, in all material respects (or 'give a true and fair view of') the financial position of the Company as at December 31, 20X0, and of its financial performance and its cash flows for the year then ended in accordance with …

Scenario 3: Use of going concern assumption inappropriate

When the going concern assumption has been used but this is considered inappropriate by the auditor, an adverse opinion must be issued, regardless of whether or not the financial statements include disclosure of the inappropriateness of management's use of the going concern assumption.

Basis for Adverse Opinion

[Provide explanation of inappropriate use of going concern assumption]

Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion paragraph, the financial statements do not present fairly (or 'give a true and fair view of') the financial position of the Company as at December 31, 20X0, and of its financial performance and its cash flows for the year then ended in accordance with …

Scenario 4: Management unwilling to make or extend its assessment

In some circumstances, the auditor may ask management to make or extend its assessment. If management does not do this, a qualified opinion or a disclaimer of opinion in the auditor's report may be appropriate, because it may not be possible for the auditor to obtain **sufficient appropriate audit evidence** regarding the use of the going concern assumption in the preparation of the financial statements. Examples of auditor's reports with a disclaimer of opinion are provided in Chapter 19 which looks at modifications to the auditor's opinion in detail.

2.6 Communicating to those charged with governance

The auditor shall **communicate with those charged with governance** events or conditions that may cast doubt on the entity's ability to continue as a going concern. This will include:

- Whether the events or conditions constitute a material uncertainty
- Whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements
- The adequacy of related disclosures

3 Written representations

The auditor obtains **written representations** from management concerning its responsibilities and to support other audit evidence where necessary.

Written representations are written statements by management provided to the auditor to confirm certain matters or to support other audit evidence. They do not include the financial statements, assertions or supporting books and records.

ISA 580 *Written representations* provides guidance to auditors in this area. The objectives of the auditor are:

- To obtain written representations that management believes that it has fulfilled the fundamental responsibilities that constitute the premise on which an audit is conducted
- To support other audit evidence relevant to the financial statements if determined by the auditor or required by other ISAs
- To respond appropriately to written representations or if management does not provide written representations requested by the auditor

There are three areas in which written representations are necessary – to **confirm management's responsibilities**, where they are **required by other ISAs** and to **support other audit evidence**. We discuss these below in more detail.

3.1 Written representations about management's responsibilities

The auditor shall request management to provide written representations on the following matters:

- That management has fulfilled its responsibility for the **preparation and presentation of the financial statements** as set out in the terms of the audit engagement and whether the financial statements are prepared and presented in accordance with the applicable financial reporting framework
- That management has provided the auditor with all **relevant information** agreed in the terms of the audit engagement and that all transactions have been recorded and are reflected in the financial statements

3.2 Other written representations

Other ISAs require written representations on specific issues but if the auditor considers it necessary to obtain representations in addition to these to support other audit evidence, the auditor shall request these other written representations.

The following table includes examples of other written representations.

Other written representations
Whether the selection and application of accounting policies are appropriate
Plans or intentions that may affect the carrying value or classification of assets and liabilities
Liabilities, both actual and contingent
Title to, or control over, assets, liens or encumbrances on assets and assets pledged as collateral
Aspects of laws, regulations and contractual agreements that may affect the financial statements, including non-compliance
All deficiencies in internal control that management is aware of have been communicated to the auditor
Written representations about specific assertions in the financial statements
Significant assumptions used in making accounting estimates are reasonable
All subsequent events requiring adjustment or disclosure have been adjusted or disclosed
The effects of uncorrected misstatements are immaterial, both individually and in aggregate
Management has disclosed the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud
Management has disclosed all information in relation to fraud or suspected fraud involving management, employees with significant roles in internal control, and others where fraud could have a material effect on the financial statements
Management has disclosed all information in relation to allegations of fraud or suspected fraud communicated by employees, former employees, analysts, regulators or others
Management has disclosed all instances of non-compliance or suspected non-compliance with laws or regulations

3.3 Quality and reliability of written representations as audit evidence

In Chapter 8 we looked at the quality of audit evidence and pointed out that **written representations** are more reliable than oral representations, since oral representations can be retracted.

However, although written representations are a form of audit evidence, they are from an internal source and **on their own** they **do not provide sufficient appropriate audit evidence** about the issues they relate to.

In addition, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence obtained by the auditor regarding the fulfilment of management's responsibilities, or about specific assertions in the financial statements.

You will have noted at the start of Section 3 on the objectives of the auditor regarding written representations that the second objective is 'To **support** other audit evidence...' This is because although written representations are necessary, they cannot provide sufficient appropriate audit evidence when they stand alone.

3.4 Obtaining written representations

The written representations are usually obtained in the form of a representation **letter** addressed to the auditor.

Throughout the course of the audit, the auditors will determine those items on which written representations are required and should inform management of those areas on which they will be seeking written representations.

At the finalisation and review stage the auditors will provide management with a draft representation letter containing the necessary representations. The auditors will then ask management to print the letter on their headed paper, review the representations, and sign the document to confirm them.

ISA 580 includes an example representation letter in an appendix. The date of the representation letter must be as near as practicable to, **but not after**, the date of the auditor's report on the financial statements and must be for all the financial statements and period(s) referred to in the auditor's report.

Written representations are requested from those responsible for the preparation of the financial statements – **management** is usually the responsible party. These representations can therefore be requested from the chief executive officer and chief financial officer, or equivalent. In some cases though, it may be that those charged with governance are also responsible for the preparation of the financial statements.

3.5 Doubt about the reliability of written representations

If written representations are **inconsistent** with other audit evidence, the auditor shall perform audit procedures to try to resolve the matter. If the matter cannot be resolved, the auditor shall reconsider the assessment of the competence, integrity and ethical values of management, and the effect this may have on the reliability of representations and audit evidence in general.

If the auditor concludes that written representations are not reliable, the auditor shall take appropriate actions, including determining the impact on the auditor's report.

3.6 Written representations not provided

If management does not provide one or more requested written representations, the auditor shall:

- **Discuss** the matter with management.
- **Re-evaluate** the integrity of management and evaluate the effect this may have on the reliability of representations and audit evidence in general.
- Take **appropriate actions**, including determining the **impact** on the auditor's report.

4 Overall review of financial statements

The auditors must perform and document an **overall review** of the financial statements by undertaking **analytical procedures** before they can reach an opinion.

Once most of the substantive audit procedures have been carried out, the auditors will have a draft set of financial statements which should be supported by appropriate and sufficient audit evidence. At the beginning of the end of the audit process, it is usual for the auditors to undertake an **overall review** of the financial statements.

This review of the financial statements, in conjunction with the conclusions drawn from the other audit evidence obtained, gives the auditors a reasonable basis for their opinion on the financial statements. It should be carried out by a senior member of the audit team, with appropriate skills and experience.

4.1 Compliance with accounting regulations

The auditors should consider whether:

(a) The information presented in the financial statements is in accordance with local/national statutory requirements.

(b) The accounting policies employed are in accordance with accounting standards, properly disclosed, consistently applied and appropriate to the entity.

When examining the **accounting policies**, auditors should consider:

(a) Policies **commonly adopted in particular industries**

(b) Policies for which there is **substantial authoritative support**

(c) Whether any **departures from applicable accounting standards** are necessary for the financial statements to give a true and fair view

(d) Whether the **financial statements reflect the substance** of the underlying transactions and not merely their form

When compliance with local/national statutory requirements and accounting standards is considered, the auditors may find it useful to use a **checklist**.

4.2 Review for consistency and reasonableness

The auditors should consider whether the financial statements are **consistent** with their knowledge of the entity's business and with the results of other audit procedures, and the manner of disclosure is fair.

This can be done by applying **analytical procedures** at or near the end of the audit in accordance with ISA 520 *Analytical procedures* which states that the auditor shall design and perform analytical procedures near the end of the audit that assist in forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

The principal considerations are as follows.

(a) Whether the financial statements adequately reflect the **information** and **explanations** previously obtained and conclusions previously reached during the course of the audit

(b) Whether it reveals any **new factors** which may affect the presentation of, or disclosure in, the financial statements

(c) Whether **analytical procedures** applied when completing the audit, such as comparing the information in the financial statements with other pertinent data, **produce results** which assist in arriving at the overall conclusion as to whether the financial statements as a whole are consistent with their knowledge of the entity's business

(d) Whether the **presentation** adopted in the financial statements may have been unduly influenced by the **directors' desire** to present matters in a favourable or unfavourable light

(e) The potential impact on the financial statements of the **aggregate of uncorrected misstatements** (including those arising from bias in making accounting estimates) identified during the course of the audit and the preceding period's audit, if any

The analytical review at the final stage should cover the following:

- Important accounting ratios
- Related items
- Changes in products/customers
- Price and mix changes
- Wages changes
- Variances
- Trends in production and sales
- Changes in material and labour content of production
- Other expenditure in the statement of profit or loss
- Variations caused by industry or economy factors

As at other stages of the audit process, significant fluctuations and unexpected relationships must be investigated by **inquiries of management** and obtaining appropriate audit evidence relevant to **management's responses**, and **performing other audit procedures** considered necessary.

4.3 Accounting treatment issues

As noted in the previous section auditors review the financial statements to assess whether the **accounting policies are consistently applied**. Auditors should therefore consider whether new accounting policies are appropriate, whether matters in financial statements are consistent with each other, and whether the financial statements give a true and fair view.

4.4 Treatment of misstatements

A **misstatement** is 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. It can arise from error or fraud.

An **uncorrected misstatement** is a misstatement accumulated during the audit by the auditor which has not been corrected**.**

ISA 450 *Evaluation of misstatements identified during the audit* requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial. The ISA distinguishes between **factual misstatements** (misstatements about which there is no doubt), **judgemental misstatements** (misstatements arising from management's judgement concerning accounting estimates or accounting policies) and **projected misstatements** (the auditor's best estimate of misstatements arising from sampling populations).

ISA 450 requires the auditor to communicate all misstatements accumulated during the audit with the appropriate level of management on a timely basis and to request management to correct those misstatements. If management refuses, the auditor must establish the reasons why and consider this when evaluating whether the financial statements as a whole are free from material misstatement.

As part of their completion procedures, auditors shall consider whether the **aggregate of uncorrected misstatements** in the financial statements is **material**, having first reassessed materiality in accordance with ISA 320 *Materiality in planning and performing an audit* to confirm that it is still appropriate. When determining whether uncorrected misstatements are material (individually or in aggregate), the auditor shall consider the size and nature of the misstatements and the effect of uncorrected misstatements related to prior periods on the financial statements as a whole.

4.4.1 Communication of uncorrected misstatements

ISA 450 requires the auditor to **communicate uncorrected misstatements** and their effect to those charged with governance, with material uncorrected misstatements being identified individually. The auditor shall request uncorrected misstatements to be corrected. The auditor shall also communicate the effect of uncorrected misstatements relating to prior periods.

The auditor shall request a **written representation** from management and those charged with governance whether they believe the effects of uncorrected misstatements are immaterial (individually and in aggregate) to the financial statements as a whole. A summary of these items shall be included in or attached to the representation.

4.4.2 Documentation

ISA 450 requires the auditor to document the following information:

- The amount below which misstatements would be regarded as clearly trivial
- All misstatements accumulated during the audit and whether they have been corrected
- The auditor's conclusion as to whether uncorrected misstatements are material and the basis for that conclusion

The audit review and finalisation stage of the external audit is very important. It could come up in a scenario-based question or in the knowledge-based question 2 of the paper. It is vital that you are completely comfortable with this stage of the audit process and can distinguish it from the audit testing stage.

Audit Report

1 The auditor's report on financial statements

The auditor is required to produce an **auditor's report** at the end of the audit which sets out his **opinion** on the truth and fairness of the financial statements. The report contains a number of **consistent elements** so that users know the audit has been conducted according to **recognised standards**.

Objective 18 of the PER performance objectives is to evaluate and report on audit. The knowledge you gain in this key chapter will assist you in demonstrating the achievement of this objective in practice. An article published in the June 2010 edition of *Student Accountant* provides more detail on how you can achieve PO 18.

ISA 700 *Forming an opinion and reporting on financial statements* establishes standards and provides guidance on the form and content of the auditor's report issued as a result of an audit performed by an independent auditor on the financial statements of an entity. It states that the auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the **applicable financial reporting framework**.

In order to form the opinion, the auditor needs to conclude as to whether reasonable assurance has been obtained that the financial statements are free from material misstatement. The auditor's conclusion needs to consider the following.

- Whether **sufficient appropriate audit evidence** has been obtained (ISA 330)
- Whether **uncorrected misstatements are material** (ISA 450)
- **Qualitative aspects of the entity's accounting practices**, including indicators of **possible bias** in management's judgements
- Whether the financial statements **adequately disclose the significant accounting policies selected and applied**
- Whether the accounting policies selected and applied are **consistent** with the applicable financial reporting framework and are **appropriate**
- Whether **accounting estimates** made by management are **reasonable**
- Whether **the information** in the financial statements is **relevant, reliable, comparable and understandable**
- Whether the financial statements provide **adequate disclosures** to allow users to understand the effect of material transactions and events on the information presented in the financial statements
- Whether the **terminology** used in the financial statements is **appropriate**
- The **overall presentation, structure and content** of the financial statements
- Whether the financial statements represent the underlying transactions and events so as to achieve **fair presentation**
- Whether the financial statements **adequately refer to or describe the applicable financial reporting framework**

1.1 Unmodified opinions in the auditor's report

An **unmodified opinion** is the opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

ISA 700 states that the auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

If the auditor concludes that the financial statements as a whole are not free from material misstatement or cannot obtain sufficient appropriate audit evidence to make this conclusion, the auditor must modify the opinion in accordance with ISA 705 *Modifications to the opinion in the independent auditor's report*. We discuss modifications to the opinion later in this chapter.

The following extract from an audit report shows an example of the opinion paragraph for an unmodified report, in accordance with ISA 700, which contains illustrations of unmodified auditors' reports in its appendix. The full unmodified report was also set out in Chapter 1 of this Study Text.

In our opinion, the financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of ABC Company as of December 31, 20X1, and (*of*) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

1.2 Basic elements of the auditor's report

A measure of **consistency** in the form and content of the auditor's report is desirable because it **promotes credibility** in the global marketplace and also helps to promote the **reader's understanding** of the report and to **identify unusual circumstances** when they occur.

The auditor's report must be **in writing** and includes the following basic elements, usually in the following layout.

Basic elements of audit report	Explanation
Title	The auditor's report must have a title that clearly indicates that it is the report of the independent auditor. This signifies that the auditor has met all the ethical requirements concerning independence and therefore distinguishes the auditor's report from other reports.
Addressee	The addressee will be determined by law or regulation, but is likely to be the shareholders or those charged with governance.
Introductory paragraph	This shall identify the entity being audited, state that the financial statements have been audited, identify the title of each statement that comprises the financial statements being audited, refer to the summary of significant accounting policies and other explanatory notes, and specify the date or period covered by each statement comprising the financial statements.
Management's responsibility for the financial statements	This part of the report describes the responsibilities of those who are responsible for the preparation of the financial statements. The report shall include a section headed 'Management's responsibility for the financial statements' and describe management's responsibility including the following: • Management is responsible for the preparation of the financial statements in accordance with the applicable financial reporting framework. • Management is responsible for such internal control necessary to enable the preparation of financial statements that are free from material misstatement, whether due to error or fraud. • Reference shall be made to 'the preparation and fair presentation of these financial statements' (or 'the preparation of financial statements that give a true and fair view') where the financial statements are prepared in accordance with a fair presentation framework.

Basic elements of audit report	Explanation
Auditor's responsibility	The report shall include a section entitled 'Auditor's responsibility'. The report must state that the auditor is responsible for expressing an opinion on the financial statements based on the audit. This section must also state that the audit was conducted in accordance with International Standards on Auditing and ethical requirements and that the auditor planned and performed the audit so as to obtain reasonable assurance that the financial statements are free from material misstatement. The report must describe an audit by stating that: • An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. • The procedures chosen depend on the auditor's judgement of risks of material misstatements, and the auditor considers internal control relevant to the preparation of the financial statements in order to design appropriate audit procedures (but not to express an opinion on the effectiveness of internal control). • An audit includes evaluation of the appropriateness of the accounting policies used, the reasonableness of accounting estimates made by management and the overall presentation of the financial statements. This part of the report shall also state whether the auditor believes that the audit evidence obtained is sufficient and appropriate to provide a basis for the opinion.
Opinion paragraph	If the auditor expresses an unmodified opinion on financial statements prepared in accordance with a fair presentation framework, the opinion shall use one of the following equivalent phrases: • The financial statements present fairly, in all material respects,…in accordance with [the applicable financial reporting framework]; or • The financial statements give a true and fair view of … in accordance with [the applicable financial reporting framework].
Other reporting responsibilities	If the auditor is required by law to report on any other matters, this must be done in an additional paragraph below the opinion paragraph which is titled 'Report on other legal and regulatory requirements' or otherwise as appropriate.
Auditor's signature	The report must contain the auditor's signature, whether this is the auditor's own name or the audit firm's name or both.
Date of the report	The report must be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements.
Auditor's address	The location where the auditor practises must be included.

1.3 Modified opinions in auditor's reports

There are three types of **modified opinion**: a **qualified opinion**, an **adverse opinion**, and a **disclaimer of opinion**.

As the examiner has pointed out in recent exams, audit reports are the only output of a statutory audit and hence an understanding of how an audit report can be modified and in which circumstances, is very important for this exam.

ISA 705 *Modifications to the opinion in the independent auditor's report* sets out the different types of modified opinions that can result. It identifies three possible types of modifications:

- A **qualified** opinion
- An **adverse** opinion
- A **disclaimer** of opinion

1.3.1 Types of modifications

Pervasiveness is a term used to describe the effects or possible effects on the financial statements of misstatements or undetected misstatements (due to an inability to obtain sufficient appropriate audit evidence). There are three types of pervasive effect:

– Those that are not confined to specific elements, accounts or items in the financial statements
– Those that are confined to specific elements, accounts or items in the financial statements and represent or could represent a substantial portion of the financial statements
– Those that relate to disclosures which are fundamental to users' understanding of the financial statements

The type of modification issued depends on the following:

- The **nature of the matter** giving rise to the modifications (ie whether the financial statements **are materially misstated** or whether they **may be misstated** when the auditor cannot obtain sufficient appropriate audit evidence)
- The auditor's judgement about the **pervasiveness** of the effects/possible effects of the matter on the financial statements

A modified opinion is required when:

- The auditor concludes that the financial statements as a whole are not free from material misstatements, or
- The auditor cannot obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

1.3.2 Qualified opinions

A qualified opinion must be expressed in the auditor's report in the following two situations:

(1) The auditor concludes that misstatements are material, but not pervasive, to the financial statements.

Material misstatements could arise in respect of:

- The appropriateness of selected accounting policies
- The application of selected accounting policies
- The appropriateness or adequacy of disclosures in the financial statements

(2) The auditor cannot obtain sufficient appropriate audit evidence on which to base the opinion but concludes that the possible effects of undetected misstatements, if any, could be material but not pervasive.

The auditor's inability to obtain sufficient appropriate audit evidence is also referred to as a limitation on the scope of the audit and could arise from:

- Circumstances beyond the entity's control (eg accounting records destroyed)
- Circumstances relating to the nature or timing of the auditor's work (eg the timing of the auditor's appointment prevents the observation of the physical inventory count)
- Limitations imposed by management (eg management prevents the auditor from requesting external confirmation of specific account balances)

1.3.3 Adverse opinions

An adverse opinion is expressed when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements are both **material and pervasive** to the financial statements. The table below gives one example of why an adverse opinion might be expressed for each of the three possible reasons for misstatements being determined as pervasive (as stated in the key term box in section 1.3.1).

Reason deemed pervasive	Example
Misstatements are not confined to specific elements, accounts or items in the financial statements	No depreciation has been provided on plant and equipment, a receivable balance consisting half of total receivables is irrecoverable and has not been provided and trade payables have been significantly understated, All misstatements are material and these balances are significant on the SOFP.
Misstatements are confined to specific elements, accounts or items in the financial statements and represent a substantial portion of the financial statements	A house building company has included all the houses it has constructed in the year as non-current assets rather than inventory. The value of these houses constitutes 90% of the total asset value on the SOFP.
Misstatements relate to disclosures which are fundamental to users' understanding of the financial statements	There is a material uncertainty in respect of going concern which has not been adequately disclosed

Sometimes it is easier to think in more general terms when deciding whether an adverse opinion is warranted (apart from specific instances where reasons for adverse opinions are specified by ISAs, such as in relation to going concern).

The question to ask yourself is this: Am I significantly diverted from the real financial position of the company as a result of the misstatement(s)?

In the house builder example above, the accounts presented would suggest that the company was holding no property for sale but had significant company property that was being utilised by the business. The effects of the misstatement are clearly pervasive.

1.3.4 Disclaimers of opinion

An opinion must be disclaimed when the auditor **cannot obtain sufficient appropriate audit evidence** on which to base the opinion and concludes that the **possible effects** on the financial statements of undetected misstatements, if any, **could be both material and pervasive**.

The opinion must also be disclaimed in situations involving **multiple uncertainties** when the auditor concludes that, despite having obtained sufficient appropriate audit evidence for the individual uncertainties, it is not possible to form an opinion on the financial statements due to the **potential interaction of the uncertainties and their possible cumulative effect** on the financial statements.

One example of when a disclaimer of opinion is used was given in Chapter 18 where, in relation to going concern, management is unwilling to make or extend its assessment. Another example might be where the auditor is unable to attend the inventory count and unable to request receivable confirmations, and there is no other realistic means of gathering evidence on these two areas. If these two areas form a significant element of the total assets value, a disclaimer may be appropriate.

1.3.5 Impact on the auditor's report

When the auditor has had to modify the auditor's opinion, the auditor's report must include a paragraph before the opinion paragraph, which provides a description of the matter giving rise to the modification. This paragraph will be entitled 'Basis for qualified opinion' or 'Basis for adverse opinion' or 'Basis for disclaimer of opinion' depending on the type of modification.

The section of the auditor's report containing the opinion will be headed either 'Qualified opinion', 'Adverse opinion' or 'Disclaimer of opinion', again depending on the type of modification.

When the auditor expresses a qualified or adverse opinion, the section of the report on the auditor's responsibilities must be amended to state that the auditor believes that the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's modified audit opinion.

When the auditor disclaims an opinion due to being unable to obtain sufficient appropriate audit evidence, the section on the auditor's responsibilities must be amended to include the following: 'Because of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.'

We will now look at some examples of extracts from auditor's reports with modified opinions for each of the situations we have discussed above.

Example 1: Qualified opinion due to material misstatement

In this example, inventories are materially misstated but the effect is not pervasive.

Basis for qualified opinion

The company's inventories are carried in the statement of financial position at xxx. Management has not stated inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from International Financial Reporting Standards. The company's records indicate that had management stated the inventories at the lower of cost and net realisable value, an amount of xxx would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of ABC Company as at December 31, 20X1, and (*of*) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Example 2: Adverse opinion due to material misstatement with a pervasive effect

This example is an adverse opinion for the house building company we looked at in section 1.3.3, which included inventory as depreciated non-current assets.

Basis for adverse opinion

The company has included houses built for re-sale (including related land) at a cost of $X as non-current assets and depreciated them at a rate of X%, resulting in depreciation of $X. Under International Financial Reporting Standards, these should have been included as inventory in the financial statements and no depreciation should have been provided in respect of these. The carrying value of the houses represent 90% of the company's total assets and the company's records indicate that …[explanation of the effect on amounts presented in the financial statements.]

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the financial statements do not present fairly (or *do not give a true and fair view of*) the financial position of ABC Company as at December 31, 20X1, and (*of*) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Example 3: Qualified opinion due to inability to obtain sufficient appropriate audit evidence

In this example, the inventory count was not attended by the auditor, but in the context of the financial statements, even though inventory could be materially misstated (which the auditor can not conclude on – so the phrase 'possible effects' is used), the effects would not be pervasive.

Basis for qualified opinion

With respect to inventory having a carrying amount of $X the audit evidence available to us was limited because we did not observe the counting of the physical inventory as at 31 December 20X1, since that date was prior to our appointment as auditor of the company. Owing to the nature of the company's records, we were unable to obtain sufficient appropriate audit evidence regarding the inventory quantities by using other audit procedures.

Qualified Opinion

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of ABC Company as at December 31, 20X1, and (*of*) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Example 4: Disclaimer of opinion due to inability to obtain sufficient appropriate audit evidence about multiple elements of the financial statements

In this example, the auditor has not only been unable to attend the inventory count, but has also been unable to gain evidence over other areas. As a result the auditor has concluded the effects of the possible misstatements could be material and pervasive.

Basis for disclaimer of opinion

We were not appointed as auditors of the company until after December 31, 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at December 31, 20X0 and 20X1 which are stated in the statement of financial position at xxx and xxx, respectively. In addition, the introduction of a new computerised accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our audit report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the statement of financial position at a total amount of xxx as at December 31, 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the statement of profit or loss, statement of changes in equity and cash flow statement.

Disclaimer of Opinion

Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

1.3.6 Communication with those charged with governance

ISA 705 states that when the auditor expects to express a modified opinion, the auditor must **communicate with those charged with governance** the circumstances leading to the expected modification and the proposed wording of the modification in the auditor's report.

This allows the auditor to give **notice** to those charged with governance of the intended modification and the reasons for it, to **seek agreement or confirm disagreement** with those charged with governance with respect to the modification, and to give those charged with governance an **opportunity to provide further information and explanations** on the matter giving rise to the expected modification.

1.3.7 Summary of modifications and impact on the auditor's report

The following table summarises the different types of modified opinion that can arise.

Nature of circumstances	*Material but not pervasive*	*Material and pervasive*
Financial statements are materially misstated	QUALIFIED OPINION	ADVERSE OPINION
Auditor unable to obtain sufficient appropriate audit evidence	QUALIFIED OPINION	DISCLAIMER OF OPINION

Question

Modified reports

During the course of your audit of the non-current assets of Eastern Engineering Inc at 31 March 20X4, two problems have arisen.

(a) The calculations of the cost of direct labour incurred on assets in the course of construction by the company's employees have been accidentally destroyed for the early part of the year. The direct labour cost involved is $10,000.

(b) The company incurred development expenditure of $25,000 spent on a viable new product which will go into production next year and which is expected to last for ten years. These costs have been expensed in full to the statement of profit or loss.

(c) Other relevant financial information is as follows.

	$
Profit before tax	100,000
Non-current asset additions (excluding constructed assets)	133,000
Assets constructed by company	34,000
Non-current asset at net book value	666,667

Required

(a) List the general forms of modification available to auditors in drafting their report and state the circumstances in which each is appropriate.

(b) State whether you feel that a modified audit opinion would be necessary for each of the two circumstances outlined above, giving reasons in each case.

(c) On the assumption that you decide that a modified audit opinion is necessary with respect to the treatment of the development expenditure, draft the section of the report describing the matter (the whole report is not required).

Answer

(a) ISA 705 *Modifications to the opinion in the independent auditor's report* suggests that the auditor may need to modify the opinion under one of two main circumstances:

- The auditor concludes that the financial statements as a whole are not free from material misstatements, or
- The auditor cannot obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

For both circumstances there can be two 'levels' of modified opinion:

(i) *Material but not pervasive,* where the circumstances prompting the misstatement or possible misstatement are material. These circumstances will result in a qualified opinion.

(ii) *Material and pervasive* to the overall view shown by the financial statements, ie the financial statements are or could be misleading. These will result in an adverse opinion (financial statements are misstated) or a disclaimer of opinion (the auditor is unable to obtain sufficient appropriate audit evidence).

(b) Whether a modification of the audit opinion would be required in the circumstances described would depend on whether or not the auditors considered either of them to be material to the financial statements as a whole. An item is likely to be considered material in the context of a company's financial statements if its omission, misstatement or non-disclosure would prevent a proper understanding of those statements on the part of a potential user.

(i) *Loss of records relating to direct labour costs for assets in the course of construction*

The loss of records supporting one of the asset figures in the statement of financial position would cause a limitation in scope of the auditor's work because the auditor would be unable to obtain sufficient appropriate audit evidence. The $10,000 represents 29.4% of the expenditure incurred during the year on assets in course of construction but only 6% of total additions to non-current assets during the year and 1.5% of the year-end net book value for non-current assets. The total amount of $10,000 represents 10% of pre-tax profit but, as in relation to asset values, the real consideration by the auditor should be the materiality of any over- or under-statement of assets resulting from error in arriving at the $10,000 rather than the total figure itself.

Provided there are no suspicious circumstances surrounding the loss of these records and the total figure for additions to assets in the course of construction seems reasonable in the light of other audit evidence obtained, then it is unlikely that this matter would be seen as sufficiently material to merit any modification of the audit opinion. If other records have been lost as well, however, it may be necessary for the auditor to comment on the directors' failure to maintain proper books and records.

(ii) *Development cost debited to the statement of profit or loss*

The situation here is one of misstatement in the financial statements, since best accounting practice as laid down by IAS 38 requires that development costs should be taken to the statement of comprehensive income over the useful life of the product to which they relate.

This departure from IAS 38 does not seem to be justifiable and would be material to the reported pre-tax profits for the year, representing 25% of that figure.

While this understatement of profit would be material to the financial statements, it is not likely to been seen as pervasive and therefore a qualified opinion would be appropriate.

(c) *Qualified audit opinion extract*

Basis for qualified opinion

As explained in note ... development costs in respect of a potential new product have been deducted in full against profit instead of being spread over the life of the relevant product as required by IAS 38; the effect of so doing has been to decrease profits before and after tax for the year by $25,000.

Qualified opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements present fairly, in all material respects, *(or give a true and fair view of)* the financial position of Eastern Engineering Inc as at March 31, 20X4, and *(of)* its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

If you are given a scenario in a question on audit reports and asked whether the opinion should be modified and on what basis, always remember to calculate materiality and comment on it in the context of its impact on the type of modification (ie qualified opinion, adverse opinion or disclaimer of opinion).

1.4 Emphasis of matter paragraphs and other matter paragraphs in the auditor's report

Emphasis of matter paragraphs and **other matter paragraphs** can be included in the auditor's report under certain circumstances. Their use does not modify the auditor's opinion on the financial statements.

ISA 706 *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report* provides guidance to auditors on the inclusion of paragraphs in the auditor's report that either draw users' attention to a matter that is of such importance that it is **fundamental** to their understanding or that is **relevant** to their understanding of the audit, the auditor's responsibilities or the auditor's report.

1.4.1 Emphasis of matter paragraphs

An **emphasis of matter paragraph** is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements.

Emphasis of matter paragraphs are used to draw readers' attention to a matter **already presented or disclosed** in the financial statements that the auditor feels is **fundamental** to their understanding, provided that the auditor has obtained sufficient appropriate audit evidence that the matter is **not materially misstated**.

When an emphasis of matter paragraph is included in the auditor's report, it comes **immediately after the opinion paragraph** and is entitled 'Emphasis of matter' (or appropriate). The paragraph must contain a **clear reference** to the matter being emphasised and to where relevant disclosures that fully describe it can be found in the financial statements. The paragraph must state that **the auditor's opinion is not modified** in respect of the matter emphasised.

The following are examples of situations in which the auditor might include an emphasis of matter paragraph in the auditor's report:

- An uncertainty relating to the future outcome of **exceptional litigation or regulatory action**
- **Early application of a new accounting standard** that has a **pervasive effect** on the financial statements
- A **major catastrophe** that has had, or continues to have, **a significant effect** on the entity's financial position

ISA 706 contains an example auditor's report that contains an emphasis of matter paragraph, relevant extracts of which are shown below.

> **Emphasis of Matter**
>
> We draw attention to Note X to the financial statements which describes the uncertainty related to the outcome of the lawsuit filed against the company by XYZ Company. Our opinion is not qualified in respect of this matter.

1.4.2 Other matter paragraphs

> An **other matter paragraph** is a paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgement, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Other matter paragraphs are used where the auditor considers it necessary to draw readers' attention to a matter that is relevant to their understanding of the audit, the auditor's responsibilities or the auditor's report.

One example of where the auditor uses such a paragraph is where the prior period financial statements of an audit client were not audited. If this is the case, the auditor will state that the corresponding figures are unaudited in an other matter paragraph in the auditor's report. This is a requirement of ISA 710 *Comparative information – corresponding figures and comparative financial statements*.

Although the ISAs do specify situations where an other matter paragraph must be used, the auditor may use it to refer to matters other than those specified in ISAs, as long as they judge it to be relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

The other matter paragraph must be included immediately after the opinion paragraph and any emphasis of matter paragraph, or elsewhere in the auditor's report if the content of it is relevant to the other reporting responsibilities section. The content of the other matter paragraph must reflect clearly that the other matter is not required to be presented and disclosed in the financial statements, and does not include information that the auditor is prohibited from providing by law and regulations or other standards, or information that is required to be provided by management.

1.4.3 Communication with those charged with governance

ISA 706 states that when the auditor expects to include an emphasis of matter paragraph or an other matter paragraph, the auditor must communicate with those charged with governance the circumstances and the proposed wording of the paragraph in the auditor's report.

1.5 Reporting on Compliance with International Financial Reporting Standards

As we have discussed above, the objective of an audit is to enable the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an **applicable financial reporting framework**. The auditor's report must indicate the financial reporting framework that has been used to prepare the financial statements.

1.6 Other information in documents containing audited financial statements

Auditors shall review the **other information** in documents containing audited financial statements for material inconsistencies and misstatements of fact.

ISA 720 *The auditor's responsibilities relating to other information in documents containing audited financial statements* provides guidance to auditors in this area. The objective of the auditor is to respond appropriately when documents containing audited financial statements include other information that could **undermine the credibility** of the financial statements and the auditor's report.

Other information is financial and non-financial information, other than the financial statements and the auditor's report, which is included, either by law, regulation or custom, in a document containing audited financial statements and the auditor's report.

An **inconsistency** means the other information contradicts information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously obtained and possibly also the basis for the auditor's opinion on the financial statements.

A **misstatement of fact** is when the other information that is unrelated to matters appearing in the audited financial statements is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing audited financial statements.

Examples of other information include the following:

- A report by management or those charged with governance on operations
- Financial summaries or highlights
- Employment data
- Planned capital expenditures
- Financial ratios
- Names of officers and directors
- Selected quarterly data

1.6.1 Material inconsistencies

ISA 720 states that the auditor shall **read** the other information to identity **material inconsistencies** with the audited financial statements. If a material inconsistency is identified, the auditor shall determine whether the audited financial statements or other information needs to be **revised**.

If the **financial statements** need to be revised but management refuses, the auditor shall **modify** the audit opinion.

If the **other information** needs to be revised but management refuses, the auditor shall **communicate** this matter to those charged with governance and:

- Include an **emphasis of matter paragraph** in the auditor's report that describes the material inconsistency, or
- **Withhold** the auditor's report, or
- **Withdraw** from the engagement (where this is legally permitted).

1.6.2 Material misstatements of fact

If the auditor becomes aware that the other information includes an apparent material misstatement of fact, he shall **discuss** this with management.

If, after the discussions, the auditor still considers there is an apparent material misstatement of fact, he shall request management to consult a **qualified third party** such as a lawyer and the auditor shall consider the advice received.

If management refuses to correct the other information, the auditor shall **notify those charged with governance** and take any **appropriate further action**, such as consulting the auditor's lawyer.

1.7 Opening balances and comparative information

The auditor's responsibilities and audit procedures to be applied in relation to opening balances and comparative information is not examinable under the current ACCA F8 syllabus. This section has been included for your reference only.

1.7.1 Opening balances

Opening balances are those account balances that exist at the beginning of the period. They are based on the closing balances of the prior period and reflect the effects of transactions of prior periods and accounting policies applied in the prior period. They also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

An **initial audit engagement** is one in which either the financial statements for the prior period were not audited or one in which the financial statements for the prior period were audited by a predecessor auditor.

ISA 510 *Initial audit engagements – opening balances* provides guidance to auditors on the audit of opening balances when conducting an initial audit engagement.

The ISA states that for initial audit engagements the auditor's objective is to obtain sufficient appropriate audit evidence whether:

- Opening balances contain **misstatements** that **materially** affect the current period's financial statements.
- **Appropriate accounting policies** are **consistently** applied or changes have been properly accounted for and adequately presented and disclosed.

1.7.2 Audit evidence for opening balances

ISA 510 states that the auditor shall **read** the most recent financial statements and the predecessor auditor's report for information relevant to opening balances.

The auditor shall obtain sufficient appropriate audit evidence about whether opening balances contain misstatements that materially affect the current period's financial statements by:

- Determining whether the prior period's closing balances have been correctly brought forward or restated
- Determining whether the opening balances reflect the application of appropriate accounting policies
- Performing one or more of the following:
  - Where the prior period's financial statements were audited, reviewing the predecessor auditor's working papers
  - Evaluating whether audit procedures performed in the current period provide evidence relevant to opening balances
  - Performing specific audit procedures to obtain evidence regarding opening balances

1.7.3 Opening balances – audit conclusions and reporting

If the auditor cannot obtain **sufficient appropriate audit evidence** for opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion.

If the opening balances contain misstatements that could **materially affect** the current year's financial statements, the auditor shall express a qualified opinion or an adverse opinion.

If the auditor concludes that the current period's **accounting policies** are not consistently applied in relation to opening balances or changes have not been properly accounted for and adequately presented and disclosed, the auditor shall express a qualified opinion or an adverse opinion.

If a prior period modification remains **relevant and material** to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements accordingly.

1.7.4 Comparative information

Comparative information is amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework. There are two methods of presentation: **corresponding figures**, where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period; and **comparative financial statements** where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's report.

ISA 710 *Comparative information – corresponding figures and comparative financial statements* provides guidance to auditors on comparatives, both corresponding figures and comparative financial statements. Whether corresponding figures or comparative financial statements are required is usually dictated by law or regulation but may also be specified in the terms of engagement.

In terms of audit reporting, for corresponding figures, the auditor's opinion refers to the current period only. For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

1.7.5 Auditor's responsibilities for comparative information

The ISA states that the auditor must determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether it is appropriately classified. This includes an evaluation of whether:

- The **accounting policies** used for corresponding figures or comparative financial statements are consistent with the current period.
- The corresponding figures or comparative financial statements **agree** with the amounts and other disclosures presented in the prior period.

If the auditor becomes aware of a possible material misstatement regarding the comparative information, the auditor must perform additional audit procedures to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists.

ISA 710 requires the auditor to obtain a **written representation** for all periods referred to in the auditor's opinion and a specific written representation regarding any restatements made to correct a material misstatement in prior period financial statements that affect the comparative information.

1.7.6 Corresponding figures – reporting

In terms of reporting, the audit report does not specifically refer to the corresponding figures because the opinion is on the current period's financial statements as a whole, and this includes the corresponding figures.

1.7.7 Comparative financial statements – reporting

The auditor's opinion must refer to each period for which financial statements are presented and on which an audit opinion is expressed.

1.8 The audit report as a means of communication

1.8.1 Implied information

Audit reports with unmodified opinions may not appear to give a great deal of information. The report says much, however, by implication. Remember that the auditors report *by exception*, so a standard report tells the user that, for example:

- **Adequate accounting** records have been **kept**.
- The **accounts agree** with the **records.**
- The **auditors** have **received** all **necessary information**.
- All **directors' transactions** have been **disclosed**.
- The **directors' report** is consistent with the **accounts**.

The real problem here is that, unfortunately, most users do not know that this is what an audit report tells them. This issue is also confused by the fact that many users do not understand the responsibilities of either the auditors or the directors in relation to the financial statements.

1.8.2 Expectations gap

This difference between the actual and the public perception is part of what is called the '**expectations gap**', defined as the difference between the apparent public perceptions of the responsibilities of auditors on the one hand (and hence the assurance that their involvement provides) and the legal and professional reality on the other. The question remains: how can we make the **meaning** of an unqualified audit report clear to the user?

The above definition of the expectations gap is not definitive but we can highlight some specific issues.

(a) **Misunderstandings of the nature of audited financial statements**, for example that:

- The statement of financial position provides a fair valuation of the reporting entity.
- The amounts in the financial statements are stated precisely.
- The audited financial statements will guarantee that the entity concerned will continue to exist.

(b) **Misunderstanding as to the type and extent of work undertaken by auditors**

(c) **Misunderstanding about the level of assurance provided by auditors**, for example that:

- An unmodified auditor's opinion means that no frauds have occurred in the period.
- The auditors provide absolute assurance that the figures in the financial statements are correct (ignoring the concept of materiality and the problems of estimation).

Different countries have tackled this problem in different ways. The role of auditors has been included in the debate on corporate governance in many western countries, leading to further rules which are nevertheless voluntary, not mandatory, as we discussed in Chapter 3.

2 Reports to management

Reports to management can be sent by external auditors after both the interim and final audits. They set out deficiencies in internal control, the implications of those deficiencies on the business and suggested recommendations to mitigate them.

ISA 265 *Communicating deficiencies in internal control to those charged with governance and management* sets out guidance on internal control deficiencies. We covered the requirements of this standard in detail in Chapter 9 of this Study Text. Many external auditors produce a **report to management** as a by-product of an external audit, listing any deficiencies they have found in systems and making recommendations for improvements. The report to management may also be referred to as the management letter, letter of weakness or letter on internal control.

2.1 The report to management

Recommendations regarding internal control are a by-product of the audit of the financial statements, not a primary objective, but nonetheless are frequently of great value to a client. The auditors shall communicate with those charged with governance any material deficiencies in the design, implementation or operating effectiveness of internal control which have come to their attention during the course of the audit. This shall be done on a **timely basis**.

When auditors prepare a written communication on internal control matters, the following points should be considered:

(a) It should not **include language** that **conflicts** with the **opinion** expressed in the auditor's report.

(b) It should state that the **accounting and internal control** system were **considered only** to the **extent necessary** to **determine** the **auditing procedures** to report on the financial statements and not to determine the adequacy of internal control for management purposes or to provide assurances on the accounting and internal control systems.

(c) It will state that it **discusses only deficiencies** in internal control which have **come to the auditors' attention** as a result of the **audit** and that other deficiencies in internal control may exist.

(d) It should also include a statement that the **communication is provided for use only by management** (or another specific named party).

After the above items and the auditors' suggestions for corrective action are communicated to management, the auditors will usually ascertain the actions taken, including the reasons for those suggestions rejected. The auditors may encourage management to respond to the auditors' comments in which case any response can be included in the report.

The significance of findings relating to the accounting and internal control systems may change with the passage of time. Suggestions from previous years' audits which have not been adopted, if any, should normally be repeated or referred to.

2.1.1 Example report to management

This is an example of a report to management with a covering letter which demonstrates how the principles described above might be put into practice.

ABC & Co
Certified Accountants
29 High Street

The Board of Directors
Manufacturing Ltd
15 South Street

1 April 20X8

Members of the board,

Financial statements for the year ended 31 May 20X8

Please find below the report to management which includes sets out deficiencies in internal control we identified as a result of our review of the accounting systems and procedures operated by your company during our recent audit. The matters dealt with in the report came to our notice during the conduct of our normal audit procedures which are designed primarily for the purpose of expressing our opinion on the financial statements.

Purchases: ordering procedures

Deficiency
During the course of our work we discovered that it was the practice of the stores to order certain goods from X Co orally without preparing either a purchase requisition or purchase order.

Implication
There is therefore the possibility of liabilities being set up for unauthorised items and at a non-competitive price.

Recommendation
We recommend that the buying department should be responsible for such orders and, if they are placed orally, an official order should be raised as confirmation.

Payables ledger reconciliation

Deficiency
Although your procedures require that the payables ledger is reconciled against the control account on the nominal ledger at the end of every month, this was not done in December or January.

Implication
The balance on the payables ledger was short by some $2,120 of the nominal ledger control account at 31 January 20X8 for which no explanation could be offered. This implies a serious breakdown in the purchase invoice and/or cash payment batching and posting procedures.

Recommendation
It is important in future that this reconciliation is performed regularly by a responsible official independent of the day-to-day payables ledger, cashier and nominal ledger functions.

Receivables ledger: credit control

Deficiency
As at 28 February 20X8 trade receivables accounted for approximately 12 weeks of sales, although your standard credit terms are cash within 30 days of statement, equivalent to an average of about 40 days (6 weeks) of sales.

Implication
This has resulted in increased overdraft usage and difficulty in settling some key suppliers' accounts on time.

Recommendation
We recommend that a more structured system of debt collection be considered using standard letters and that statements should be sent out a week earlier if possible.

Preparation of payroll and maintenance of personnel records

Deficiency

Under your present system, just two members of staff are entirely and equally responsible for the maintenance of personnel records and preparation of the payroll. Furthermore, the only independent check of any nature on the payroll is that the chief accountant confirms that the amount of the wages cheque presented to him for signature agrees with the total of the net wages column in the payroll. This latter check does not involve any consideration of the reasonableness of the amount of the total net wages cheque or the monies being shown as due to individual employees.

Implication

It is a serious weakness of your present system that so much responsibility is vested in the hands of just two people. This situation is made worse by the fact that there is no clearly defined division of duties between the two of them. In our opinion, it would be far too easy for fraud to take place in this area (eg by inserting the names of 'dummy workmen' into the personnel records and hence on to the payroll) and/or for clerical errors to go undetected.

Recommendations

(i) Some person other than the two wages clerks be made responsible for maintaining the personnel records and for periodically (but on a surprise basis) checking them against the details on the payroll.

(ii) The two wages clerks be allocated specific duties in relation to the preparation of the payroll, with each clerk independently reviewing the work of the other.

(iii) When the payroll is presented in support of the cheque for signature to the chief accountant, he should be responsible for assessing the reasonableness of the overall charge for wages that week.

Please note that this report only sets out those significant deficiencies identified during our audit. If more extensive procedures on internal control had been carried out, we may have identified and reported more deficiencies.

This letter has been produced for the sole use of your company. It must not be disclosed to a third party, or quoted or referred to, without our written consent. No responsibility is assumed by us to any other person.

We should like to take this opportunity of thanking your staff for their co-operation and assistance during the course of our audit.

Yours faithfully

ABC & Co

If you are answering a question which requires you to prepare a report to management you should **only include a covering letter if you are asked to** provide one.

Question 1 of the December 2010 exam asked for a report to management and included a requirement which asked candidates to include a covering letter. Two marks were available for presentation.

If you are asked for a covering letter, in addition to including the report to management, you should make sure your letter includes:

- An address and the date
- A short introduction explaining the purpose and content of the report to management
- A closing paragraph that states the report only sets out those significant deficiencies identified during the audit and more extensive procedures on internal control may have resulted in more deficiencies being identified. It should also state that the report is solely for management's use