

ACCA

Applied Skills

Audit and Assurance (AA)

Workbook

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Helping you to pass

BPP Learning Media – ACCA Approved Content Provider

As an ACCA Approved Content Provider, BPP Learning Media gives you the opportunity to use study materials reviewed by the ACCA examining team. By incorporating the examining team's comments and suggestions regarding the depth and breadth of syllabus coverage, the BPP Learning Media Workbook provides excellent, ACCA-approved support for your studies.

These materials are reviewed by the ACCA examining team. The objective of the review is to ensure that the material properly covers the syllabus and study guide outcomes, used by the examining team in setting the exams, in the appropriate breadth and depth. The review does not ensure that every eventuality, combination or application of examinable topics is addressed by the ACCA Approved Content. Nor does the review comprise a detailed technical check of the content as the Approved Content Provider has its own quality assurance processes in place in this respect.

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The PER alert

Before you can qualify as an ACCA member, you not only have to pass all your exams but also fulfil a three-year practical experience requirement (PER). To help you to recognise areas of the syllabus that you might be able to apply in the workplace to achieve different performance objectives, we have introduced the 'PER alert' feature (see the next section). You will find this feature throughout the Workbook to remind you that what you are learning to pass your ACCA exams is equally useful to the fulfilment of the PER requirement. Your achievement of the PER should be recorded in your online My Experience record.

Chapter features

Studying can be a daunting prospect, particularly when you have lots of other commitments. This Workbook is full of useful features, explained in the key below, designed to help you to get the most out of your studies and maximise your chances of exam success.



Key term

Central concepts are highlighted and clearly defined in the Key terms feature. Key terms are also listed in bold in the Index, for quick and easy reference.



Formula to learn

This boxed feature will highlight important formula which you need to learn for your exam.



PER alert

This feature identifies when something you are reading will also be useful for your PER requirement (see 'The PER alert' section above for more details).



Exam focus point

This feature provides tips about how a specific topic may be examined.



Example

These will give examples to help demonstrate the concepts you are reading about.



Exercise

Exercises suggest tasks which can be done to further your understanding.



Activity

Activities give you essential practice of techniques covered in the chapter.



Essential reading

Links to the Essential reading are given throughout the chapter. The Essential reading is included in the free eBook, accessed via the Exam Success Site (see inside cover for details on how to access this).

Figure 1.1: Key to icons

At the end of each chapter you will find a Knowledge diagnostic, which is a summary of the main learning points from the chapter to allow you to check you have understood the key concepts. You will also find a Further study guidance which contains suggestions for ways in which you can continue your learning and enhance your understanding. This can include: recommendations for question practice from the Further question practice and solutions, to test your understanding of the topics in the Chapter; suggestions for further reading which can be done, such as technical articles and ideas for your own research. The Chapter summary provides more detailed revision of the topics covered and is intended to assist you as you prepare for your revision phase.

Introduction to the Essential reading

The electronic version of the Workbook contains additional content, selected to enhance your studies. Consisting of revision materials and further explanations of complex areas including illustrations and activities, as well as practice questions and solutions and background reading, it is designed to aid your understanding of key topics which are covered in the main printed chapters of the Workbook.

A summary of the content of the Essential reading is given below.

	Chapter	Summary of Essential reading content
1	The concept of audit and other assurance engagements	Accountability, stewardship and agency
2	Statutory audit and regulation	- Small company audit exemption - Regulation of auditors
3	Corporate governance	- Additional guidance to support corporate governance principles - Audit committees
4	Internal audit	Nature and purpose of internal audit assignments
5	Professional ethics and quality management procedures	Engagement letters
6	Risk assessment	- Materiality - Performance materiality - Gaining an understanding of the entity and its environment - Fraud, laws and regulations
7	Audit planning and documentation	- Impact of interim work on the final audit - Examples of working papers
8	Introduction to audit evidence	Audit procedures to obtain audit evidence
9	Internal control	- Components of an internal control system - Recording accounting and control systems
10	Test of controls	Internal auditor's reports
11	Audit sampling and automated tools and techniques	- Audit sampling - Automated tools and techniques - Audit data analytics
12	Non-current assets	- Assertions - Use of a management's expert - Auditing accounting estimates
13	Inventory	- Assertions - The physical inventory count - Valuation of inventory - Using the work of internal audit

	Chapter	Summary of Essential reading content
14	Receivables	• Assertions • External confirmations • Other audit procedures for receivables
15	Bank and cash	• Bank confirmation letter • Cash counts
16	Payables and accruals	• Assertions • Supplier statements • Other audit procedures for payables, accruals, purchases and expenses • Audit considerations relating to an entity using a service organisation
17	Non-current liabilities, capital and directors' emoluments	• Non-current liabilities • Provisions and contingencies • Share capital, distributions and reserves • Directors' emoluments
18	Not-for-profit organisations	• Accounting for not-for-profit organisations • Planning the audit • Audit evidence • Assumed knowledge from Financial Accounting
19	Audit review and finalisation	• Subsequent events • Going concern • Written representations • Overall review of financial statements
20	Reports	• ISA 700 (Revised) <i>Forming an Opinion and Reporting on financial Statements</i> • ISA 701 <i>Communicating Key audit Matters in the Independent Auditor's Report</i> • ISA 705 (Revised) <i>Modifications to the Opinion in the Independent Auditor's Report</i> • ISA 706 (Revised) <i>Emphasis of Matter Paragraphs and Other Matter Paragraphs</i> • The auditor's report as a means of communication

Introduction to Audit and Assurance (AA)

Overall aim of the syllabus

This exam requires students to develop knowledge and understanding of the process of carrying out the assurance engagement and its application in the context of the professional regulatory framework.

Brought forward knowledge

The Audit and Assurance syllabus assumes prior knowledge and understanding of the accounting topics in Financial Accounting (with the exception of group financial statements). A summary of such knowledge is included in the Essential reading relating to Chapter 18.

The syllabus

The broad syllabus headings are:

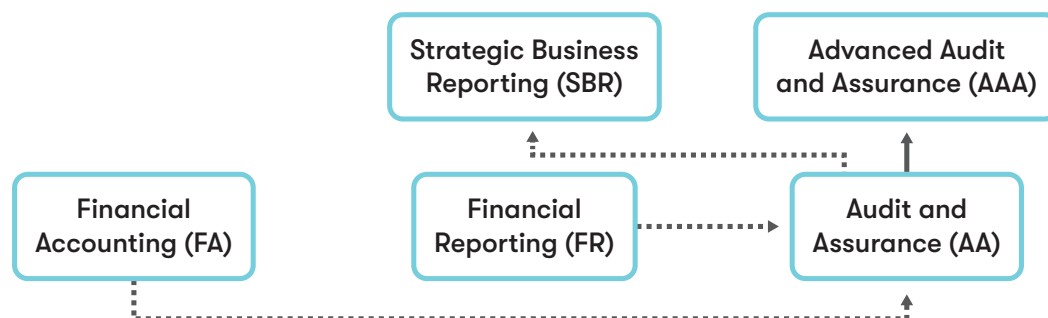
A	Audit framework and regulation
B	Planning and risk assessment
C	Internal control
D	Audit evidence
E	Review and reporting
F	Employability and technology skills

Main capabilities

On successful completion of this exam, you should be able to:

A	Explain the concept of audit and assurance and the functions of audit, corporate governance, including ethics and professional conduct.
B	Demonstrate how the auditor obtains and accepts audit engagements, obtains an understanding of the entity and its environment, assesses the risk of material misstatement (whether arising from fraud or other irregularities) and plans an audit of financial statements.
C	Describe and evaluate internal controls, techniques and audit tests, including IT systems to identify and communicate control risks and their potential consequences, making appropriate recommendations. Describe the scope, role and function of internal audit.
D	Identify and describe the work and evidence obtained by the auditor and others required to meet the objectives of audit engagements and the application of the International Standards on Auditing (ISAs).
E	Explain how consideration of subsequent events and the going concern principle can inform the conclusions from audit work and are reflected in different types of auditor's report, written representations and the final review and report.
F	Demonstrate employability and technology skills.

Links to other exams



This diagram shows where direct (solid line arrows) and indirect (dashed line arrows) links exist between this exam and others that may precede or follow it.

Although ACCA's diagram shows Financial Reporting feeding into Audit and Assurance, the accounting knowledge assumed in the Audit and Assurance exam will only be that covered within Financial Accounting.

Achieving ACCA's Study Guide Outcomes

This BPP Workbook covers all the Audit and Assurance syllabus learning outcomes. The tables below show in which chapter(s) each area of the syllabus is covered.

A	Audit framework and regulation	
A1	The concept of audit and other assurance engagements	Chapter 1
A2	External audits	Chapter 2
A3	Corporate governance	Chapter 3
A4	Professional ethics and the ACCA's Code of Ethics and Conduct	Chapter 5
B	Planning and risk assessment	
B1	Obtaining and accepting audit engagements	Chapter 6
B2	Objective and general principles	Chapter 6
B3	Assessing audit risks	Chapter 6
B4	Understanding the entity, its environment and the applicable financial reporting framework	Chapter 6
B5	Fraud, laws and regulations	Chapter 6
B6	Audit planning and documentation	Chapter 7

C	Internal control

C1	Systems of internal control	Chapter 9
C2	The use and evaluation of systems of internal control by auditors	Chapter 9
C3	Tests of controls	Chapter 10
C4	Communication on internal control	Chapter 10
C5	Internal audit and governance and the differences between external and internal audit	Chapter 4
C6	The scope of the internal audit function, outsourcing and internal audit assignments	Chapter 4

D	Audit evidence

D1	Assertions and audit evidence	Chapter 8
D2	Audit procedures	Chapter 11
D3	Audit sampling and other means of testing	Chapter 11
D4	The audit of specific items	Chapters 12 – 17
D5	Automated tools and techniques	Chapter 11
D6	The work of others	Chapter 12
D7	Not-for-profit organisations	Chapter 18

E	Review and reporting

E1	Subsequent events	Chapter 19
E2	Going concern	Chapter 19
E3	Written representations	Chapter 19
E4	Audit finalisation and the final review	Chapter 19
E5	The Independent Auditor's Report	Chapter 20

F Employability and technology skills		
F1	Use computer technology to efficiently access and manipulate relevant information	
F2	Work on relevant response options, using available functions and technology as would be required in the workplace	
F3	Navigate windows and computer screens to create and amend responses to exam requirements, using the appropriate tools	
F4	Present data and information effectively, using the appropriate tools	

The complete syllabus and study guide can be found by visiting the exam resource finder on the ACCA website.

The exam

Computer-based exams

Applied Skills exams are all computer-based exams (CBE).

Approach to examining the syllabus

The Audit and Assurance syllabus is assessed by a three hour exam. The pass mark is 50%. All questions in the exam are **compulsory**.

Format of the exam		Marks
Section A	Section A questions will be selected from the entire syllabus. This section comprises three 10 mark case-based questions. Each case has five objective test questions worth 2 marks each.	30
Section B	Section B of the exam comprises one 30 mark question and two 20 mark questions. This section will predominantly examine one or more aspects of audit and assurance from planning and risk assessment, internal control or audit evidence, although topics from other syllabus areas may also be included.	70
		100

The table below provides details of when each element of the syllabus has been examined in the most recent sittings.

Chapter		Mar/Jun 2021	Sep/Dec 2020	Mar/Jun 2020	Sep/Dec 2019	Mar/Jun 2019	Sep/Dec 2018	Mar/Jun 2018	Sep/Dec 2017	Mar/Jun 2017	Specimen Paper
	Audit framework and regulation										
1	The concept of audit and other assurance engagements										

Chapter		Mar/Jun 2021	Sep/Dec 2020	Mar/Jun 2020	Sep/Dec 2019	Mar/Jun 2019	Sep/Dec 2018	Mar/Jun 2018	Sep/Dec 2017	Mar/Jun 2017	Specimen Paper
2	External audits										
3	Corporate governance					B Q16d					
5	Professional ethics and ACCA's Code of Ethics and Conduct	B Q17a	B Q16d	B Q16a, b					B Q16a	B Q16c	A Q1, Q2, Q3, Q5
	Planning and risk assessment		Q B16a								
6	Obtaining and accepting audit engagements										
6	Objective and general principles	B Q17c									
6	Assessing audit risks	B Q17b	B Q16b	B Q16c	B Q16b, c	B Q17	B Q16c	B Q17b	B Q17c	B Q16a, b	B Q16a, Q16b
6	Understanding the entity and its environment						B Q16a, b				
6	Fraud, laws and regulations			B Q18c	B Q16a			B Q17a			
7	Audit planning and documentation								B Q17a, b		B Q16c, Q16d, Q16e
	Internal control										
9	Systems of internal control	B Q16c				B Q16a		B Q16a	B Q16b	B Q18a	
9	The use and evaluation of systems of internal control by auditors	B Q16a	B Q17a								
10	Tests of controls	B Q16b	B Q17	B Q17	B Q17	B Q16b	B Q17b	B Q16a, b	B Q16c	B Q18b	B Q17a
10	Communication on internal						B Q17a				

Chapter		Mar/Jun 2021	Sep/Dec 2020	Mar/Jul 2020	Sep/Dec 2019	Mar/Jun 2019	Sep/Dec 2018	Mar/Jun 2018	Sep/Dec 2017	Mar/Jun 2017	Specimen Paper
	control										
4	Internal audit and governance and the differences between external and internal audit										A Q4
4	The scope of the internal audit function, outsourcing and internal audit assignments							B Q16c			
	Audit evidence										
8	Financial statement assertions and audit evidence										A Q7, Q8
11	Audit procedures										
11	Audit sampling and other means of testing										
12-17	The audit of specific items	B Q16d, B Q18a, b, c	B Q16c, B Q18a, b, c	B Q16d, B Q18a, b	B Q16d, e, B Q18a, b	B Q16c, B Q18a, b, c	B Q16d, e, B Q18a, b	B Q16d, B Q18a, b, c	B Q16d, B Q18a, b, c	B Q17a, c, d	A Q6, Q7, Q9, Q10, Q13, Q14 B Q17b, B Q18b (ii)
11	Computer-assisted audit techniques									B Q17b	
12	The work of others										B Q18 b (i)
18	Not-for-profit organisations										
	Review and reporting										
19	Subsequent events					B Q18d					A Q12

Chapter		Mar/Jun 2021	Sep/Dec 2020	Mar/Jul 2020	Sep/Dec 2019	Mar/Jun 2019	Sep/Dec 2018	Mar/Jun 2018	Sep/Dec 2017	Mar/Jun 2017	Specimen Paper
19	Going concern				B Q18c, d		B Q18c				
19	Written representations										
19	Audit finalisation and the final review										
20	Auditor's reports	B Q18d	B Q18d	B Q18d			B Q18d	B Q18d	B Q18d	B Q17e	A Q11, Q15, B Q18c

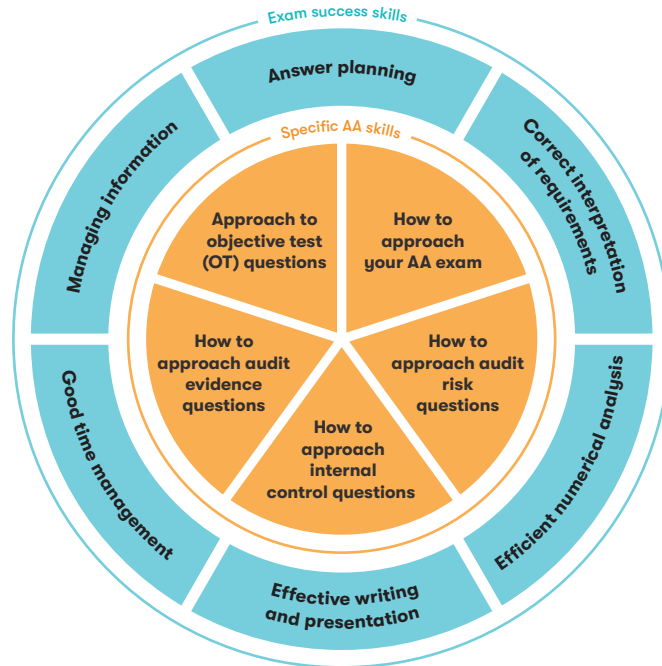
Since December 2016, the ACCA have released a 'hybrid' exam every two sittings which shows only questions set in Section B of the exam.

Essential skills areas to be successful in Audit and Assurance (AA)

We think there are three areas you should develop in order to achieve exam success in AA:

- (a) Knowledge application
- (b) Specific AA skills
- (c) Exam success skills

These are shown in the diagram below.



Specific AA skills

These are the skills specific to AA that we think you need to develop in order to pass the exam.

In this Workbook, there are five **Skills Checkpoints** which define each skill and show how it is applied in answering a question. A brief summary of each skill is given below.

Skill 1: How to approach your AA exam

Passing AA is much more about exam technique than detailed knowledge. Therefore, it is important that you plan your approach to the exam, and practise this approach, before you sit your exam.

A step-by-step technique for ensuring that you have a planned approach to your AA exam is outlined below:

Step 1 Attempt Section A first. Read the requirements to each of the OT questions before reading the OT case scenario.

Do not rush through this section of the exam.

Step 2 Then attempt Section B. Skim through all three questions and attempt them in your order of preference. Read all requirements in detail and use the scenario fully.

Skills checkpoint 1 covers this technique in detail through application to an exam-standard question.

Skill 2: How to approach audit risk questions

In the exam, it is highly likely that you will need to attempt a scenario-based question on audit risk.

- Step 1** Allow some of your allotted time to read the requirement and the scenario. Don't rush into starting to write your answer.
- Start by analysing the requirements so that you know what you are looking for when you read the scenario.
- Step 2** Re-read the scenario and set out an answer plan using the risks you identify as you read through.
- Use headings.
- Work through each paragraph of the scenario identifying specific audit risks. Each risk is worth one mark and the auditor's response is also worth one mark, so you would need five properly explained risks and responses to gain ten marks.
- Step 3** Where there are more than the required number of audit risks, choose those that you can best explain.
- Use your headings to write your answer, describe the audit risk in detail explaining the potential impact on the financial statements. Also remember to explain the practical steps the auditor would take and the work they would do.
- Start each point in a new paragraph.

Skills checkpoint 2 covers this technique in detail through application to an exam-standard question.

Skill 3: How to approach internal control questions

Similarly, to Skill 2, it is likely that you will need to attempt a scenario-based question on internal controls in your exam.

There are several types of questions which may be tested:

- Identify and explain control deficiencies and make recommendations to address each deficiency;
- Explain direct controls and describe tests of control to ensure the controls are operating effectively; and
- Control deficiencies, recommendations and tests of control.

We will consider how you should approach such questions using the example of the first type of question although the same approach should be applied to all three types.

A step-by-step technique for attempting deficiencies questions is outlined below.

- Step 1** Allow some of your allotted time to read the requirement and the scenario. Don't rush into starting to write your answer.
- Start by analysing the requirements so that you know what you are looking for when you read the scenario.
- Step 2** Re-read the scenario and set out an answer plan using the points you identify as you read through.
- Use headings.
- Work through each paragraph of the scenario identifying specific points to make, for example deficiencies. Each deficiency is worth one mark and the recommendation is also worth one mark, hence why you would need six properly explained deficiencies and recommendations to gain 12 marks.
- Step 3** Often there are more than the required number of deficiencies in a scenario, therefore choose the ones for which you can provide a recommended control.
- Use your headings to write your answer, explain the deficiency in terms of its impact on the entity. Also remember to explain the recommendation, what internal control should be implemented and by whom.
- Start each point in a new paragraph.

Skills checkpoint 3 covers this technique in detail through application to an exam-standard question.

Skill 4: How to approach audit evidence questions

These questions can appear in both sections of the exam. It is very important that you discern exactly what the requirement is asking for and that you use any scenario provided in the exam.

A step-by-step technique for approaching audit evidence questions is outlined below.

Step 1 Identify exactly what you are being asked for in the requirement: audit procedures, tests of controls or substantive procedures.

Also identify whether the requirement is testing audit procedures that relate to a particular assertion.

Step 2 Now that you have understood what the requirement demands you are much better placed to answer it. Consider the following:

- Is there a scenario you should use?
- Can you remember the accounting treatment for the item? Would that give you a starting point?
- What audit procedures have you learnt/used at work?
- Can you use the mnemonic AEIOU to help you to generate audit procedures?

Step 3 Write out your audit procedure using the ‘verb-document-reason’ approach.

- What do you want to be done (eg recalculate, agree, vouch)?
- To which document (eg invoice, physical asset, board minutes)?
- Why (eg to ensure that receivables are recoverable (valuation))? You might choose to link this to an assertion.

Start each audit procedure on a new line.

Skills checkpoint 4 covers this technique in detail through application to an exam-standard question.

Skill 5: Approach to objective test (OT) questions

Section A comprises 30% of the exam and consists of three OT case questions. Candidates can be tempted to rush through this section in order to make up time for Section B however this is a risky approach because there are a lot of marks you could lose.

A step-by-step technique for approaching OT questions is outlined below:

Step 1 Answer the questions you know first.

If you’re having difficulty answering a question, move on and come back to tackle it once you’ve answered all the questions you know. It is often quicker to answer discursive style OT questions first, leaving more time for calculations. The AA exam doesn’t have many calculations but you may be asked to calculate financial statement ratios.

Step 2 Answer all questions.

There is no penalty for an incorrect answer in ACCA exams, there is nothing to be gained by leaving an OT question unanswered. If you are stuck on a question, as a last resort, it is worth selecting the option you consider most likely to be correct, and moving on. Make a note of the question, so if you have time after you have answered the rest of the questions, you can revisit it.

Step 3 Read the requirement first!

The requirement will be stated in bold text in the exam. Identify what you are being asked to do, any technical knowledge required and **what type of OT question** you are dealing with. Look for key words in the requirement such as “which TWO of the following,” or “which of the following is NOT”.

Skills checkpoint 5 covers this technique in detail through application to an exam-standard question.

Exam success skills

Passing the AA exam requires more than applying syllabus knowledge and demonstrating the specific AA skills; it also requires the development of excellent exam technique through question practice.

We consider the following six skills to be vital for exam success. The Skills Checkpoints show how each of these skills can be applied specifically to the AA exam.

Exam success skill 1

Managing information

Questions in the exam will present you with a lot of information. The skill is how you handle this information to make the best use of your time. The key is determining how you will approach the exam and then actively reading the questions.

Advice on developing managing information

Approach

The exam is three hours long. There is no designated 'reading' time at the start of the exam, however, one approach that can work well is to start the exam by spending 10–15 minutes carefully reading through all of the questions to familiarise yourself with the exam.

Once you feel familiar with the exam, consider the order in which you will attempt the questions; always attempt them in your order of preference. For example, you may want to leave to last the question you consider to be the most difficult.

If you do take this approach, remember to adjust the time available for each question appropriately – see Exam success skill 6: Good time management.

If you find that this approach doesn't work for you, don't worry – you can develop your own technique.

Active reading

You must take an active approach to reading each question. In Section B questions in particular, focus on the requirement first, underlining key verbs such as 'prepare', 'comment', 'explain', 'discuss', to ensure you answer the question properly. Then read the rest of the question, underlining and annotating important and relevant information, and making notes of any relevant technical information you think you will need.

Exam success skill 2

Correct interpretation of the requirements

The active verb used often dictates the approach that written answers should take (eg 'explain', 'discuss', 'evaluate'). It is important you identify and use the verb to define your approach. The **correct interpretation of the requirements** skill means correctly producing only what is being asked for by a requirement. Anything not required will not earn marks.

Advice on developing correct interpretation of the requirements

This skill can be developed by analysing question requirements and applying this process:

Step 1 Read the requirement

Firstly, read the requirement a couple of times slowly and carefully and highlight the active verbs. Use the active verbs to define what you plan to do. Make sure you identify any sub-requirements.

Step 2 Read the rest of the question

By reading the requirement first, you will have an idea of what you are looking out for as you read through the case overview and exhibits. This is a great time saver and means you don't end up having to read the whole question in full twice. You should do this in an active way – see Exam success skill 1: Managing Information.

Step 3 Read the requirement again

Read the requirement again to remind yourself of the exact wording before starting your written answer. This will capture any misinterpretation of the requirements or any missed

requirements entirely. This should become a habit in your approach and, with repeated practice, you will find the focus, relevance and depth of your answer plan will improve.

Exam success skill 3

Answer planning: Priorities, structure and logic

This skill requires the planning of the key aspects of an answer which accurately and completely responds to the requirement.

Advice on developing answer planning: priorities, structure and logic

Everyone will have a preferred style for an answer plan. For example, it may be a mind map, bullet-pointed lists or simply annotating the question. Choose the approach that you feel most comfortable with, or, if you are not sure, try out different approaches for different questions until you have found your preferred style.

Exam success skill 4

Efficient numerical analysis

This skill aims to maximise the marks awarded by making clear to the marker the process of arriving at your answer. This is achieved by laying out an answer such that, even if you make a few errors, you can still get some credit for your calculations. It is vital that you do not lose marks purely because the marker cannot follow what you have done.

Advice on developing efficient numerical analysis

There are not many marks available for numbers in the AA exam, however you may need to calculate ratios such as the receivables collection period.

This skill can be developed by applying the following process:

Step 1 Use a standard proforma working/formula where relevant

If answers can be laid out in a standard proforma or using a standard formula then always plan to do so. This will help the marker to understand your working and allocate the marks easily. It will also help you to work through the figures in a methodical and time-efficient way.

Step 2 Show your workings

Keep your workings as clear and simple as possible and ensure they are cross-referenced to the main part of your answer. Where it helps, provide brief narrative explanations to help the marker understand the steps in the calculation. This means that if a mistake is made you should not lose any subsequent marks for follow-on calculations.

Step 3 Keep moving!

It is important to remember that, in an exam situation, it is difficult to get every number 100% correct. The key is therefore ensuring you do not spend too long on any single calculation. If you are struggling with a solution then make a sensible assumption, state it and move on.

Exam success skill 5

Effective writing and presentation

Written answers should be presented so that the marker can clearly see the points you are making, presented in the format specified in the question. The skill is to provide efficient written answers with sufficient breadth of points that answer the question, in the right depth, in the time available.

Advice on developing effective writing and presentation

Step 1 Use headings

Using the headings and sub-headings from your answer plan will give your answer structure, order and logic. This will ensure your answer links back to the requirement and is clearly signposted, making it easier for the marker to understand the different points you are making. Making your headings bold will also help the marker.

Step 2 Write your answer in short, but full, sentences

Use short, punchy sentences with the aim that every sentence should say something different and generate marks. Write in full sentences, ensuring your style is professional.

Step 3 Do your calculations first and explanation second

Questions often ask for an explanation with suitable calculations, such as materiality. The best approach is to prepare the calculation first but present it on the bottom half of the page of your answer, or on the next page. Then add the explanation before the calculation. Performing the calculation first should enable you to explain what you have done.

Exam success skill 6**Good time management**

This skill means planning your time across all the requirements so that all tasks have been attempted at the end of the three hours available and actively checking on time during your exam. This is so that you can flex your approach and prioritise requirements which, in your judgment, will generate the maximum marks in the available time remaining.

Advice on developing Good time management

The exam is 3 hours long, which translates to 1.8 minutes per mark. Therefore a 20-mark requirement should be allocated a maximum of 36 minutes to complete your answer before you move on to the next task. At the beginning of a question, work out the amount of time you should be spending on each requirement and note the finishing time next to each requirement on your exam. If you take the approach of spending 10–15 minutes reading and planning at the start of the exam, adjust the time allocated to each question accordingly.

Keep an eye on the clock

Aim to attempt all requirements, but be ready to be ruthless and move on if your answer is not going as planned. The challenge for many is sticking to planned timings. Be aware this is difficult to achieve in the early stages of your studies and be ready to let this skill develop over time.

If you find yourself running short on time and know that a full answer is not possible in the time you have, consider recreating your plan in overview form and then add key terms and details as time allows. Remember, some marks may be available, for example, simply stating a conclusion which you don't have time to justify in full.

Question practice

Question practice is a core part of learning new topic areas. When you practice questions, you should focus on improving the Exam success skills – personal to your needs – by obtaining feedback or through a process of self-assessment.

Sitting this exam as a computer-based exam and practicing as many exam-style questions as possible in the ACCA CBE practice platform will be the key to passing this exam. You should attempt questions under timed conditions and ensure you produce full answers to the discussion parts as well as doing the calculations. Also ensure that you attempt all mock exams under exam conditions.

ACCA have launched a free on-demand resource designed to mirror the live exam experience helping you to become more familiar with the exam format. You can access the platform via the Study Support Resources section of the ACCA website navigating to the CBE question practice section and logging in with your my ACCA credentials.



The concept of audit and other assurance engagements

Learning objectives

On completion of this chapter, you should be able to:

Syllabus learning outcomes	Syllabus reference no.
Identify and describe the objective and general principles of external audit engagements	A1 (a)
Explain the nature and development of audit and other assurance engagements	A1 (b)
Discuss the concepts of accountability, stewardship and agency	A1 (c)
Define and provide the objectives of an assurance engagement	A1 (d)
Explain the five elements of an assurance engagement	A1 (e)
Describe the types of assurance engagement	A1 (f)
Explain the level of assurance provided by an external audit and other review engagements and the concept of true and fair presentation	A1 (g)
Describe the limitations of external audits	A2 (e)

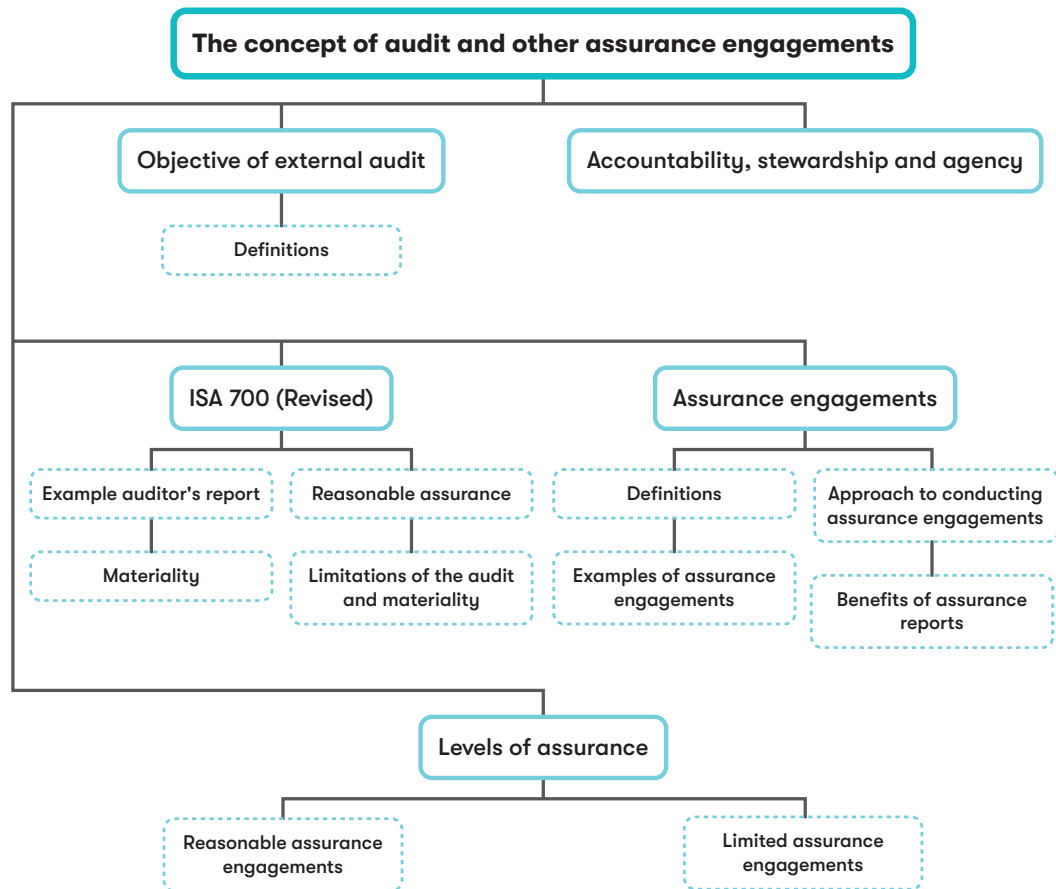
Business and exam context

Assurance is another word for “comfort”. This chapter aims to help you understand more about what assurance is, why we need it, and the different levels of assurance that can be given.

The external audit is an example of an assurance engagement because, by providing an opinion on the financial statements, the external auditor is providing assurance to the entity’s shareholders as to whether or not the financial statements are ‘reliable’. Other key assurance services in the syllabus include review engagements and internal audit assignments.

We will also see that there are essentially two levels of assurance: reasonable assurance and limited assurance.

Chapter overview



1 Objective of external audit

1.1 Definitions

ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (ISAs)* has the following definitions:

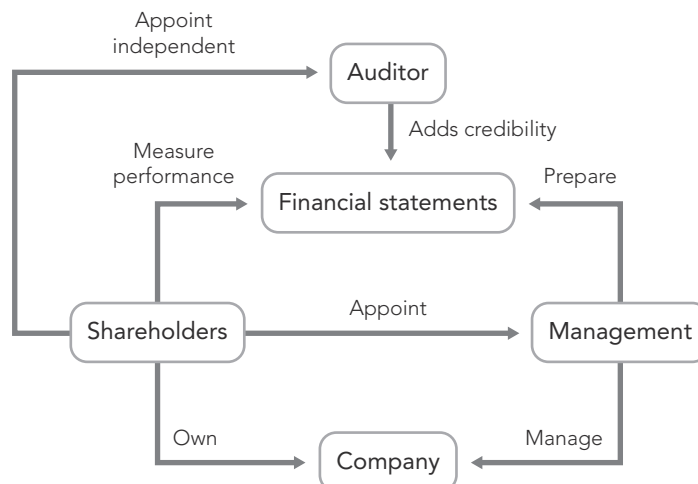


The objective of an audit: of financial statements is to enable the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. (ISA 200: para. 3)

The objectives of an auditor: are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, in order to enable them to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. (ISA 200: para. 11)

2 Accountability, stewardship and agency

An audit provides assurance to the shareholders and other stakeholders of a company on the financial statements because it is independent and impartial.



In a company the management act as agents for the body of shareholders (the principals). They are accountable to the shareholders for their stewardship of the entity's assets which are placed under their control.

They achieve this by preparing financial statements which are presented to the shareholders.

Most incorporated entities are legally required to have their financial statements audited, although many smaller entities are exempt from the requirement.

Auditors must be independent of the entity they are auditing, and seek to provide an opinion to the shareholders as to whether the financial statements are 'presented fairly', or give a true and fair view.



True: Information is factual and conforms with reality. In addition, the information conforms with required standards and law. The financial statements have been correctly extracted from the books and records.

Fair: Information is free from discrimination and bias and in compliance with expected standards and rules. The accounts should reflect the commercial substance of the company's underlying transactions.

Present fairly: The financial statements show a true and fair view. They are factual and free from bias.

The auditor's opinion enhances the credibility of the financial statements by providing reasonable assurance that the financial statements are free from material misstatement.

Reasonable assurance is a high level of assurance.

The auditor can also be seen as an agent of the body of shareholders as they report to and are appointed by them.



Essential reading

See Chapter 1 of the Essential reading for more information on accountability, stewardship and agency.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

3 ISA 700 (Revised) *Forming an Opinion and Reporting on Financial Statements*

At the end of the audit process the auditors should be in a position to express their opinion to the shareholders as to whether the financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework.

The opinion is expressed in the auditor's report. If the auditors are satisfied that the financial statements are presented fairly, they will issue a report which gives an unmodified opinion.

3.1 Example auditor's report – unmodified opinion (listed entity)

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements

Opinion

We have audited the financial statements of ABC Company (the Company), which comprise of the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of the Company as at 31 December 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants* (IESBA Code) together with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with ISA 701.]

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report

unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

The engagement partner on the audit resulting in this independent auditor's report is [name].

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

3.2 Materiality

Materiality is covered in detail in Chapter 6; however, for now you should note its definition:



Materiality: is an expression of the relative significance or importance of a particular matter in the context of the financial statements as a whole. A matter is **material** if its omission or misstatement would **reasonably be expected to influence the economic decisions** of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. (ISA 200: para. 6)

3.3 Reasonable assurance

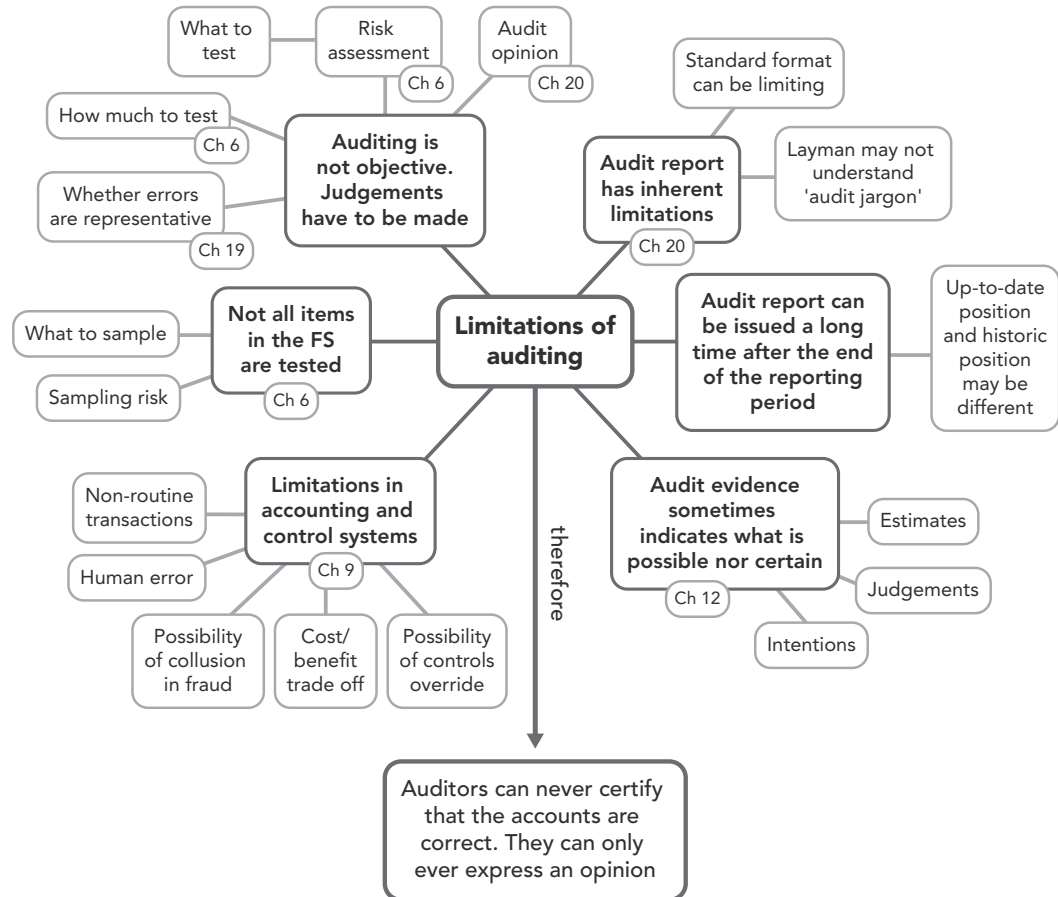
No auditor can give a 100% guarantee that the financial statements are free from material misstatement but 'reasonable assurance' is the highest level of assurance that can be given.

Reasonable assurance is not absolute assurance because there are inherent limitations of an audit which result in the auditor forming an opinion on evidence that is persuasive rather than conclusive.

3.4 Limitations of the audit and materiality

The assurance given by auditors is limited by the fact that auditors use judgement in deciding what audit procedures to use and what conclusions to draw, and also by the limitations of every audit.

These are illustrated in the following diagram:



4 Assurance engagements

4.1 Definitions



Assurance engagement: is one in which: a **practitioner** aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the **intended users** other than the **responsible party** about the outcome of the measurement or evaluation of an underlying **subject matter** against **criteria**. (IFAC, 2016(e))

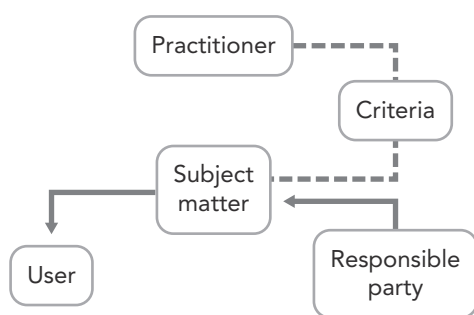
Practitioner: 'the individual conducting the engagement (usually the engagement partner or other members of the engagement team, or as applicable, the firm'. (ISAE 3000 (Revised): para. 12r)

Intended users: 'the individual(s) or organisation(s), or group(s) thereof that the practitioner expects will use the assurance report'. (ISAE 3000 (Revised): para. 12m)

Responsible party: 'the party responsible for the underlying subject matter'. (ISAE 3000 (Revised): para. 12v)

4.2 Elements of an assurance engagement

There are **five elements** to an assurance engagement. These are illustrated by the diagram below:



The five elements can be remembered using the mnemonic **CREST**:

C	Criteria: The subject matter is evaluated or measured against criteria in order to reach an opinion.
R	Report: A written report containing the practitioner's opinion is issued to the intended user, in the form appropriate to a reasonable assurance engagement or a limited assurance engagement.
E	Evidence: Sufficient appropriate evidence needs to be gathered to support the required level of assurance.
S	Subject matter: The data to be evaluated that has been prepared by the responsible party. It can take many forms, including financial performance (eg historical financial information), non-financial performance (eg key performance indicators), processes (eg internal controls) and behaviour (eg compliance with laws and regulations).
T	Three party relationship: The three parties are the intended user, the responsible party and the practitioner.

Assurance describes the process whereby one party is trying to provide a level of comfort to another party about a subject matter.

Many assurance engagements are undertaken voluntarily; however, some, such as the statutory audit, happen as a result of a requirement imposed on the entity by another party (for example, legislation, a regulator or a bank). (IFAC, 2017)



Activity 1: Assurance and assurance reports

What other examples of assurance and assurance reports exist?

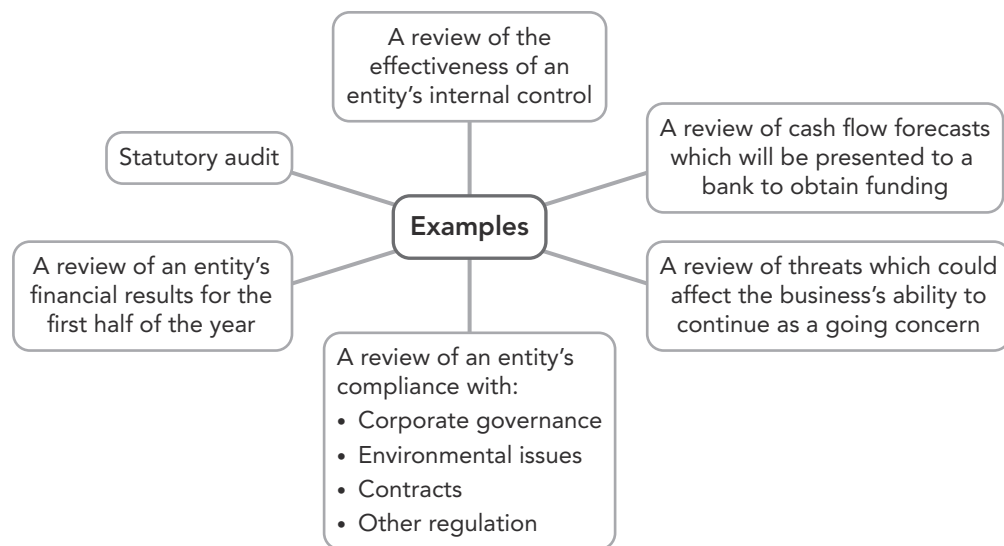
Consider the following scenarios:

Required

- 1 You are currently thinking of buying a house built in 1900. What assurance report could you obtain and who might provide this?
- 2 You work for a local council which is just about to issue a \$10,000 grant to an organisation which runs sports activity courses for children with special needs. What assurance report could you obtain and who might provide this?

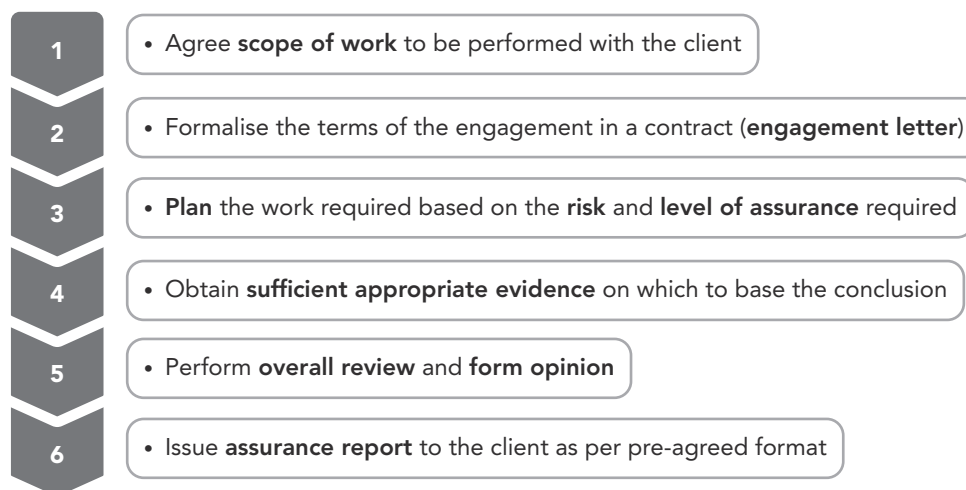
4.3 Examples of assurance engagements

These include:



4.4 Approach to conducting assurance engagements

Assurance engagements should be performed according to the following process:



4.5 Benefits of assurance reports

An assurance report provides the following benefits to the users of information:

- Provides an **independent opinion** from an external source that **enhances the credibility** of the information.
- Reduces **management bias**.
- Any non-standard or modified opinion draws attention to risk.
- Relevance of information is improved because of the expertise and knowledge of the assurance firm.

5 Levels of assurance

ISAE 3000 (Revised) *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* distinguishes between two forms of assurance engagements:

- **Reasonable assurance** engagements
- **Limited assurance** engagements

The two types and levels of assurance are discussed below.

5.1 Reasonable assurance engagements

A **reasonable assurance** engagement provides a **high, but not absolute** level of assurance.

In order to give reasonable assurance, a significant amount of testing and evaluation is required to support the practitioner's conclusion.

The external audit is therefore a key example of a reasonable assurance engagement.

The conclusion formed in any report relating to a reasonable assurance engagement would usually be expressed in a **positive form**, for example:

'In our opinion internal control is effective, in all material respects, based on XYZ criteria.'

5.2 Limited assurance engagements

Limited assurance is a lower level of assurance. The nature, timing and extent of the procedures carried out by the practitioner in a limited assurance engagement would be limited compared with what is required in a reasonable assurance engagement. Nevertheless, the procedures performed should be planned to obtain a level of assurance which is meaningful, in the practitioner's professional judgement.

For a limited assurance engagement, the conclusion conveys whether, based on the procedures performed and evidence obtained, a matter(s) has come to the practitioner's attention to cause the practitioner to believe the subject matter information is materially misstated. (ISAE 3000 (Revised): para. 12ib)

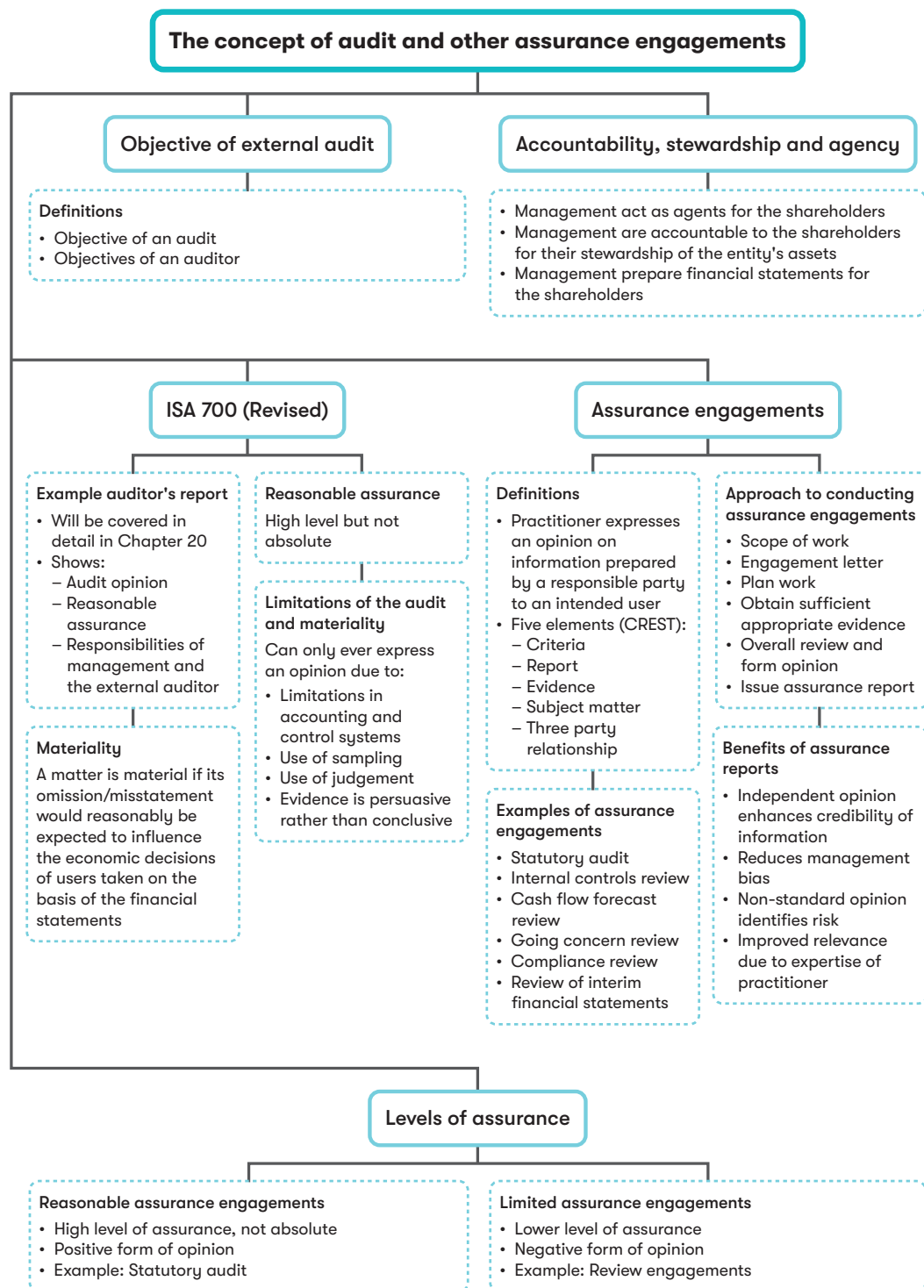
This would usually be expressed in a **negative form of words**, for example:

'Based on our work described in this report, nothing has come to our attention that causes us to believe that internal control is not effective, in all material respects, based on XYZ criteria.'

5.3 Summary

Type of engagement	Evidence – gathering procedures	Assurance report
Reasonable assurance eg statutory audit	Sufficient appropriate evidence is obtained by: • Obtaining an understanding of the entity • Assessing risk • Responding to risk • Performing further procedures (sampling) to draw a conclusion	Positive
Limited assurance eg review of cash flow forecasts	The evidence gathered is limited, involving techniques such as enquiry and analytical procedures	Negative

Chapter summary



Knowledge diagnostic

1. Objective of an external audit

The objective of an **external audit** is for the auditor to provide an independent opinion on the financial statements as to whether they are free from material misstatement, whether due to fraud or error, and whether they are prepared, in all material respects, in accordance with an applicable financial reporting framework.

2. Stewardship

Management/those charged with governance act as agents for the body of shareholders and are accountable to them for their stewardship of the entity's assets.

3. The auditor's report

The auditor's report follows a standard format in order for users to be able to clearly see the opinion given, basis of work done and the respective responsibilities of management and the external auditor. The auditor's report will be covered in detail in chapter 20.

4. The external audit

The external audit is only one example of an assurance engagement. The audit provides reasonable assurance which is a high level of assurance (although not absolute).

5. Elements of an assurance engagement

There are five elements to an assurance engagement, remember these using the mnemonic CREST.

6. Levels of assurance

An assurance engagement can provide one of two levels of assurance: reasonable assurance which is usually reported in terms of positive form of opinion and limited assurance which is usually reported in terms of negative form of opinion.

Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the workbook):

- Section A Q4 and Q5
- Section B Q46 Audit and assurance engagements

Further reading

This is very much an introductory chapter and so there are no technical articles or study support videos on the ACCA website for this area. However the start of the course is a great time to understand the approach you'll need to take to the Audit and Assurance exam and so you should read the following exam technique articles:

Exam technique article:

- Read the mind of the marker
(https://www.accaglobal.com/content/dam/ACCA_Global/Students/fun/f8/Read_the_mind_of_AA_marker_WEB_v3.pdf)
- Examiner approach (<https://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/approach-sept16.html>)

Own research

Have you or a friend/family member ever bought a flat or house and had a survey performed? This is a type of assurance report! Have a look at the report and see if you can identify the five elements of an assurance engagement and judge the level of assurance provided and whether the opinion is in a positive or negative form.

Activity answers

Activity 1: Assurance and assurance reports

- 1 Here you would want some comfort as to whether or not the house you plan to buy is structurally sound, whether the roof is in a good condition, whether there is any damp and so on. Most house buyers would have a survey carried out by a building surveyor prior to completing a purchase. This survey is carried out by an independent party who is professionally qualified and would give you confidence/comfort that there are no major issues with the property you plan to purchase.
- 2 Here the council body will be concerned that the money they have given is used for the designated purpose. They will need assurance that the money has been spent on sports equipment, sports hall premises, staff and so forth rather than on items which are not related to this cause. The council could require the organisation to provide them with a report stating that the money was spent in accordance with the stipulations of the grant. This report would need to be produced by an independent body, perhaps an accountant.

2

Statutory audit and regulation

Learning objectives

On completion of this chapter, you should be able to:

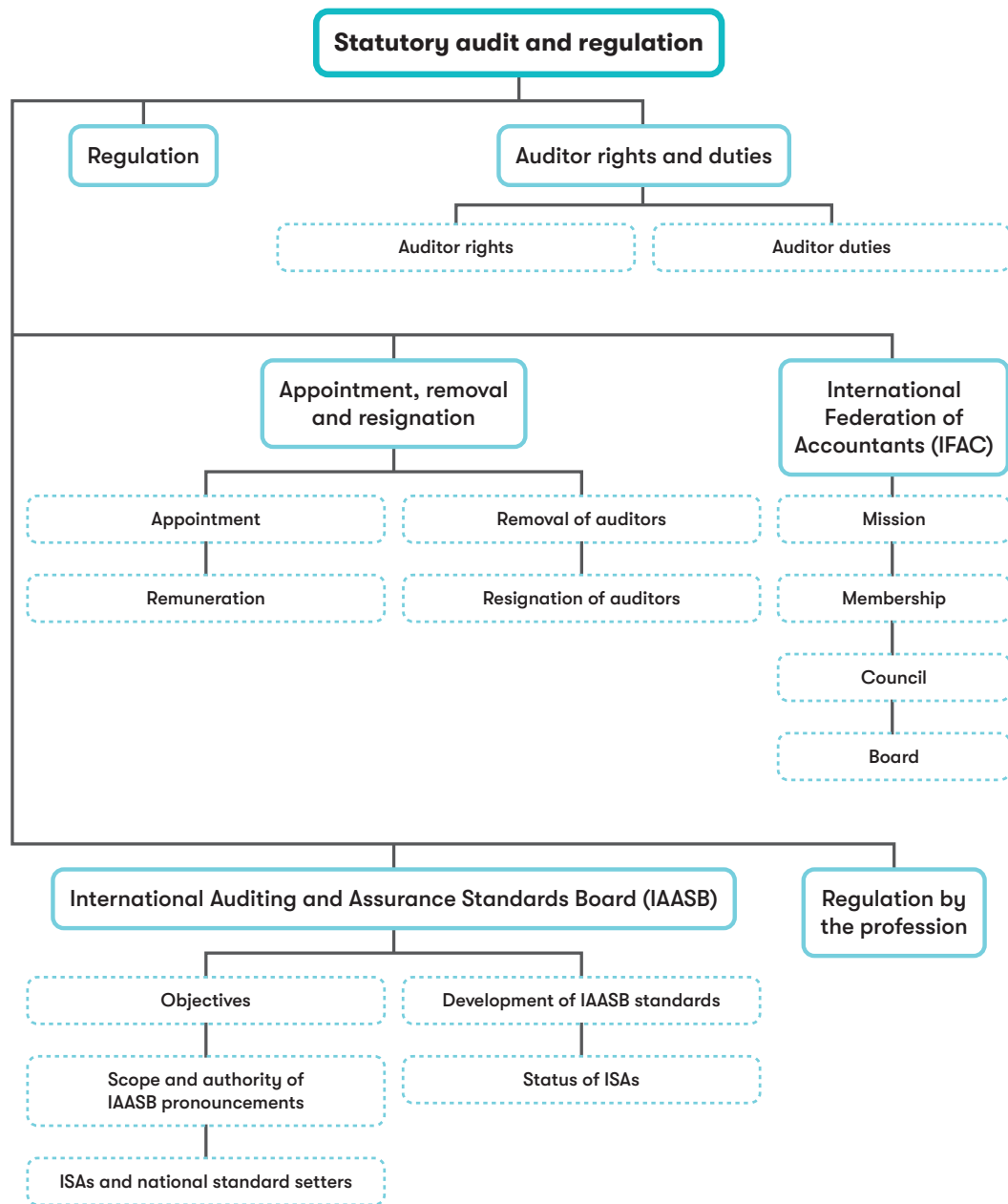
Syllabus learning outcomes	Syllabus reference no.
Describe the regulatory environment within which external audits take place	A2 (a)
Discuss the reasons and mechanisms for the regulation of auditors	A2 (b)
Explain the statutory regulations governing the appointment, rights, removal and resignation of auditors	A2 (c)
Explain the regulations governing the rights and duties of auditors	A2 (d)
Explain the development and status of International Standards on Auditing (ISAs)	A2 (f)
Explain the relationship between International Standards on Auditing and national standards	A2 (g)

Business and exam context

This chapter covers the regulatory framework within which the external auditor operates and how the auditing profession is regulated. It is important that you understand the rights and duties the auditor has and also the specific processes that must be followed when auditors are appointed, removed and resign.

There are several bodies which govern auditing and financial reporting and it is essential that you understand the role of the International Auditing and Assurance Standards Board and how International Standards on Auditing are set.

Chapter overview



1 Regulation

The audit is primarily a statutory concept which means that an audit is required by statute (law) and the majority of companies are required by national law to have an audit.

A key exception to this requirement is that given to small companies. Many European Commission (EC) countries have a small company exemption from audit that is based on the turnover (revenue) and total assets at the year-end.



Essential reading

See Chapter 2 of the Essential reading for more information on smaller companies and the advantages and disadvantages of retaining the audit of smaller companies.

The Essential reading is available as an Appendix of the digital edition of the Workbook.



Exam focus point

Note that, unless otherwise stated, companies in the AA exam will require an audit.

The auditing profession is subject to **regulation** from a range of sources:



Essential reading

See Chapter 2 of the Essential reading for more information on the regulation of auditors.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

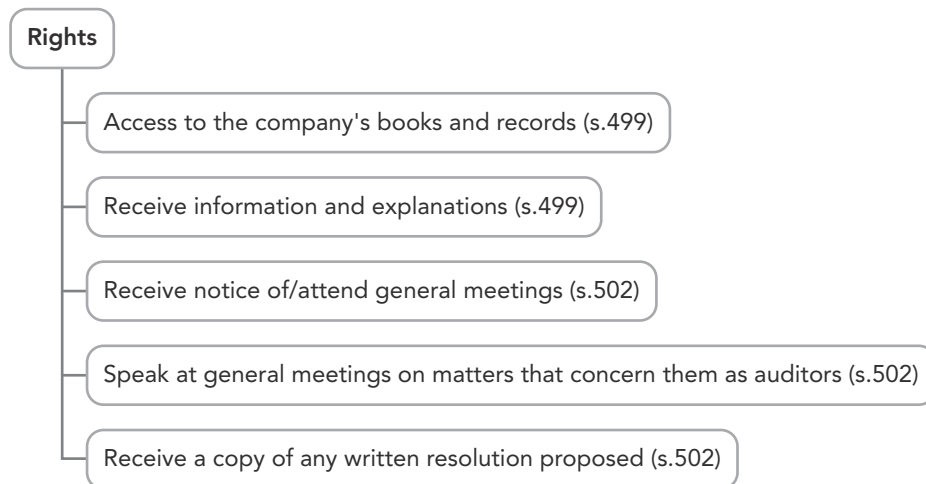
2 Auditor rights and duties

The rights and duties of auditors are often set out in law, to ensure that the auditors have sufficient power to carry out an effective audit.

Here we look at the rights and duties of auditors in the **UK as an example** where the relevant legislation is the **Companies Act 2006**.

Note that the rights and duties of auditors may be different in other jurisdictions.

2.1 Auditor rights



2.2 Auditor duties

Duties

- Report opinion on:
- Whether financial statements are fairly presented (s.495)

Duties

- Report opinion on additional statutory requirements:
- Adhere to local law (s.495)
- Maintain adequate records and returns (s.498)
- Ensure financial statements agree to records (s.498)
- Ensure consistency of other information (s.496)
- Ensure disclosure of directors' benefits (s.498)

The Companies Act 2006 (s.501) makes it an offence for a company's officer knowingly or recklessly to make a statement in any form to an auditor which is misleading, false or deceptive.

3 Appointment, removal and resignation

Chapter 1 identified the importance of the auditor being **independent** and their role as an **agent of the shareholders**.

In most jurisdictions this is established in the law relating to appointment, removal and resignation of auditors.

3.1 Appointment

The auditors should be appointed by and therefore answerable to the **shareholders**.

The table below shows the ideal position using the UK as an example.

Auditor appointment (UK, Companies Act 2006: s.489-490)	
Directors	Can appoint auditor: (a) Before company's first period for appointing auditors (b) Following a period during which the company did not have an auditor (as exempt), at any time before the next period for appointing auditors

Auditor appointment (UK, Companies Act 2006: s.489-490)	
	(c) To fill a casual vacancy
Members (shareholders)	Can appoint auditor by ordinary resolution: (a) During a period for appointing auditors (b) If company should have appointed auditor during a period for appointing auditors but failed to do so (c) If directors fail to do so
Secretary of State	Can appoint auditors if no auditors are appointed per above

An auditor must be appointed for each financial year unless the directors reasonably resolve otherwise on the grounds that audited financial statements are unlikely to be required.

3.2 Remuneration

The remuneration of the auditors, which will include auditors' expenses, will be fixed by **whoever made the appointment**.

In many countries the auditor's remuneration must be disclosed in the annual financial statements of the company. (Companies Act 2006: s.492)

3.3 Removal of auditors

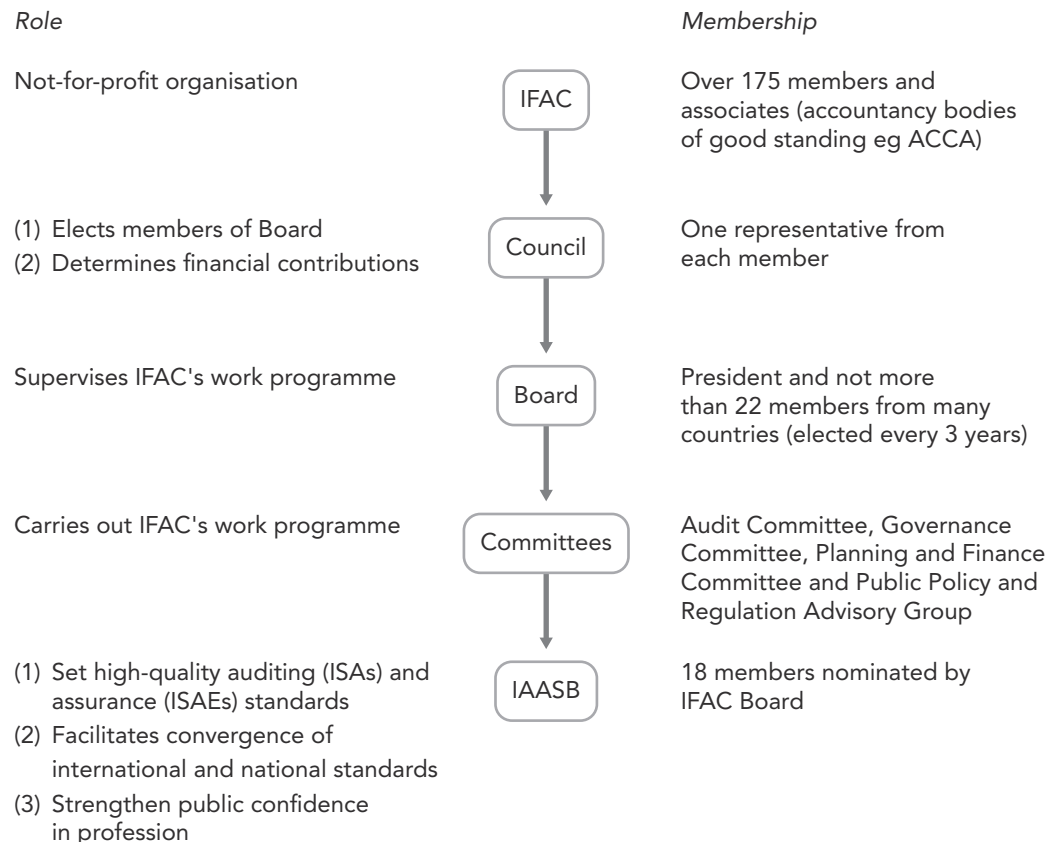
Removal of auditors (UK, Companies Act 2006: s.510–513)	
1 Notice of removal	Either special notice (28 days) with copy sent to auditor Or if elective resolution in place, written resolution to terminate auditors' appointment Directors must convene a meeting within a reasonable period of time.
2 Representations	Auditors can make representations on why they ought to stay in office. They may require company to state in notice that representations have been made and send copy to members.
3 If resolution passed	(a) Company must notify regulatory authority (b) Auditors must deposit statement of circumstances at company's registered office within 14 days of ceasing to hold office. Statement must be sent to regulatory authority, eg ACCA.
4 Auditor rights	Can receive notice of and speak at: (a) A general meeting at which their term of office would have expired (b) A general meeting where casual vacancy caused by their removal is to be filled

3.4 Resignation of auditors

Resignation of Auditors (UK, Companies Act 2006: s.516-518)	
1 Resignation procedures	Auditors deposit written notice together with statement of circumstances relevant to members/creditors or statement that no such circumstances exist. A statement of circumstances must always be submitted for a quoted company/public interest entity, even if the auditor considers that there are no circumstances that should be brought to the attention of members or creditors. Certain exemptions apply for non-public interest entities.
2 Notice of resignation	Sent by company to regulatory authority.
3 Statement of circumstances	Sent by: (a) Auditors to regulatory authority (b) Company to everyone entitled to receive a copy of accounts
4 Convening of general meeting	Auditors can require directors to call an extraordinary general meeting to discuss circumstances of resignation. Directors must send out notice for meeting within 21 days of having received requisition by auditors.
5 Statement prior to general meeting	Auditors may require company to circulate (different) statement of circumstances to everyone entitled to notice of meeting.
6 Other rights of auditors	Can receive all notices that relate to: (a) A general meeting at which their term of office would have expired (b) A general meeting where casual vacancy caused by their resignation is to be filled Can speak at these meetings on any matter which concerns them as auditors.

4 International Federation of Accountants (IFAC)

IFAC was set up in 1977 and is based in New York. It is a non-profit, non-governmental and non-political international organisation of accountancy bodies. The ACCA is a member of IFAC.



4.1 Mission

IFAC's mission is 'to serve the public interest, strengthen the global accountancy profession and contribute to the development of strong international economies by establishing and promoting adherence to high-quality professional standards, furthering the international convergence of such standards, and speaking out on public interest issues where the profession's expertise is most relevant.' (IFAC, 2017)

4.2 Membership

Any accountancy body may join IFAC if it is recognised by law or general consensus within its own country as a substantial national organisation of good standing within the accountancy profession.

Members of IFAC automatically become members of the International Accounting Standards Committee Foundation, which is an independent not-for-profit, private sector organisation which sets international financial reporting standards through its standard-setting body, the International Accounting Standards Board.

4.3 Council

This consists of one representative from each member body of IFAC. It elects the members of the Board and establishes the basis of financial contributions by members.

4.4 Board

The Board consists of the President and not more than 22 members elected by the Council for 3-year terms. Elections to the Board are held annually so that one-third of the Board retires each year.

The role of the Board is to supervise the general IFAC work programme.

The work programme itself is implemented by smaller working groups or the following standing technical committees:

- International Auditing and Assurance Standards Board
- Compliance Committee
- Education Committee
- Ethics Committee
- Financial and Management Accounting Committee
- Public Sector Committee
- Transnational Auditors Committee (executive arm of the Forum of Firms)

5 International Auditing and Assurance Standards Board (IAASB)

The IAASB was established to develop and issue standards and statements on auditing, assurance and related services on behalf of the IFAC Board.

The 18 members of the IAASB are nominated by the IFAC Board based on names put forward by the member bodies and Forum of Firms.

5.1 Objectives

The objective of the IAASB, on behalf of the IFAC Board, is to serve the public interest by setting high-quality auditing and assurance standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. The IAASB achieves this objective by:

- (a) Establishing high-quality auditing standards and guidance for financial statement audits that are generally accepted and recognised by investors, auditors, governments, banking regulators, securities regulators and other key stakeholders across the world
- (b) Establishing high-quality standards and guidance for other types of assurance services on both financial and non-financial matters
- (c) Establishing high-quality standards and guidance for other related services
- (d) Establishing high-quality standards for quality management covering the scope of services addressed by the IAASB
- (e) Publishing other pronouncements on auditing and assurance matters, thereby advancing public understanding of the roles and responsibility of professional auditors and assurance service providers

5.2 The scope and authority of IAASB pronouncements

The IAASB's pronouncements govern assurance and related services that are conducted in accordance with international standards. They do not override the local laws or regulations.

The pronouncements of the IAASB examinable fall into two categories:

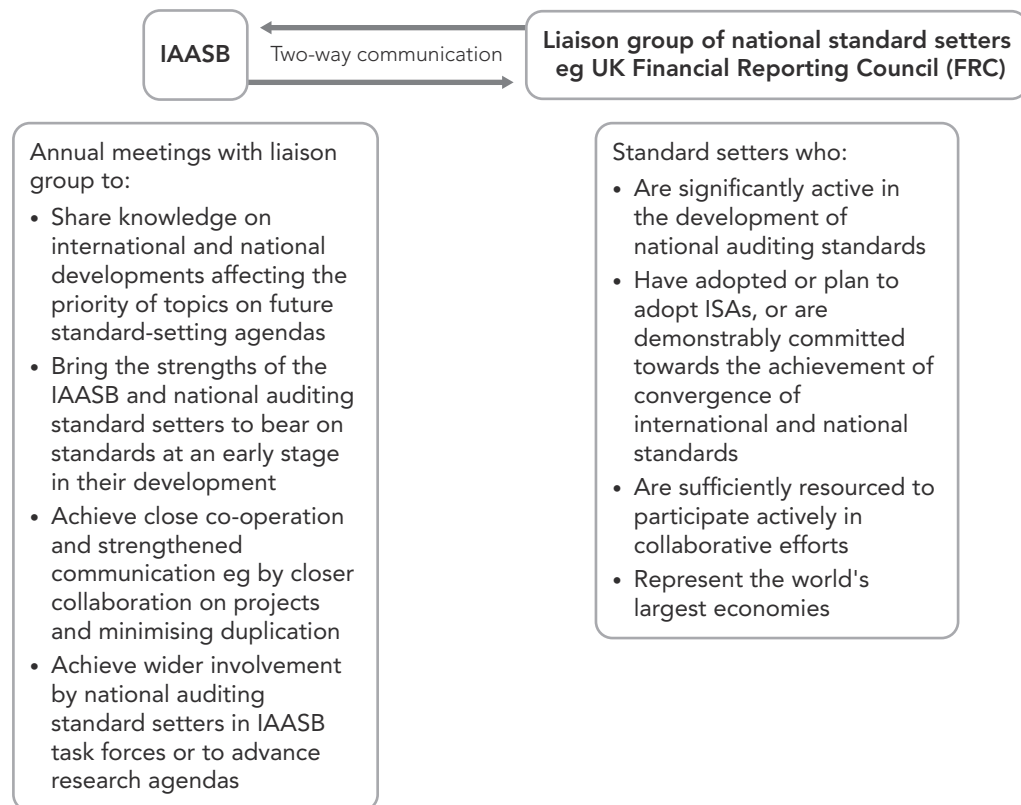
- International Standards on Auditing (ISAs)
- International Standards on Assurance Engagements (ISAEs)

The IAASB's standards contain basic principles and essential procedures together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be understood and applied in the context of the explanatory and other material that provide guidance for their application. It is therefore necessary to consider the whole text of a standard to understand and apply the basic principles and essential procedures.

In exceptional circumstances, a professional accountant may judge it necessary to depart from a requirement of a standard to achieve more effectively the objective of the engagement. When such a situation arises, the professional accountant should be prepared to justify the departure.

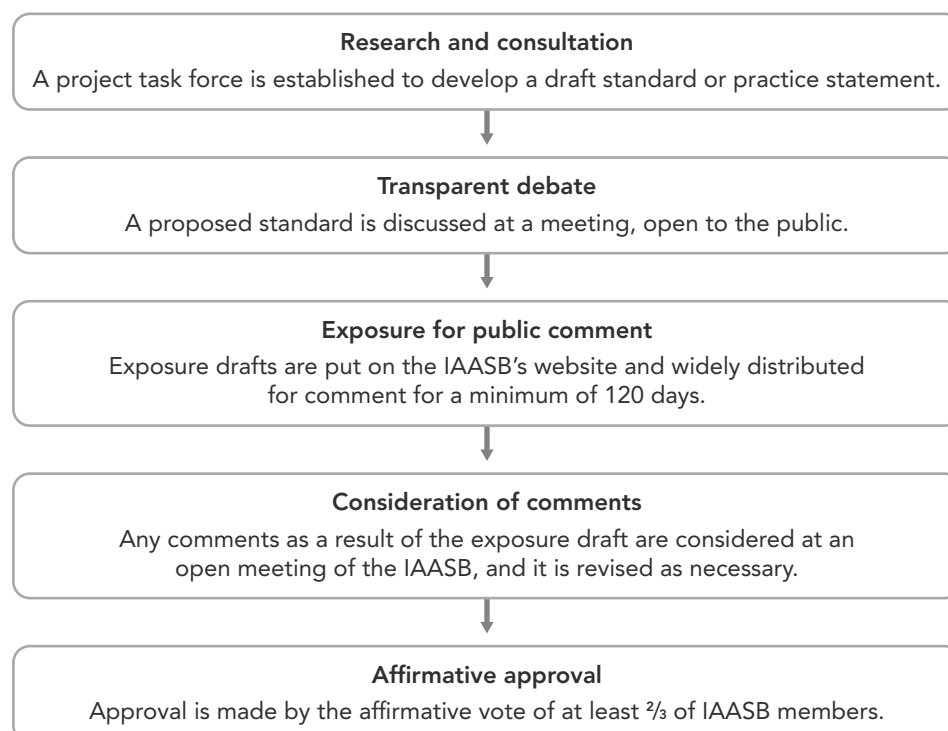
5.3 ISAs and national standard setters

Many national standard setters are moving towards the adoption of ISAs in place of their previous local auditing standards, with a large number of countries having adopted or incorporated ISAs into their national auditing standards or using ISAs as a basis for preparing national auditing standards.



5.4 The development of IAASB standards

The development of IAASB standards adheres to the following process:



5.5 Status of ISAs

As statutory audit is governed by local legislation, the status of ISAs will vary between countries:

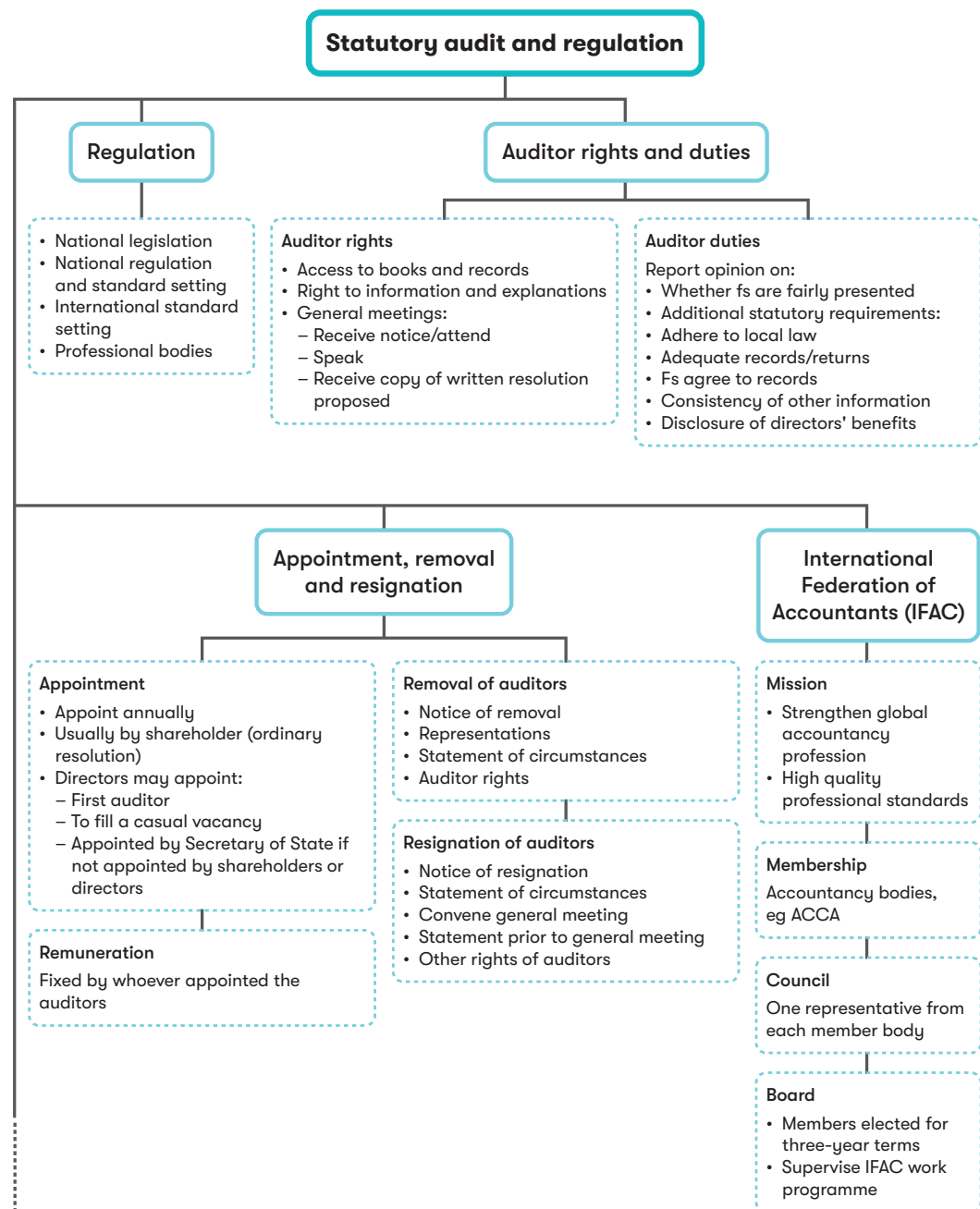
- National standards may continue to exist but aligned with the principles of ISAs.
- The ISAs could be adopted without any additional guidance relating to national circumstances (eg South Africa).
- The ISAs could be adopted but with additional specific guidance added (eg ISAs (UK)).

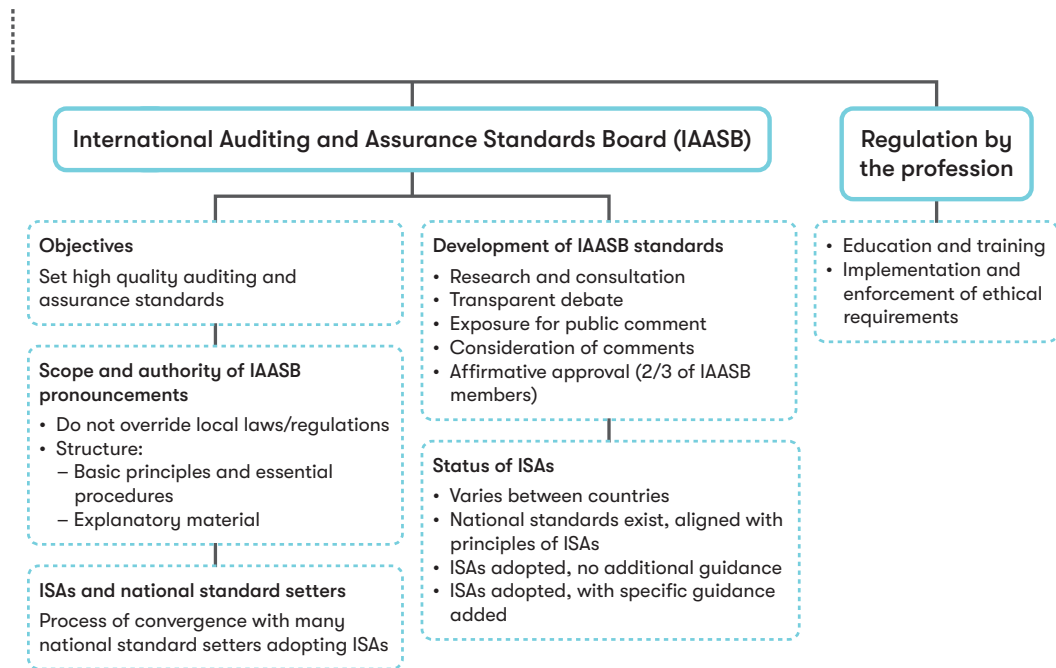
6 Regulation by the profession

Bodies such as ACCA play a part in the regulation of the profession as follows:

Education and training of auditors	As a member of IFAC, ACCA must comply with IFAC's international standards and guidelines on: • Pre-qualification education and training • Continuing professional education
Implementation and enforcement of ethical requirements	IFAC member bodies such as ACCA must prepare ethical requirements based on IFAC's International Code of Ethics for Professional Accountants. Member bodies must provide high standards of professional conduct and ensure that ethical requirements are observed. Disciplinary action should normally be taken in the following instances: • Failure to observe the required standard of professional care, skills or competence; • Non-compliance with the rules of ethics; or • Discreditable or dishonourable conduct. The power for disciplinary action may be provided by legislation or by the constitution of the professional body.

Chapter summary





Knowledge diagnostic

1. Sources of regulation

The regulation of auditors comes from a range of sources.

2. Auditors' rights and duties

Auditors' **rights and duties** are usually governed by **national legislation**, for example the Companies Act 2006 in the UK.

3. Auditors' rights

Auditors' rights exist in order for them to be able to gather all of the evidence required so that they can perform an effective audit.

4. Appointment of auditors by shareholders

Auditors will usually be **appointed** at a company's general meeting by the **shareholders**. This requires an ordinary resolution (>50% votes).

5. Appointment of auditors by other parties

Where the shareholders fail to appoint an auditor, the auditor may be appointed by the directors or the Secretary of State (if the directors fail to appoint).

6. Remuneration

The auditor's remuneration will be set by those who appointed them.

7. Removal of auditors

Auditors must receive **special notice** (28 days) of any intention to **remove** them from office. They are entitled to make representations to defend themselves.

8. Statement of circumstances

In the event of the auditors being **removed** from office, they must deposit a **statement of circumstances** at the company's registered office.

9. Resignation of auditors

When an auditor **resigns**, they must submit written notice plus a **statement of circumstances**. They can ask the directors to convene an extraordinary general meeting if warranted by the circumstances.

10. IFAC

IFAC is an international organisation of accountancy bodies. Its mission is to establish and promote adherence to **high-quality professional standards**.

11. IAASB

IAASB pronouncements (ISAs and ISAEs) **do not overrule** local laws or regulations but where they form part of the regulatory framework (e.g. in the UK) they are mandatory.

12. Regulation by the profession

Professional bodies, such as ACCA, establish regulations relating to **education and training** and **ethics**.

Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the workbook):

- Section A Q6 and Q7
- Section B Q47 Standards

Further reading

There are no technical articles or study support videos on the ACCA website for this area. However, this is a great time to think about exam technique and so you should read the following exam technique article:

Exam technique article:

- A guide to using the examiner's reports
(https://www.accaglobal.com/content/dam/ACCA_Global/Learning%20Providers/exam-reflection/reflections-1st-F8-audit-and-assurance-form.pdf)

Own research

Choose a country which is not the UK and research the rights and duties of auditors in that jurisdiction. Think about how and why they may be different from those stipulated in the Companies Act 2006.



Corporate governance

Learning objectives

On completion of this chapter, you should be able to:

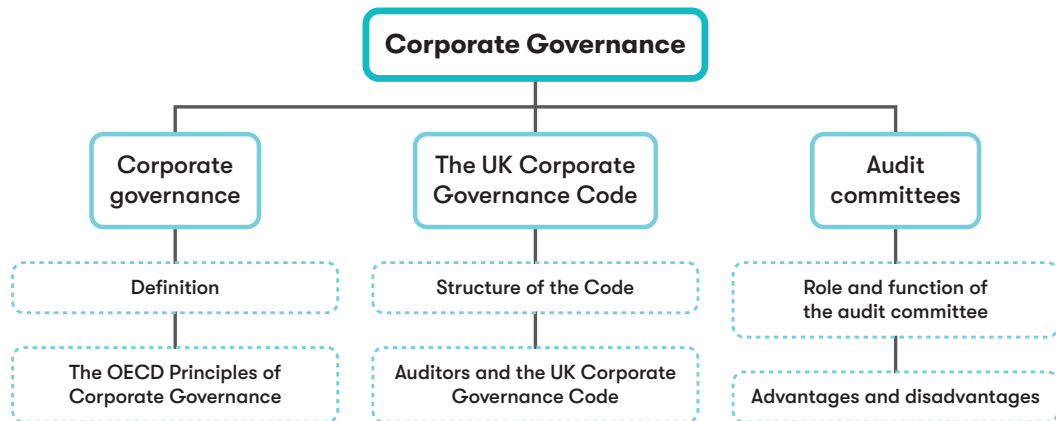
Syllabus learning outcomes	Syllabus reference no.
Discuss the objectives, relevance and importance of corporate governance.	A3 (a)
Discuss the provisions of international codes of corporate governance (such as the Organisation for Economic Co-operation and Development (OECD)) that are most relevant to auditors.	A3 (b)
Describe good corporate governance requirements relating to directors' responsibilities (eg for risk management and internal control) and the reporting responsibilities of auditors.	A3 (c)
Evaluate corporate governance deficiencies and provide recommendations to allow compliance with international codes of corporate governance.	A3 (d)
Analyse the structure and roles of audit committees and discuss their benefits and limitations.	A3 (e)
Explain the importance of internal control and risk management.	A3 (f)

Business and Exam context

The concept of corporate governance was introduced in Chapter 1. In this chapter, we will look at the codes of practice that have been put in place to ensure that companies are well managed and controlled. The UK Corporate Governance Code is an internationally recognised code which we will use as an example of a code of best practice. The audit carried out by the external auditors is a very important part of corporate governance, as it is an independent check on what the directors are reporting to the shareholders.

We will also see the important role played by the audit committee, a sub-committee of the board of directors. Its role is to oversee a company's risk assessment procedures and its financial statements and monitor the internal audit function and the independence of the external auditor. External auditors liaise with the audit committee over the audit, and internal auditors will report their findings about internal control effectiveness to it.

Chapter overview



1 Corporate governance

1.1 Definition



Corporate governance: the internal systems or means by which companies are **directed** and **controlled**.

It describes the framework of rules and practices by which a board of directors ensures accountability, fairness, and transparency in a company's relationship with each of its stakeholders.

In recent decades, there have been several reviews performed in many different countries in order to try to establish a set of principles for corporate governance.



PER alert

One of the PER performance objectives (PO4) requires you to demonstrate that you contribute to effective governance in your area. You evaluate, monitor and implement risk management procedures, complying with the spirit and the letter of policies, laws and regulations. Reviewing this chapter should help you achieve that objective.

1.2 The OECD Principles of Corporate Governance

The OECD has developed its own Principles of Corporate Governance.

These Principles provide best practice recommendations on corporate governance and are used worldwide as a benchmark for establishing guidelines on this area.

The Principles address the following six areas:



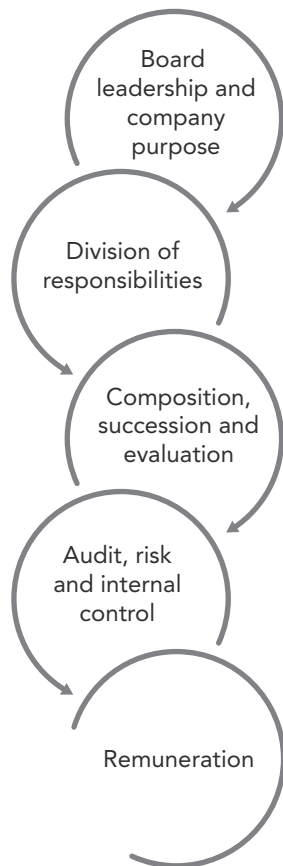
The OECD document provides detailed recommendations expanding on each of the principles. In reality, each country can then develop its own corporate governance code for companies to follow.

2 The UK Corporate Governance Code

2.1 Structure of the Code

In the UK, the UK Corporate Governance Code gives guidance to companies as to how they should be directed and controlled.

The UK Corporate Governance Code was revised by the Financial Reporting Council (FRC) in July 2018 and offers guidance under the following headings:



The Code applies to **listed companies** and is part of the UK Stock Exchange listing rules.

Listed companies **must** include a corporate governance report in their annual report. The report should describe how the company applies the principles in the Code and should include a statement as to whether or not the company complies with the provisions of the Code.

Where the company does not comply with certain provisions of the Code, the corporate governance report should provide an explanation for the non-compliance. This is known as the **'comply or explain'** basis.

The UK Corporate Governance Code is an example of how the OECD Principles can be implemented and the requirements listed companies must adhere to in order to satisfy the UK Stock Exchange listing rules.

The broad principles of the Code are as follows:

Principles of the UK Corporate Governance Code (for listed UK companies)

Board Leadership and Company Purpose

Principle A

A successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company, generating value for shareholders and contributing to wider society.

Principle B

The board should establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned. All directors must act with integrity, lead by example and promote the desired culture.

Principle C

The board should ensure that the necessary resources are in place for the company to meet its objectives and measure performance against them. The board should also establish a

Principles of the UK Corporate Governance Code (for listed UK companies)

framework of prudent and effective controls, which enable risk to be assessed and managed.

Principle D

In order for the company to meet its responsibilities to shareholders and stakeholders, the board should ensure effective engagement with, and encourage participation from, these parties.

Principle E

The board should ensure that workforce policies and practices are consistent with the company's values and support its long-term sustainable success. The workforce should be able to raise any matters of concern.

(FRC UK Corporate Governance Code: Section 1)

Division of Responsibilities

Principle F

The chair leads the board and is responsible for its overall effectiveness in directing the company. They should demonstrate objective judgement throughout their tenure and promote a culture of openness and debate. In addition, the chair facilitates constructive board relations and the effective contribution of all non-executive directors, and ensures that directors receive accurate, timely and clear information.

Principle G

The board should include an appropriate combination of executive and non-executive (and, in particular, independent non-executive) directors, such that no one individual or small group of individuals dominates the board's decision-making. There should be a clear division of responsibilities between the leadership of the board and the executive leadership of the company's business.

Principle H

Non-executive directors should have sufficient time to meet their board responsibilities. They should provide constructive challenge, strategic guidance, offer specialist advice and hold management to account.

Principle I

The board, supported by the company secretary, should ensure that it has the policies, processes, information, time and resources it needs in order to function effectively and efficiently.

(FRC UK Corporate Governance Code: Section 2)

Composition, Succession and Evaluation

Principle J

Appointments to the board should be subject to a formal, rigorous and transparent procedure, and an effective succession plan should be maintained for board and senior management. Both appointments and succession plans should be based on merit and objective criteria and, within this context, should promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths.

Principle K

The board and its committees should have a combination of skills, experience and knowledge. Consideration should be given to the length of service of the board as a whole and membership regularly refreshed.

Principle L

Annual evaluation of the board should consider its composition, diversity and how effectively members work together to achieve objectives. Individual evaluation should demonstrate whether each director continues to contribute effectively.

(FRC UK Corporate Governance Code: Section 3)

Principles of the UK Corporate Governance Code (for listed UK companies)

Audit, Risk and Internal Control

Principle M

The board should establish formal and transparent policies and procedures to ensure the independence and effectiveness of internal and external audit functions and satisfy itself on the integrity of financial and narrative statements.

Principle N

The board should present a fair, balanced and understandable assessment of the company's position and prospects.

Principle O

The board should establish procedures to manage risk, oversee the internal control framework, and determine the nature and extent of the principal risks the company is willing to take in order to achieve its long-term strategic objectives.

(FRC UK Corporate Governance Code: Section 4)

Remuneration

Principle P

Remuneration policies and practices should be designed to support strategy and promote long-term sustainable success. Executive remuneration should be aligned to company purpose and values, and be clearly linked to the successful delivery of the company's long-term strategy.

Principle Q

A formal and transparent procedure for developing policy on executive remuneration and determining director and senior management remuneration should be established. No director should be involved in deciding their own remuneration outcome.

Principle R

Directors should exercise independent judgement and discretion when authorising remuneration outcomes, taking account of company and individual performance, and wider circumstances.

(FRC UK Corporate Governance Code: Section 5)



Essential reading

See Chapter 3 of the Essential reading which sets out the broad principles of the UK Corporate Governance Code.

The Essential reading is available as an Appendix of the digital edition of the Workbook.



Activity 1: Reviewing corporate governance

Introduction and client background

Dress You Like Co is a clothing manufacturer, based in the UK, which has been trading for over ten years. It operates from two sites, a factory where clothes are made and a head office where the administration is carried out. Completed inventory orders are despatched from both the factory and the head office.

In an effort to reduce costs, Dress You Like Co now imports its material from one sole supplier based in China.

Dress You Like Co sells its finished products to small independent retailers and also one major supermarket chain. The supermarket chain often requires additional deliveries without much prior notice and so Dress You Like Co has to maintain a high level of inventory should this occur. Credit terms are normally 30 days, but the supermarket is given 60-day credit terms.

Dress You Like Co is not a listed company but its directors believe that the company's annual report should provide as much information as possible to shareholders. Consequently, they have voluntarily included a corporate governance report each year in their annual report.

As the audit senior, you have been asked to review Dress You Like Co's corporate governance report for the **year ended 30 September 20X5**. Your firm did **not** complete the audit for the year in question and your audit manager has given you a series of questions to answer in order to get a better understanding as to how the company is directed and controlled.

Review the corporate governance report extract below and answer the questions which follow;

Dress You Like Co Corporate Governance Report extract for the year ended 30 September 20X5

As a clothing manufacturer, Dress You Like Co operates within a particularly challenging sector. I believe that in order to conquer modern economic challenges, we must continue to act responsibly in all of our business decisions and monitor our performance closely. Strong leadership (governance) and tight control are fundamental to the success of our business.

Board leadership and company purpose

As Chairman of the board of directors, my role is to lead the board and make sure that each of our directors is fulfilling their role effectively. I will ensure that the board is unified, ably supported by our non-executive directors and offers a greater service to the company as a board than its members could individually.

On 1 January 20X5, I appointed Mary Batter to take over from me as Chief Executive Officer. Relinquishing this position has meant that I could concentrate solely on my role as Chairman rather than dividing my time between the two roles.

As Chief Executive Officer, Mary and her team will seek to develop the company's strategy and steer the company through the years ahead.

Composition, succession and evaluation

During the year an independent consultant conducted a board evaluation. This included individual interviews with each director to gather their opinions on issues ranging from how effective the current board is and risk management to how we can better conduct our relationships with shareholders. To be consistent with best practice, this evaluation will now become an annual occurrence.

As mentioned above Mary Batter joined us this year. She was appointed on the recommendation of the Nomination Committee and completed a tailored induction process.

All directors are offered training throughout the year and are subject to annual re-election.

Audit, risk and internal control

The board is responsible for risk management and for maintaining a system of internal controls. The risks affecting the company are widespread; however, key risks are firstly the ability to predict customer demand in terms of tastes and fashions and secondly security of inventory. We have an internal audit department which we outsource to an independent firm.

The audit committee reviews the effectiveness of the board's risk management procedures.

Our board	
Gary Lewis (Chairman)	Chairman of Nomination Committee
Mary Batter (CEO)	Member of Nomination Committee
Katie Escombe (Chief Finance Officer)	Executive Director
Bob Part (Non-executive Director)	Chairman of the Audit Committee Member of the Remuneration and Nomination Committees
Adam Knight (Non-executive Director)	Chairman of the Remuneration Committee Member of the Audit and Nomination Committees

Our board	
Jeremy Flage (Non-executive Director)	Member of the Audit, Remuneration and Nomination Committees

- 1 Why should the role of the Chairman and the Chief Executive Officer ideally be carried out by two different people?
- 2 How does Dress You Like Co ensure that board members are properly equipped to do their job?
- 3 Why do you think the directors are re-elected each year?
- 4 How is the responsibility for risk management shared in Dress You Like Co?
- 5 Why does the company have both executive and non-executive directors?
- 6 Which sub-committees do the non-executive directors form and what are their roles?

Solution

2.2 Auditors and the UK Corporate Governance Code

In the UK, auditors are required to review whether listed companies have complied with specific provisions in the Code. They must then report this to shareholders in the auditor's report.

There are nine specific provisions auditors must review and report on.

The following is an example of the type of work programme the auditor may use to determine whether the specific provisions have been complied with:

	Provision	Yes ✓	No ✓
(a)	Is the directors' responsibility for preparing the annual report and accounts explained in the report?		
(b)	Have the directors reviewed and reported on the effectiveness of the risk management and internal control systems		

	Provision	Yes ✓	No ✓
(c)	Has the board established an audit committee of at least three non-executive directors (or at least two non-executive directors for smaller companies)?		
(d)	Does the audit committee have written terms of reference?		
(e)	Are the terms of reference for the audit committee available/ described in the annual report?		
(f)	Does the audit committee arrange methods for staff to report impropriety in financial reporting?		
(g)	Does the audit committee monitor and review the effectiveness of the internal audit activities?		
(h)	Does the audit committee have primary responsibility for the appointment of the external auditors?		
(i)	Are there procedures in place to ensure that auditor independence is maintained where the external auditor provides non-audit services?		

3 Audit committees

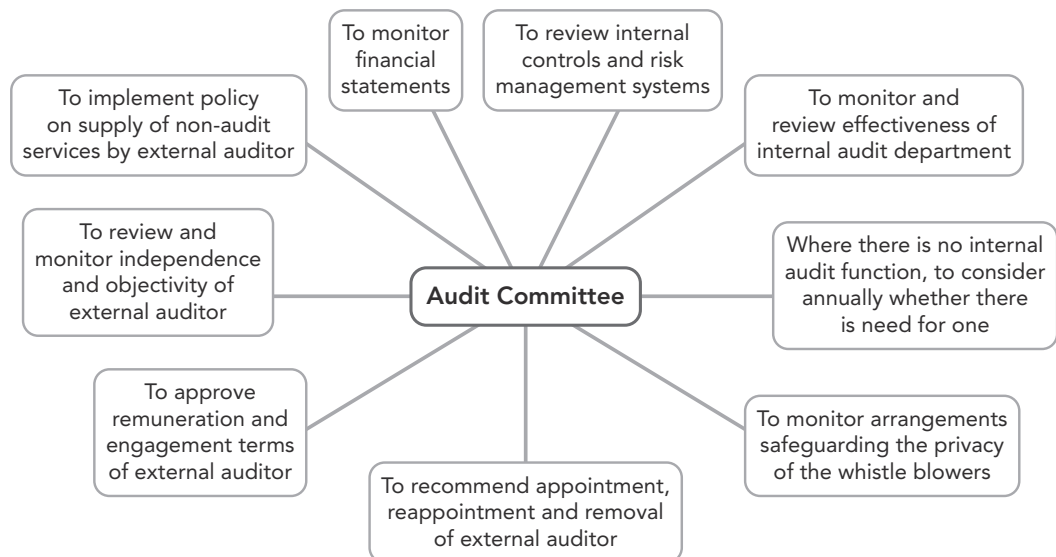


Audit committee: a sub-committee of the board of directors, usually containing a number of independent non-executive directors.

3.1 Role and function of the audit committee

The role and function of the audit committee should be set out in written terms of reference.

The diagram below summarises the responsibilities of the audit committee:





Essential reading

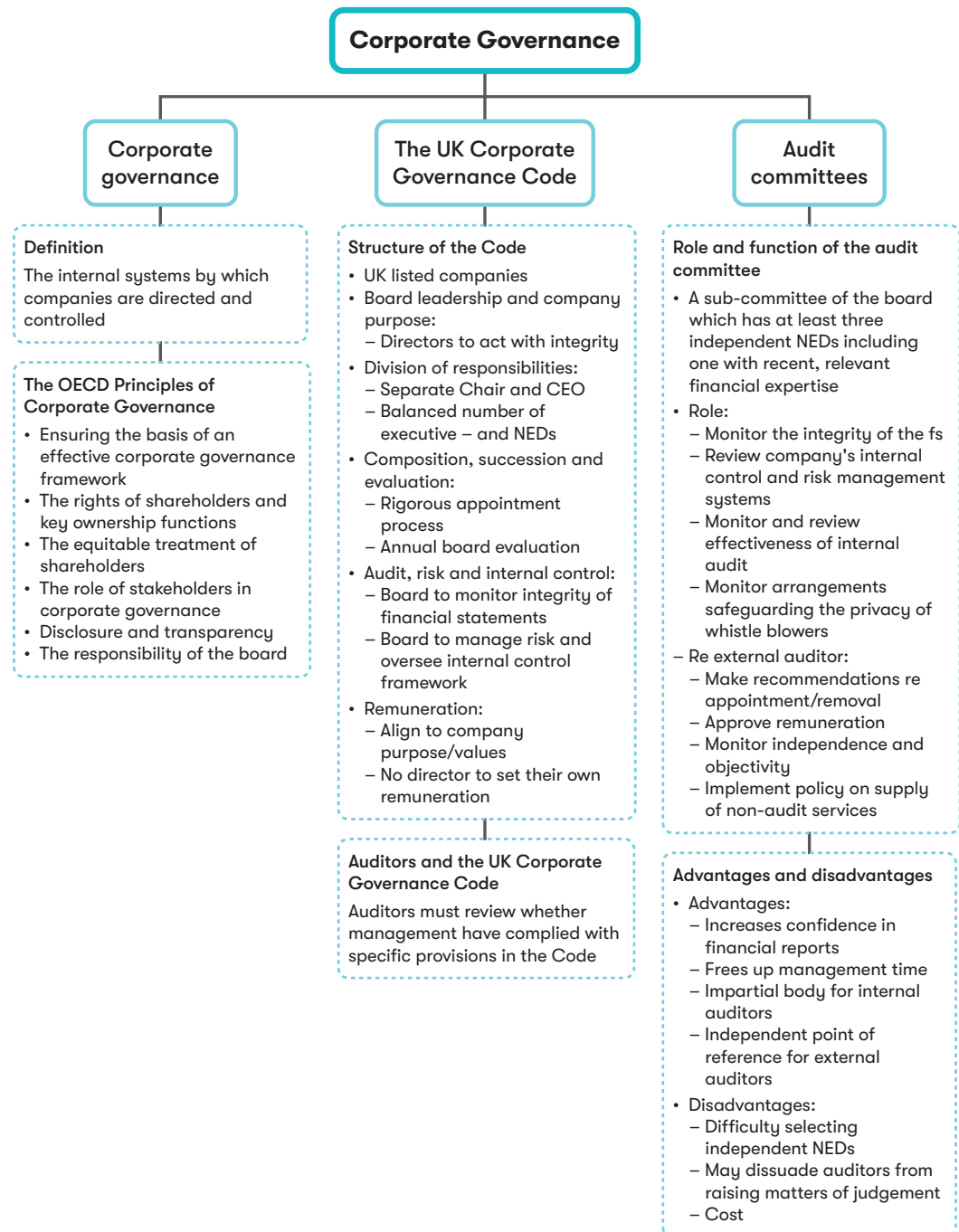
See Chapter 3 of the Essential reading which sets out the detailed provisions relating to the audit committee and internal control effectiveness in the UK Corporate Governance Code.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

3.2 Advantages and disadvantages of audit committees

Advantages	Disadvantages
Increased confidence in the credibility and objectivity of financial reports.	There may be difficulty selecting sufficient non-executive directors with the necessary competence in auditing matters for the committee to be really effective.
Allows executive directors to devote their attention to management as the audit committee can specialise in the problems of financial reporting	The establishment of such a formalised reporting procedure may dissuade the auditors from raising matters of judgement and limit them to reporting only on matters of fact.
Provides an impartial body for the internal auditors to report which increases their independence	Costs may be increased.
Provides an independent point of reference for the external auditors	

Chapter summary



Knowledge diagnostic

1. Corporate governance

Corporate governance is the system by which companies are **directed and controlled**. Good corporate governance is especially important where the owners of a company are not involved in the day-to-day running of the company.

2. OECD Principles of Corporate Governance

The **OECD** has developed **Principles of Corporate Governance** as a reference point for national policy makers. These set out the rights of shareholders, the importance of disclosure and transparency and the responsibility of the board of directors.

3. UK Corporate Governance Code

The **UK Corporate Governance Code** issued by the Financial Reporting Council requires **listed** companies to include a corporate governance report in the annual report detailing how the company has been directed and controlled in terms of board leadership and company purpose, division of responsibilities, composition, succession and evaluation, audit, risk and internal control and remuneration.

4. Comply or explain approach

A company must explain any non-compliance with the specific provisions of the Code in their annual report.

5. Audit committee

All listed companies must have an audit committee which should be made up of at least three non-executive directors. Some of the main roles of the audit committee are to **monitor the integrity of the financial statements and the auditor's independence** and also to **review the company's internal controls and risk management systems**.

Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the workbook):

- Section A Q1
- Section B Q48 Corporate Governance

Further reading

There are no technical articles on the ACCA website written by members of the AA examining team and other tutors which are relevant to some of the topics covered in this chapter that you should read. However, later on in Chapters 9 and 10, you will find several articles relating to internal control which are linked to this chapter.

Own research

Identify a UK listed company which interests you and download the company's annual report from their website. Read through the disclosures relating to corporate governance and the audit committee and see if you can identify the principles of the UK Corporate Governance Code.

Activity answers

Activity 1: Reviewing corporate governance

- 1 The Chairman's role is to run/direct the board of directors so that its members can undertake their roles effectively. These duties include ensuring that the board is appropriately balanced (in terms of the numbers of executive and non-executive directors) and that each director is aware of their responsibilities and is equipped to fulfil them.

The Chief Executive Officer's role is to decide on the company's strategy and put procedures in place to achieve these.

These are very different roles and so should ideally be undertaken by two separate people.

Also separating the roles will not allow one person to have too much power (as in the case of Robert Maxwell from Mirror Group Newspapers).

- 2 Dress You Like Co undertakes a board evaluation each year which allows directors to voice their concerns as to how the board is being run.

It also makes training available to its directors and offers a full induction to new directors.

- 3 Directors should only remain in position if they are performing in their role. Having the annual re-election of directors allows companies to remove directors who are not performing and also encourages directors to work effectively for the company/shareholders.

- 4 Board of directors:

The responsibility for risk management lies with the board of directors. It is the directors' responsibility to assess the risks that the business is exposed to. All businesses are exposed to general risks; however, there are additional, specific risks relevant to each business. Dress You Like Co is a clothing manufacturer and so there are lots of risks inherent in the business – two of these are mentioned in the scenario: changing fashion trends and the security of inventory.

Once the board has identified the key risks to which the business is exposed, it must then implement a system of internal controls (or procedures) to prevent and/or detect these risks occurring.

Internal controls could range from performing continual market research into consumer fashion tastes to installing security cameras in the factory to deter theft of inventory.

The existence of an internal audit function is often cited as a positive form of risk management and internal control.

Audit committee:

As well as giving the board of directors the responsibility for risk management, corporate governance principles require a company to establish an audit committee. This should comprise at least three non-executive directors (two non-executive directors for a small company).

The audit committee has a responsibility to review the company's risk management and internal control systems and should include at least one non-executive director with financial knowledge.

The audit committee must also review the effectiveness of the internal audit department where one exists. If there is no internal audit department, then the audit committee should consider annually whether or not there is a need for one.

- 5 Executive directors are responsible for the day -to -day running of the company and perform operational and strategic business functions such as entering into contracts, safeguarding company assets and managing people.

Non-executive directors are not involved in the day to day running of the business. Instead they should use their experience and expertise to provide independent advice and objectivity to the board as a whole. They also perform a supervisory role and will review and monitor the

executive directors to ensure that they are fulfilling their duties and running the company in the best interests of the shareholders.

In order to improve their independence, non-executive directors should not be reliant on the company for their main source of income. They often work part-time for the company and can have a specialist role within the organisation.

All directors, executive and non-executive, are required to attend as many board meetings as they reasonably can.

Also, there is no legal distinction between executive and non-executive directors; – each has the same responsibilities and rights under law.

Dress You Like Co has three executive and three non-executive directors which makes the board very well balanced.

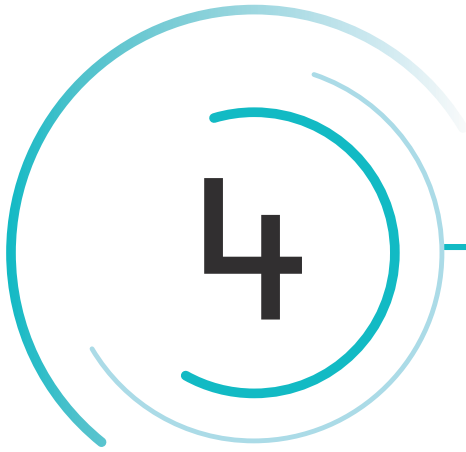
- 6 As well as forming part of the board of directors as a whole, the non-executive directors also sit on the audit committee, remuneration committee and nomination committee. These are sub-committees of the board of directors.

The audit committee is responsible, amongst other things, for reviewing the effectiveness of the board's risk management processes.

The remuneration committee is responsible for making sure that the company offers a performance-related remuneration package which is sufficient to attract and retain quality directors (but not excessive).

The nomination committee is responsible for identifying and approving the appointment of new directors to the board, for example Mary Batter, the new Chief Executive Officer.

Non-executive directors have a very important role to play in each of these sub-committees and their independence and objectivity can improve the quality and relevance of the decisions taken.



Internal audit

Learning objectives

On completion of this chapter, you should be able to:

Syllabus learning outcomes	Syllabus reference no.
Discuss the factors to be taken into account when assessing the need for internal audit.	C5 (a)
Discuss the elements of best practice in the structure and operations of internal audit.	C5 (b)
Compare and contrast the role of external and internal audit.	C5 (c)
Discuss the scope of internal audit and the limitations of the internal audit function.	C6 (a)
Explain outsourcing and the associated advantages and disadvantages of outsourcing the internal audit function.	C6 (b)
Discuss the nature and purpose of internal audit assignments including value for money, IT, financial, regulatory compliance, fraud investigations and customer experience.	C6 (c)
Discuss the nature and purpose of operational internal audit assignments.	C6 (d)
Discuss the responsibilities of internal and external auditors for the prevention and detection of fraud and error.	B5 (b)
Discuss the extent to which external auditors are able to rely on the work of experts, including the work of internal audit.	D6 (b)

Business and Exam context

The internal audit function (or department) is a function established by management and those charged with governance of an entity to assist in corporate governance by assessing internal controls and helping in risk management. It can be a department of employees or can be outsourced to expert service providers.

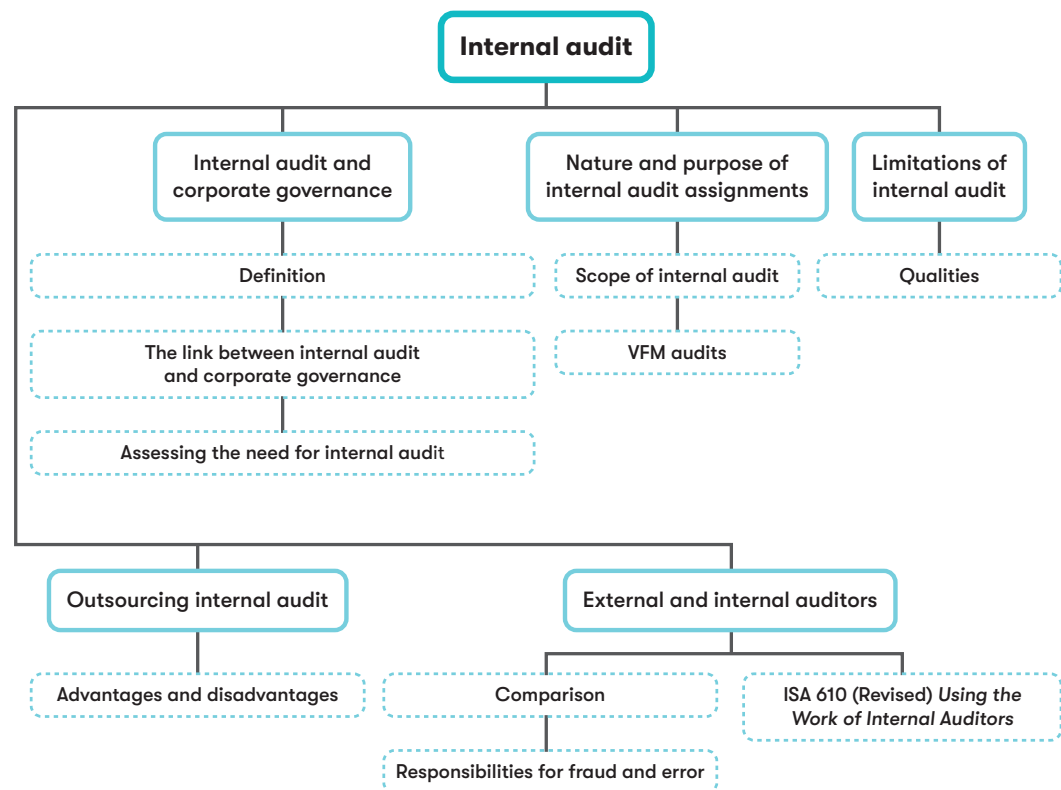
Internal auditing is different from external auditing, although the techniques used by each are very similar. While the techniques used may be similar, the focus and reasons behind the audit are different.

We will consider what the internal audit function is, what they do, and the key differences between the internal and external auditors. It is very important to know these differences as the

roles are distinct and you may see questions on their roles and the differences between them in the exam.

The role of the internal auditor is far more varied than that of the external auditor and we will see the various assurance assignments that may be undertaken by internal auditors.

Chapter overview



1 Internal audit and corporate governance

1.1 Definition

In the previous chapter, we saw that corporate governance relates to the internal systems or means by which companies are **directed** and **controlled**.

The UK Corporate Governance Code includes a section on **audit, risk and internal control** and this introduces the requirement for the board to “establish procedures to manage risk, oversee the internal control framework, and determine the nature and extent of the principal risks the company is willing to take in order to achieve its long-term strategic objectives” (FRC UK Corporate Governance Code: Principle O).

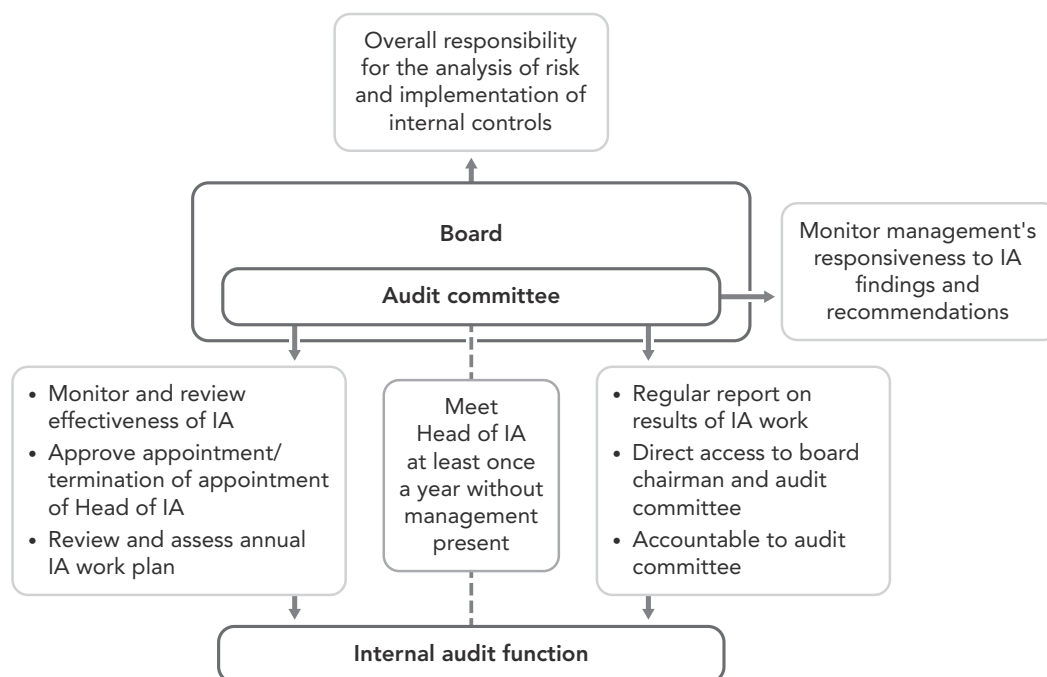
One way in which this requirement can be satisfied is for the board to create an internal audit function to assess and monitor internal control policies and procedures.



Internal audit function: 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. (IFAC, 2016(b))

1.2 The link between internal audit and corporate governance

There is a relationship between the board, the audit committee and corporate governance as follows:



1.3 Assessing the need for internal audit

The UK Corporate Governance Code does not require all listed companies to have an internal audit function, although many listed companies do have one.

In the UK, where a listed entity does not have an internal audit function, the Code requires the board to review whether or not the company would benefit from having an internal audit function **on an annual basis**.

Note that many entities which are not listed also have internal audit functions as this helps the board discharge their corporate governance responsibilities.

When considering the need for an internal audit function, the board should consider:

- The cost of setting up an internal audit department versus the predicted benefit

- Predicted savings in external fees where work carried out by consultants will be carried out by the new internal audit department
- The complexity and scale of the organisation's activities and the systems supporting those activities
- Management's perceived need for assessing risk and internal control
- The pressure from external stakeholders to establish an internal audit department
- Whether it is more cost effective or desirable to outsource the work

2 Nature and purpose of internal audit assignments

As we have seen, the role of the internal audit function is to provide independent assurance that a company's risk management, governance and internal control processes are operating effectively.

To do this, they will examine and evaluate the quality of risk management, governance and internal control processes across all parts of a company and report this directly and independently to the audit committee.

Unlike external auditors, the internal audit function looks beyond the financial statements and considers wider issues such as the company's reputation, compliance with laws and regulations, growth, its impact on the environment and employee satisfaction levels.

This is because the key to a company's success is often managing such risks effectively.

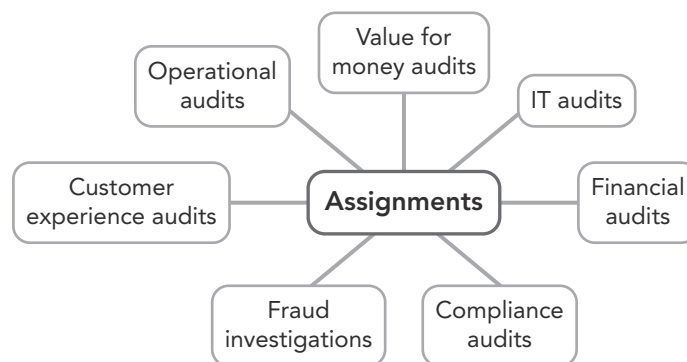
2.1 Scope of internal audit



PER alert

Being able to explain the overall role and process of internal audit, review and control is identified in the performance objectives booklet as being part of the key knowledge and understanding required for Performance Objective 20 (PO 20). This section will help you to gain that knowledge and understanding, and ultimately help you to achieve PO 20.

There are many types of work that the internal auditor performs. Those listed in the syllabus are:



The assignments internal auditors will carry out will depend on the particular circumstances of the company involved and its objectives.

A brief summary of the examples of internal audit assignments is:

- **IT audits:** Internal auditors may be asked to look specifically at controls over the accounting system, or, instead, over other computer systems that supply data to the accounting system. For example, a travel company's reservation system will usually link to the accounting system and is an important element in determining when the revenue on a flight or holiday is recorded. Or for companies with retail stores, assignments may include reviewing controls over computer systems linking tills to head office.
- **Financial audits and operational audits:** This may include testing controls operating centrally (at head office) or at branches. One example is the testing of controls over inventory counting

or cash counting. This would include observation of controls in operation at warehouses or retail stores during attendance at counts.

- **Compliance audits:** Internal auditors may assist with or review compliance with laws and regulations. For example, if a company has an overseas branch, the internal audit department may review compliance with laws/regulations specific to that country (such as filing adequate financial or non-financial returns).
- **Fraud investigations:** Fraud can range from theft of assets to fraudulent financial reporting. Internal audit may be asked to investigate specific instances of suspected fraud or, more generally, to review and test controls to prevent or detect fraud.
- **Customer experience audits:** Internal auditors may be asked to assess the level of customer service. They could do this by phoning in or visiting stores/outlets and pretending to be customers. Alternatively they could review and analyse the results of customer surveys.

Value for money audits are covered in detail below.



Exam focus point

If you are asked to suggest assignments that the internal audit function could be asked to perform, you must give specific and feasible assignments applicable to that particular company rather than just listing the general categories of assignments. Read the description of the company in the scenario carefully.



Essential reading

See Chapter 4 of the Essential reading which provides information on the other examples of internal audit work listed in the syllabus.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2.2 Value for money audits

Value for money (VFM) audits may be performed by the internal audit function and try to determine whether the optimal combination of goods/services have been obtained for the lowest level of resources.

VFM audits tend to focus on three areas: economy, efficiency and effectiveness. These are commonly known as 'the three Es':

Economy	Buying the resources needed at the cheapest cost
Efficiency	Using the resources purchased as wisely as possible
Effectiveness	Doing the right things and meeting the organisation's objectives

Management will need to set objectives for each of the three areas, the objectives will detail the goals/aims they hope to achieve in terms of the company's economic purchase of resources, efficient use of resources and the effectiveness of achieving the company's objectives.

Once the objectives have been set, they will then need to put controls in place to ensure each objective is met.



Activity 1: VFM objectives and controls

Dress You Like Co is a clothing manufacturer, based in the UK, which has been trading for over ten years. It operates from two sites; a factory where the clothes are made and a head office where the administration is carried out. Completed inventory orders are despatched from both the factory and the head office.

In an effort to reduce costs, Dress You Like Co now imports its material from one sole supplier based in China.

Dress You Like Co sells its finished products to small independent retailers and also one major supermarket chain. The supermarket chain often requires additional deliveries without much prior notice and so Dress You Like Co has to maintain a high level of inventory should this occur. Credit terms are normally 30 days, but the supermarket is given 60-day credit terms.

Required

Suggest TWO objectives Dress You Like Co may set in each of the areas of economy, efficiency and effectiveness and describe the controls you would expect to be put in place to ensure they are achieved.

	Objective	Control
Economy		
Efficiency		
Effectiveness		

Solution

Audits which are concerned **solely** with 'economy' objective are often termed '**best value**' audits.

3 Limitations of internal audit

3.1 Qualities

If the internal audit function is to be **effective**, then both they and their work need to possess certain qualities.

These qualities include **independence**, **objectivity** and **due skill and care**:

Qualities	Description
Independence	- Internal auditors should be independent of the activities they audit. For example, internal auditors should not generally be involved in designing, installing and operating systems. Rather their role is to review the effectiveness of them. - Internal audit departments should be granted sufficient status to achieve independence from the various company functions. - Internal auditor's reports should be considered appropriately by directors and recommendations acted upon. Internal auditors must have a reporting line that is independent of the function they are auditing – highest level of management/audit committee.
Objectivity	Objectivity is all about maintaining an independent mental attitude. When they conduct their work, the internal auditors should consider the facts in front of them without having any pre-conceived ideas .
Due skill and care	- Need for internal auditors to have wide-ranging skills (accounting, auditing, business and management skills) - Need for a multi-disciplinary internal audit team - Need for ongoing training - Adherence to internal audit quality management manuals/procedures - Work should be planned, documented, supervised and reviewed

Note that internal auditors are not normally subject to any regulatory authority.

4 Outsourcing internal audit

The internal audit function either can be provided internally by employees of the company or may be outsourced externally, for example to an accountancy or consultancy firm.



Activity 2: Advantages and disadvantages of outsourcing

Explain **FOUR** advantages and disadvantages to a company of outsourcing the internal audit function.

Advantages	Disadvantages

Solution

Note that where the internal audit function is outsourced to the company's external auditor, there may be a **self-review threat** to the auditor's independence (Chapter 5).

5 External and internal auditors

5.1 Comparison

External auditor:

Statutory duty to give an **opinion** as to whether the financial statements 'present fairly' the activities of the business.
Conducted in accordance with **ISAs**.

Internal auditor:

Assist the board in achieving its corporate objectives



Activity 3: External and internal auditors

Abbie Jones has recently signed a training contract with Check & Co, a firm of Chartered Certified Accountants, and is working in the firm's audit department. She has been reviewing some of the firm's client audit files in an attempt to gain a better understanding of what an audit is. She has noticed that some clients seem to have an internal audit function whilst others do not.

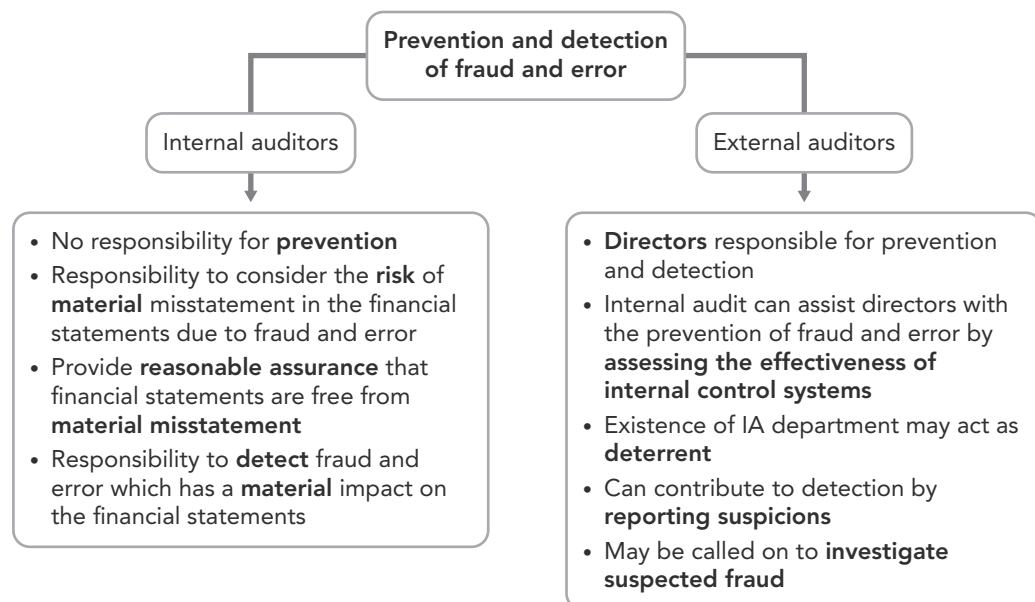
Abbie is a little confused as to the difference between her role as an external auditor and the role of the internal audit function.

Required

You are an audit senior in Check & Co and have been asked to complete the following table for Abbie which distinguishes between the key elements of the roles of the external and internal auditor.

	External auditor	Internal auditor
Objectives		
Reports to		
Status		
Qualification		

5.2 Responsibilities for fraud and error (ISA 240)



5.3 ISA 610 (Revised) Using the work of internal auditors

5.3.1 Relying on the work of the internal auditor

It is possible that the objectives of some of the work performed by the internal audit department may overlap with those of the external auditor. In these cases, it **may** be possible for the external auditor to rely on the work of the internal auditor.

ISA 610 (Revised) Using the Work of Internal Auditors provides guidance for 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 are:

- (a) 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
- (b) If using the work of the internal audit function, to determine whether that work is appropriate for the purposes of the audit
- (c) If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work. (ISA 610 (Revised): para. 13)

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.

The following criteria must first be considered by the external auditors when determining **whether the work of the internal audit function can be used**. (ISA 610 (Revised): para. 15)

Criteria	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. (ISA 610 (Revised): paras. A5–A7)
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 (ISA 610 (Revised): para. A8)
Whether the internal audit function applies a systematic and disciplined approach (including quality management)	Consider whether internal audit activities include a systematic and disciplined approach to planning, supervising, reviewing and documenting assignments, whether the function has appropriate quality management procedures , the existence of audit manuals, work programmes and internal audit documentation . (ISA 610 (Revised): para. A11)

These can be remembered using the mnemonic ‘SODIT’:

- Scope of work
- Organisational status
- Due skill and care
- Independent

- Technical competence

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

(ISA 610 (Revised): para. 17)

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

(ISA 610 (Revised): para. 18)

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 that the external auditor is solely responsible for the audit opinion.

5.3.2 Direct assistance

It is also possible that the external auditors may use the internal auditors to provide **direct assistance** to them.

Direct assistance refers to the use of the internal auditors to perform audit procedures under the direction, supervision and review of the external auditor. (ISA 610 (revised): para. 14(b))

When deciding whether the internal auditors should provide direct assistance the external auditor should consider:

- The amount of **judgement** involved in planning and performing the relevant audit procedures, and in evaluating the audit evidence gathered
- The assessed **risk of material misstatement**
- The existence and significance of threats to the **objectivity** and the level of **competence** of the internal auditors. (ISA 610 (revised): para. 29)

Where the external auditors have used direct assistance from the internal auditors they should document:

- 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 the review

ISA 610 ((Revised): para. 30) **prohibits** the use of internal auditors to provide direct assistance to perform procedures that:

- Involve making **significant judgements** in the audit
- Relate to **higher assessed risks of material misstatement** where more than a limited degree of **judgement** 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**

- (d) Relate to **decisions** the external auditor makes **regarding the internal audit function** and the use of its work or direct assistance

The sole responsibility for the audit opinion rests with the external auditors (ISA 610 (Revised): para. 32). 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.

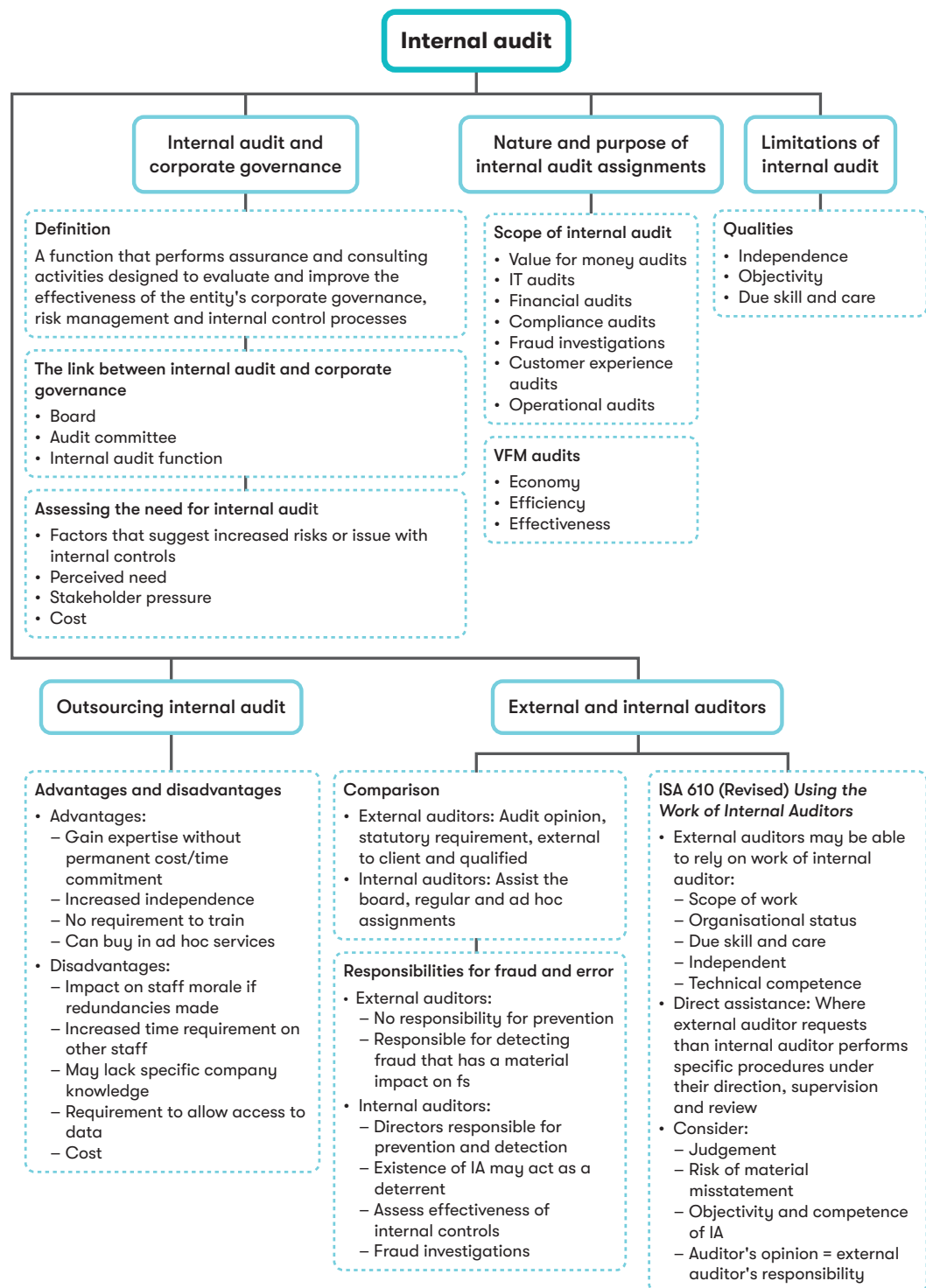


Essential reading

See Chapter 13 of the Essential reading which illustrates how the work of an internal auditor may be used when auditing inventory.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

Chapter summary



Knowledge diagnostic

1. Internal audit

Having an internal audit function is one way in which the board of directors can **demonstrate good corporate governance**. The internal audit function should report regularly to the audit committee and the audit committee should review and assess the internal audit function's work plan.

2. Value for money (VFM) audits

The role of the internal audit function is extremely wide and varied. **VFM audits** assess whether the business has obtained the best goods/services for the lowest level of resources. They focus on **economy, efficiency and effectiveness**.

3. Other internal audit assignments

Other internal audit function assignments include **IT audits, financial audits, audits to verify regulatory compliance, fraud investigations, customer experience audits and operational audits**.

4. Effective internal audit

For the work of the internal audit function to be effective, internal auditors must be **independent** and **objective** and carry out their work with **due skill and care**.

5. Outsourcing

An entity may **outsource** its internal audit function to accountancy or consultancy firms.

6. Roles of external and internal auditors

The role of the **external auditor** is clearly defined in **statute**; the role of the **internal audit function** is decided by the **management** of a specific company.

Further study guidance

Question practice

Now try the following from the Further question practice bank [available in the digital edition of the Workbook]:

- Section A Q1, Q8, Q9, Q12 and Q32
- Section B Q45 Objectives, characteristics and responsibilities
- Section B Q51 ZX

Further reading

There are technical articles on the ACCA website written by members of the AA examining team and other tutors which are relevant to some of the topics covered in this chapter that you should read:

Technical articles:

- Using the work of internal auditors (<https://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/internal-auditors.html>)

Own research

If you are working, does your company have an internal audit function? If so, find out a bit more about the types of assignments they undertake. Do you think the internal audit function helps the board run your company more effectively?

Activity answers

Activity 1: VFM objectives and controls

Objective	Control
Economy	
To ensure that material is purchased at the best possible price for the quality required	The prices from the Chinese supplier should be checked regularly against those offered by other suppliers. Where alternative suppliers offer better value for money, these suppliers should be used or prices renegotiated with the Chinese supplier. A list of preferred suppliers, who have been vetted for price and quality, should be established and orders only placed with these suppliers. Establish a tender process whereby suppliers are invited to quote for the supply of materials. This may take place on a season by season or six-monthly basis.
To ensure that transportation and delivery costs are minimised whilst ensuring goods are received on a timely basis	Identify a list of companies which import goods from China and invite them to tender for the delivery contract. Regularly review the price paid under the tender to ensure it is competitive against other companies.
To ensure that the accommodation costs of the factory and head office are minimised	If premises are owned establish an ongoing schedule of maintenance for the property to avoid unexpected repair costs. Establish a capital expenditure budget to ensure monies are not wasted continually repairing machines which should be replaced.
Efficiency	
To ensure that the clothes manufacturing process is as efficient as possible and minimises waste	The factory machines should be serviced according to a rolling schedule of maintenance in order for them to work efficiently.
To ensure that machine down time due to changing the machine set up for different clothing items is minimised	Orders for different clothing items should be collated and scheduled into a weekly plan of work in order to minimise the requirement to set up machines to manufacture different clothing items.
Effectiveness	
To ensure that all additional deliveries ordered by the supermarket are completed within the required timescales	A record should be maintained of the principal inventory lines ordered by the supermarket and a buffer of inventory for these items maintained. The level of this buffer should be reviewed on a fortnightly/monthly basis.
To minimise the level of inventory which becomes obsolete/un-saleable due to changing seasons/fashions	A fortnightly/monthly count of inventory held should be conducted and compared to the schedule of work planned for the next fortnight/month to ensure that only sufficient quantities of inventory are manufactured to supply orders and maintain the required buffer.

Objective	Control
To monitor the company's cash flow to ensure that the company does not suffer from short-term cash flow problems given the 60-day terms given to the supermarket	Monthly cash flow forecasts should be produced by management to monitor when cash is due to be received from all customers and when cash needs to be paid out to suppliers and employees. Establish an overdraft facility with the company's bank to cover short-term deficits in cash flow. Implement strong credit control procedures whereby customers are contacted as soon as their account becomes overdue. Send regular customer statements to all customers and letters to those with overdue accounts.

Note. Only **two** points were required under each heading.

Activity 2: Advantages and disadvantages of outsourcing

Advantages	Disadvantages
A company can benefit from the services provided by an internal audit function without incurring the time and cost involved in recruiting staff.	If a company already has an internal audit function and makes them redundant in order to outsource the function, the redundancies may prove very expensive. Furthermore, the company would lose in-house skills. Also, remaining staff may oppose outsourcing if it has come about as a result of colleagues being made redundant. This could reduce staff morale.
Outsourcing the internal audit function may well increase their independence as the role will be performed by a third party rather than employees who may fear losing their jobs if they report adversely on the company's management.	The staff that come to perform the regular internal audit services may vary from month to month. This will mean that staff from the company will need to spend more time explaining systems and processes to them than if the internal audit function were company employees.
There will be no need for the company to train internal audit staff as those providing the service will be trained by their own employer.	The outsourced staff may lack specific knowledge of the company.
As well as buying in regular services, it may be able to take advantage of ad hoc engagements provided that the company to which services are outsourced has spare capacity.	Outsourcing the internal audit function will require the company to allow a third party access to commercially sensitive data. Despite the fact that any engagement letter would stipulate that confidentiality be maintained, data could still be lost or disclosed.
Internal auditors supplied by a bespoke outsourcing company are likely to possess relevant accounting and auditing skills which will increase the reliability of the internal auditors' work.	The cost of outsourcing the internal audit function may well increase over time and become more expensive than employing your own staff.

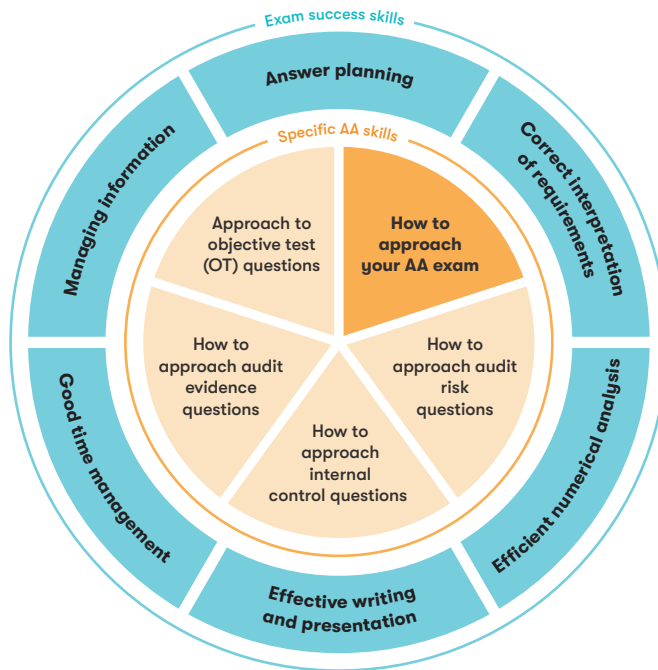
Note. Only **four** advantages and disadvantages were required.

Activity 3: External and internal auditors

	External auditor	Internal auditor
Objectives	Give an opinion as to whether: • The financial statements 'present fairly' the activities of the business; and • Proper accounting records have been kept.	Varied and wide ranging Determined by management/board but may include: • Review of accounting/internal control systems • Examination of financial/operating information • Value for money (VFM) reviews • Review of implementation of corporate policies, laws and regulations • Special investigations, eg suspected fraud • Procurement, marketing, treasury and HR reviews
Reports to	Shareholders of the company	Board of directors/audit committee
Status	Independent of/external to company they are auditing	Company employee/outsourced to a third party
Qualification	Audit partner will be qualified and hold a practising certificate as a registered auditor Not all team members will be qualified	No formal qualifications required

Skills checkpoint 1

How to approach your AA exam



Introduction

You can answer your AA exam in whatever order you prefer. It is important that you adopt a strategy that works best for you. We would suggest that you decide on your preferred approach and practice it by doing a timed mock exam before your real exam. Remember your AA exam will be structured as follows:

Section A – Three **OT case questions** worth 10 marks each. Each case question will consist of five individual OT questions worth two marks each. All syllabus areas can be tested in Section A, however each individual case does however tend to focus on a particular syllabus area, for example: corporate governance and internal audit, audit finalisation and the auditor's report, audit risk, audit evidence or internal control.

Section B – Section B will contain one, 30-mark question and two, 20-mark questions which will be **scenario based**. Section B questions will mainly focus on the following syllabus areas, but some marks can be drawn from any other area of the syllabus:

- Planning and risk assessment (syllabus area B)
- Internal control (syllabus area C)
- Audit evidence (syllabus area D)

This Skills Checkpoint will provide you with one suggested approach for tackling your AA exam.
Good luck!

Skills Checkpoint 1: How to approach your AA exam

AA Skill: How to approach your AA exam

We would suggest the following approach for tackling your AA exam. It is important that you adopt an approach that works best for you and practice it by completing several mock exams to time prior to your real exam.

Complete section A first - allocated time 54 minutes

- You will have 18 mins of exam time to allocate to each of the three OT case questions in Section A. Tackle any easier OT questions first. Do not leave any questions unanswered. Even if you are unsure, make a reasoned guess. Skills Checkpoint 5 covers how to approach OT questions in more detail.
- Each individual case tends to focus on a specific syllabus area. Start with the OT case question you feel most confident with.
- The majority of the questions will be discursive; some will be knowledge based whilst others will require application to the scenario.
- If you do not feel that you need the full 54 minutes to complete Section A, you can carry this time forward to your Section B questions which tend to be more time pressured. With practice, it may be possible for you to complete Section A approximately five minutes quicker than the allocated time of 54 minutes.

Finally, complete section B – allocated time 126 minutes

- Section B will contain one, 30-mark question and two, 20-mark questions which will be scenario based. Allocate 54 minutes to the 30-mark question and 36 minutes to each of the 20-mark questions (remembering to split your time between each of the sub requirements) but you may have a few minutes of extra time if you have completed Section A of the exam in less than the allotted time.
- Skills Checkpoints 2, 3 and 4 look specifically at the techniques you should use for audit risk, internal control and audit evidence questions. Whilst these areas may not comprise an entire question, they will usually be worth a good proportion of marks and so you should make sure you are confident using the techniques covered in these skills checkpoints

Set some time aside to practice this approach through the completion of at least two mock exams to time.

5

Professional ethics and quality management procedures

Learning objectives

On completion of this chapter, you should be able to:

Syllabus learning outcomes	Syllabus reference no.
Define and apply the fundamental principles of professional ethics of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.	A4 (a)
Define and apply the conceptual framework, including the threats to the fundamental principles of self-interest, self-review, advocacy, familiarity and intimidation.	A4 (b)
Discuss the safeguards to offset the threats to the fundamental principles.	A4 (c)
Describe the auditor's responsibility with regard to auditor independence, conflicts of interest and confidentiality.	A4 (d)
Discuss the requirements of professional ethics and ISAs in relation to the acceptance/ continuance of audit engagements.	B1 (a)
Explain the preconditions for an audit.	B1 (b)
Explain the process by which an auditor obtains an audit engagement.	B1 (c)
Discuss the importance and purpose of engagement letters and their contents.	B1 (d)
Explain the overall objectives and importance of quality management procedures in conducting an audit.	B1 (e)
Explain the quality management procedures that should be in place over engagement resources, engagement performance, monitoring and remediation and compliance with ethical requirements.	B1 (f)
Evaluate quality management deficiencies and provide recommendations to allow compliance with quality management requirements.	B1 (g)

Business and Exam context

This chapter focuses on the ethical and professional behaviour that is expected of you as an assurance provider. It is an important syllabus area which you need to be comfortable with, as ethical matters could arise in every type of exam question. You must be able to apply the ACCA's guidance on ethical matters to any given situation, but remember that common sense is usually a good guide. This guidance comes from the ACCA's *Code of Ethics and Conduct*, which incorporates the IESBA *International Code of Ethics for Professional Accountants*.

We need ethics in our role as auditors because stakeholders place reliance on the work that we do and we are in a position of trust, so we want to make sure that we are, amongst other things, honest and objective; and that we don't do anything which could abuse this trust.

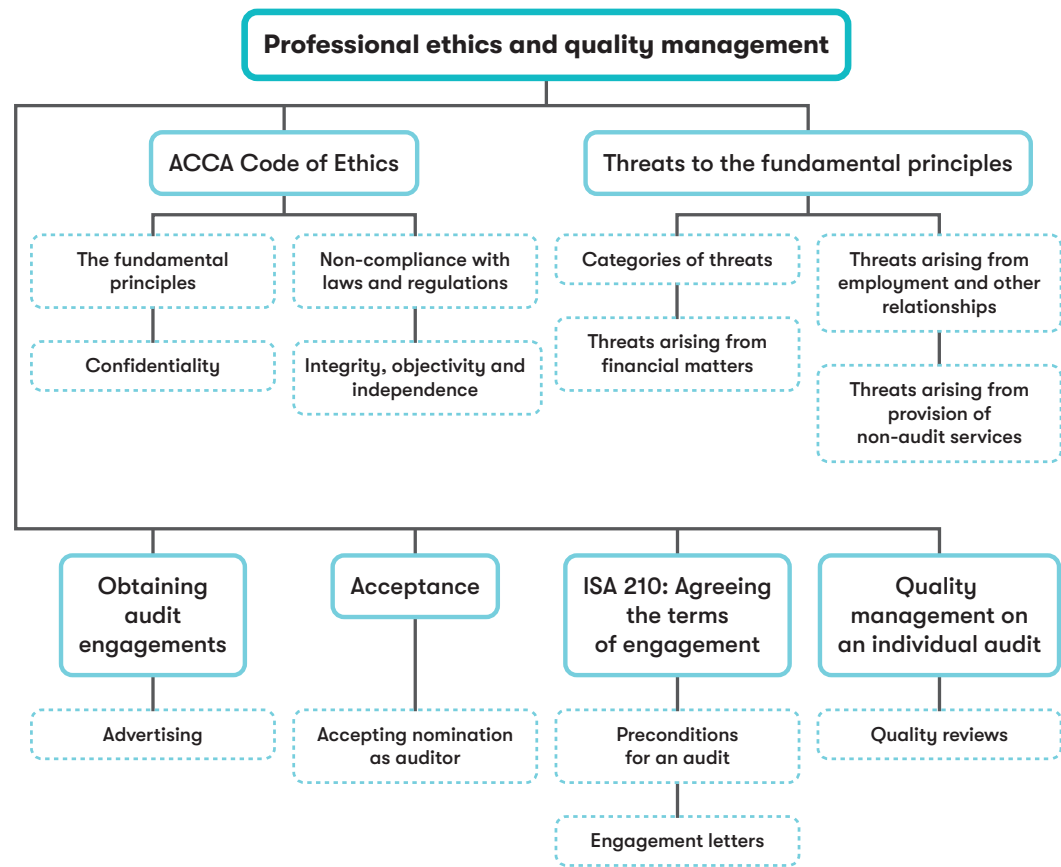
It is also necessary that we are independent of the company that we are auditing, as we seek to give confidence to users of the financial statements that we review. The key with independence is that not only is it necessary to be independent of mind, but also independent in appearance – that is, we are perceived to be truly independent by the people around us.

We need to fully understand the specific threats or actions in relation to the ethical principles that are expected of us, and any safeguards that we can put in place to prevent these threats from becoming serious issues. We will consider the various situations that may impair our ability to remain objective or independent, as well as look at the appropriate course of action to respond to those situations.

This chapter also considers confidentiality, one of the ethical principles, in more detail. We have access to a company's sensitive information, and are required to keep that information confidential. Generally speaking, we should always maintain confidentiality. However, sometimes, we are put in a position where we may have to disclose information, for example for legal reasons, so we will also consider situations where disclosure is allowed.

The final part of this chapter covers the business and ethical considerations about how auditors obtain work and the factors they need to think about before accepting an audit engagement. These factors include issues such as their assessment of management's integrity, and whether they have enough time and staff to take on the audit work.

Chapter overview



1 ACCA Code of Ethics and Conduct

The ACCA Code of Ethics and Conduct (the Code) is found in the ACCA Rulebook. The ACCA have adopted the Code of Ethics for Professional Accountants, which is issued by the International Ethics Standards Board for Accountants (IESBA).

The Code applies to all members, affiliates and students of the ACCA. These individuals are referred to in the Code as 'professional accountants'. (ACCA Code: para.7)



PER alert

One of the PER performance objectives is to demonstrate the application of professional ethics, values and judgements (objective 1). Applying the knowledge you gain from this chapter will help you to achieve that objective.

1.1 The fundamental principles

The Code sets out five fundamental principles that professional accountants should comply with:



These are explained below:

Fundamental principle	Definition
Integrity	To be straightforward and honest in all professional and business relationships. (ACCA Code: s.110.1 A1(a))
Objectivity	Not to compromise professional or business judgements because of bias, conflict of interest or undue influence of others. (ACCA Code: s.110.1 A1(b))
Professional competence and due care	To attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organisation receives competent professional service, based on current technical and professional standards and relevant legislation. To act diligently and in accordance with applicable technical and professional standards. (ACCA Code: s.110.1 A1(c))
Confidentiality	To respect the confidentiality of information acquired as a result of professional and business relationships.

Fundamental principle	Definition
	(ACCA Code: s.110.1 A1(d))
Professional behaviour	To comply with relevant laws and regulations and avoid any conduct that the professional accountant knows, or should know, might discredit the profession. (ACCA Code: s.110.1 A1(e))

1.2 Confidentiality

Members acquiring information in the course of their professional work **should not disclose** any such information to third parties **without first obtaining permission** from their clients.

Likewise, students and affiliates must treat any information given by members in the strictest confidence.

There are, however, certain circumstances where members **may disclose information to third parties without first obtaining permission** (ACCA Code: s.114.1 A1).

Obligatory disclosure (disclosure required by law)

- Production of documents or other evidence in the course of **legal proceedings**
- Disclosure to public authorities of **infringements of law** (eg terrorism, money laundering)

Voluntary disclosure (professional duty/right to disclose)

- To comply with the quality review of ACCA or another professional body
- To respond to an inquiry/ investigation by ACCA/other professional or regulatory body
- To **protect the interests of a professional accountant** in legal proceedings
- To comply with technical/ professional standards
- Where disclosure is in the **public interest**

1.3 Non-compliance with laws and regulations ('NOCLAR')

ISA 250 (Revised) *Consideration of Laws and Regulations in an Audit of Financial Statements* provides guidance for auditors in the area of suspected or identified instances of non-compliance with laws and regulations.



Non-compliance with laws and regulations (NOCLAR): acts of omission or commission, intentional or unintentional, committed by the entity, or by those charged with governance, by management or by other individuals working for or under the direction of the entity, which are contrary to the prevailing laws or regulations. Non-compliance does not include personal misconduct unrelated to the business activities of the entity. (ISA 250 (Revised): para. 12)

The **objectives** of the auditor when responding to NOCLAR are:

- To comply with the fundamental principles of integrity and professional behaviour;
- By alerting management or, where appropriate, those charged with governance of the client, to seek to:
 - Enable them to rectify, remediate or mitigate the consequences of the identified or suspected non-compliance; or
 - Deter the commission of the non-compliance where it has not yet occurred; and
- To take such further action as appropriate in the public interest. (ACCA Code: s.260.4)

Examples of laws and regulations covered by the Code include the following:

- Fraud, corruption and bribery

- (b) Money laundering, terrorist financing and proceeds of crime
- (c) Securities markets and trading
- (d) Banking and other financial products and services
- (e) Data protection
- (f) Tax and pension liabilities and payments
- (g) Environmental protection
- (h) Public health and safety

(ACCA Code: s.260.5 A2)

Procedures suggested for the auditor when considering NOCLAR are to:

- (a) Obtain an understanding of the NOCLAR matter.
- (b) Discuss with an appropriate level of management (at least one above those parties involved or potentially involved).
- (c) Advise the client to rectify the consequences, deter any future instances or disclose to whoever is considered in a position to need to know.
- (d) Consider the client's response and whether it indicates any concerns over their integrity.
- (e) Consider whether disclosure to an appropriate authority should be made (if applicable laws and regulations allow) or if withdrawal from the engagement may be necessary.
- (f) Document all decisions, discussions and judgements.

(ACCA Code: s.260.12-260.27)

1.4 Integrity, objectivity and independence

Professional accountants who provide assurance services are required to be **independent** of the assurance client.

Independence has two aspects to it:

- (a) Independence of mind; and
- (b) Independence in appearance.

Much of the guidance in relation to ethical guidance applies to all company audits. However, there are sometimes **additional requirements** relating purely to **public interest entities**.

Public interest entities are defined as:

- (a) All listed entities
- (b) Entities that are of significant public interest because of their business, size or number of employees or because they have a wide range of stakeholders.

Examples include banks, insurance companies and pension firms.

2 Threats to the fundamental principles

2.1 Categories of threats

There are many circumstances, relationships and situations that could threaten the professional accountant's ability to satisfy the fundamental principles.

These threats fall into one or more of the following five categories:



These are explained below:

Threat	Description
Self-interest threat	The risk that a financial or other interest in a client will inappropriately influence the professional accountant's judgement or behaviour. For example, owning shares in an audit client or receiving gifts from an audit client.
Self-review threat	This arises where a professional accountant from the audit firm performs work for the client and this work must later be reviewed by the same person, or another professional accountant from the same firm, in order to arrive at a judgement on the subject matter.
Advocacy threat	The risk that a professional accountant promotes a client's position to the point that the professional accountant's objectivity is compromised. For example, acting as an advocate on behalf of an assurance client in litigation or disputes, or promoting shares in a listed audit client.
Familiarity threat	The risk that due to a long or close relationship with a client, the professional accountant could be too sympathetic to their interests or too accepting of their work. For example, if a firm has audited the same client for several years they may not question the information presented by the client as closely as in the initial years.
Intimidation threat	The risk that the professional accountant is deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the professional accountant. For example, being pressured to reduce inappropriately the extent of work performed in order to reduce the fees charged.

Where the above threats exist, appropriate **safeguards** must be put in place to eliminate or reduce them to an acceptable level.



Activity 1: Explaining ethical threats

You are an audit manager of Check and Co. The following situations have arisen with different audit clients of your firm.

- (1) In an initial meeting with the finance director of Weadon Co, an audit client, you learn that the entire audit team will be invited to the company's annual summer social event, a weekend at an exclusive spa hotel.
- (2) Mr Walker has been the engagement partner for a client, Stewards Co, for nine years. He has excellent knowledge of the client and knows all of the directors of Stewards Co very well. Stewards Co is considered to be a public interest entity.

Required

Explain the ethical threats which may affect the independence of Check and Co in respect of each of the client audits. For each threat, explain how it may be reduced.

Threat	Safeguards

Solution



Activity 2: Threats and safeguards

The following scenario relates to questions 1–3.

You are an audit manager of Check and Co, which has annual revenue in the region of \$2,400,000. You have recently been assigned the audit of Emerald Co (Emerald), a public interest entity.

Mrs Sayer, a partner in Check and Co, is the Audit Engagement Partner for Emerald. Her daughter, Holly, joined Emerald six months ago and is working as an assistant to the receivables ledger clerk whilst she studies for her first set of accountancy exams.

Mrs Sayer has informed you that Emerald is one of your firm's most important clients as it generates fees of approximately \$480,000 for Check and Co. Unfortunately, Emerald has fallen behind on its payments to Check and Co and overdue fees have built up, including the invoices issued during the last six months.

In an initial meeting with the Finance Director of Emerald, you learn that due to time pressure and staff shortages in the accounts department, the finance director has requested assistance from your firm with year-end procedures, including the preparation of the annual financial statements for the company.

- 1 From a review of the information above, your audit assistant has highlighted some of the potential risks to independence in respect of the audit of Emerald.

- (1) Audit engagement partner's daughter works for Emerald.
- (2) Audit fee is significant to Check and Co.
- (3) Overdue fees exist.
- (4) Firm has been asked to help provide accountancy services.

Required

For each of the above risks, place a tick in the box which correctly identifies the appropriate threat to independence. You may tick more than one box for each threat.

	Intimidation	Self-interest	Self-review
Risk (1)	☐	☐	☐
Risk (2)	☐	☐	☐
Risk (3)	☐	☐	☐
Risk (4)	☐	☐	☐

- 2 In relation to the audit fee being significant to Check and Co:

Required

Which of the following safeguards should be implemented in order to comply with ACCA's Code of Ethics and Conduct?

- ☐ Use one team to conduct the year-end audit and a separate team to perform any non-audit work.
- ☐ Appoint a second partner from Check and Co to perform an independent partner review on the audit of Emerald that should focus on areas of judgement and estimates.
- ☐ Discuss the situation with Emerald's audit committee and consider resigning from some services.
- ☐ Rotate the audit engagement partner every seven years.

- 3 In relation to Check and Co providing accountancy services to Emerald:

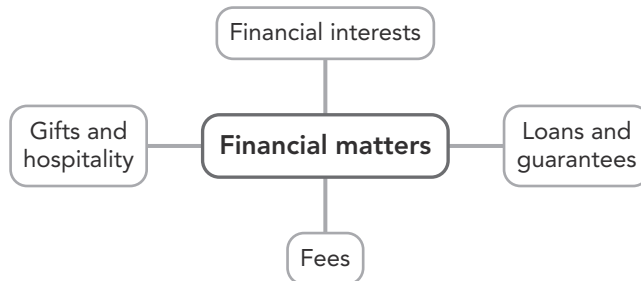
Required

Which of the following safeguards should be implemented in order to comply with ACCA's Code of Ethics and Conduct?

- ☐ The directors of Emerald must provide all source data and approve all journal entries.
- ☐ Use one team to conduct the year-end audit and a separate team to provide accountancy services.

- Appoint a second partner from Check and Co to perform an independent partner review on the audit of Emerald, which should focus on areas of judgement and estimates.
- Check and Co should decline the offer to prepare the financial statements.

2.2 Threats arising from financial matters



2.2.1 Financial interests

Threats	Safeguards
Financial interests might create a self-interest threat . (ACCA Code: s.510.2)	
Examples include ownership of shares in a client by: • The firm • An audit team member • An immediate family member of the audit team member A self-interest threat arises as the firm, audit team member (or their immediate family) would benefit personally if the client's financial statements exceed market expectations.	• Disposal of shares (only option if firm holds shares) • Remove individual from audit team • Inform audit committee • Review by an appropriate reviewer (eg an independent partner)

2.2.2 Loans and guarantees

Threats	Safeguards
Loans and guarantees might create a self-interest threat . (ACCA Code: s.511.2)	
Loans/guarantees with an audit client that is a bank (ACCA Code: s.R511.5): • Loans or guarantees to the firm - No threat if immaterial to audit client or firm and on normal terms - If material to audit client or firm, apply safeguards • Loans to an audit team member or their immediate family - Not a threat to independence if on normal commercial terms	Review of work performed by professional accountant from outside the firm

Threats	Safeguards
Loans/guarantees with an audit client that is not a bank (ACCA Code: s.R511.4): Loans or guarantees to/from the firm, audit team member or their immediate family	No safeguard can reduce the threat unless the loan is immaterial to client and firm/team member.

2.2.3 Fees

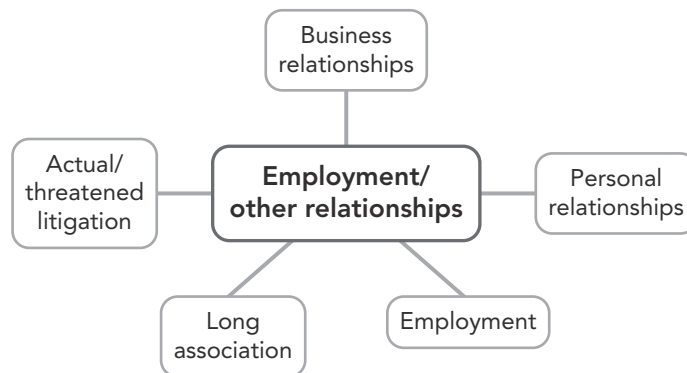
Threats	Safeguards
Fees might create a self-interest or intimidation threat . (ACCA Code: s.410.2)	
(i) <i>Relative size</i> When the total fees generated from an audit client represent a large proportion of the total fees of that firm, the dependence on that client and concern about losing the client create a self-interest or intimidation threat. (ACCA Code: s.410.3 A1)	- Increase audit firm's client base to reduce dependence on the client - Discuss with audit committee - Resign from some services - External quality review - Consult ACCA or another professional accountant on any key audit areas requiring judgement
If the audit client is a public interest entity, then there are additional ethical requirements. If the total fees from the client represent more than 15% of the total fees received by the firm for two consecutive years, then there is likely to be undue dependence on the client and the firm should put safeguards in place. (ACCA Code: s.R410.4)	- Disclose to those charged with governance - Pre-issuance review on second year's financial statements prior to the auditor's opinion being issued - Post-issuance review on second year's financial statements after the auditor's opinion has been issued
(ii) <i>Overdue fees</i> When a significant part of fees is not paid before the audit report for the following year is issued, this might create a self-interest threat. (ACCA Code: s. 410.7 A1) The firm may issue a favourable opinion rather than possibly lose the amounts owed.	- Obtain partial payment of overdue fees - Discuss with audit committee - Consider resignation if overdue fees not paid
(iii) <i>Contingent fees</i> These are fees calculated on a predetermined basis relating to the outcome of a transaction or the result of the services performed. (ACCA Code: s.410.9 A1) This creates a self-interest threat.	No safeguards acceptable – contingent fees are not allowed for audit services, however contingent fees may be permitted for non-assurance work provided that adequate safeguards are implemented

2.2.4 Gifts and hospitality

Threat	Safeguards
Accepting gifts and hospitality from an audit client might create a self-interest, familiarity or intimidation threat . (ACCA Code: s.420.2)	
Acceptance of gifts from a client may create a self-interest threat because the firm/individual may feel obliged to give a favourable opinion.	Gifts and hospitality should not be accepted unless the value is trivial and inconsequential.

Threat	Safeguards
Acceptance of gifts may also be perceived as a bribe. Hospitality from clients may give rise to a familiarity threat.	

2.3 Threats arising from employment and other relationships



2.3.1 Business relationships

Threats	Safeguards
A close business relationship with an audit client or its management might create a self-interest or intimidation threat . (ACCA Code: s.520.2)	
Examples include: • Holding an interest in a joint venture with a client • Arrangements to combine one or more services or products of the firm with one or more services or products of the client and to market the package with reference to both parties • Distribution of a client's products/services	• Disposal of firm's interests unless clearly insignificant • Removal of any individual audit team member who has an interest from the audit team

2.3.2 Personal relationships

Threats	Safeguards
Family or personal relationships with client personnel might create a self-interest, familiarity or intimidation threat . (ACCA Code: s.521.2)	
(i) <i>Immediate family of an audit team member</i> Immediate family is defined as a spouse (or equivalent) or dependent. A self-interest, familiarity or intimidation threat is created when an immediate family member of an audit team member is an employee in a position to exert significant influence over the client's financial position, financial performance or cash flows. (ACCA Code: s.521.4 A1)	• Restructure the audit team's responsibilities so that the audit team member does not deal with matters that are within the responsibility of the immediate family member. • Note that this is required where any member of the individual's immediate family: - Is a director/officer of the audit client -

Threats	Safeguards
The level of the threat depends on: • The position held by the immediate family member • The role of the audit team member	- Is an employee in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion; or - Was in such a position during any period covered by the engagement or the financial statements (ACCA Code: s.R521.5)
(ii) Close family Close family is defined as a parent, child or sibling who is not an immediate family member. A self-interest, familiarity or intimidation threat is created when a close family member of an audit team member is: • A director/officer of the audit client • An employee in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion (ACCA Code: s.521.6 A1) Note 'other close relationships of an audit team member' are addressed in the same way as close family relationships.	• Restructure the audit team's responsibilities so that the audit team member does not deal with matters that are within the responsibility of the close family member. • Remove the individual from the audit team
(iii) Relationships of partners and employees of the firm Partners and employees of the firm shall consult in accordance with firm policies and procedures if they are aware of a personal or family relationship between: • A partner or employee of the firm who is not an audit team member and • A director/officer of the audit client and an employee of the audit client in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion	• Structure the partner's/employee's responsibilities to reduce potential influence over the audit engagement • Review of audit work by an appropriate reviewer

2.3.3 Employment

Threats	Safeguards
Where a partner or employee of the firm leaves to join an audit client, this might create a self-interest, familiarity or intimidation threat. (ACCA Code: s.524.2)	• Consider modification of audit plan • Change members of audit team • Review by an appropriate reviewer • Quality review •

Threats	Safeguards
	- For public interest entities, if an individual who was a key audit partner joins an audit client as a director/officer or an employee able to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion, independence is compromised unless, subsequent to the individual ceasing to be a key audit partner: - The audit client has issued audited financial statements covering a period of not less than 12 months; and - The individual was not an audit team member with respect to the audit of those financial statements (ACCA Code: s.R524.6)
Where a director/officer or employee of the audit client leaves the audit client to join the firm, a self-interest, self-review or familiarity threat might be created. (ACCA Code: s.522.2)	Individual should not be assigned to the audit team if the work they performed whilst employed by the client is to be evaluated in the current period as part of the current audit engagement.

2.3.4 Long association

Threats	Safeguards	
When an individual is involved on an audit engagement over a long period of time, familiarity and self-interest threats might be created. (ACCA Code: s.540.2)	- Independent partner review - Independent quality review - Rotate senior staff	
For public interest entities , the Code sets out a compulsory cooling-off period (ACCA Code: s.R540.11-13). These are as follows:	Rotate after	Cooling-off period
Engagement partner	Seven years	Five years
Individual responsible for the engagement quality review	Seven years	Three years
Key audit partner	Seven years	Two years

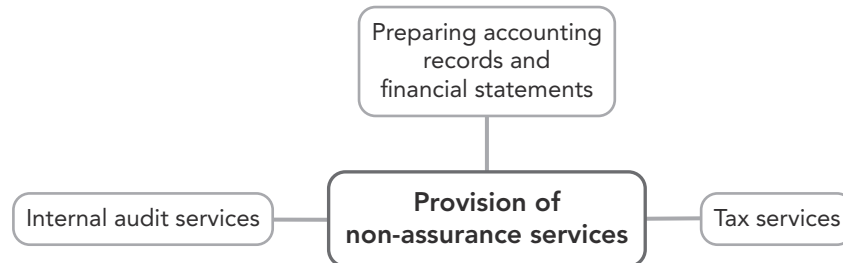
A key audit partner is an audit partner on the engagement team who is responsible for key decision or judgements on significant matter with respect to the audit of the financial statements on which the firm will express an opinion other than as the engagement partner or the individual responsible for the engagement quality review.

2.3.5 Actual and threatened litigation

Threat	Safeguards
When litigation with an audit client occurs, or appears likely, self-interest and intimidation	Disclose to the audit committee

Threat	Safeguards
threats are created. (ACCA Code: s.430.2)	- Removal of individual involved in litigation from the assurance team - Refuse to perform the assurance engagement

2.4 Threats arising from provision of non-assurance services



2.4.1 Preparing accounting records and financial statements

Threats	Safeguards
Providing accounting and bookkeeping services to an audit client might create a self-review threat. (ACCA Code: s.601.12) This is because it is unlikely that the firm will criticise its own work and decisions.	If the client is not a public interest entity: - Accounting services should not be performed by audit team staff - Client must provide all source data - Client must approve all journal entries - Discuss non-audit services with audit committee If the client is a public interest entity: - The provision of accounting or bookkeeping services is not permitted

2.4.2 Tax services

Threats	Safeguards
Providing tax services to an audit client might create self-review or advocacy threats. (ACCA Code: s.604.1) The Code divides taxation services into four categories:	
Tax return preparation (ACCA Code: s.604.4 A1)	Does not usually create a threat. - Tax returns are usually based on historical information and principally involve analysis and presentation of such historical information under existing tax law, including precedents and established practice. - Management must take responsibility for the tax returns.
Tax calculations for the purpose of preparing accounting entries (ACCA Code: s. 604.6, A1) Preparing such calculations that will be subsequently audited by the firm creates a self-review threat.	- Calculations must not be performed by a member of the audit team. - Independent review of audit work should be conducted by a reviewer who was not involved in providing the service. For public interest entities:

Threats	Safeguards
	Tax calculations may not be performed.
Tax planning and other tax advisory services (ACCA Code: s.604.7 A1) May create a self-review or advocacy threat	- Services must not be performed by a member of the audit team. - Independent review of audit work to be conducted by a reviewer who was not involved in providing the service. - Obtain pre-clearance from the tax authorities. Such services may not be provided where the effectiveness of the tax advice depends on a particular accounting treatment or presentation in the financial statements and the audit team has reasonable doubt as to the appropriateness of the related accounting treatment or presentation and the outcome/consequence of the tax advice will have a material effect on the financial statements being audited.
Assistance in the resolution of tax disputes (ACCA Code: s.604.10 A1) May create a self-review or advocacy threat	- Assistance services must not be provided by a member of the audit team. - Independent review of audit work to be conducted by a reviewer who was not involved in providing the assistance. Such services may not be provided if they involve the firm acting as an advocate for the audit client before a public tribunal or court in the resolution of a tax matter and the amounts involved are material to the financial statements being audited.

2.4.3 Internal audit services

Threat	Safeguards
Providing internal audit services to an audit client might create a self-review threat if the audit team plan to rely on the work of the internal audit department. (ACCA Code: s.605.1, 605.4 A3)	- Stipulate that it is the client's responsibility to establish, maintain and monitor a system of internal controls and that client management remain responsible for evaluating and acting on internal control findings and for reporting significant findings to those charged with governance. - Independent partner review to ensure appropriate reliance is placed on internal audit and that its work is rigorously audited. For public interest entities: Internal audit services must not be provided if they relate to: - A significant part of the internal controls over financial reporting:

Threat	Safeguards
	- Financial accounting systems that generate information that is, individually or in the aggregate, material to the client's accounting records or financial statements on which the firm will express an opinion; or - Amounts or disclosures that are, individually or in the aggregate, material to the financial statements on which the firm will express an opinion.
A threat to objectivity from assuming management responsibility may arise if the firm makes decisions on behalf of the client when providing internal audit services. (ACCA Code: s.R600.7)	Client is reminded that it must evaluate and determine which recommendations of the firm should be implemented.

2.4.4 Recruiting services

Providing recruiting services to an audit client might create a **self-interest, familiarity or intimidation threat**. (ACCA Code: s.609.1)

Audit firms must not make management decisions for the client and so their role in recruiting services should be limited to:

- Reviewing the professional qualifications of a number of applicants and providing advice on their suitability for the position
- Interviewing candidates and advising on a candidate's competence for financial accounting, administrative or control positions.

Audit firms should **not** provide a recruiting service to an audit client if the service relates to:

- Searching for, or seeking out, candidates; or
- Undertaking reference checks of prospective candidates.

With respect to the following positions:

- Director/officer of the entity; or
- A member of senior management in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion. (ACCA Code: s.R609.7)

2.5 Conflicts of interest

A professional accountant must take reasonable steps to identify circumstances that could pose a conflict of interest.

A conflict of interest creates threats to compliance with the principle of **objectivity** and might create threats to compliance with the other fundamental principles. Such threats might be created when:

- A professional accountant provides a professional service related to a particular matter for **two or more clients whose interests with respect to that matter are in conflict**; or
- The **interests of a professional accountant** with respect to a particular matter and the **interests of the client** for whom the accountant provides a professional service related to that matter **are in conflict**. (ACCA Code: s.310.2)

Before accepting a new client, or where there is a change in a client's circumstances, audit firms must take reasonable steps to ascertain whether there is a conflict of interest or if there is likely to be one in the future. (ACCA Code: s.R310.5, R310.6)

2.5.1 Conflicts between a professional accountants' and clients' interests

A professional accountant in public practice **shall not accept or continue an engagement** in which there is, or is likely to be, a significant conflict of interest between the professional accountant and the client. (ACCA Code: s.310.14)

This might arise if the professional accountant competes directly with a client or has a joint venture or similar with a company that is in competition with the client and may threaten the professional accountant's objectivity.

Any form of financial gain which accrues, or is likely to accrue, to a professional accountant in public practice as a result of an engagement, or as a result of using information known to them about a client, will always amount to a significant conflict of interest between the professional accountant and the client, unless the financial gain is disclosed to the client in writing or advance agreement is obtained from the client. (ACCA Code: s.310.16, 310.17)

2.5.2 Conflicts between the interests of different clients

This situation arises when different clients are in **direct competition** with each other and where the auditor has access to information that is particularly sensitive.

An audit firm may have two or more clients whose interests may be in conflict, provided that the work the audit firm undertakes is not, itself, likely to be the subject of dispute between those clients. (ACCA Code: s. 310.23)

Where the acceptance or continuance of an engagement would, even with safeguards, materially prejudice the interests of any client, the appointment shall not be accepted or continued. (ACCA Code: s. 310.25)

Such prejudice might arise due to:

- The leakage of information from one client to another
- The audit firm being forced into a position where it has to choose between the interests of different clients (ACCA Code: s. 310.26)

2.5.3 Safeguards

Safeguards that may reduce threats to the fundamental principles due to conflicts of interest include:

- **Notify** all known relevant parties and **obtain their consent**
- Use of **separate engagement letters**
- Procedures to **prevent access to information** (eg separate teams, confidential and secure data access and filing and password protection)
- Clear **guidelines** for members of each engagement team on the issues of security and confidentiality
- Use of **confidentiality agreements** signed by employees and partners of the firm
- **Regular review** of the application of safeguards by an independent partner/other senior individual
- Advise one or more **clients to seek additional independent advice**

3 Obtaining audit engagements

3.1 Advertising

Subject to the rules that follow, members may seek publicity for their services and achievements and may advertise their services and products in any way they think fit.

Members may inform the public of the services they are capable of providing by means of advertising or other forms of promotion, subject to the general requirement that the medium should not reflect adversely on the member, ACCA or the accountancy profession.

Advertisements and promotional material prepared or produced by members or firms should not (either in content or presentation):

- (a) Bring ACCA into disrepute or bring discredit to the member, firm or the accountancy profession
- (b) Discredit the services offered by others, whether by claiming superiority for the member's or firm's own services, or otherwise
- (c) Be misleading, either directly or by implication
- (d) Fall short of the requirements of the UK Advertising Standards Authority's Code of Advertising and Sales Promotion, notably as to legality, decency, clarity, honesty, and truthfulness

An advertisement should be clearly distinguishable as such.

Care should be taken to ensure that any reference to fees does not mislead the reader as to the precise range of services and time commitment that the reference is intended to cover.

Any promotional activities should not amount to harassment of prospective clients.

Commissions, fees or rewards in return for the introduction of a client are permitted, provided appropriate safeguards are put in place, such as disclosure to the client.

4 Acceptance

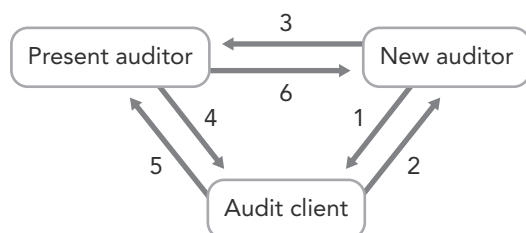
New auditors should ensure that they have been appointed in a proper and legal manner.

4.1 Accepting nomination as auditor

Before accepting nomination as auditor, the auditor must:

Acceptance procedures	
Ensure professionally qualified to act	Consider whether disqualified on legal or ethical grounds
Ensure existing resources adequate	Consider available time, staff and technical expertise
Obtain references	Make independent enquiries if directors not personally known
Communicate with present auditors	Enquire whether there are reasons/ circumstances behind the change which the new auditors ought to know, also courtesy

The new auditors should communicate with the present auditors to determine whether there are any professional reasons as to why they should not accept appointment as auditors.



If at any point in the above process, the audit client refuses permission to correspond, then the new auditor should not accept appointment as auditor.

After accepting nomination, the new (incoming) auditor should:

- (a) Ensure outgoing auditor's removal/resignation properly conducted in accordance with national regulations
- (b) Ensure new appointment properly conducted – obtain a copy of the resolution passed
- (c) Agree the terms of the engagement

4.2 Client screening

As well as contacting the previous auditors, many firms, particularly larger ones, carry out **stringent checks** on potential client companies and their management. Factors to be considered are detailed below.

4.2.1 Management integrity

The integrity of those managing a company will be of great importance, particularly if the company is controlled by one or a few dominant personalities

4.2.2 Risk

Potential audit clients will be classified as high or low risk, depending on the characteristics of the company:

Low risk	High risk
Good long-term prospects	Poor recent or forecast performance
Well-financed	Likely lack of finance
Strong internal controls	Significant control deficiencies
Conservative, prudent accounting policies	Evidence of questionable integrity, doubtful accounting policies
Competent, honest management	Lack of finance director
Few usual transactions	Significant related party or unexplained transactions

Where the risk level of a company's audit is determined as anything other than low, the specific risks should be identified and documented. It might be necessary to assign specialists in response to these risks, particularly industry specialists, as independent reviewers.

4.2.3 Engagement economics

The expected fees from a new client should reflect the **level of risk** expected. They should also offer the same sort of return expected of clients of this nature and reflect the overall financial strategy of the audit firm. Occasionally, an audit firm will want to accept a new client to gain entry into the client's particular industry, or to establish better contacts within that industry. These factors will contribute to a total expected economic return.

4.2.4 Relationship with client

The audit firm will generally want the relationship with a client to be **long term**. This is not only to enjoy receiving fees year after year, but also to allow the audit work to be enhanced by better knowledge of the client, thereby offering a better service.

4.2.5 Ability to perform work

The audit firm must have the **resources** to perform the work properly, as well as any **specialist knowledge** or **skills**. The impact on existing engagements must be estimated, in terms of staff time and the timing of the audit.

5 ISA 210: Agreeing the terms of audit engagements

The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is performed has been agreed, through:

- Establishing certain preconditions for an audit are present; and
- Confirming that there is a common understanding between the auditor and management of the terms of the engagement. (ISA 210: para. 3)

5.1 Preconditions for an audit

The **preconditions** for an audit are as follows:

- (a) The use by management of an acceptable financial reporting framework in the preparation of financial statements
- (b) Obtain management's agreement (written representation) that it acknowledges and understands its responsibilities for:
 - (i) Preparing the financial statements
 - (ii) Establishing internal control to ensure the financial statements are free of material misstatement
 - (iii) Providing the auditor with access to all records and documents and staff (ISA 210: para. 6)

If the preconditions are **not present**, the auditor **shall not accept** the proposed engagement. (ISA 210: para. 8)

5.2 Engagement letters



Engagement letters: are the written terms of an engagement in the form of a letter.

5.2.1 Purpose and content of engagement letters

The auditor shall agree the terms of the engagement with management or those charged with governance as appropriate. (ISA 210: para. 9)

This should be done **before** the audit engagement to avoid misunderstandings regarding the audit. (ISA 210: para. A23)

The agreed terms of the audit engagement shall be recorded in an **audit engagement letter** or other suitable form of written agreement and **must** include the following:

- The **objective and scope** of the audit
- The **auditor's responsibilities**
- **Management's responsibilities**
- Identification of the **applicable financial reporting framework** for the preparation of the financial statements
- Reference to the **expected form and content of any reports** to be issued by the auditor
- A statement that there may be circumstances in which a report may differ from its expected form and content (ISA 210: para. 10)

The audit engagement letter **may** also make reference to the following (ISA 210: para. A24):

- Elaboration of the scope of the audit, including reference to legislation, regulations, ISAs, ethical and other pronouncements of professional bodies to which the auditor adheres
- The form of any other communication of results of the audit engagement
- The requirement for the auditor to communicate key audit matters in the auditor's report in accordance with ISA 701
- The fact that due to the inherent limitations of an audit and those of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with ISAs
- Arrangements regarding planning and performance, including the composition of the engagement team
- The expectation that management will provide written representations
- The expectation that management will provide access to all information of which management is aware that is relevant to the preparation of the financial statements, including an expectation that management will provide access to information relevant to disclosures
- Agreement of management to provide draft financial statements and other information in time to allow auditor to complete the audit in accordance with proposed timetable

- Agreement of management to inform auditor of facts that may affect the financial statements, of which management may become aware from the date of the auditor's report to the date of issue of the financial statements
- Fees and billing arrangements
- Request for management to acknowledge receipt of the letter and agree to the terms outlined in it
- Involvement of other auditors and experts
- Involvement of internal auditors and other staff
- Arrangements to be made with predecessor auditor
- Any restriction of auditor's liability
- Reference to any further agreements between auditor and entity
- Any obligations to provide audit working papers to other parties

5.2.2 Reissuing engagement letters

On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. (ISA 210: para. 13)

Examples include:

- Any indication that the entity **misunderstands** the objectives and scope of the audit
- Any **revised or special terms** of the audit engagement
- A recent **change of senior management**
- A **significant change in ownership**
- A significant change in **nature or size** of the entity's business
- A change in **legal or regulatory requirements**
- A change in the **financial reporting framework**
- A change in **other reporting requirements** (ISA 210: para. A30)



Essential reading

See Chapter 5 of the Essential reading for an example of an engagement letter.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

5.3 Quality management at a firm level

The fact that auditors follow international auditing standards provides a general quality management framework within which audits should be conducted. In addition to this, they must follow the IAASB's suite of quality management standards, including ISQM 1 *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*.

Quality management at a firm level encompasses the following areas:

- The firm's risk assessment process
- Governance and leadership
- Relevant ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Engagement performance
- Resources
- Information and communication
- The monitoring and remediation process (ISQM 1: para. 6)

Exam focus point

ISQM 1 is not an examinable document for your *Audit and Assurance* exam, but it is a reliable source of information for you to draw upon in relation to the syllabus learning objectives in this area (quality management).

5.3.1 Engagement performance

The firm should take steps to ensure that engagements are performed correctly – that is, in accordance with standards and guidance (ISQM 1: para. 31).

Firms often produce a manual of standard engagement procedures to give to all staff so that they know the standards they are working towards.

Good engagement performance involves:

- Direction
- Supervision
- Review
- Consultation
- Resolution of disputes

Where there are differences of opinion on an engagement team, a report should not be issued until the dispute has been resolved. This may involve the intervention of a quality reviewer.



Peer review: A review of the audit file carried out by another partner in the assurance firm.

Hot review/ Pre-issuance review: A peer review carried out **before** the auditor's report is signed. This is also known as an engagement quality review (EQR).

Cold review/ Post-issuance review: A peer review carried out **after** the auditor's report is signed.

5.3.2 Monitoring

The monitoring of the firm's quality management system and procedures involves:

- **Ongoing evaluation:** Considering whether the firm has kept up to date with regulatory requirements
- **Periodic inspection:** Inspecting the audit engagements of each engagement partner over an inspection cycle

Those monitoring the system are required to evaluate the effect of any **deficiencies** found. Such deficiencies may be one-offs or systematic/repetitive deficiencies. This latter group will require **corrective action** such as:

- Remedial action with an individual
- Communication of findings with the training department
- Changes in the quality management policies and procedures
- Disciplinary action

6 Quality management of an individual audit

The quality management of individual audits is governed by ISA 220 (Revised) *Quality Management for an Audit of Financial Statements*.

Auditors must implement quality management procedures for each individual audit engagement so that they have reasonable assurance that:

- (a) The auditor has fulfilled the auditor's responsibilities, and has conducted the audit, in accordance with professional standards and applicable legal and regulatory requirements; and
- (b) The auditor's report issued is appropriate in the circumstances. (ISA 220: para. 11)

The **engagement partner** has overall responsibility for managing and achieving quality within an audit engagement. In order to achieve this, an engagement must manage quality in each of the following areas:

- Leadership responsibilities for managing and achieving quality on audits
- Relevant ethical requirements, including those related to independence
- Acceptance and continuance of client relationships and audit engagements
- Engagement resources
- Engagement performance
- Monitoring and remediation
- Taking overall responsibility for managing and achieving quality
- Documentation

6.1 Relevant ethical requirements

The engagement partner is responsible for ensuring ethical compliance. This includes identifying and addressing threats, evaluating any breaches and ensuring that engagement personnel take appropriate action (ISA 220: paras. 17-21).

6.2 Acceptance and continuance of client relationships and audit engagements

Again, the engagement partner is responsible for acceptance / continuance procedures in line with ISQM 1 (ISA 220: para. 22). If the engagement is ethically unacceptable then it is the **partner's responsibility to decline** it.

6.3 Engagement resources

The engagement partner must ensure that sufficient and appropriate resources are made available to the engagement team including human, technological, and intellectual resources.

6.4 Engagement performance

The engagement partner is responsible for the **direction** and **supervision** of the member of the engagement team and the **review** of their work (ISA 220: para. 29).

Direction, supervision and review is **shared** between more and less senior personnel, who should recognise the variations across different engagements. This process should also consider whether sufficient appropriate audit evidence has been obtained, and whether it supports both the conclusions reached and the various elements of the auditor's report that are to be communicated in advance.

The engagement partner is required to **stand back** and ensure their involvement in the engagement is sufficient to satisfy the requirement for taking overall responsibility.

The partner must ensure that direction, supervision and review is planned and performed in line with the firm's policies and with ISAs, and that it is responsive to the particular engagement in question (ISA 220: para. 30).

The partner is also responsible for making sure there is appropriate **consultation** on the audit - both within the audit team and outside it, where required (ISA 220: para. 35). If there are **differences of opinion**, then the partner is responsible for **resolving** them, using the firm's policies and procedures (ISA 220: paras. 37-38).

6.4.1 Direction

The partner is required by other auditing standards to hold a meeting with the audit team to discuss the audit, in particular the risks associated with the audit.

ISA 220 (para. A85) states that direction includes 'informing members of the engagement team of their responsibilities, such as:

- Contributing to engagement quality through their personal conduct, communication and actions
- Professional scepticism: maintaining a questioning mind
- Fulfilling relevant ethical requirements
- The responsibilities of respective engagement team members to perform audit procedures and of more experienced engagement team members to direct, supervise and review the work of less experienced engagement team members
- Understanding the objectives of the work to be performed
- Addressing threats to the achievement of quality, for example budget/resource constraints should not result in the failure to perform planned audit procedures

6.4.2 Supervision

The audit is supervised overall by the engagement partner, but more practical supervision is given within the audit team by senior staff to more junior staff, as is also the case with review. It includes:

- Tracking the progress of the audit engagement
- Considering the capabilities and competence of individual members of the team, and whether they have sufficient time and understanding to carry out their work
- Addressing significant issues arising during the audit engagement and modifying the planned approach appropriately
- Identifying matters for consultation or consideration by more experienced engagement team members during the audit engagement.

6.4.3 Review

Review includes consideration of whether:

- The work has been performed in accordance with professional standards and applicable legal and regulatory requirements
- Significant matters have been raised for further consideration
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented
- There is a need to revise the nature, timing and extent of work performed
- The work performed supports the conclusions reached and is appropriately documented
- The evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion
- The objectives of the audit procedures have been achieved

6.5

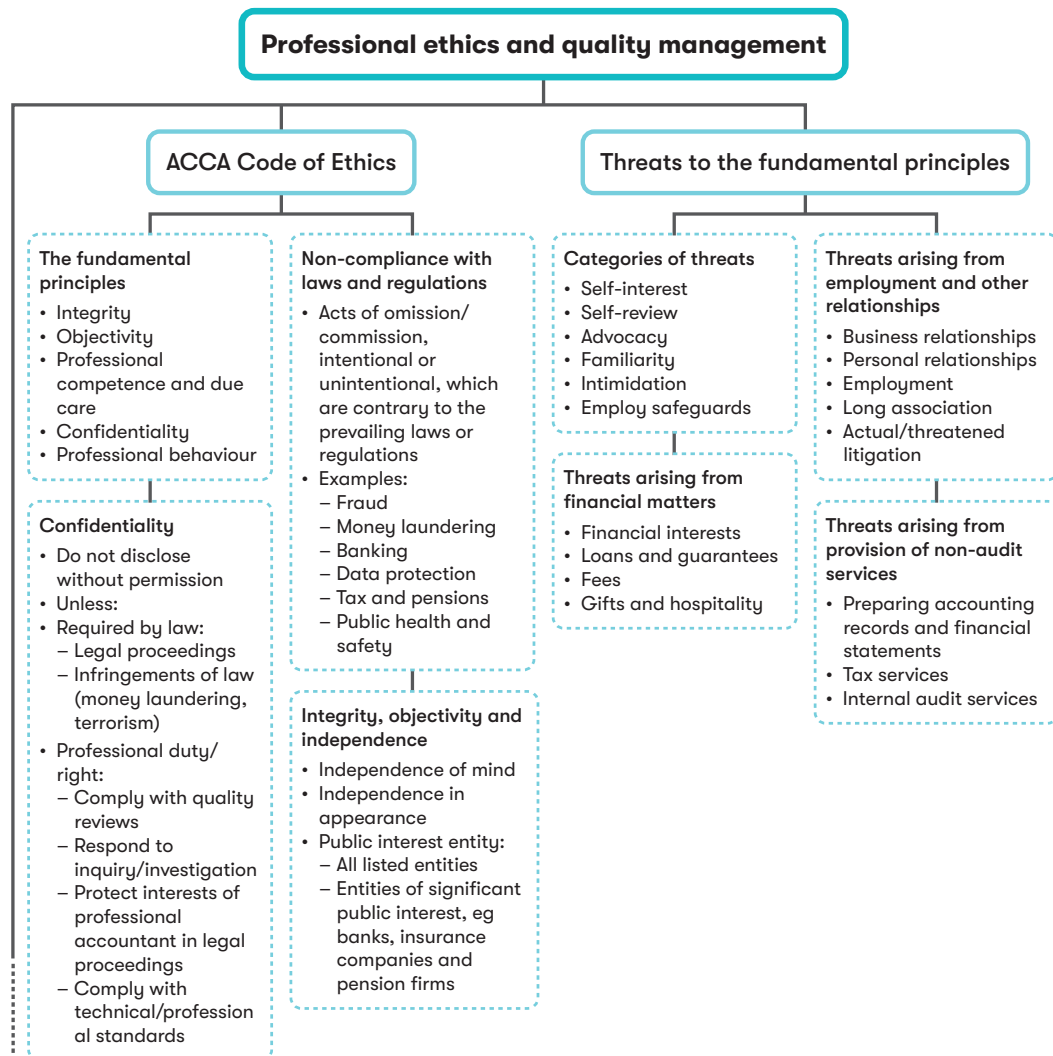
6.6 Engagement quality reviews

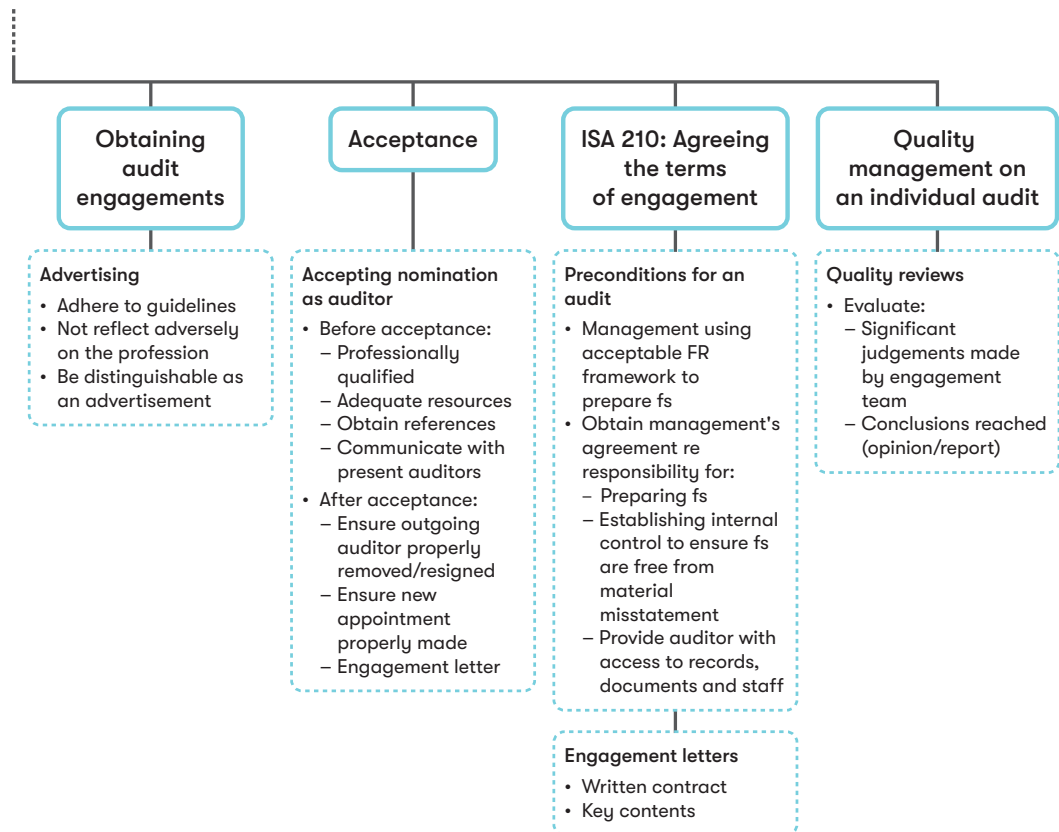
Engagement quality reviews are required for audits of listed entities and any other engagements where the audit firm has determined a quality review is required.

The engagement partner should:

- Appoint** an engagement quality reviewer (where needed)
- Cooperate** with the reviewer, and inform the team that they should cooperate with them too
- Discuss** significant matters and judgements with the reviewer
- Only **date the auditor's report after the review** (ISA 220: para. 36)

Chapter summary





Knowledge diagnostic

1. ACCA Code of Ethics and Conduct

The ACCA Code of Ethics and Conduct applies to members, affiliates and students of the ACCA and details the fundamental principles of **integrity, objectivity, professional competence and due care, confidentiality** and **professional behaviour**.

2. Confidentiality

The auditor must not disclose confidential information obtained in their professional work without prior consent, unless there is an obligation to do so by law or a professional duty/right to disclose.

3. Threats to the fundamental principles

There are many circumstances that can lead to threats to the fundamental principles. These circumstances will fall into one or more of the five categories of: **self-interest, self-review, advocacy, familiarity and intimidation**.

4. Safeguards

Where threats exist, safeguards should be put in place to eliminate or reduce the threat.

5. Principles vs rules based

The ACCA Code adopts a principles-based, rather than rules-based, approach, but also gives many examples of specific situations where independence can be threatened and the relevant safeguards that may mitigate these.

6. Advertising

An audit firm **may** advertise to obtain new work; however any advertisements must comply with advertising standards and must not discredit others.

7. Accepting new clients

Before accepting nomination as auditor, the audit firm must ensure that it is properly qualified to act and that it has communicated with the outgoing auditor.

8. Preconditions for an audit

The auditor must also establish that the preconditions for an audit are present and confirm acceptance of the appointment in an engagement letter. You will not need to reproduce an **engagement letter** but must be familiar with its contents.

9. Quality management

Quality management is extremely important for the credibility of the auditing profession.

10. Ultimate responsibility

The audit engagement partner is ultimately responsible for ensuring that an audit has been carried out in accordance with the firm's quality management procedures.

Further study guidance

Question practice

Now try the following from the Further question practice bank [available in the digital edition of the workbook]:

- Section A Q10 & Q11
- Section B Q49 Independence
- Section B Q50 Confidentiality and independence

Further reading

There are technical articles and study support videos on the ACCA website written/recorded by members of the AA examining team and other tutors which are relevant to some of the topics covered in this chapter that you should read:

Technical articles:

- Laws and regulations (<https://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/laws-and-regulations.html>)

Own research

Consider the ethical safeguards that exist to protect you in your workplace. Would you know the procedures you should follow if you felt pressured to manipulate information (financial or otherwise)?

Activity answers

Activity 1: Explaining ethical threats

Threat	Safeguards
<i>Weadon Co</i> This involves a self-interest threat because the auditors may wish to continue enjoying lavish hospitality so may be reluctant to raise any problems in their auditor's report. There is also a familiarity threat because involvement in social events with the client is likely to increase the audit staff's familiarity with the client staff and make them more likely to accept explanations without adequate questioning.	Gifts and hospitality should not be accepted unless the value is trivial and inconsequential. In this case, it would be appropriate to decline the weekend away so as not to impair the firm's independence.
<i>Stewards Co</i> This involves a familiarity threat because Mr Walker has been the engagement partner for nine years and his long association with the client could mean that he does not question judgements made by the client and does not exercise sufficient professional scepticism.	Mr Walker should be rotated off the audit and another partner assigned to the client. Given that Stewards Co is a public interest entity, key audit partners (such as the engagement partner) should serve for no more than seven years before being rotated off. They should not return to having involvement in the client for a period of five years.

Activity 2: Threats and safeguards

1

	Intimidation	Self-interest	Self-review
Risk (1)	-	<u>x</u>	-
Risk (2)	-	<u>x</u>	-
Risk (3)	<u>x</u>	<u>x</u>	-
Risk (4)	-	-	<u>x</u>

- The correct answer is: Discuss the situation with Emerald's audit committee and consider resigning from some services.
- The correct answer is: Check and Co should decline the offer to prepare the financial statements.



Risk assessment

Learning objectives

On completion of this chapter, you should be able to:

Syllabus learning outcomes	Syllabus reference no.
Identify the overall objectives of the auditor and the need to conduct an audit in accordance with ISAs.	B2 (a)
Explain the need to plan and perform audit engagements with an attitude of professional scepticism, and to exercise professional judgement.	B2 (b)
Explain the components of audit risk.	B3 (a)
Describe the audit risks in the financial statements and explain the auditor's response to each risk.	B3 (b)
Define and explain the concepts of materiality and performance materiality.	B3 (c)
Explain and calculate materiality levels from financial information.	B3 (d)
Explain how auditors obtain an initial understanding of the entity, its environment and the applicable financial reporting framework.	B4 (a)
Describe and explain the nature, and purpose of, analytical procedures in planning.	B4 (b)
Compute and interpret key ratios used in analytical procedures.	B4 (c)
Discuss the effect of fraud and misstatements on the audit strategy and extent of audit work.	B5 (a)
Explain the auditor's responsibility to consider laws and regulations.	B5 (c)

Business and Exam context

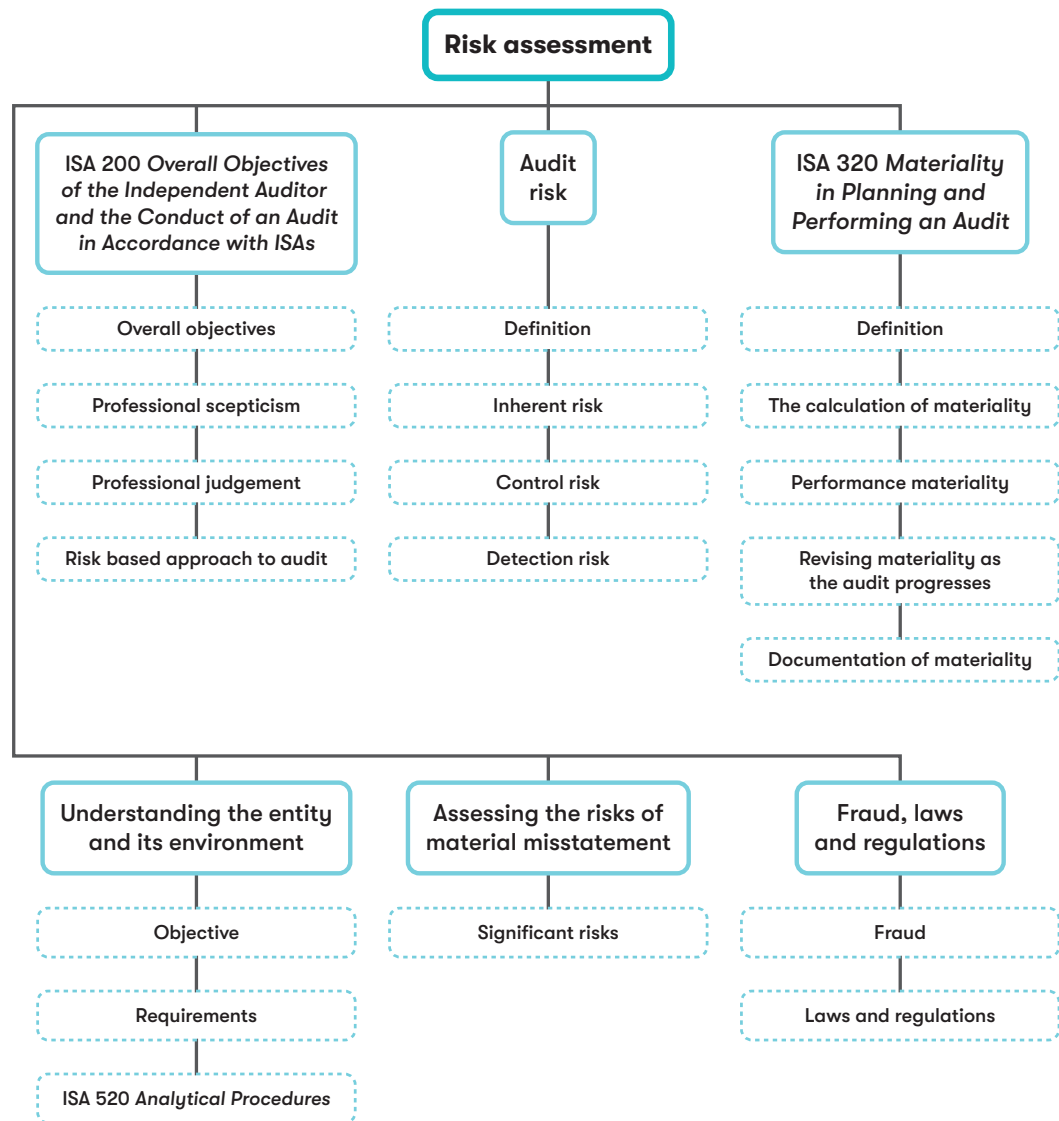
Auditors must ensure that they plan their audits in order to identify audit risk. The first step in planning is making sure that you understand the entity you are auditing. There is a phrase which says “you can’t audit what you don’t understand” and this is very true. Auditors must understand the products and services their client supplies and the markets in which it operates as well as key personnel.

If auditors know what they expect, their client’s financial statements to look like it is much easier to recognise when they do not look like that and therefore spot audit risks. For example, if the auditor knows that a client has expanded during the year and financed this expansion by taking out a long-term loan then the auditor would expect to see a non-current liability in the statement of financial position. If this is not included, this indicates that there may be an error in the financial statements.

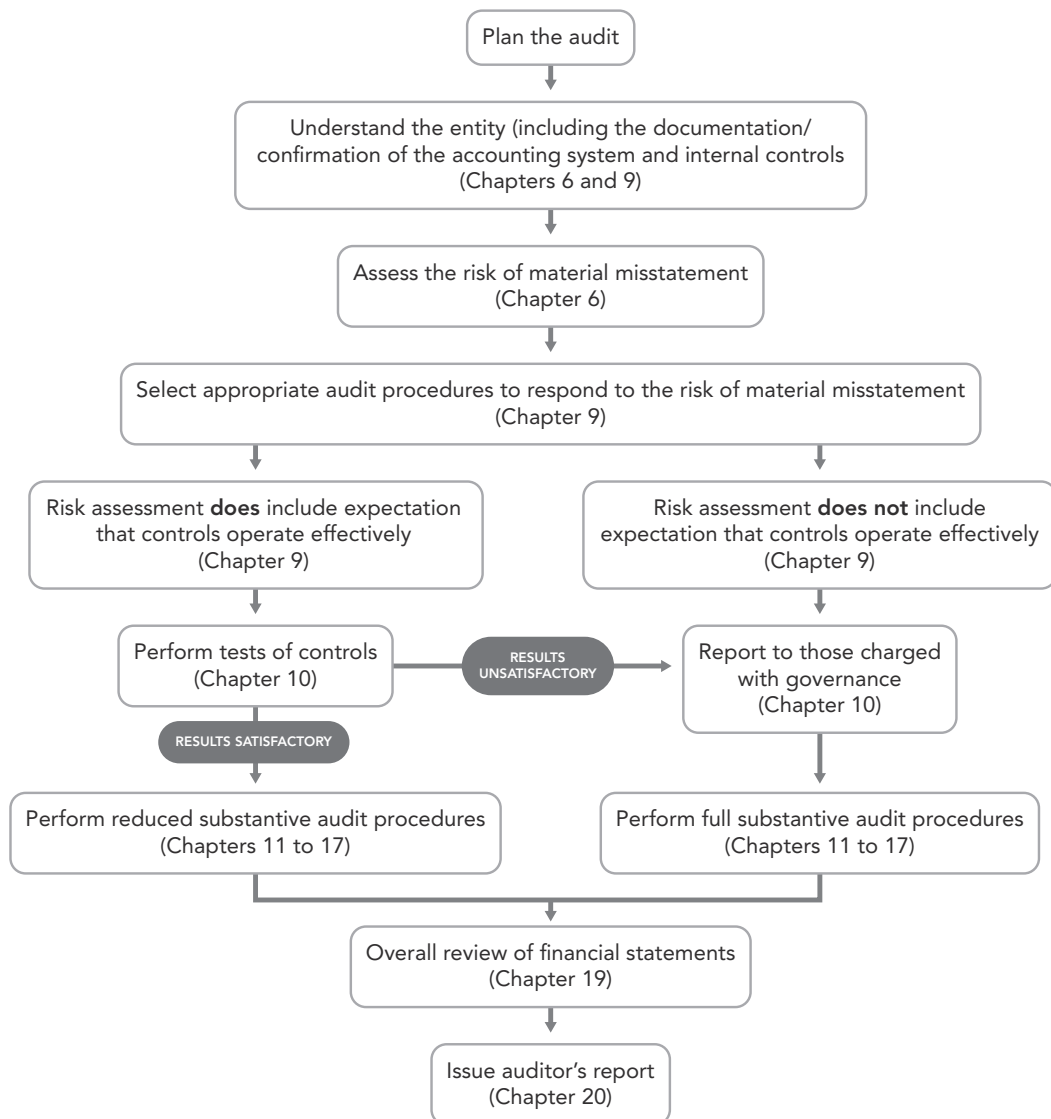
Audit risk is the risk that the auditor gives the wrong opinion on the financial statements, for example they say the financial statements are true and fair when they are not! Auditors adopt a risk-based approach to auditing, in other words, they decide on what level of overall audit risk they are willing to accept and then ensure that they perform enough audit testing to ensure that this level is met. If they get their assessment wrong at the planning stage, it could mean that the audit is not carried out correctly.

Another planning consideration is materiality, which assesses how important the auditors think something is in relation to the financial statements that they are auditing. Auditors will focus on the areas that are material, so it is very important that they set materiality at an appropriate level.

Chapter overview



1 ISA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing



1.1 Overall objectives

When conducting an audit of financial statements, the overall objectives of the auditor are:

To obtain **reasonable assurance** about whether the financial statements as a whole are **free from material misstatement**, whether due to fraud or error, thereby enabling 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; and to report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings. (ISA 200: para. 11)

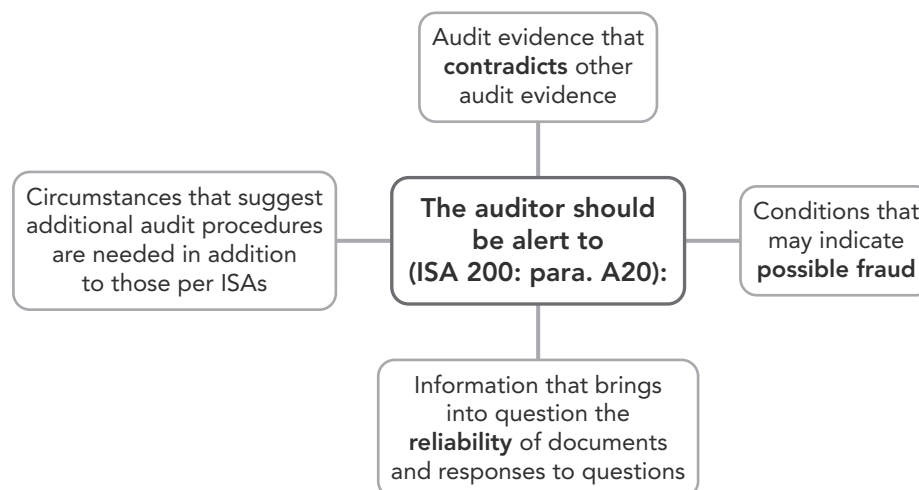
In order to do this, the auditor should plan and perform the audit with professional scepticism and apply professional judgement.

1.2 Professional scepticism



Professional scepticism: “an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence” (ISA 200: para. 13(l)).

Auditors must plan and perform an audit with an attitude of **professional scepticism** recognising that circumstances may exist that cause the financial statements to be materially misstated (ISA 200: para. 15).



1.3 Professional judgement



Professional judgement: “application of relevant training, knowledge and experience in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement” (ISA 200: para. 13(m)).

ISA 200 also requires the auditor to exercise professional judgement in planning and performing an audit of financial statements (ISA 200: para. 16). Professional judgement is required in the following areas:

- Determining the level of audit risk and setting materiality
- Determining the nature, timing and extent of audit procedures to be performed
- Evaluating whether sufficient appropriate audit evidence has been obtained
- Evaluating management’s judgements in applying the applicable financial reporting framework
- Drawing conclusions based on the audit evidence obtained (ISA 200: para. A23)

1.4 Risk-based approach to audit

The ISAs require auditors to adopt a risk-based approach to auditing. This means the auditor must:

- Analyse the risk in the client’s business, transactions and systems that could lead to material misstatement in the financial statements
- Direct audit testing to risky areas

2 Audit risk

2.1 Definition

In order to obtain **reasonable assurance** that the financial statements are free from material misstatement, the auditor shall obtain **sufficient appropriate** audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion (ISA 200: para. 11).

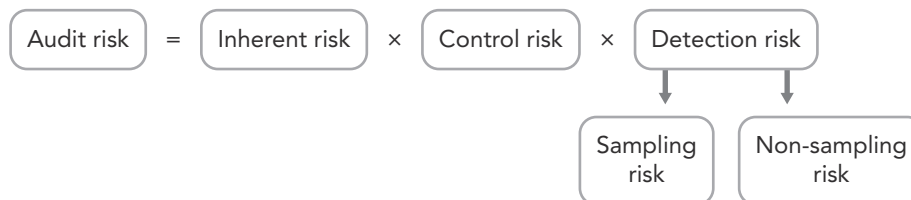


Audit risk: the risk that the auditor expresses an **inappropriate audit opinion** when the financial statements are materially misstated (ISA 200: para. 13(c)). **Audit risk** is the risk that the auditor expresses an **inappropriate audit opinion** when the financial statements are materially misstated' (ISA 200: para. 13(c)).

Audit risk has **two** major components:

- One is **dependent on the entity** and is the risk of material misstatement arising in the financial statements (**inherent risk** and **control risk**)
- The other is **dependent on the auditor** and is the risk that the auditor will not detect material misstatements in the financial statements (**detection risk**)

Audit risk can be represented by the **audit risk model**:



2.2 Inherent risk



Inherent risk: the **susceptibility** of an assertion about a class of transaction, account balance or disclosure to a **misstatement** that could be material either individually or when aggregated with other misstatements, **before consideration of any related internal controls** (ISA 200: para. 13(nii)).

Inherent risk is affected by the **nature of the entity**. For example:

- The industry in which the audit client operates
- Any regulations it is subject to
- Whether its financial statements:
 - Include complex calculations
 - Are subject to complex accounting standards
 - Include amounts derived from accounting estimates rather than routine, factual data

2.3 Control risk



Control risk: the **risk that a material misstatement** that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, individually or when aggregated with other misstatements, **will not be prevented or detected and corrected** on a timely basis by the entity's **internal control**. (ISA 200: para. 13 (nii))

Some control risk will always exist because of the inherent limitations of internal control, for example human error. The inherent limitations of internal control are covered in Chapter 9.

2.4 Detection risk



Detection risk: the risk that the **procedures performed by the auditor** to reduce audit risk to an acceptably low level **will not detect a misstatement** that exists and that could be material, either individually or when aggregated with other misstatements (ISA 200: para. 13(e)).

Detection risk is sub-divided into two components: sampling risk and non-sampling risk.

Sampling risk relates to the fact that the auditor does not, and cannot, examine all available evidence and only performs audit procedures on a sample of items. There is, therefore, always a risk that the conclusion the auditor draws based on the sample they have tested is not appropriate for the population as a whole. Sampling risk is covered in more detail in Chapter 11.

Non-sampling risk however describes the risk that the auditor's procedures do not detect material misstatement due to factors other than the sample tested.

Factors which increase non-sampling risk include:

- Auditor's lack of experience
- Time pressure
- Financial constraints
- Poor planning
- New client
- Lack of industry knowledge



Exam focus point

Whilst you must be able to describe the audit risk model and each component of audit risk, most exam questions on audit risk are scenario based. Here it is not essential to differentiate between inherent, control and detection risk but rather apply your knowledge to describe the audit risk that exists in the scenario.

3 ISA 320 Materiality in Planning and Performing an Audit

3.1 Definition



Material: Information is **material** if its omission or misstatement could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

There are two aspects of materiality:



The materiality level set by the auditor will always be a matter of **judgement** and will depend on the level of audit risk. The higher the anticipated level of audit risk, the lower the value at which materiality will be set.

The materiality level set has a critical impact on several key areas:

- The **nature, timing and extent of audit procedures** performed. The lower the level at which materiality is set, the more work will need to be performed to ensure the overall audit engagement risk is kept at an acceptably low level.
- Whether to use sampling techniques
- The evaluation of the effect of misstatements in terms of:
 - Whether to **seek adjustments** to the financial statements; or
 - The degree of any auditor's report **modification**.

Materiality is also central to the assessment of individual audit risks - when assessing risks, the auditor bears in mind not just the misstatements that could arise, but whether these

misstatements would be material. In this way, the auditor is able to direct their work to those areas that matter the most for the audit as a whole.

3.2 The calculation of materiality

During audit planning, the auditor establishes materiality for the **financial statements as a whole** by exercising judgment.

The following **benchmarks and percentages** may be appropriate in the calculation of materiality for the financial statements as a whole:



Formula to learn

Value	Percentage (%)
Revenue	1/2 to 1
Total assets	1 to 2
Profit before tax	5 to 10

The figure chosen will depend on the confidence the auditor has in the client's figures, the uses the financial statements will be put to and any other factors affecting the auditor's judgment.

Once the materiality level for the financial statements as a whole has been set, it is important to consider what would happen if this materiality level was applied directly to, for example, different account balances (such as receivables and inventory). It could be that a number of balances (or elements making up those balances) are untested or dismissed on the grounds that they are immaterial. However, a number of errors or misstatements could exist in those untested balances, and these could aggregate to a material misstatement.

For this reason, the auditor is required to set **performance materiality** levels which are **lower than the materiality for the financial statements as a whole**. This means a lower threshold is applied during testing. The risk of misstatements which could add up to a material misstatement is therefore reduced.



Essential reading

See Chapter 6 of the Essential reading for more information on determining materiality. The Essential reading is available as an Appendix of the digital edition of the Workbook.

3.3 Performance materiality



Performance materiality: “the amount or amounts set by the auditor at **less than materiality for the financial statements as a whole** to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole”.

It also refers to “the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures” (ISA 320: para. 9).

Determining performance materiality involves the auditor's professional judgment. It is affected by their understanding of the entity and the results of risk assessment procedures. It can be qualitative and quantitative.

For example, if there are particular account balances that could reasonably be expected to significantly influence the decisions of users (for example, revenue for the year) then the auditors may decide to use performance materiality when performing their audit procedures.



Essential reading

See Chapter 6 of the Essential reading for more information on determining performance materiality.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

3.4 Revising materiality as the audit progresses

Materiality may need to be revised due to events that occur during the audit, **new information**, or a **change in the auditor's understanding** of the entity and its operations as a result of performing further audit procedures.

In evaluating whether the financial statements give a true and fair view, the auditor should assess the materiality of the aggregate of uncorrected misstatements. This is normally documented on a schedule of unadjusted differences.

3.4.1 Documentation of materiality

ISA 320 (para. 14) requires the following to be documented:

- Materiality for the financial statements as a whole
- Materiality level or levels for particular classes of transactions, account balances or disclosures if applicable
- Performance materiality
- Any revision of the above as the audit progressed

4 Risk assessment, and understanding the entity and its environment



PER alert

Objective 19 of the PER performance objectives is to prepare for and collect evidence for audit. An important aspect of preparing for an audit is understanding the nature of the client's organisation. The knowledge you gain in this section will assist you in demonstrating the achievement of this element of PO 19 in practice.

4.1 Objective

ISA 315 *Identifying and Assessing the Risks of Material Misstatement* was revised by the IAASB in 2019, and it is on this version of ISA 315 that you may be examined for your Audit & Assurance exam. The 2019 revisions of the ISA were far-reaching, and focused mainly on strengthening requirements in relation to the auditor's assessment of the risks of material misstatement. This is a key part of the Audit & Assurance exam.

It states that the objective of the auditor here is to:

Identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement (ISA 315: para. 11).

The auditor first identifies the risks and then assesses their severity. This will then allow them to design responses to the risks in accordance with ISA 330 *The Auditor's Responses to Assessed Risks*. The auditor must understand the entity in order to perform an adequate risk assessment.

ISA 315 considers the risk assessment itself to be part of the audit evidence (ISA 315: para. 13). Risk assessment procedures have to include:

- Inquiries of management;
- Analytical procedures; and
- Observation and inspection (ISA 315: para. 14)

The auditor may use information from last year's audit, but this must be evaluated to consider whether it remains relevant and appropriate this year (ISA 315: para. 16).

The auditor may also seek to use **automated tools and techniques** as part of the risk assessment. ISA 315 gives the following examples of this.

- Remote observation tools (eg drones) could be used when inspecting certain assets
- Auditors can obtain digital downloads of accounting records and use data analytics techniques (ranging from spreadsheets to more complex systems) to perform analysis that assists in the prioritisation of significant risks of material misstatement
- The analysis of accounting records could include journals to identify those posted outside of normal working hours or by staff who do not normally post such items
- Entire populations of transactions could be analysed to identify situations that could indicate a higher position on the spectrum of inherent risk (eg account balances that are zero at the reporting date but which have seen significant transactions and journal entries during the period, suggesting possible manipulation)
- To assist the auditor, key messages from data analytics procedures are often presented using a dashboard (sometimes referred to as data visualisation) which highlights significant matters for the auditor's attention

(ISA 315: paras. A31, A35, A137, A161 and A203)

As the ISA points out, the auditor must perform their risk assessment **in a way that is not biased toward obtaining corroborative evidence, or excluding contradictory evidence** (ISA 315: para. 13). Thus the auditor must exercise professional scepticism, and be open to evidence that may undermine the narrative that management gives them.



Exam focus point

Questions in the *Audit & Assurance* exam may ask you to identify 'audit risks' and explain the 'auditor's response' to those risks. This reflects the way the ISAs encourage real-life auditors to think, and is something that you should get used to doing.

ISA 315 distinguishes two main types of risk: risks at the **financial statement level**, and at the **assertion level**.

Risks at the financial statement level are pervasive to the financial statements and may affect any assertion – for example, the effects of a poor management attitude to internal control could be felt in any area of the financial statements.

Risks at the assertion level are more specific and will take the form of specific issues – for example, a company which keeps inventory in multiple locations will be subject to the inherent risk that not all inventory will be counted, and may also be subject to a control risk in relation to the entity's system for counting that inventory.

In order to assess these risks, the auditor must obtain an understanding of three things:

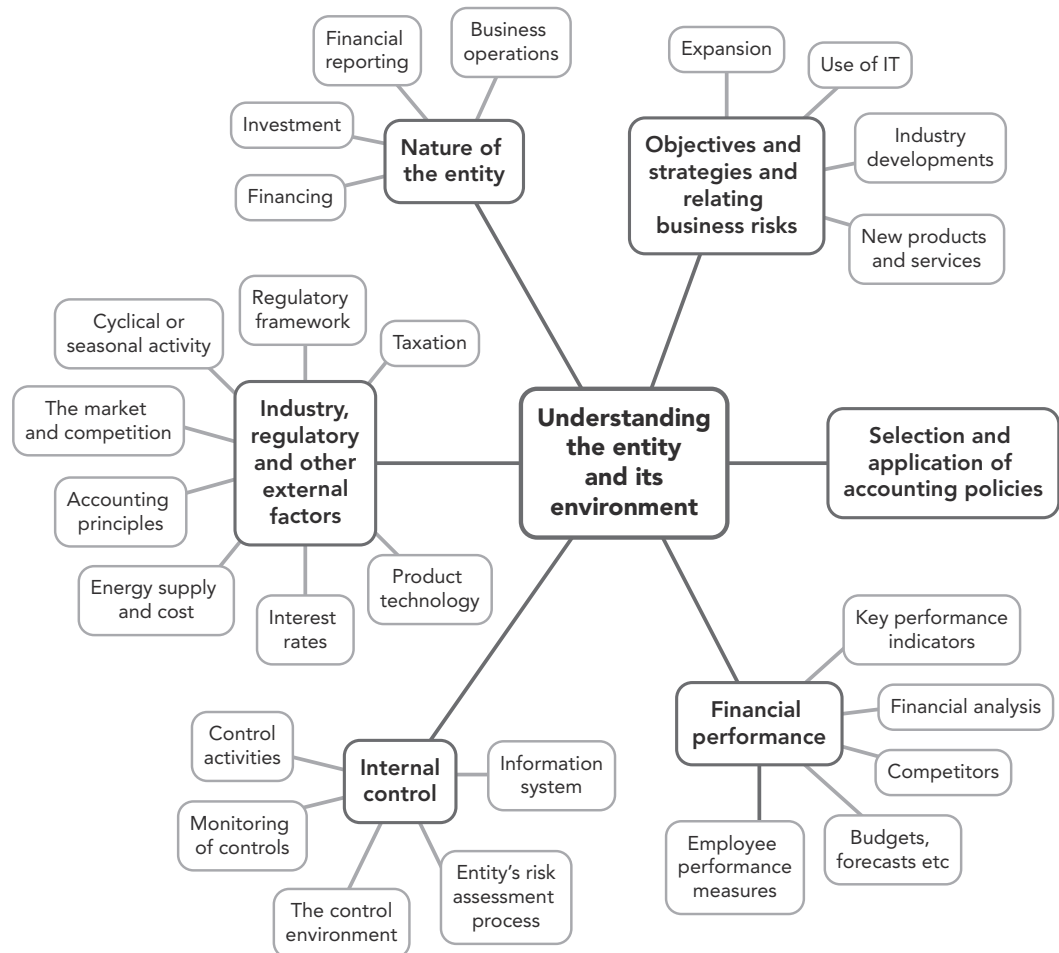
- The entity and its environment
- The applicable financial reporting framework (this is IFRS for the AA exam)
- The entity's system of internal control

4.2 Understanding the entity and its environment

As part of understanding the entity and its environment, the auditor must understand the following (ISA 315: paras. 19-20).

- The entity's **organisational structure**, ownership and governance, and its **business model**, including the extent to which the business model integrates the use of IT
- Industry, regulatory and other external factors
- The **measures** used, internally and externally, to assess the entity's **financial performance**
- IFRS and the entity's **accounting policies**
- How the **inherent risk factors** affect the susceptibility of assertions to misstatement

The following diagram gives summarises the factors the auditor should consider when obtaining an understanding of the entity and its environment.



As mentioned above, ISA 315 requires auditors to perform procedures to obtain this understanding.



Essential reading

See Chapter 6 of the Essential reading for information on enquiry and observation and inspection, which should be used to obtain an understanding of the entity.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

4.3 Understanding the entity's system of internal control

The auditor must understand the entity's system of internal control. This has five elements:

- Control environment
- The entity's risk assessment process
- The entity's process to monitor internal control
- The information system and communication
- Control activities

These elements are covered in detail in Chapter 9 of this Workbook.

The auditor must understand the entity's **risk assessment process** relevant to the preparation of the financial statements, ie its process for (ISA 315: para. 22):

- **Identifying business risks** (which are relevant to financial reporting objectives)
- Assessing the significance of risks

- Addressing risks

The auditor then evaluates whether the risk assessment process is appropriate for an entity of its nature complexity.

ISA 315 gives auditors five inherent risk factors (ISA 315: para. A7):

- Complexity;
- Subjectivity;
- Change;
- Uncertainty; or
- Susceptibility to misstatement due to **management bias** or other **fraud** risk factors insofar as they affect inherent risk.

The final risk factor here (management bias or fraud) was a new inclusion in the 2019 revision of the ISA, and can be understood as an attempt to respond to criticisms of auditors in this area.



Assessment focus point

Fraud is a hot topic in the profession at the moment, and is therefore examinable. It is important that you understand the auditor's responsibilities in relation to it (covered in detail later in this Chapter), and are able to identify when fraud might be taking place.

The auditor must understand the entity's process to **monitor internal control**:

- **How** the entity monitors the effectiveness of controls, and how it remedies any deficiencies identified
- The **sources of information** used to monitor controls

The auditor then evaluates whether this monitoring process is appropriate for an entity of its nature and complexity (ISA 315: para. 24).



Activity 1: Audit risks and auditor's response

Introduction and client background

You are an audit senior in Check and Co and you are commencing the planning of the audit of Dress You Like Co for the year ending 30 September 20X6. This audit was won by your firm in January 20X6.

Dress You Like Co is a clothing manufacturer, based in the UK, which has been trading for over 10 years. It operates from two sites: a factory where the clothes are made and a head office where the administration is carried out. Completed inventory orders are despatched from both the factory and the head office and errors can sometimes occur concerning the transfer of inventory between sites.

In an effort to reduce costs, Dress You Like Co now imports its material from one sole supplier based in China. Any delays in supply are likely to have a significant impact on Dress You Like Co's relationships with its customers and could lead to the loss of contracts. Unfortunately, some delays have been experienced with the new supplier and it has been difficult to find alternative suppliers at short notice.

Dress You Like Co sells its finished products to small independent retailers and also one major supermarket chain. The supermarket chain often requires additional deliveries without much prior notice, so Dress You Like Co has to maintain a high level of inventory should this occur. Credit terms are normally 30 days, but the supermarket is given 60-day credit terms. Dress You Like Co's cash flow and working capital have deteriorated during the year.

Personnel

Also, as part of the cost-cutting exercise mentioned above, Dress You Like Co froze the finance director's salary this year despite giving other directors a 5% salary increase. This decision was made based on the fact that the finance role was no more demanding than in previous years. The finance director was not happy about this decision and left the company in March 20X6. He is

now suing the company for constructive dismissal; the company is not proposing to make any provision or disclosure of this as it does not believe the ongoing claim has any merit. The finance director has not yet been replaced and his work is being done by his assistant on top of her existing workload.

Dress You Like Co had previously outsourced their internal audit department but cancelled this contract in May 20X6 in a further effort to cut costs. The internal audit department used to perform monthly bank and supplier statement reconciliations and a monthly check on the controls over inventory despatch at each location.

Required

Describe SIX audit risks and explain the auditor's response to each risk in planning the audit of Dress You Like Co.

Audit risk	Auditor's response

Audit risk	Auditor's response

Solution

4.4 ISA 520 Analytical Procedures

Analytical procedures mean the analysis of relationships to identify inconsistencies and unexpected relationships.

The auditor should apply analytical procedures as risk assessment procedures and in the overall review at the end of the audit.

They can also be used as a source of substantive audit evidence when their use is more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions.

Analytical procedures include the following types of comparisons:

- (a) Prior periods
- (b) Budgets and forecasts
- (c) Industry information
- (d) Predictive estimates ie expectations

- (e) Relationships between elements of financial information, ie ratio analysis
- (f) Relationships between financial and non-financial information, eg payroll costs to the number of employees

The auditor must apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment.

Application of analytical procedures may indicate aspects of the entity of which the auditor was unaware and will assist in assessing the risks of material misstatement in order to determine the nature, timing and extent of further audit procedures.

Common ratios for use in analytical procedures include:

Ratio	Calculation
Profitability ratios	
Return on capital employed (ROCE)	$\frac{\text{Profit before interest and tax (PBIT)}}{\text{Share capital + reserves + Non-current liabilities}}$
Net profit margin	$\frac{\text{PBIT}}{\text{Revenue}}$
Asset turnover	$\frac{\text{Revenue}}{\text{Share capital + reserves + Non-current liabilities}}$
Gross profit margin	$\frac{\text{Gross profit}}{\text{Revenue}}$
Liquidity ratios	
Current ratio	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$
Quick ratio (acid test)	$\frac{\text{Current Assets - Inventories}}{\text{Current Liabilities}}$
Inventory holding period	$\frac{\text{Inventories} \times 365 \text{ days}}{\text{Cost of sales}}$
Receivables collection period	$\frac{\text{Trade receivables} \times 365 \text{ days}}{\text{Credit sales}}$
Payables payment period	$\frac{\text{Trade payables} \times 365 \text{ days}}{\text{Credit purchases}}$
Gearing	
Debt/equity	$\frac{\text{Interest bearing debt}}{\text{Share capital and reserves}}$
Interest cover	$\frac{\text{PBIT}}{\text{Finance costs}}$



Activity 2: Ratios and risk

You have also been provided with the following draft accounts of Dress You Like Co for the year ended 30 September 20X6:

EXTRACTS FROM THE DRAFT STATEMENT OF FINANCIAL POSITION AS ON 30 SEPTEMBER 20X6

	<i>Draft</i>	<i>Actual</i>
	20X6	20X5
	\$'000	\$'000
Inventory: Finished goods	13,800	4,900
Receivables: Trade (supermarket)	11,800	8,300
Trade (other)	700	600
Bank:	0	200
Payables: Trade	2,060	1,470
Other	500	450
Bank overdraft:	750	0

EXTRACTS FROM THE DRAFT STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 30 SEPTEMBER 20X6

	<i>Draft</i>	<i>Actual</i>
	20X6	20X5
	\$'000	\$'000
Revenue (supermarket)	53,500	49,000
Revenue (other)	8,200	6,700
Cost of sales (supermarket)	(51,895)	(45,080)
Cost of sales (other)	<u>(7,380)</u>	<u>(5,900)</u>
Gross profit	2,425	4,720
Other expenses	<u>(1,400)</u>	<u>(2,450)</u>
Profit before taxation	<u>1,025</u>	<u>2,270</u>

Required

- 1 Calculate THREE ratios for BOTH years, which would assist the audit senior in planning the audit.
- 2 Using the ratios calculated, describe THE MAIN audit risk and explain the auditor's response to this risk in the planning of Dress You Like Co.

5 Assessing the risks of material misstatement

Once the auditor has obtained an understanding of the entity and its environment, they shall **assess the risks of material misstatement in the financial statements** and identify significant risks.

5.1 Significant risks



Significant risk: An identified risk of material misstatement:

- For which the assessment of inherent risk is close to the upper end of the **spectrum of inherent risk** due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur; or
- That is to be treated as a significant risk in accordance with the requirements of other ISAs. (ISA 315: para. 12l)

The auditor will begin simply by identifying risks, but will then need to consider how severe each risk is in terms of the 'spectrum of inherent risk'. Significant risks are essentially the most severe risks.

Routine, non-complex transactions are **less** likely to give rise to significant risks as client staff are likely to be more used to processing these transactions and such transactions are likely to be subject to robust internal controls.

Unusual and complex transactions and matters where judgment is required are more likely therefore to pose significant risk.

The ISA gives the following examples of the inherent **risk factors** (which we gave above, in the section 'Understanding the entity's system of internal control'). These are the kinds of things that could feature in an exam question and which you therefore need to be able to recognise as risks (ISA 315: Appendix 2).

Risk factor	
Complexity	Regulatory - lots of complex regulation

Risk factor	
	Business model - complex alliances and joint ventures Financial reporting framework - complex accounting measurements Transactions - complex arrangements (eg off-balance sheet finance)
Subjectivity	Financial reporting framework: • Wide range of possible accounting estimates (eg depreciation) • Management choice of valuation technique
Change	Changes in: Economic conditions - instability (eg current devaluation) Markets - exposure to volatility (eg futures trading) Customer loss - going concern / liquidity risk Industry model - changes in the industry in which the entity operates Business model - change in supply chain, new lines of business Geography - expanding into new locations Entity structure - for example reorganisations, subsidiaries sold IT - IT environment change / new IT systems relevant to FR
Uncertainty	Financial reporting - estimation uncertainty Pending litigation and contingent liabilities
Management bias or fraud risk	Opportunities for fraudulent financial reporting Transactions with related parties Non-routine or non-systemic transactions Transactions recorded based on management intentions

5.1.1 Response to audit risk

The auditor should obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks (ISA 330: para. 3) .

In the exam you are likely to be asked to explain the auditor's response to each audit risk you have identified in the scenario. Here you are not required to write out specific audit procedures, rather you need to explain:

- the types of enquiries the auditor should make (and of whom)
- the information/documentation they would require
- the correspondence they should review
- the impact on the level of materiality
- the type of testing they should perform
- the calculations they would do/re-perform
- the assets they should inspect

The best way to be able to explain the auditor's response to identified audit risks is to practice past exam questions and build your confidence at explaining the auditor's response. This is because the best response to each risk will depend on the particular circumstances of the audit client and the environment in which it operates.

To help you with this, we have considered some examples of audit risks along with an appropriate response to each risk. Note however, that you should not simply learn a list of responses.

Audit risk	Auditor's response
Risk that inventory has a lower net realisable value than cost and is therefore overstated (eg NRV falls due to the client being in an industry where tastes/fashions change quickly).	Examine the instructions to identify slow moving inventory lines when attending the inventory count. Increase the emphasis on reviewing the year end aged inventory analysis for evidence of slow-moving inventory. Ascertain sales values for items sold post year end that were in inventory at the year end to ensure their NRV was higher than the cost recorded as part of the inventory value in the financial statements.
Assets are desirable / more susceptible to theft leading to a risk that recorded assets do not exist (eg inventory/non-current assets).	Focus on testing internal controls over those assets (including physical controls to prevent theft). Increase sample sizes for inspecting recorded assets, ensuring any material assets are verified (in the context of performance materiality).
Increased risk of revenue expenditure being incorrectly classified as capital (or vice versa), leading to misstatement of assets/expenses (eg extensive refurbishment of non-current assets where judgement is needed to establish whether the nature of the work is to enhance the asset or repair/replace it).	Obtain a breakdown of related costs and review accounting entries against invoices/details of work done to ensure expenditure is correctly treated as capital/revenue. Perform a detailed review of repairs accounts for any items which should be included in non-current assets. Review the asset register to ensure only capital items have been included.
Increased risk of incomplete or unrecorded income due to fraud or theft (eg large amounts of cash collected and held prior to banking).	Perform analytical procedures focusing on comparing revenue with expected seasonal/monthly patterns. If a retail client, perform/reperform a reconciliation of a sample of till records to actual bankings.
Receipts/invoicing significantly in advance/arrears of providing services or goods, therefore leading to an increased risk of revenue being in the wrong period (eg deposits received in advance, reservation fees, contracts spanning the year end).	For a sample of revenue entries recorded prior to the year end, agree the transactions as relating to pre year end sales by inspecting the contract / other supporting documentation. Trace post year end transactions back to a supporting contract/documentation to test that revenue was recorded in the proper period. For a sample of contracts or GDNs, verify the revenue was recognised according to the provision of services/goods. Perform analytical procedures where monthly revenue is compared to expectations and budgeted revenue. Unexpected deviations should be investigated.

Audit risk	Auditor's response
Invoices received (or payments made) in advance/arrears of goods or services delivery date leading to overstatement or understatement of costs and/or liabilities.	Review post year end bank statements / cash book payments for evidence of amounts relating to the financial year but not included in liabilities. For a sample of documents pre and post year end indicating date of delivery of goods/services (eg GRNs), verify the cost and liability were recorded in the appropriate period.
There is an increased risk of irrecoverable debts (eg due to the nature of the client's industry or customers), resulting in assets being potentially overstated.	Identify year end receivable balances still outstanding at the date of the audit by reviewing post year end receipts from customers. For amounts still outstanding establish whether these are provided for. Review aged receivables analysis and customer correspondence files for evidence of disputes with receivables and consider the adequacy of any related receivables allowance.
Significant client borrowing and/or overdraft with cash flow problems which may indicate going concern problems.	Review correspondence with the bank/lender for any evidence of withdrawal or extension of facilities. If there are bank covenants linked to performance on which facilities depend, review compliance with these, and increase testing on areas where management could manipulate performance indicators (such as provisions). Review post year end results and cash flow forecasts (if prepared) for evidence the company can continue as a going concern.
New client systems/controls/staff impacting on amounts recorded in the financial statements, increasing the risk of errors and the risk of internal controls not operating effectively.	Undertake additional visits (eg interim audit) to assess the effectiveness of controls operating over areas affected. Perform extra work to document and evaluate new systems/controls, performing tests of controls where necessary. Increase sample sizes for substantive testing over financial statement areas impacted.
Management has an incentive to manipulate performance, increasing the risk of profits being overstated (eg remuneration or bank funding is reliant on performance).	Focus on and increase testing on judgemental areas in the financial statements (eg provisions, revenue recognition accounting policies).

6 Fraud, laws and regulations

6.1 Fraud



Fraud: an “intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage” (ISA 240: para. 11(a)).

Fraud may be perpetrated by an individual, or colluded in, with people internal or external to the business.

Fraud risk factors are “events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud” (ISA 240: para. 11(b)).

There are two types of fraud which may cause material misstatement in the financial statements:

- (a) **Fraudulent financial reporting** (intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users)
 - (b) **Misappropriation of assets** (the theft of an entity’s assets)
- (ISA 240: para. 3)



Essential reading

See Chapter 6 of the Essential reading for more information on fraudulent financial reporting and misappropriation of assets.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

The **responsibility to prevent and detect fraud** lies with an entity’s **management** and those charged with governance. It is their responsibility to establish a culture of honesty and ethical behaviour and to implement a system of internal control to mitigate the risk of fraud.

(ISA 240: para. 4)

ISA 240 *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements* states that the **auditor** is responsible for obtaining reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. (ISA 240: para. 5)

The auditor is responsible for maintaining professional scepticism throughout the audit, considering the possibility of management override of controls, and recognising that the audit procedures effective for detecting errors may not be effective for detecting fraud.

(ISA 240: para. 12)

Where the auditor’s risk assessment suggests there is a risk of material misstatement due to fraud the risk should be treated as a significant risk.

In this event the auditor should:

- Assign and supervise audit staff taking into account their knowledge, skill and ability;
- Evaluate whether the client’s accounting policies may indicate fraudulent financial reporting; and
- Incorporate unpredictability in the selection of the nature, timing and extent of audit procedures (ISA 240: para.29).

There should be a discussion among audit team members that places particular emphasis on how and where the financial statements may be susceptible to fraud.

Risk assessment procedures to obtain information in identifying the risks of material misstatement due to fraud shall include the following:

- (a) **Enquiries of management** regarding:
 - (i) **Management’s assessment** of the risk that the financial statements may be misstated due to fraud

- (ii) **Management's process** for identifying and responding to the risk of fraud
 - (iii) **Management's communication to those charged with governance** in respect of its process for identifying and responding to the risk of fraud
 - (iv) **Management's communication to employees** regarding its views on business practices and ethical behaviour
 - (v) **Knowledge** of any actual, suspected or alleged fraud
 - (b) **Enquiries of internal audit** for knowledge of any actual, suspected or alleged fraud, and its views on the risks of fraud
 - (c) Obtaining an **understanding** of how those charged with governance **oversee** management's processes for identifying and responding to the risk of fraud and the internal control established to mitigate these risks
 - (d) **Enquiries of those charged with governance** for knowledge of any actual, suspected or alleged fraud
 - (e) Evaluating whether any unusual relationships have been identified in performing **analytical procedures** that may indicate risk of material misstatement due to fraud
 - (f) Considering whether any **other information** may indicate risk of material misstatement due to fraud
 - (g) Evaluating whether any **fraud risk factors** are present
- (ISA 240: paras. 17–24)

If the auditor identifies fraud or receives information that a fraud may exist, the auditor shall report this on a **timely basis** to the **appropriate level of management** (ISA 240: para. 40).

If the auditor identifies or suspects fraud involving management, employees with significant roles in internal control, and others where fraud could have a material effect on the financial statements, they shall communicate this on a **timely basis to those charged with governance** (ISA 240: para. 41).

The auditor also needs to consider whether there is a responsibility to report to the **regulatory or enforcement authorities** – the auditor's professional duty of **confidentiality** may be **overridden** by **laws and statutes** in certain jurisdictions (ISA 240: para. 43).

6.2 Laws and regulations

An entity is likely to be subject to several laws and regulations.

The auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations (ISA 250 (Revised): para. 4).

The **auditor's responsibility** is to obtain reasonable assurance that the financial statements are **free from material misstatement** whether due to fraud or error and, in this respect, the auditor must take into account the legal and regulatory framework within which the entity operates (ISA 250 (Revised): para. 5).

ISA 250 (Revised) (para. 6) distinguishes the auditor's responsibilities in relation to compliance with two different categories of laws and regulations:

- (a) Those that have a **direct effect** on the determination of **material amounts** and disclosures in the financial statements (such as tax or pension laws and regulations)
- (b) Those that **do not have a direct effect** on the determination of material amounts and disclosures in the financial statements but where compliance may be fundamental to the **operating aspects**, ability to **continue in business**, or to avoid **material penalties** (such as regulatory compliance or compliance with the terms of an operating licence)

For the first category, the auditor's responsibility is to obtain sufficient appropriate audit evidence about **compliance** with those laws and regulations (ISA 250 (Revised): para. 14).

For the second category, the auditor's responsibility is to undertake specified audit procedures to help **identify non-compliance** with laws and regulations that may have a **material effect** on the financial statements. These include enquiries of management and inspecting correspondence with the relevant licensing or regulatory authorities (ISA 240 (Revised): para. 15).

Examples of laws and regulations that may be included in these categories include the following:

- Fraud, corruption and bribery
- Money laundering, terrorist financing and proceeds of crime
- Securities markets and trading
- Banking and other financial products and services
- Data protection
- Tax and pension liabilities and payments
- Environmental protection
- Public health and safety

(ISA 250 (Revised): para. A6)

The responsibility to comply with relevant laws and regulations lies with an entity's management and those charged with governance.

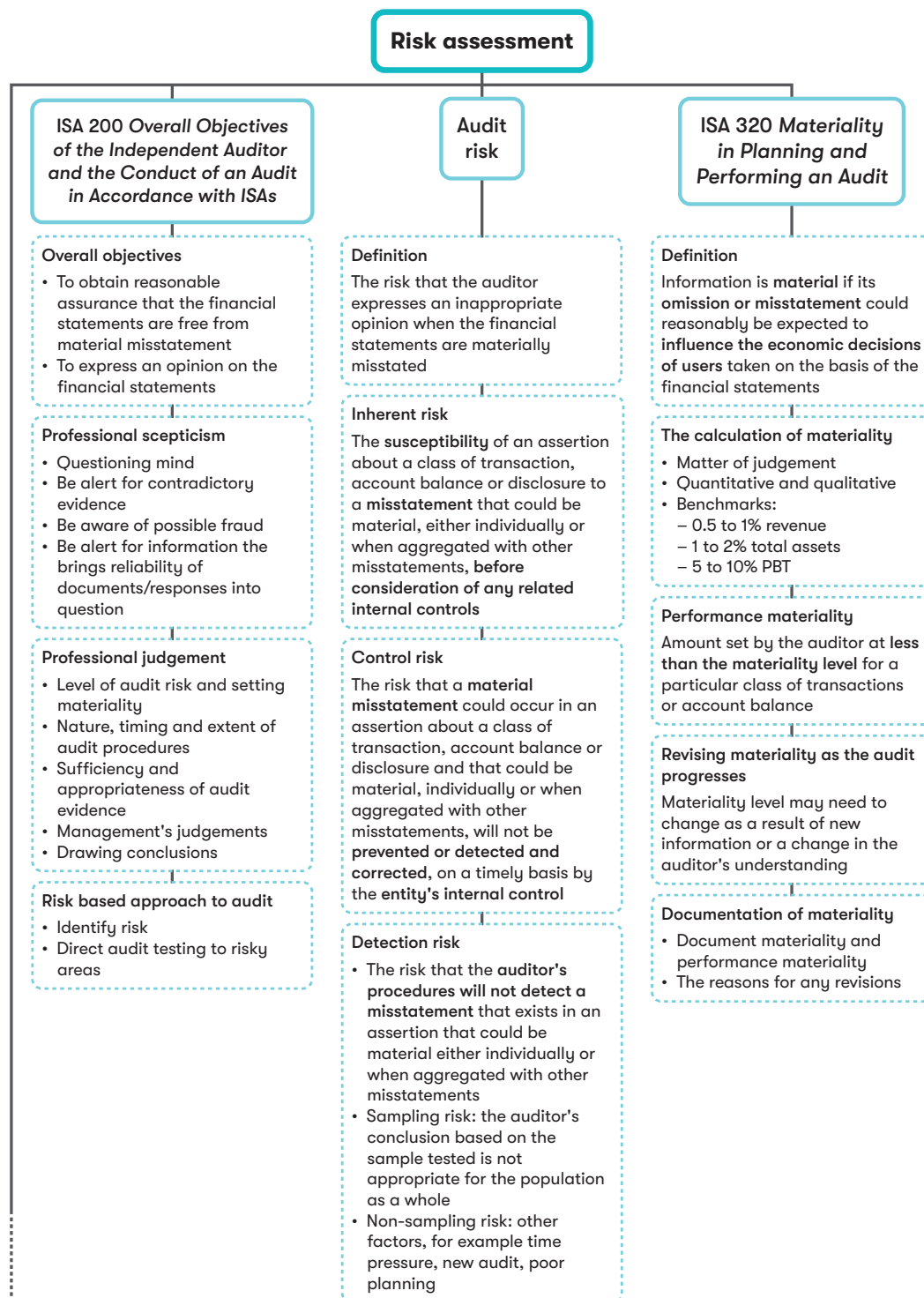


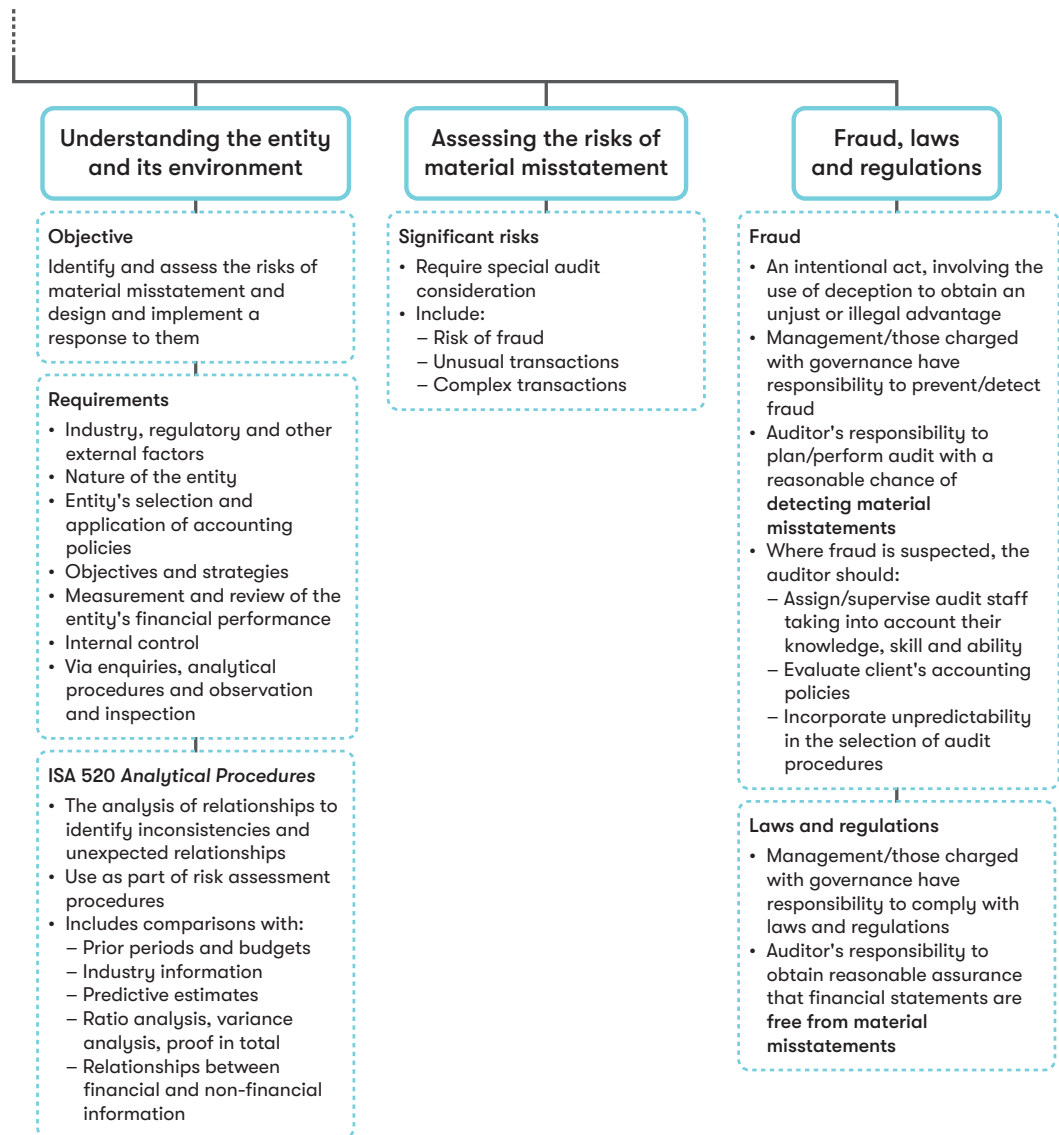
Essential reading

See Chapter 6 of the Essential reading for more information on laws and regulations.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

Chapter summary





Knowledge diagnostic

1. Professional scepticism and professional judgement

Auditors must carry out their work with professional scepticism and exercise professional judgement.

2. Audit risk

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. It has three components: inherent risk, control risk and detection risk (which includes sampling and non-sampling risk).

3. Inherent risk and control risk

Inherent risk and control risk are determined by the nature of the entity, the industry in which it operates and its internal control systems. The auditor cannot influence these but must assess whether they are high, medium or low.

4. Detection risk

Detection risk is the only component of audit risk over which the auditor has control. The auditor's actions can decrease detection risk, for example by extending sample sizes or using more experienced audit staff.

5. Materiality

The auditor must determine a materiality level for the financial statements at the planning stage. Where audit risk is deemed to be high, the level of materiality will be less which in turn increases the amount of audit testing performed.

6. Materiality considerations

An item may be material due to its monetary value (quantitative materiality) or by its nature (qualitative materiality). The materiality level may be revised during the course of the audit if information comes to light that indicates the level set at the planning stage is not appropriate.

7. Performance materiality

The auditor should also set a level for performance materiality which will be lower than the materiality level set for the financial statements.

8. Management's responsibilities for fraud and error

An entity's management and those charged with governance are responsible for the prevention and detection of fraud and error and for non-compliance with laws and regulations.

9. Auditor's responsibilities for fraud and error

The auditor should plan and perform their audit so that they have reasonable assurance of detecting material fraud and non-compliance with laws and regulations that may have a material impact on the financial statements.

Further study guidance

Question practice

Now try the following from the Further question practice bank [available in the digital edition of the Workbook]:

- Section A Q13, Q15, Q18 and Q19
- Section B Q52 Glo
- Section B Q53 Stone Holidays
- Section B Q10 Parker (a) and (b)(i)
- Section B Q11 Heels (a), (b) and (c)
- Section B Q12 Turbo (a) and (b)

Further reading

There are technical articles and study support videos on the ACCA website written/recorded by members of the AA examining team and other tutors which are relevant to some of the topics covered in this chapter that you should read:

Technical articles:

- *Risk and understanding the entity* (<https://www.accaglobal.com/lk/en/student/exam-support-resources/professional-exams-study-resources/p7/technical-articles/risk-understanding-entity.html>)
- *Laws and regulations* (<https://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/laws-and-regulations.html>)
- *Audit Risk* (<https://www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p7/technical-articles/audit-risk.html>)
- *ISA 330 and Responses to Assessed Risks* (<https://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/ISA330-responses-assessed-risks.html>)

Study Support Videos:

- *Audit Risk* (<https://www.youtube.com/watch?v=4anGILgLn4>)

Exam technique article:

- *Answering Audit Risk Questions* (<https://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/audit-risk0.html>)

Own research

Identify an industry which interests you and choose a company from that industry. Download the company's financial statements and consider which areas of the financial statements or the nature of the company may pose increased audit risk.

Activity answers

Activity 1: Audit risks and auditor's response

Audit risk	Auditor's response
The audit is a new audit for the firm; the firm may not have as good an understanding of the client as it would have for an established client and so there is likely to be an increased level of detection risk.	The auditors should spend time ensuring they fully understand the nature of the business, its products or services, its locations, revenue sources, key customers and suppliers, internal controls and any external pressures or laws and regulations it is subject to in order to best assess the risk of material misstatement in the financial statements. This information must be communicated to all members of the audit team. Consideration should also be given to using a more experienced audit team and the testing that will be required on the opening balances.
Dress You Like Co is a clothing manufacturer whose inventory will be subject to changing seasons and trends. It is possible that some inventory items may be difficult to sell and may be overvalued at the year-end if they are recorded at cost rather than at the lower of cost and net realisable value as required by IAS 2.	An aged inventory report should be obtained to identify items of slow moving or non-saleable inventory. The saleability of these items should then be discussed with management and their valuation in the financial statements reviewed to ensure they are valued at the lower of cost and net realisable value.
Dress You Like Co has two sites where inventory is held/despached and errors have previously occurred concerning the transfer of inventory between sites. There is the possibility that some items are counted twice (once at each location), and that some are not counted at all leading to a risk that inventory may be under or overstated.	Review the inventory counting instructions of Dress You Like Co to determine whether controls exist to ensure that all inventory items are counted only once. Where inventory count instructions are not sufficient, discuss this with management before the count so that changes can be made to counting procedures.
Dress You Like Co is reliant on one supplier for its purchases. Should it encounter a problem or delay with its supply chain, it may not be able to fulfil its orders (especially to the supermarket chain). This could lead to dissatisfaction from its customers and ultimately the loss of the customer. This in turn could lead to going concern problems.	Discuss with management whether Dress You Like Co has any alternative suppliers in the event that the supply chain is interrupted. Review Dress You Like Co's contract with the supermarket chain and any other customers to determine whether there are any penalties payable should deliveries be delayed and whether they could cancel their contract with Dress You Like Co.
Dress You Like Co allows its supermarket customer 60-day credit terms. This may place additional strain on cash flow and lead to potential going concern problems given the deterioration during the year of cash flow and working capital.	Request that management produce cash flow forecasts for the year ahead to identify any deficits in cash flow. Consider the reasonableness of the assumptions on which these are based (especially relating to the timing of cash flows from the supermarket). Consider whether there are any known concerns about the supermarket's ability to

Audit risk	Auditor's response
	settle its debts. Determine from management whether they have access to any short-term finance should any cash flow problems arise.
The finance director is suing the company for constructive dismissal but no mention of this has been made in the year-end financial statements (ie no provision or contingent liability). The case has been going on for some time which suggests that at least disclosure of a contingent liability is required and so there is a risk that provision/contingent liability disclosures may not be complete.	Review correspondence from both the director and the entity's legal advisers relating to the legal claim in order to establish the likely outcome of the claim. Discuss the appropriate accounting treatment for the claim with the directors. Review minutes of board meetings and events after the reporting period to determine whether the claim was settled.
There has not been a finance director in place for the last six months of the year (since March 20X6). The lack of finance director increases control risk and furthermore there is a lack of experience at this high level and the assistant is also overloaded. The assistant may not have the time or ability to answer queries from the audit team which could lead to difficulty in obtaining sufficient information and explanations required by the auditor.	Determine from management whether there will be appropriate personnel available to answer the audit team's queries and provide the information they require for the audit. Particular attention should be paid to judgemental areas to ensure any judgements made are reasonable.
The internal audit function used to perform reviews on the bank reconciliation and supplier statement reconciliations which would increase the reliability of the bank and payables balances. The fact that there is now no longer any internal audit function means that there is an increased likelihood that material errors in the completeness, accuracy and validity of the bank balance and the completeness of payables may not have been detected by the client staff.	A detailed review of the year-end bank reconciliation and supplier statement reconciliations should be performed in order to determine the accuracy and completeness of bank and payables. A larger sample size may be necessary if it is anticipated that there will be a high level of errors. A detailed review of reconciling items and payments made in the post year-end period should be conducted.

Activity 2: Ratios and risk

1

	20X6	20X5
Gross profit margin (supermarket)	1,650/53,500	3,920/49,000
	= 3%	= 8%
Gross profit margin (other)	820/8,200	800/6,700
	= 10%	= 12%
Receivables collection period (supermarket)	$(11,800/53,500) \times 365$	$(8,300/49,000) \times 365$

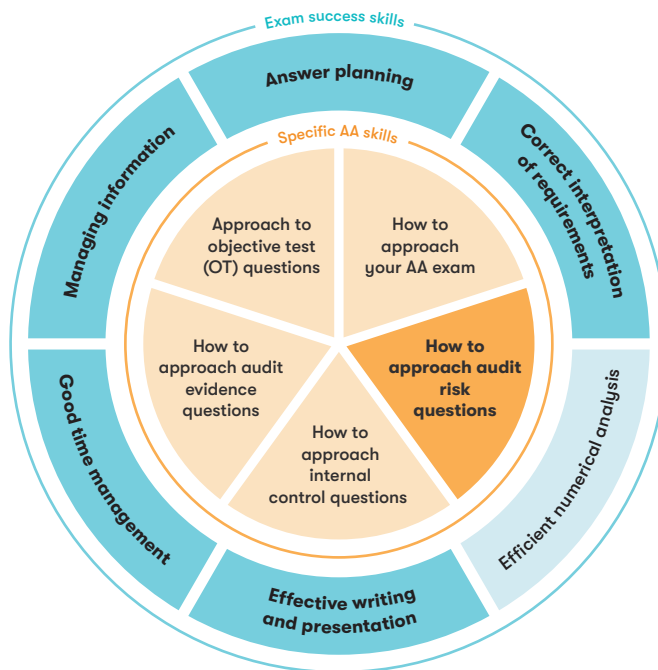
	= 81 days	= 62 days
Receivables collection period (other)	$(700/8,200) \times 365$	$(600/6,700) \times 365$
	= 31 days	= 33 days
Inventory holding period	$(13,800/59,275) \times 365$	$(4,900/50,980) \times 365$
	= 85 days	= 35 days
* 59,275 = 51,895 + 7,380 ^ 50,980 = 45,080 + 5,900		

2

The draft financial statement extracts indicate that there may be cash flow problems leading to concern over going concern. Dress You Like Co has seen falling gross profit margins during the year. For the supermarket customer, these are from 8% in 20X5 to 3% in 20X6 and for other customers 12% (20X5) to 10% (20X6). The receivables collection period for the supermarket customer is 81 days in 20X6 compared to 62 days in 20X5. For other customers the receivables collection period is largely stable at 31 and 33 days. The inventory holding period has risen from 35 days in 20X5 to 85 days in 20X6 largely due to stockpiling for last minute orders. Overall, the fall in margins, lack of credit control and increased inventory holdings mean that the company has gone from a cash position of \$200,000 in 20X5 to an overdraft of \$750,000 in 20X6. This further compounds cash flow and going concern worries and worries that inventory may be overstated.	Discuss the going concern status of Dress You Like Co with management. Obtain a copy of the cash flow forecasts produced by management and consider whether the assumptions on which they are based are reasonable, particularly in terms of the timings of cash received from customers. Discuss with management whether Dress You Like Co has any alternative funding available in the event that it struggles with cash flow. Discuss with management whether any disclosures relating to going concern have been made in the financial statements.

Skills checkpoint 2

How to approach audit risk questions



Introduction

The external auditor must assess the level of audit risk when planning an audit as this impacts the amount and nature of audit procedures they will perform. Consequently, questions on audit risk feature regularly in the Audit and Assurance (AA) exam.

There are two main types of audit risk questions: knowledge based questions where you need to explain audit risk and its components (inherent, control and detection risk), and scenario based questions on audit risk which tend to feature in Section B of the exam.

The Examiner's reports state that candidates' performance in Section B questions on audit risk can often be very mixed. You will be provided with a scenario and the requirement will ask you to 'Describe (for example) seven audit risks and explain the auditor's response to each risk in planning the audit of ABC Co'.

This skills checkpoint will therefore consider how you should approach such questions.

Skills Checkpoint 2: How to approach audit risk questions

AA Skill: How to approach audit risk questions

A step-by-step technique for ensuring that your approach to audit risk questions uses the scenario provided in the exam and maximises your marks is outlined below. Each step will be explained in more detail in the following sections and illustrated by answering a requirement from a past exam question.

STEP 1:

Allow some of your allotted time to read the requirements and the scenario.
Don't rush into starting to write your answer.



STEP 2:

Re-read the scenario and start to develop an answer plan.
Use the table headings provided (Audit risk and Auditor's response) and as you read through the scenario for the second time, write down a few words or a bullet point each time you identify a potential audit risk in the scenario.
Use these as headings in your answer.



STEP 3:

Re-read the requirement to confirm how many audit risks you need to describe.
You may have written down more headings than required, in which case decide which ideas you can explain most easily and include those in your answer.
When you write your answer the audit risk should describe the specific impact that the issue might have on the financial statements (ie a balance could be under/overstated or a disclosure missing) or the impact on the smooth running of the audit (ie information may not be available). Next explain the practical steps you would expect the auditor to take to address the risks.

Exam success skills

The following illustration is based on an extract from a past exam question, about a pharmaceutical manufacturer, called 'Abrahams'. This extract was worth 10 marks.

For this question, we will also focus on the following **exam success skills**:

- **Managing information.** It is easy for the amount of information contained in scenario based questions to feel overwhelming. To manage this, focus on the requirement first, noting the key exam verbs to ensure you answer the question properly. Then, read the rest of the question, noting important and relevant information from the scenario.
- **Correct interpretation of requirements.** Here you need to **both** describe the audit risk **and** explain the auditor's response to each risk.
- **Answer planning.** Everyone will have a preferred style for an answer plan. For example, it may be highlighting, bullet-pointed lists, or simply making notes. Choose the approach that you feel most comfortable with or, if you are not sure, try out different approaches for different questions until you have found your preferred style.
- **Effective writing and presentation.** Often, the examining team will specify the format your answer should take. If you follow this then you stand the best chance of maximising your marks. You may also wish to use sub-headings in your answer. You could use a separate sub-heading for each audit risk you identify in the scenario and then go on to explain the impact that audit risk could have on the financial statements or the smooth running of the audit.

Underline or embolden your headings and sub-headings and full sentences, ensuring your style is professional.

- **Good time management.** It is essential that you do not overrun on the constructed response questions in Section B and so you must always keep an eye on time. Note down the time you should finish the question.

Skill Activity

STEP 1 Allow some of your allotted time to read the requirement and the scenario. Do not rush into starting to write your answer.

Start by analysing the requirements so that you know what you are looking for when you read the scenario.

Required

(b) Using the information provided, describe **FIVE** audit risks, and explain the auditor's response to each risk in planning the audit of Abrahams Co.

Note. Prepare your answer using two columns headed Audit risk and Auditor's response respectively.

10 marks

The first part of the requirement is to 'describe **FIVE** audit risks'. Here you need to use the scenario to generate five issues that could cause a problem in the financial statements or affect the smooth running of the audit. Note that where you asked for *audit* risks, you should not be writing about *business* risks, which are something altogether different.

Problems in the financial statements could include:

- A balance being over or understated (for example if there is an error in the accounting treatment or cut-off)
- A disclosure being omitted or misleading (for example relating to a contingent liability)
- Uncertainty relating to going concern (for example loss of a key customer or the impending renewal of bank loan/overdraft facilities)
- Loss of client accounting information/systems

Events that might impact the smooth running of the audit include:

- The client is a new audit client (so the auditor is less familiar with the client's business/systems)
- Loss of key client personnel (for example the loss of a finance director/finance officer before the year-end)
- Whether there are time pressures on the audit or a tight reporting schedule

The second part of the requirement is to 'explain the auditor's response to each risk'. This does not mean that you need to provide a list of audit procedures but rather you should explain the practical action the auditor would take. For example, what questions should they ask, what information would they need, what documents would they require access to and which figures might they recalculate?

This requirement is worth 10 marks and at 1.8 minutes a mark, should take 18 minutes to both plan and write the solution.

Abrahams

Abrahams Co develops, manufactures and sells a range of pharmaceuticals and has a wide customer base across Europe and Asia. You are the audit manager of Nate & Co and you are planning the audit of Abrahams Co whose financial year end is 31 January. You attended a planning meeting with the finance director and audit engagement partner and are now reviewing the meeting notes in order to produce the audit strategy and plan. Revenue for the year is forecast at \$25 million.

During the year the company has spent \$2.2 million on developing several new products. Some of these are in the early stages of development whilst others are nearing completion. The finance director has confirmed that all projects are likely to be successful and so he is intending to capitalise the full \$2.2 million.

Once products have completed the development stage, Abrahams Co begins manufacturing them. At the year-end it is anticipated that there will be significant levels of work in progress. In addition, the company uses a standard costing method to value inventory; the standard costs are set when a product is first manufactured and are not usually updated. In order to fulfil customer orders promptly, Abrahams Co has warehouses for finished goods located across Europe and Asia; approximately one-third of these are third-party warehouses where Abrahams Co just rents space.

In September a new accounting package was introduced. This is a bespoke system developed by the information technology (IT) manager. The old and new packages were not run in parallel as it was felt that this would be too onerous for the accounting team. Two months after the system changeover, the IT manager left the company; a new manager has been recruited but is not due to start work until January.

In order to fund the development of new products, Abrahams Co has restructured its finance and raised \$1 million through issuing shares at a premium and \$2.5 million through a long-term loan. There are bank covenants attached to the loan, the main one relating to a minimum level of total assets. If these covenants are breached then the loan becomes immediately repayable. The company has a policy of revaluing land and buildings, and the finance director has announced that all land and buildings will be revalued as at the year-end.

The reporting timetable for audit completion of Abrahams Co is quite short, and the finance director would like to report results even earlier this year.

STEP 2 Now you should be ready to re-read the scenario and set out an answer plan using the risks you identify as you read through.

Use headings.

Work through each paragraph of the scenario identifying specific audit risks. Each risk is worth one mark and the auditor's response is also worth one mark, hence why you need five properly explained risks and responses to gain 10 marks.

Completed answer plan

Having worked through each paragraph, an answer plan can now be completed. A possible answer plan is shown here.

Abrahams Co develops, manufactures and sells a range of pharmaceuticals and has a wide customer base across Europe and Asia. You are the audit manager of Nate & Co and you are planning the audit of Abrahams Co whose financial year end is 31 January. You attended a planning meeting with the finance director and audit engagement partner and are now reviewing the meeting notes in order to produce the audit strategy and plan. Revenue for the year is forecast at \$25 million. During the year, the company has spent \$2.2 million on developing several new products. Some of these are in the early stages of development whilst others are nearing completion. The finance director has confirmed that all projects are likely to be successful and so he is intending to capitalise the full \$2.2 million¹.

Once products have completed the development stage, Abrahams Co begins manufacturing them. At the year-end, it is anticipated that there will be significant levels of work in progress². In addition, the company uses a standard costing method to value inventory; the standard costs are set when a product is first manufactured and are not usually updated.³ In order to fulfil customer orders promptly, Abrahams Co has warehouses for finished goods located across Europe and Asia; approximately one-third of these are third-party warehouses where Abrahams Co just rents space.⁴

In September, a new accounting package was introduced⁵. This is a bespoke system developed by the IT manager. The old and new packages were not run in parallel as it was felt that this would be too onerous for the accounting team. Two months after the system changeover the IT manager left⁶ the company; a new manager has been recruited but is not due to start work until January.

¹ Risk that intangible assets and profit may be overstated if IAS 38 PIRATE criteria not met

² Risk that work in progress may be overvalued/difficult to value – do we have sufficient skills? Expert required?

³ Standard costs used – must be kept up to date so they approximate to actual costs – inventory may be over/understated

⁴ Inventory held at third party locations – any inaccuracies in inventory count may lead to material over/understatement. Which locations should we attend for the inventory count?

⁵ New accounting system (and bespoke) – any errors on transfer of information could lead to material errors in fs. Testing required on transfer of balances.

⁶ IT manager left, replacement not yet started. Investigate level of errors occurring and support available. Document new internal controls.

In order to fund the development of new products, Abrahams Co has restructured its finance and raised \$1 million through issuing shares⁷ at a premium and \$2.5 million through a long-term loan. There are bank covenants⁸ attached to the loan, the main one relating to a minimum level of total assets. If these covenants are breached then the loan becomes immediately repayable. The company has a policy of revaluing⁹ land and buildings, and the finance director has announced that all land and buildings will be revalued as at the year-end.

The reporting timetable for audit completion of Abrahams Co is quite short¹⁰, and the finance director would like to report results even earlier this year.

⁷ Share issue – risk that transaction not properly disclosed in statement of changes in equity. Recalculate split between nominal value and premium.

⁸ Loan covenants exist – risk that financing could be recalled if covenants not met (going concern). Review covenants to determine whether breach has occurred and bank correspondence.

⁹ Revaluation may be required to satisfy loan covenants – risk that valuation overstated. Consider status of valuer (independent/competent).

¹⁰ Tight reporting timescale may not allow enough time to gather sufficient evidence. Plan to perform work on assets pre year end, use more experienced staff.

STEP 3 You will see that there are more than five audit risks, therefore choose the five that you can best explain.

Use your headings to write your answer, describe the audit risk in detail explaining the potential impact on the financial statements. Also remember to explain the practical steps the auditor would take and the work they would do.

Start each point in a new paragraph.

STEP 4 Suggested solution

Audit risk – Abrahams Co's finance director intends to capitalise the \$2.2 million of development expenditure incurred. This material amount should only be capitalised if the related product can generate future profits as set out in IAS 38 *Intangible Assets*. There is a risk that at least some of the expenditure does not meet the criteria. This will mean assets and profits are overstated¹¹.

Auditor's response – An analysis¹² showing developments costs in relation to each product should be obtained and reviewed. Testing should be carried out to ensure the technical and commercial feasibility of each product and, where it cannot be proven that future economic benefits will result from the product developed, the related costs should be expensed.

¹¹ Here the requirements of the accounting standard are explained as well as the potential impact on the fs

¹² Response is to obtain a breakdown of costs which have been capitalised and test them to determine whether they meet the IAS 38 criteria

Audit risk — At the year-end it is anticipated that there will be significant levels of work in progress, likely to constitute a material balance. The pharmaceuticals production process is likely to be complex and the audit team may not be sufficiently qualified to assess the quantity and value of work in progress. Therefore, they may be unable to gain sufficient evidence¹³ over a material area of the financial statements.

¹³ Audit risk explains that WIP is a complex/judgemental area so there is risk that the balance may be materially misstated

Auditor's response — Nate & Co should assess its ability to gain the required level of evidence and if it is not sufficient, it should approach an independent expert to value the work in progress. This should be arranged after obtaining consent from Abrahams Co's management and in time for the year-end inventory count.

Audit risk — In September, a new accounting package was introduced. The fact the two systems were not run in parallel increases the risk that errors occurring during the changeover were not highlighted, and all areas of the financial statements could potentially be affected.¹⁴

¹⁴ New accounting system brings the risk that data produced by the new system at the year-end may not be reliable

Auditor's response — The new system will need to be fully documented¹⁵ by the audit team including relevant controls. Testing should be performed to ensure the closing data on the old system was correctly transferred as the opening data on the new system, and that transactions have not been duplicated on both systems and therefore included twice.

¹⁵ Action: document new system and test changeover of data

Audit risk — The loan has covenants¹⁶ attached to it. If these are breached then the loan would be repayable straight away and would need to be classified as a current liability, potentially resulting in a net current liability position on the statement of financial position. If the company did not have sufficient cash available to repay the loan balance the going concern status of the company could be threatened.

¹⁶ Loan covenants pose a going concern risk if breached and also the potential to manipulate fs to ensure breaches do not occur

Auditor's response — Obtain and review (or reperform) covenant calculations to identify any breaches. If there are any the likelihood of the bank demanding repayment will need to be assessed and the potential impact on the company considered. The need to avoid breaching the covenants reinforces the audit team's need to maintain professional scepticism¹⁷ in areas that could be manipulated.

¹⁷ Response – be alert for potential manipulation, review covenants for evidence of breaches

Audit risk — The already short reporting timetable¹⁸ for Abrahams Co is likely to be reduced. This could increase detection risk because there is pressure on the team to obtain sufficient and appropriate evidence in a shorter timescale, which could adversely influence judgement on the size of samples and the extent of work needed.

¹⁸ Risk that short timescale means we cannot gather all of the evidence that we need to form our opinion

Auditor's response — If it is confirmed with the finance director that the time available at the final audit is to be reduced then the ability of the team to gather sufficient appropriate evidence should be assessed. If it is not realistically possible to perform all the required work at a final audit then an interim audit¹⁹ should take place in late December or early January to reduce the level of work to be done at the final audit.

¹⁹ Response is to perform work before the year end to reduce pressure after the year end

Exam success skills diagnostic

Every time you complete a question, use the diagnostic below to assess how effectively you demonstrated the exam success skills in answering the question. The table has been completed below for the 'Abrahams' activity to give you an idea of how to complete the diagnostic.

Exam success skills	Your reflections/observations
Managing information	Did you identify audit risks in the scenario?
Correct interpretation of requirements	Did you identify that you only need five audit risks and five (related) auditor's responses to gain ten marks?
Answer planning	Did you draw up an answer plan using your preferred approach (eg highlighting, bullet-pointed list)? Did your plan help to create a structure for your answer?
Effective writing and presentation	Did you use headings (key words from requirements)? Did you use full sentences? And most importantly – did you explain why your points constituted an audit risk?
Good time management	Did you manage to read, plan and write out your solution in the allotted time?

Exam success skills	Your reflections/observations
Most important action points to apply to your next question	

Summary

You are likely to see a scenario-based question on audit risk in the exam. You cannot prepare for every type of business and all audit risks, however you can equip yourself with the skills to attempt audit risk questions by using the information given in the question to guide the structure of your answer. A key skill is then applying this back to the given scenario. You will not be able to pass these questions unless you explain both the audit risk and the auditor's response. It is therefore essential that you try to create a practical answer that is relevant to the scenario, and/or addresses the issues identified in the scenario, instead of simply producing risks/responses you have learned by heart.

As you move into practising questions as part of your final revision, you will need to practise taking in information from a scenario quickly (using active reading), accurately understanding the requirements, and creating an answer plan and a final answer that addresses the requirements in the context of the scenario.



Audit planning and documentation

Learning objectives

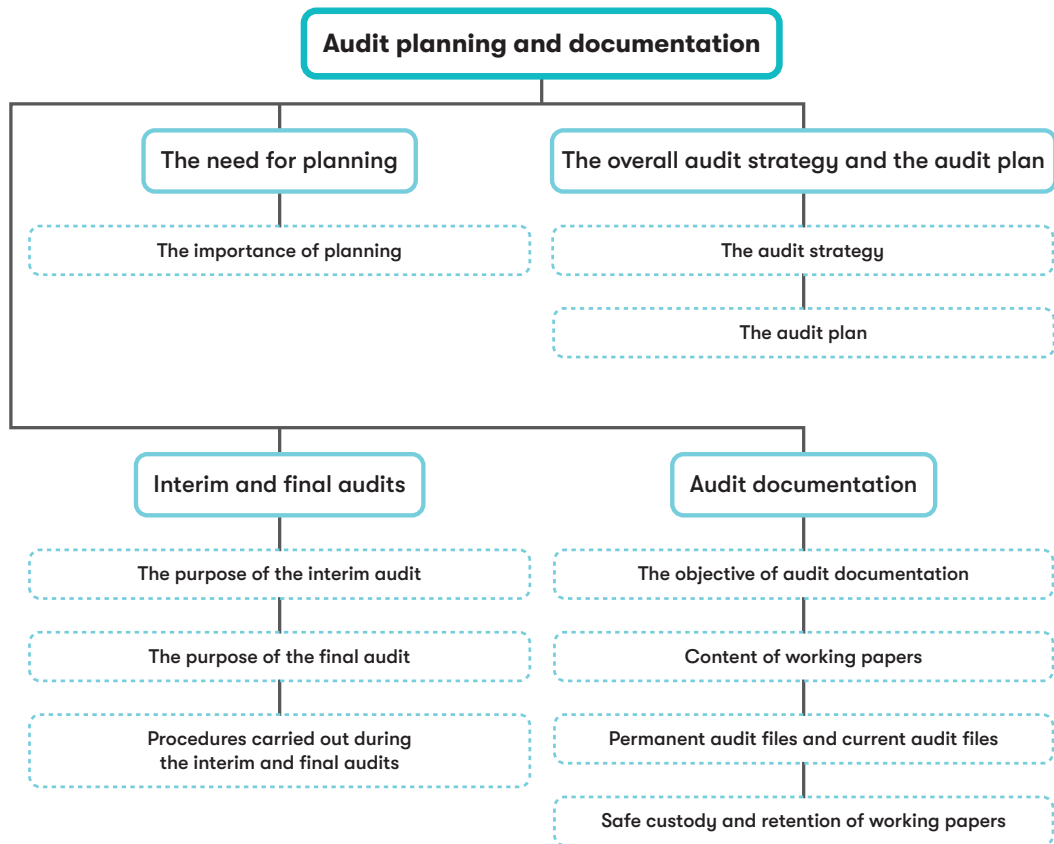
On completion of this chapter, you should be able to:

Syllabus learning outcomes	Syllabus reference no.
Identify and explain the need for, benefits of and importance of planning an audit	B6 (a)
Identify and describe the contents of the overall audit strategy and audit plan	B6 (b)
Explain and describe the relationship between the overall audit strategy and the audit plan	B6 (c)
Explain the difference between an interim and final audit	B6 (d)
Describe the purpose of an interim audit, and the procedures likely to be adopted at this stage in the audit	B6 (e)
Describe the impact of the work performed during the interim audit on the final audit	B6 (f)
Explain the need for, and the importance of, audit documentation	B6 (g)
Describe the form and contents of working papers and supporting documentation	B6 (h)
Explain the procedures to ensure safe custody and retention of working papers	B6 (i)

Business and Exam context

This chapter covers the more detailed aspects of audit planning and the documentation that is produced at this stage of the audit. It is important to understand why we plan an audit and the purpose, form and content of audit documentation. We will also look at the retention of documentation, who it belongs to and whether we are allowed to show it to anyone else.

Chapter overview



1 The need for planning

1.1 The importance of planning

An effective and efficient audit relies on proper planning procedures. ISA 300 *Planning an Audit of Financial Statements* states the auditor shall plan the audit work so that the engagement will be performed in an effective manner.

The objectives of planning are:

To ensure that appropriate attention is devoted to important areas of the audit

To ensure that potential problems are identified and resolved on a timely basis

To ensure that audit work is organised and completed expeditiously

To enable appropriate audit staff to be selected and for work to be properly assigned to them

To facilitate the direction, supervision and review of audit work performed

To co-ordinate work done by experts and other auditors

The form and nature of planning is different for each audit and is affected by:

- Size of the entity
- Complexity of the audit
- Auditor's experience with the entity and their knowledge of the business
- Commercial environment
- Method of processing transactions
- Reporting requirements

2 The overall audit strategy and the audit plan

2.1 The audit strategy



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 appendix to ISA 300 sets out the following matters that should be considered when establishing an overall audit strategy:

Matters to consider

Characteristics of the engagement (ISA 300: para. 8(a))

- 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

Matters to consider	
Reporting objectives, timing of the audit and nature of communications (ISA 300: para. 8(b))	• 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 (ISA 300: para. 8(c)–(d))	• 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 • Changes within the applicable reporting framework which may involve significant new or revised disclosures • Volume of transactions • Process used by management to identify and prepare disclosures • Significant business developments • Significant industry developments • Significant changes in financial reporting framework • Other significant recent developments
Nature, timing and extent of resources (ISA 300: para. 8(e))	• Selection of engagement team • Assignment of work to team members • Engagement budgeting

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

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

2.2 The audit plan



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 sets out the detailed audit procedures which need to be performed in order to implement the audit strategy and includes 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

(ISA 300: para. 9)

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)
- Materiality for the financial statements as a whole and performance materiality

During the audit the auditor may need to modify the overall audit strategy or audit plan, due to unexpected events, changes in conditions or audit evidence obtained. All decisions must be documented and reviewed. (ISA 300: para. 12(c))

3 Interim and final audits

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**.

Any interim audit visits are carried out **during the period of review** and the final audit visit will take place **after the year end**.

3.1 The purpose of the interim audit

The purpose of the interim audit is to **carry out procedures that would be difficult to perform at the year end** because of time constraints.

Work performed during an interim audit tends to focus on **risk assessment** and on **documenting and testing internal controls**.

Some substantive procedures can also be carried out but these are limited because statement of financial position figures will not be the ones reported on.

3.2 The purpose of the final audit

During the final audit, the auditor will focus on the audit of the financial statements and issue a report which contains the opinion expressed on the financial statements covering the entire year being audited.

The final audit opinion will take account of conclusions reached at both (or all) audit visits.

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.

3.3 Procedures carried out during the interim and final audits

The following table shows the procedures performed at the interim and final audits:

Interim audit procedures may include:	Final audit procedures include:
• Inherent risk assessment and gaining an understanding of the entity • Recording the entity's system of internal control • Evaluating the design of internal controls • Carrying out tests of controls on the company's internal controls to ensure they are operating as expected • Performing substantive testing of transactions/balances to gain evidence that the books and records are a reliable	• Substantive procedures involving verification of statement of financial position balances and amounts in the statement of profit or loss • Obtaining third-party confirmations • Analytical procedures relating to figures in the financial statements • Subsequent events review • Agreeing the financial statements to the accounting records

Interim audit procedures may include:	Final audit procedures include:
basis for the preparation of financial statements • Identification of issues that may have an impact on work to take place at the final audit	• Examining adjustments made during the process of preparing the financial statements • Consideration of the going concern status of the entity • Performing tests to ensure that the conclusions formed at the interim audit are still valid • Obtaining written representations



Essential reading

See Chapter 7 of the Essential reading for information on how the work performed at the interim audit impacts the final audit.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

4 Audit documentation



PER alert

Objective 19 of the PER performance objectives is to collect and evaluate evidence for an audit or assurance engagement. One of the ways to demonstrate PO 19 is through the preparation of working papers that document and evaluate audit procedures. The knowledge you gain in this section will be a useful aid in preparing these sorts of working papers.

4.1 The objective of audit documentation

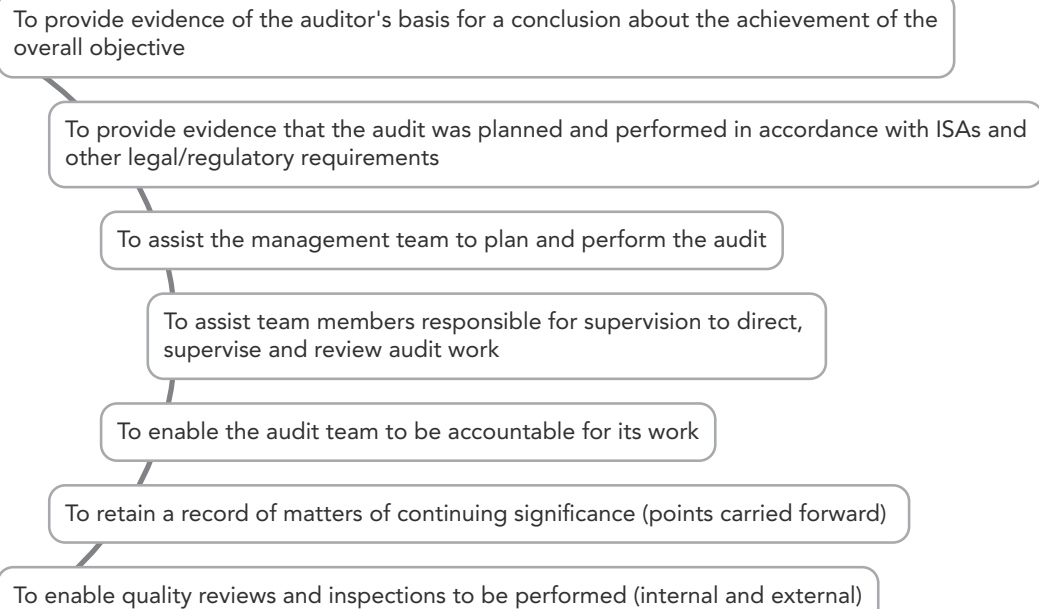


Audit documentation: is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as 'working papers' or 'work papers' are also sometimes used). (ISA 230: para. 6(a))

All audit work must be documented: the working papers are the tangible evidence of the work done to support the audit opinion.

ISA 230 *Audit Documentation* (para. 7), states that 'the auditor shall prepare audit documentation on a **timely basis**'.

Audit documentation is necessary for the following reasons. (ISA 230: para. 3)



4.2 Content of working papers

Working papers should be sufficiently complete and detailed to **enable an experienced auditor with no previous connection** with the audit subsequently to ascertain from them what work was performed and to support the conclusions reached. (ISA 230: para. 8)

They should record information on the auditor's planning of the audit, the nature, timing and extent of the audit procedures performed, and the results thereof, and the conclusions drawn from the audit evidence obtained.

They should also document the auditor's reasoning on all significant matters requiring exercise of judgement, with auditor's conclusions thereon.



Essential reading

See Chapter 7 of the Essential reading for examples of working papers and an illustration of a typical audit working paper.

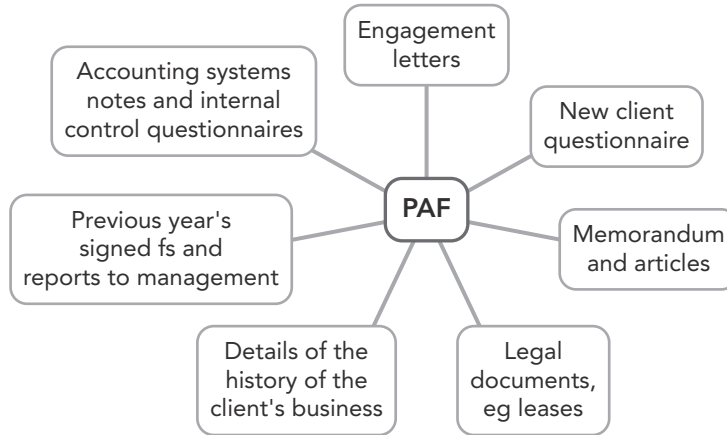
The Essential reading is available as an Appendix of the digital edition of the Workbook.

4.3 Permanent audit files and current audit files

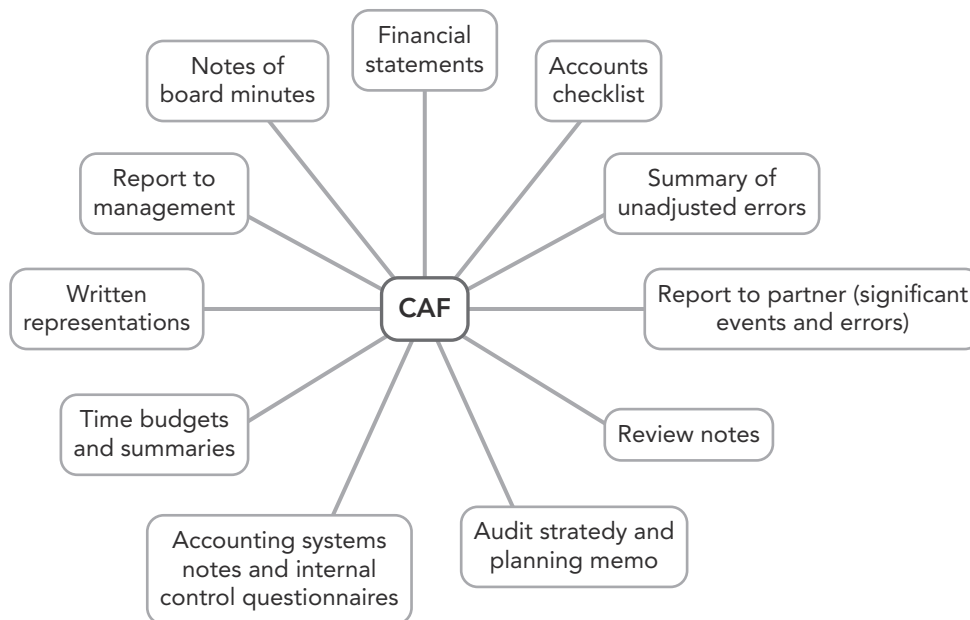
Working papers may be divided in to two types:

- Permanent audit files (containing information of **continuing importance** to the audit; and
- Current audit files (containing information relevant to the **current year's audit**).

Examples of information included in the permanent audit file (PAF) are:



Examples of information included in the current audit file (CAF) are:



The current audit file also contains working papers covering each audit area. These should include a lead schedule for each balance in the financial statements and a list of audit procedures performed along with the results and conclusions of the testing.

4.4 Safe custody and retention of working papers

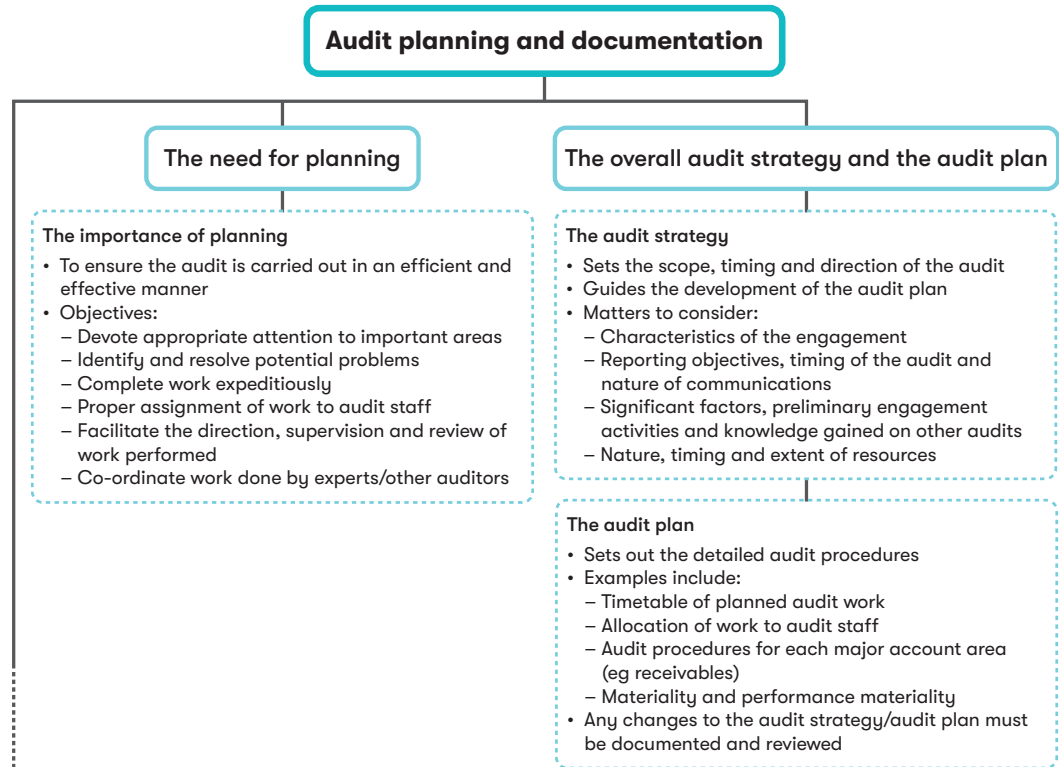
Working papers are the property of the auditors and so the audit firm should establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of documentation, for example:

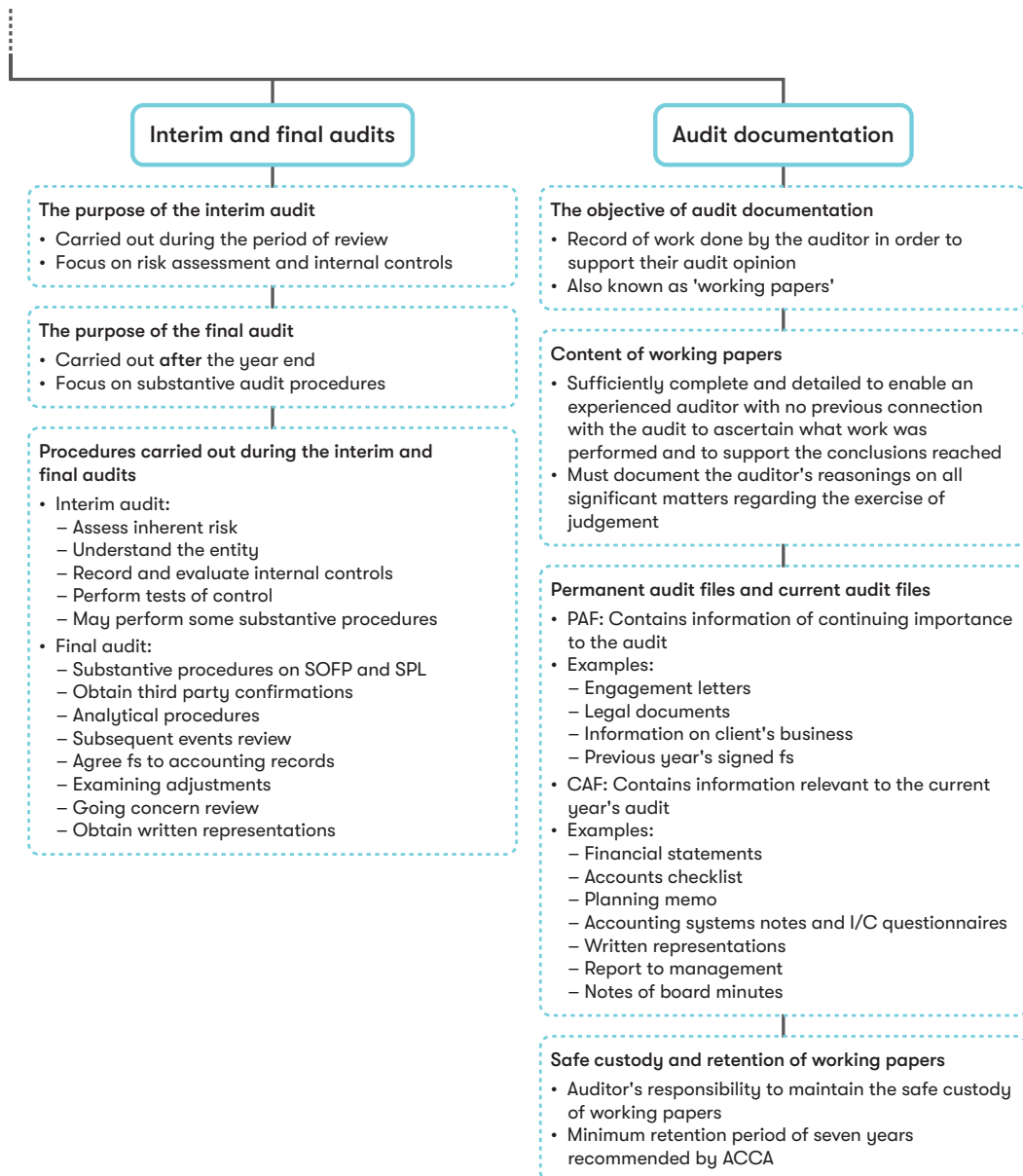
- Passwords to restrict access to electronic documentation to authorised users
- Back-up routines
- Confidential storage of hard copy documentation

The ACCA recommends **seven years** as a minimum retention period.

Information contained in working papers should not be made available to third parties without the permission of the entity.

Chapter summary





Knowledge diagnostic

1. Objectives of planning

An auditor must plan their audit work in order to ensure that the audit engagement is performed in an effective manner. This will mean that appropriate attention is devoted to each area, that work is directed, supervised and reviewed and that appropriate audit staff are allocated to the audit team.

2. 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. It should consider the characteristics of the engagement; the reporting objectives, timing of the audit and nature of communications; the significant factors, preliminary engagement activities; knowledge gained on other engagements and the nature, timing and extent of resources.

3. Audit plan

The audit plan is more detailed than the audit strategy and includes the nature, timing and extent of audit procedures that will be performed in order to obtain sufficient appropriate audit evidence. It will show the timetable of planned work; allocation of work to audit team members; audit procedures for each major account area and materiality for the financial statements as a whole and performance materiality.

4. Interim and final audits

Audit work is normally carried out over the course of more than one sitting. Audit work performed during the period of review is called interim audit work and audit work performed after the year end is called final audit work.

5. Interim audit: procedures

Audit procedures performed during an interim audit focus on risk assessment, internal controls testing and identification of issues that may affect the final audit.

6. Final audit: procedures

Audit procedures performed during the final audit focus on substantive audit procedures (including analytical procedures), subsequent events review, going concern review and obtaining written representations.

7. Audit documentation

Audit documentation forms a record of the work performed by the auditor and the basis of conclusion for their opinion on the financial statements.

8. Permanent and current audit files

There are two main types of audit documentation: the permanent audit file contains information of continuing importance to the audit and the current audit file contains information relevant to the current year's audit.

Further study guidance

Question practice

Now try the following from the Further question practice bank [available in the digital edition of the Workbook]:

- Section A Q16 and Q20
- Section B Q57 Audit planning and documentation

Further reading

There are technical articles and study support videos on the ACCA website written/recorded by members of the AA examining team and other tutors which are relevant to some of the topics covered in this chapter that you should read:

Technical articles:

- *Audit working papers* (<https://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/effective-audit-service.html>)

Own research

Imagine the situation whereby an auditor is taken to court and accused of not having performed an audit properly. What sort of information do you think the auditor should have documented in order to demonstrate that they had conducted their audit in accordance with ISAs?



Introduction to audit evidence

Learning objectives

On completion of this chapter, you should be able to:

Syllabus learning outcomes	Syllabus reference no.
Explain the assertions contained in the financial statements about classes of transactions and events and related disclosures; and account balances and related disclosures at the period end.	D1 (a)
Describe audit procedures to obtain audit evidence, including inspection, observation, external confirmation, recalculation, re-performance, analytical procedures and enquiry.	D1 (b)
Discuss the quality and quantity of audit evidence.	D1 (c)
Discuss the relevance and reliability of audit evidence.	D1 (d)
Discuss substantive procedures for obtaining audit evidence.	D2 (a)
Discuss and provide examples of how analytical procedures are used as substantive procedures.	D2 (b)
Discuss the difference between tests of control and substantive procedures.	D2 (e)

Business and Exam context

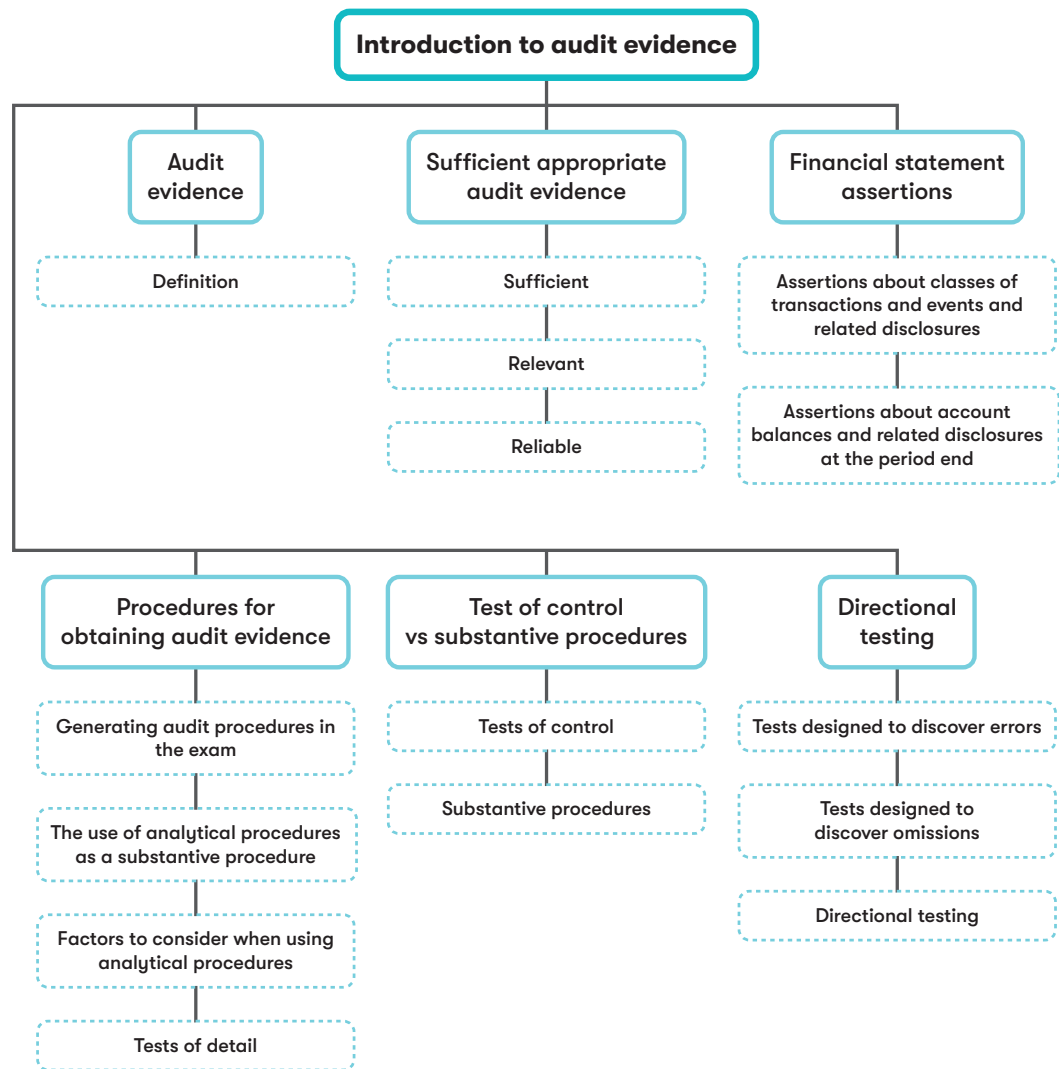
This chapter is an introductory chapter to the next ten chapters where we consider what audit evidence is and the methods the auditor uses to gather that evidence. We will look at the type and quantity of evidence that we need to gather to support the opinions we make. We want to ensure that we have enough, in other words sufficient, evidence and the right type of evidence, in other words appropriate evidence. So, we will consider what exactly is meant by sufficient, appropriate evidence in a bit more detail.

We will then learn about the financial statement assertions. These are the statements that management make about the financial statements that we are auditing. For example, when management include an amount for property, plant and equipment in the statement of financial position they are asserting that, amongst other things, the assets exist. As auditors, we need to make sure that this is really the case and so will need to gather evidence relating to the existence of property, plant and equipment. Similarly, auditors need to gather evidence over several other assertions, so it is essentially we understand what these actually are.

We will also discuss the procedures auditors can use to gather audit evidence. There are five main types of procedures which can be remembered with the mnemonic **AEIOU**: Analytical procedures,

enquiry (both internal and external), inspection, observation and recalculation (including re-performance).

Chapter overview



1 Audit evidence

1.1 Definition

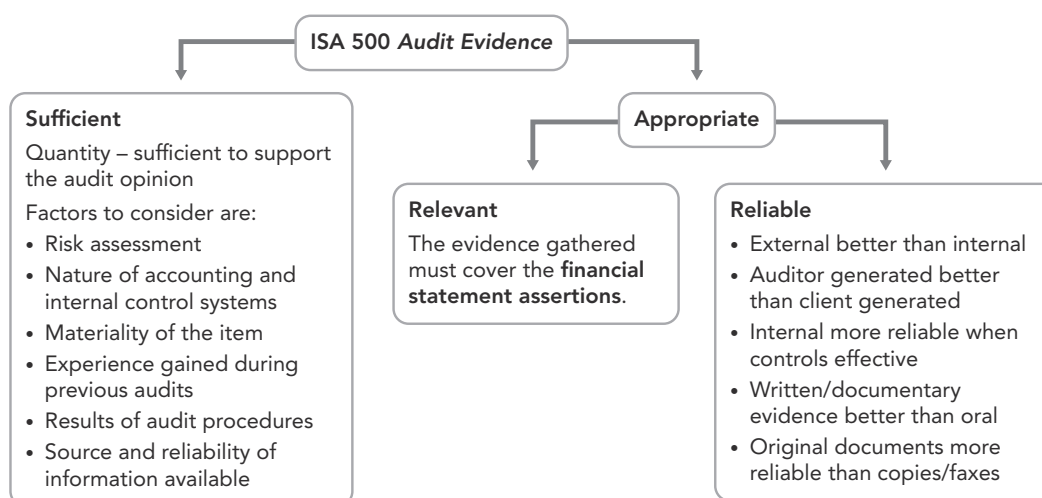
The objective of an audit of financial statements is to enable the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework (ISA 200: para. 3).



Audit evidence: is all the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based **Audit evidence (ISA 500: para. 5(c)).**

2 Sufficient appropriate audit evidence

The auditor should obtain **sufficient appropriate** audit evidence to be able to draw reasonable conclusions on which to base the audit opinion (ISA 500: para. 4).



PER alert

Objective 19 of the PER performance objectives is to collect and evaluate evidence for audit or assurance engagement. You can apply the knowledge you gain from this and subsequent chapters to assist in achieving this objective.

3 Financial statement assertions



Assertions: Representations, explicit or otherwise, with respect to the recognition, measurement, presentation and disclosure of information in the financial statements which are inherent in management representing that the financial statements are prepared in accordance with the applicable financial reporting framework. Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing and responding to the risks of material misstatement (ISA 315: para. 12a).

Evidence must be relevant to the particular financial statement **assertion** the auditor is trying to test. There are two categories:

Assertions about classes of transactions

Occurrence:

Transactions and events that have been recorded or disclosed

and events and related disclosures O C C C A P	have occurred and pertain to the entity. Completeness: All transactions and events that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included. Cut-off: Transactions and events have been recorded in the correct accounting period. Classification: Transactions and events have been recorded in the proper accounts. Accuracy: Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described. Presentation: Transactions and events are appropriately aggregated or disaggregated and are clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.
Assertions about account balances and related disclosures at the period end C O V E C P	Completeness: All assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included. Obligations and rights: The entity holds or controls the rights to assets, and liabilities are the obligations of the entity. Valuation, accuracy 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, and related disclosures have been appropriately measured and described. Existence: Assets, liabilities, and equity interests exist. Classification: Assets, liabilities, and equity interests have been recorded in the proper account. Presentation: Assets, liabilities and equity instruments are appropriately aggregated or disaggregated and are clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

Sometimes an entity will use an **expert**, for example a chartered surveyor, to assist them in the preparation of the financial statements.



Management's expert: 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 states that when wanting to rely on the work of the 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.

If the auditor is unable to obtain sufficient appropriate evidence, then they should consider the implications for the auditor's report (Chapter 20).

4 Procedures for obtaining audit evidence

There is rarely one piece of audit evidence that gives sufficient appropriate evidence over a class of transactions, account balance or presentation and disclosure. Rather, audit evidence is obtained by performing an appropriate mix of audit procedures.

There are two types of audit procedure:



Tests of controls: audit procedures designed to **evaluate the operating effectiveness of controls** in preventing, or detecting and correcting, material misstatements at the assertion level (ISA 330: para. 4(b)).

Substantive procedures: audit procedures designed to detect material misstatements at the assertion level. Substantive procedures comprise:

- (a) Tests of details (of classes of transactions, account balances, and disclosures); and
- (b) Substantive analytical procedures

(ISA 330: para. 4(a))

4.1 Generating audit procedures in the exam

Exam questions will often ask you to describe audit procedures for specific items, for example additions to property, plant and equipment. The mnemonic **AEIOU** may be useful in helping you to generate audit procedures.

Audit procedure	Description	Type of procedure
Analytical procedures	The evaluation of financial information by a comparison to financial and non-financial data and the investigation of significant differences and relationships which are inconsistent with other information	Substantive procedure
Enquiry (and confirmation)	Seeking information of knowledgeable persons throughout the entity or outside the entity (enquiry) and obtaining representations directly from a third party (confirmation)	Enquiry – both substantive procedure and a test of controls Confirmation – substantive procedure
Inspection	Examining records, documents and tangible assets	Both
Observation	Looking at a process or procedure being performed by others	Test of controls
Recalculation (and re-performance)	Verifying the arithmetical accuracy of documents or records and the auditor's	Recalculation – substantive procedure

Audit procedure	Description	Type of procedure
	independent execution of procedures and the re-performance of controls	Re-performance – test of controls

4.2 The use of analytical procedures as a substantive procedure

There are three main types of analytical procedures which an auditor can use:

Variance analysis

- the review of current year financial information in comparison to prior period or budgeted information

Ratio analysis

- the calculation of ratios and analysis and investigation of **significant differences**

Proof in total

- the use of interrelationships between data (financial and non-financial) to estimate an expected value in the financial statements, again with the investigation of significant differences

4.3 Factors to consider when using analytical procedures

The auditor will need to consider:

The suitability of analytical procedures to a particular **assertion**

The **reliability of the data** from which the expected amounts or ratios are developed

Whether the expectation is sufficiently precise to identify a **material** misstatement

The amount of any **difference that is acceptable** without further investigation being required

4.4 Tests of details

Tests of details are a further type of substantive procedure and describe the process of gathering audit evidence through detailed inspection of invoices, documents and assets.

Examples include:

- Inspection of invoices** to verify the accuracy of the amounts recorded in the financial statements
- Physical inspection** of non-current assets and inventory to verify their existence
- Review of **board meeting minutes** for evidence of any provisions for legal claims which should be included in the financial statements
- Review of after-date monies received** per the cash book in order to gain evidence over the valuation of receivables



Essential reading

See Chapter 8 of the Essential reading for more information on audit procedures to obtain audit evidence.

The Essential reading is available as an Appendix of the digital edition of the Workbook.



Activity 1: Analytical procedures

You are an audit senior of Check & Co and are currently conducting the audit of HMA for the year ended 30 September 20X6.

HMA Co (HMA) is a marketing company that designs advertisements which are then placed in newspapers and magazines and on websites. During the course of the audit a number of events and issues have been brought to your attention.

Expenses

HMA rents an office in an upmarket location in order to promote itself as a fashionable and quality marketing company. HMA currently has a Human Resource team, Accounts department and Sales team and also employs a significant number of design staff.

On 1 January 20X6 HMA decided that it needed to occupy a second floor in its current office premises in order to be able to create a specialist publishing department so that the designers' adverts can be modified in-house which would then allow them to be used across different publishing platforms (both published products and online). The directors decided to take out a loan to help fund the cost of this in the short term.

The following information is available in relation to the loan:

	\$
Finance charge in the statement of profit or loss	81,000
Opening loan liability on 1 January 20X6	400,000

The loan carries a fixed rate of interest of 2% per month and interest is paid at the end of each month. HMA repaid capital of \$50,000 on 1 April 20X6. In order to verify the finance charge for the year, you have been asked to perform a proof in total.

Required

What is the expected finance charge for the above loan for the year ended 30 September 20X6 and the resultant impact on profit for the period?

- ☐ Finance charge should be \$96,000, profit is overstated
- ☐ Finance charge should be \$72,000, profit is understated
- ☐ Finance charge should be \$67,000, profit is understated
- ☐ Finance charge should be \$66,000, profit is understated



Activity 2: Analytical procedures

In relation to the rent expense for the office premises:

Required

Which of the following audit procedures would provide the auditor with the MOST reliable audit evidence regarding the rent expense?

- ☐ Calculate the rent expense variance this year compared to last year and discuss any significant differences with management.
- ☐ Obtain a copy of the latest rental agreement and recalculate the expected rent expense for the year.
- ☐ Agree the rent expense to copies of invoices provided by management
- ☐ Determine the general level of rent increases during the year for offices near to HMA's location and recalculate the expected rent expense. Discuss any significant differences with management.



Activity 3: Analytical procedures

The audit assistant who has been assigned to help you appears to be unsure as to which audit procedures provide audit evidence in relation to different financial statement assertions.

Required

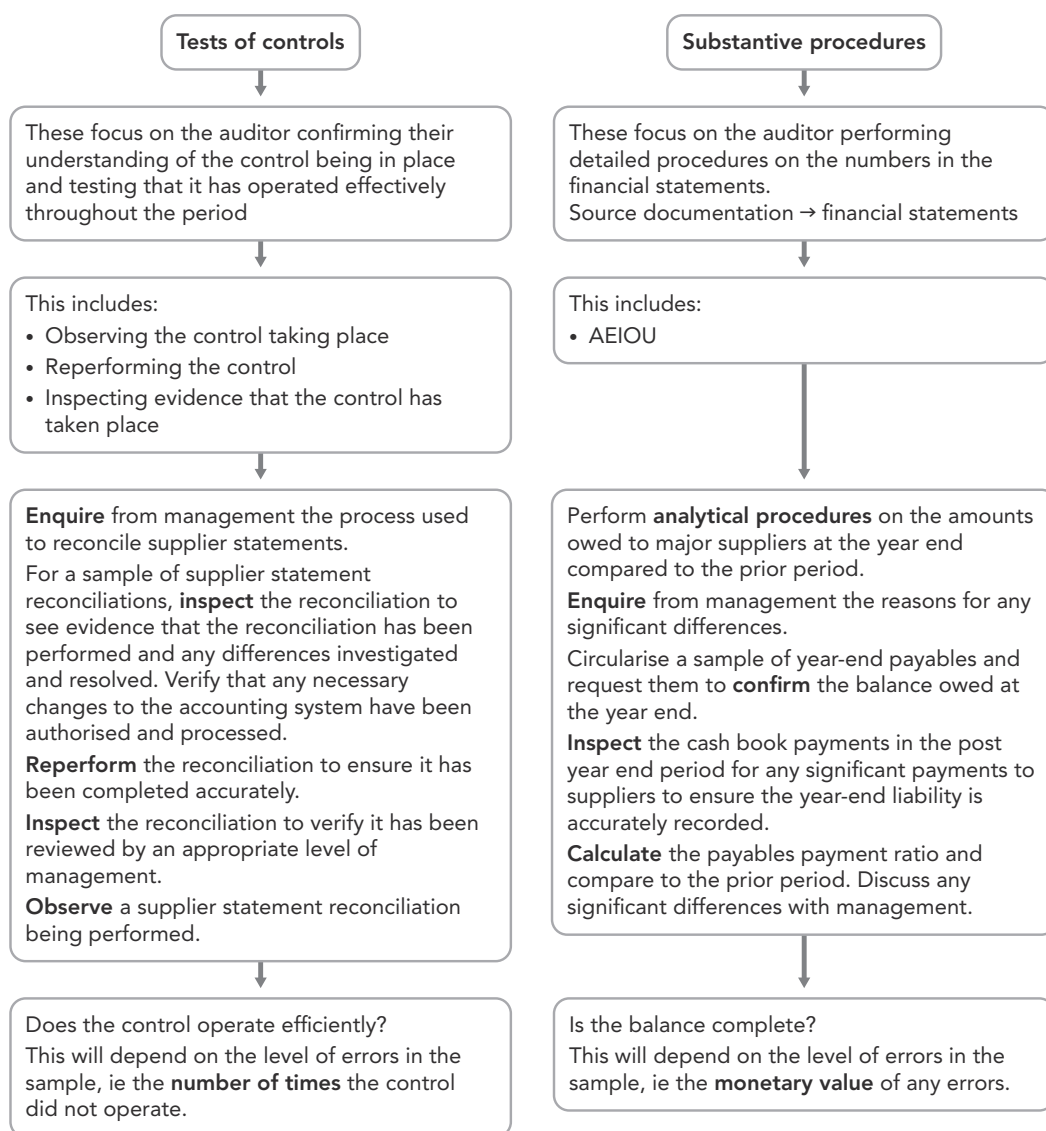
Which of the following audit procedures provide evidence over the CUT OFF assertion for revenue?

- ☐ Obtain a breakdown of revenue for the period and vouch a sample of revenue values to sales invoices.
 - ☐ Calculate the gross profit margin for the years ended 30 September 20X6 and 20X5 and investigate any significant differences in the ratio with management.
 - ☐ Review credit notes issued post year end to determine the levels of returns and whether any adjustment is required in the financial statements.
 - ☐ Review cash book receipts during the post year end period to determine whether any sales need to be removed due to irrecoverable debts.
-

5 Tests of control vs substantive procedures

Gaining audit evidence through tests of controls is very different from gaining audit evidence through substantive procedures.

For example, consider audit procedures to test the **completeness** of the **payables** balance:



6 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)

6.1 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 receivables ledger. Prices would then be checked to the official price list.

6.2 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 payables ledger.

6.3 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 receivables ledger was chosen from a file of sales invoices then it would not substantiate the fact that there were no errors in the receivables 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 procedures 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.

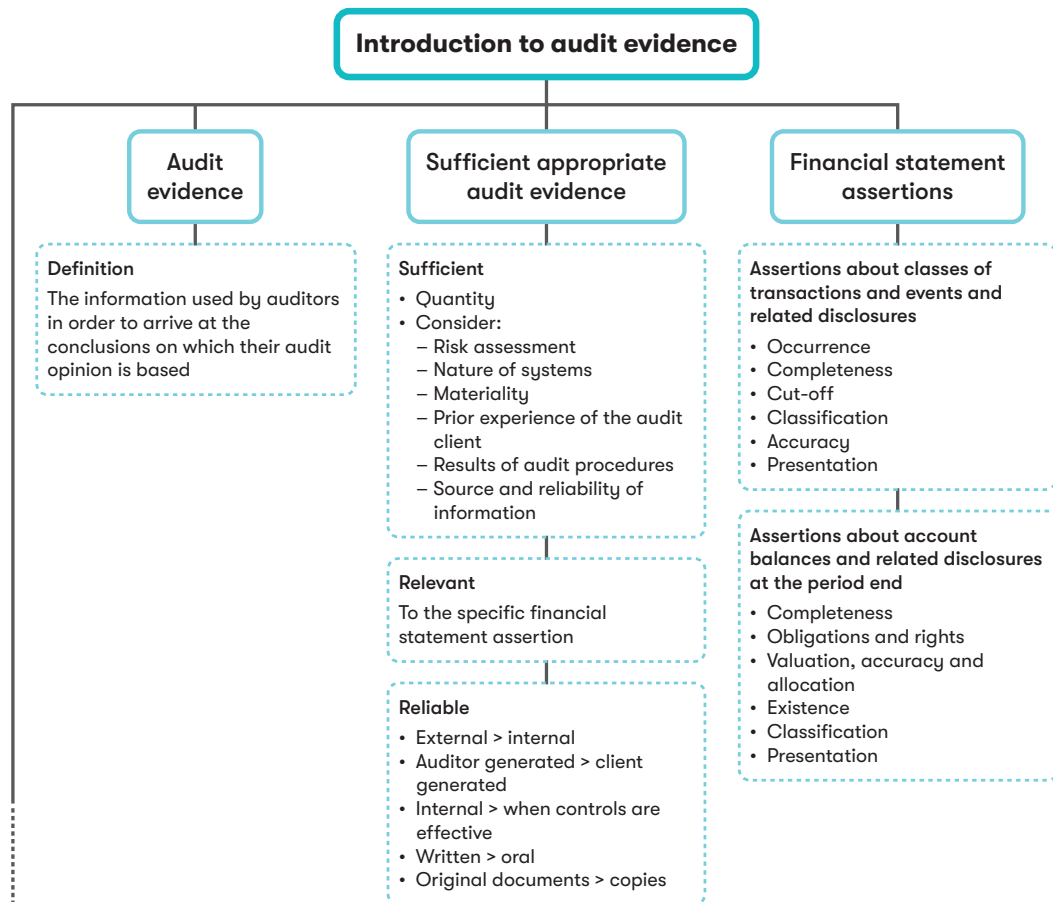
Audit procedures are therefore designed in the following way:

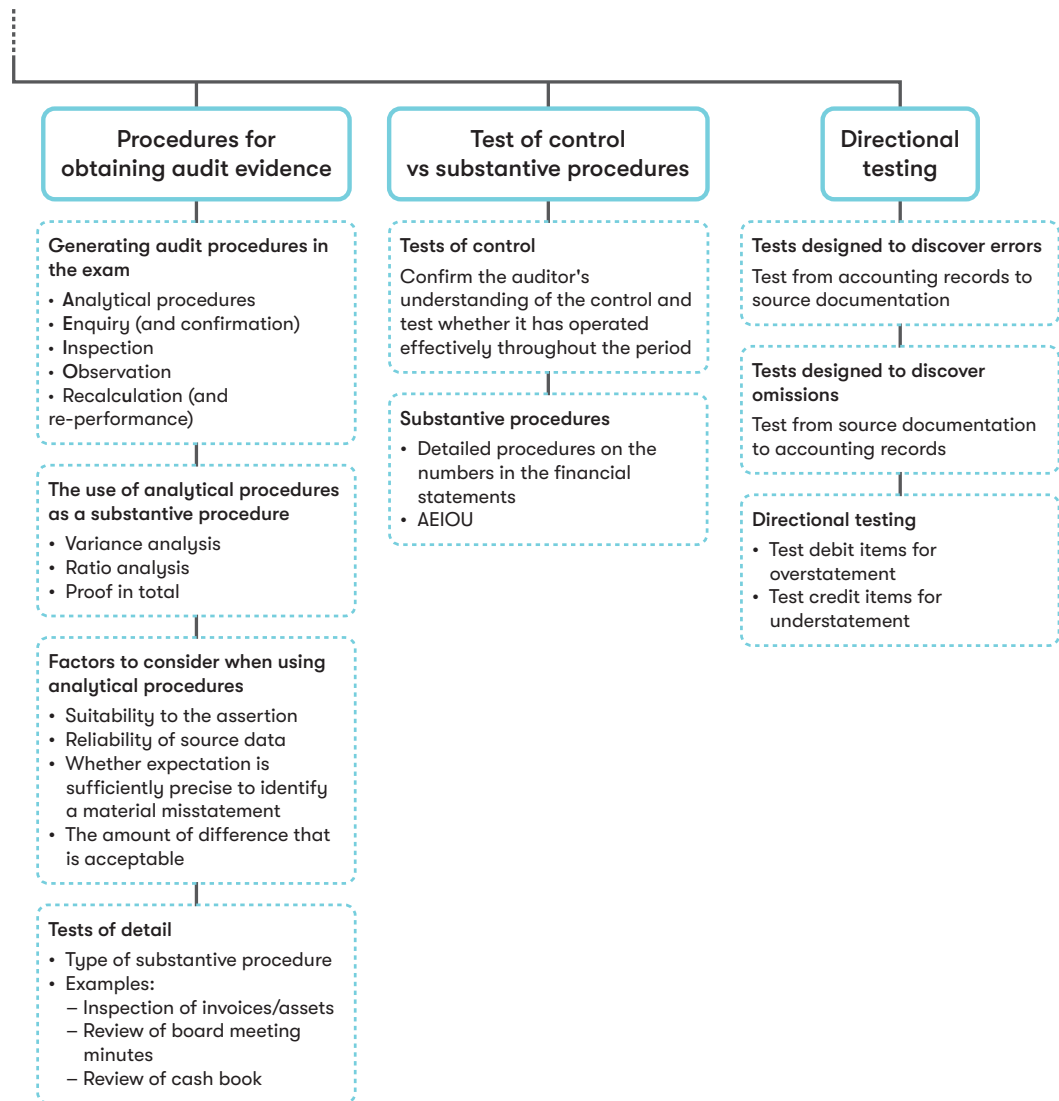
Test item	Example
Test debit items (expenditure or assets) for overstatement by selecting debit entries recorded in the nominal ledger and confirming value, existence and ownership.	If a non-current asset entry in the nominal ledger of \$1,000 is selected, it would be overstated if it should have been 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 despatched note and agree that the resultant sale has been recorded in the nominal ledger revenue account. Revenue 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 revenue 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 for both overstatement and understatement.

Chapter summary





Knowledge diagnostic

1. Reasons for obtaining evidence

Auditors need to gain audit evidence in order to support the conclusions on which they base their auditor's opinion.

2. Quantity and quality of evidence

The auditor should obtain **sufficient appropriate** audit evidence. Evidence is appropriate if it is both **relevant** (to the **financial statement assertion** being tested) and **reliable**.

3. Financial statement assertions

There are two categories of financial statement assertions: assertions about **classes of transactions and events and related disclosures** and assertions about **account balances and related disclosures at the period**.

4. Types of substantive procedures

There are two types of audit procedures: tests of controls and substantive procedures. Substantive procedures are broken down into two further categories: tests of details and analytical procedures. The mnemonic **AEIOU** serves to remind you of the ways in which you can generate audit procedures.

5. Tests of controls

Tests of controls involve identifying and repeatedly testing an entity's internal controls in order to determine whether they have operated effectively throughout the period under audit.

6. Substantive procedures

Substantive procedures are used by the auditor to detect material misstatements.

Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

- Section A Q17
- Section B Q58 Audit evidence considerations

Further reading

There are technical articles on the ACCA website written/recorded by members of the AA examining team and other tutors which are relevant to some of the topics covered in this chapter that you should read:

- *The audit of financial statement assertions*: www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/assertions.html
- *Analytical procedures*: www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p7/technical-articles/analytical-procedures.html

Own research

Consider the entity that you work for and talk to some of the staff in the finance department who deal with the auditors when they visit. Do the auditors focus mainly on tests of controls or substantive procedures?

Activity answers

Activity 1: Analytical procedures

The correct answer is: Finance charge should be \$66,000, profit is understated

	\$
1.1.X6 - 31.3.X6	
$(\$400,000 \times 2\%) = \$8,000 \times 3 \text{ months}$	24,000
1.4.X6 - 30.9.X6	
$(\$400,000 - \$50,000) \times 2\% = \$7,000 \times 6 \text{ months}$	<u>42,000</u>
Total	<u><u>66,000</u></u>

Activity 2: Analytical procedures

The correct answer is: Obtain a copy of the latest rental agreement and recalculate the expected rent expense for the year.

The latest rental agreement is documented evidence from a third party and should stipulate the rental charge for both floors which are now occupied by HMA

Activity 3: Analytical procedures

The correct answer is: Calculate the gross profit margin for the years ended 30 September 20X6 and 20X5 and investigate any significant differences in the ratio with management.

Generally speaking, an entity's gross profit margin tends to remain relatively stable and so any unexpected changes should be investigated as they could indicate that material misstatements exist. For example, an unexpected increase in gross profit margin could indicate a cut-off error where sales after the year end have been included in the year-end figures.



Internal control

Learning objectives

On completion of this chapter, you should be able to:

Syllabus learning outcomes	Syllabus reference no.
Explain why an auditor needs to obtain an understanding of the components of internal control relevant to the preparation of the financial statements.	C1 (a)
Describe and explain the five components of a system of internal control: the control environment; the entity's risk assessment process; the entity's process to monitor the system of internal control; the information system and communication; control activities.	C1 (b)
Describe why smaller entities may have different control environments and describe the types of evidence likely to be available in smaller-entities.	D2 (d)
Explain how auditors record systems of internal control system including the use of narrative notes, flowcharts and questionnaires.	C2 (a)
Evaluate internal control components, including deficiencies and significant deficiencies in internal control.	C2 (b)
Discuss the limitations of internal control components.	C2 (c)
Describe computer systems controls including general IT controls and information processing controls.	C3 (a)

Business and Exam context

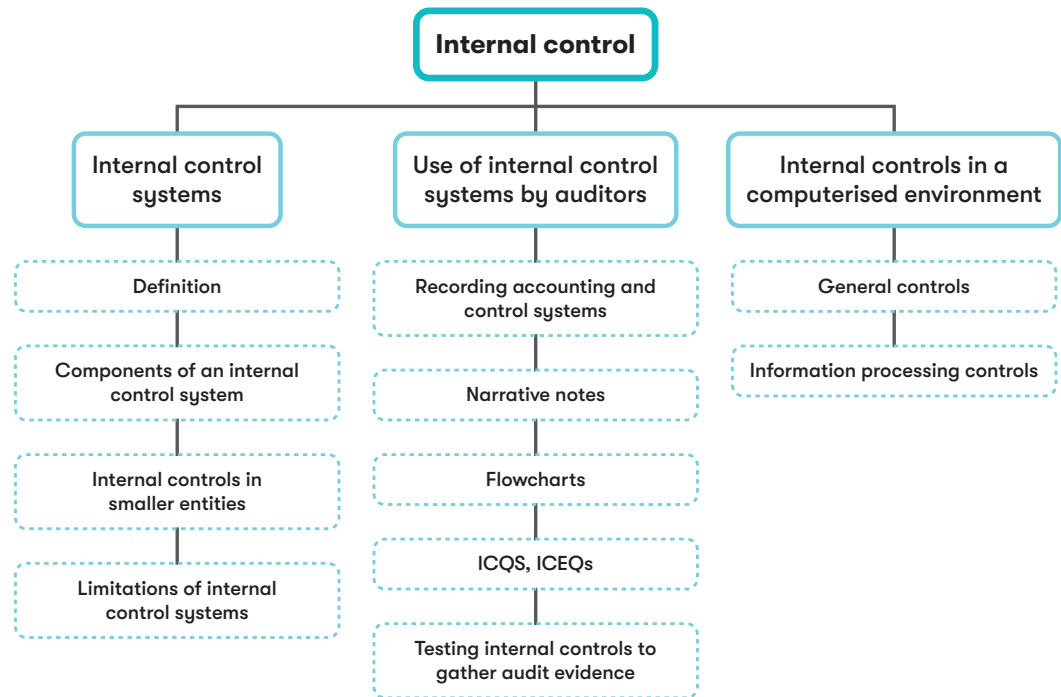
This chapter looks at internal control systems, but what is internal control? Let's take the example of a fast food outlet. One of their aims is to make sure that the food that they sell is sold as soon as possible after it has been prepared so that customers enjoy it and return to buy more, and consequently the outlet makes money. They do not want food sitting behind the counter for too long in case it goes stale and makes customers ill. In addition to this, there are health and safety regulations which they need to adhere to in terms of how long food can be left out before being thrown away, assuming that it is not sold. The fast food outlet wants to make sure that they achieve their aims of selling more food and managing the risks, such as selling stale food or not adhering to health and safety regulations. As such, they will design, implement and maintain processes to make sure that the chance of these problems happening are kept to a minimum. These processes and who is responsible for them describes the entity's system of internal controls.

The auditor generally seeks to rely on the internal controls within the entity in order to reduce the amount of substantive procedures they perform. The initial evaluation of a client's system is essential as the auditor gains an understanding of the entity, as we outlined in Chapter 6. In this chapter, we shall look at some of the detailed requirements of ISA 315 with regard to internal controls, and also set out control issues that the auditor may come across.

The auditor will assess the risks of material misstatement arising and, as we discussed in Chapter 6, may respond to those risks by carrying out tests of controls. If they conclude that they can rely on the controls in place, the level of substantive audit testing required can be reduced.

In this chapter, we also look at the ways in which auditors can document the internal control systems using narrative notes, flowcharts, questionnaires and checklists, focusing particularly on the use of questionnaires.

Chapter overview



1 Systems of internal control

1.1 Definition



System of internal control: The system designed, implemented and maintained by those charged with governance, management and other personnel, to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations (ISA 315: para. 12(m)).

1.2 Components of a system of internal control

ISA 315 *Identifying and Assessing the Risks of Material Misstatement* (paras. 21 – 26) describes **five components** of an internal control system:

Component	Description
Control environment	• Governance and management functions • Attitudes, awareness and actions of management • Sets the tone by creating a culture of honest and ethical behaviour • Provides an appropriate foundation for the other components of internal control
The entity's risk assessment process	• How management identifies risks and decides upon actions to manage them
The entity's process to monitor the system of internal control	• Assess the design and operation of controls over time • Ongoing monitoring is part of regular management activity • Separate monitoring may be performed by the internal audit function
The information system and communication	• Consists of infrastructure, software, people, procedures and data • The related accounting records, supporting information and specific accounts in the financial statements that are used to record, process and report transactions
Control activities	• The policies and procedures that help ensure that management directives are carried out The categories most relevant to an audit are: • Performance reviews • Information processing • Physical controls • Segregation of duties

Prominent Note

The ACCA examining team has said to BPP that students should know that this 5-point understanding of the system of internal control was amended by the 2019 revision of ISA 315 and differed from what went before it.



Essential reading

See Chapter 9 of the Essential reading for more information on the components of an internal control system.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

1.3 Internal controls in smaller entities

Many of the controls which would be relevant to a large entity are neither practical nor appropriate for the smaller entity.

Two key issues arise:

- Smaller entities are likely to have **less segregation of duties** due to limited numbers of staff.
- **Management override of controls** is likely to be an increased risk as a result of the close involvement of directors/owners.

To compensate for these issues, management should instigate additional physical authorisation, arithmetical, accounting and supervisory procedures.

The attitudes, awareness and actions of management are of particular importance to the auditor's understanding and assessment of the control environment in a smaller entity.

If an auditor is satisfied that the internal control system in a smaller entity is robust, and the auditor can test that direct controls are operating effectively, then the level of substantive procedures can be reduced.

However, because of the key issues discussed above, 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



Activity 1: Examples of internal control

Consider each of the following examples. What checks (internal controls) would you expect to be carried out in each situation?

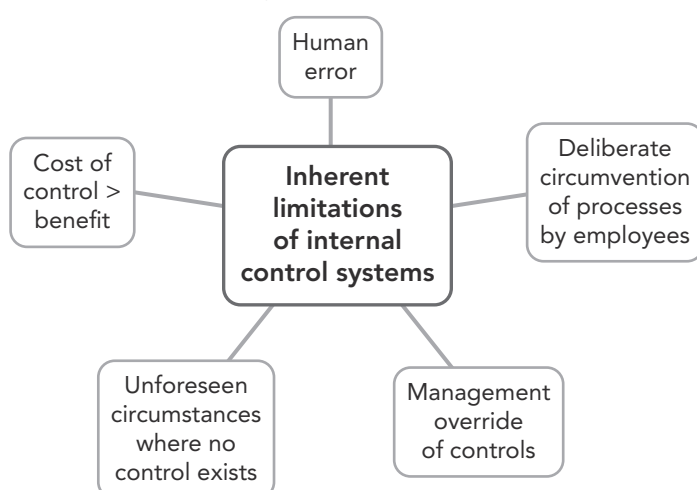
(1)	The postman knocks at your front door and hands you a letter which has been sent by recorded delivery.
(2)	You submit a claim for expenses to your line manager.
(3)	You need to work an extra day over and above your normal hours to clear a backlog of work and will expect to be paid overtime for this.
(4)	You are responsible for maintaining the cash book and have just been passed the latest bank statement.
(5)	You have just received a monthly statement from your main supplier.
(6)	You are responsible for payroll processing and you have just received notification from human resources that an employee wants to take advantage of a season ticket loan offered by your company. Your password does not give you permission to amend employee deductions.
(7)	You have just returned from a three-month holiday and are trying to log on to your computer.
(8)	You are preparing to pay an invoice received from a supplier.

(9)	You have prepared a bank reconciliation for your supervisor.
(10)	You are entering 75 sales invoices into the accounting records and want to check the accuracy of your posting.
(11)	You have been working on the computer but have now gone away to make a cup of tea, leaving the computer inactive for a period of time.
(12)	You have a Saturday job operating the till in a small corner shop which is closing for the night.
(13)	You work in a shop that sells diamond jewellery; the jeweller is very keen to keep their inventory secure.

Solution

1.4 Limitations of systems of internal control

Even with the best system of internal control, there is no guarantee that an entity will be able to fulfil all of its objectives and be fully protected from fraud and error. This is due to the inherent limitations of internal control systems:

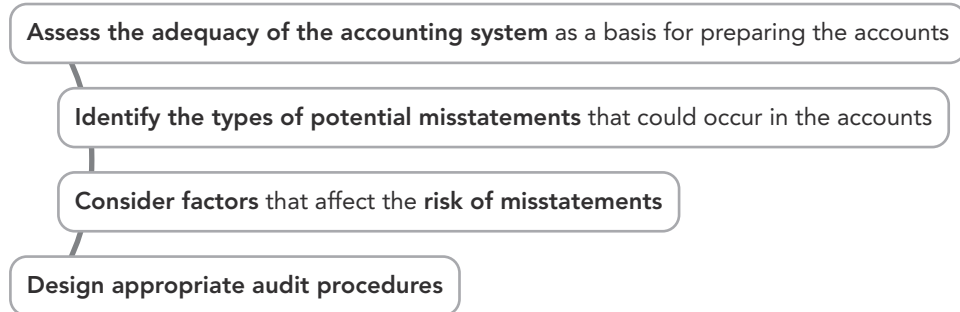


The inherent limitations of internal control systems mean that an auditor cannot rely solely on audit evidence from tests of control, they will always need to conduct some substantive procedures.

2 Use of systems of internal control by auditors

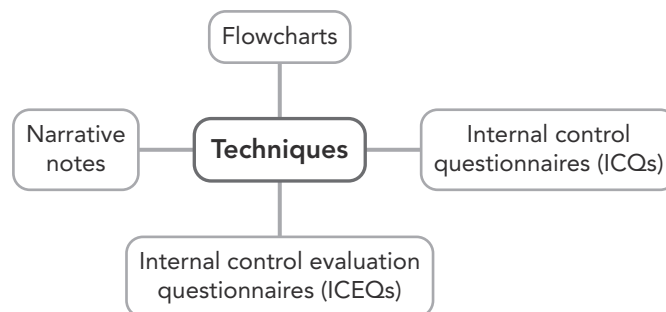
ISA 315 requires the auditor to understand the system of internal control insofar as it is relevant to the preparation of the financial statements.

The auditor shall:



2.1 Recording accounting and control systems

The auditor must obtain and document an understanding of the entity's internal controls **regardless** of whether they want to gain audit evidence by relying on the internal controls.



2.2 Narrative notes

Narrative notes tend to be used to document simple internal control systems; they are usually typed, and detail and explain each stage of the entity's systems.

Advantages	Disadvantages
Relatively simple to record and can facilitate understanding by all audit team members	Describing a process 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.
Can be used for any system due to the method's flexibility	Awkward to update if written manually
Editing in future years can be relatively easy if they are computerised	Potential difficulty in identifying missing internal controls because notes record the detail of systems but may not identify control exceptions clearly

2.3 Flowcharts

Flowcharts are generally a graphic illustration 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.

Advantages	Disadvantages
Can be prepared quickly by an experienced user	They are most suitable for describing standard systems . Procedures for dealing with unusual transactions will normally have to be recorded using narrative notes.
Easy to follow and review due to information being presented in a standard form	Major amendment is difficult without redrawing.
Ensures 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	Time can sometimes be wasted by charting areas that are of no audit significance.
Eliminates the need for extensive narrative and can be of considerable help in highlighting the salient points of control and any deficiencies in the system	



Essential reading

See Chapter 9 of the Essential reading for an example of a flowchart.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2.4 Internal control questionnaires (ICQs)

Internal control questionnaires (ICQs) comprise a series of questions designed to help the auditor to assess the strength of the system of controls.

Generally, ICQs conform to the following basic principles:

- They **comprise a list of questions** designed to determine whether desirable controls are present for each major transaction cycle (for example, sales, purchases).
- 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.

Examples of questions on an ICQ are:

'Is a bank reconciliation performed each month?'	Yes / No
'Is the bank reconciliation reviewed by a supervisor or member of management?'	Yes / No



Essential reading

See Chapter 9 of the Essential reading for a further example of an ICQ.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2.5 Internal control evaluation questionnaires (ICEQs)

Internal control evaluation questionnaires (ICEQs) are slightly more robust in that they ask questions which concentrate on the significant errors or omissions that could occur at each phase of the appropriate cycle if controls are weak. This, in turn, enables the auditor to elicit the controls which exist.

An example of a question on an ICEQ is:

Is there reasonable assurance that 'Goods cannot be received without an associated liability being recorded in the accounting records?'

The idea behind the above question is that the person responsible for this part of the purchases cycle will answer:

'Yes, because a **sequentially numbered, multi-part** goods received note is generated upon receipt of the goods and one copy passed to the accounts department. This is then filed whilst we wait for the supplier's invoice. This **file is then reviewed** at the end of each month and an **accrual made** for any goods received which have not yet been invoiced.'

ICQs and ICEQs	
Advantages	Disadvantages
If drafted thoroughly, questionnaires can ensure all controls are considered .	Can be drafted vaguely , hence misunderstood and important controls not identified
Quick to prepare	May contain a large number of irrelevant controls
Easy to use and control and can therefore be given to junior staff to complete	May not include unusual controls , which are nevertheless effective in particular circumstances
ICEQs are easier to apply to a variety of systems than ICQs because they are drafted in terms of objectives rather than specific controls.	Can give a distorted view of the entity's internal controls as there is no weighting of more important controls . 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 direct 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 procedures will be required.	



Essential reading

See Chapter 9 of the Essential reading for a further example of an ICEQ.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

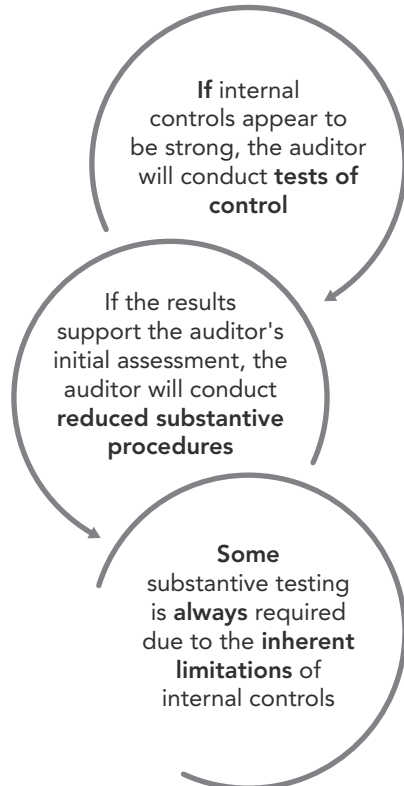
2.6 Confirming understanding

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 being in existence were in operation with regard to that transaction.

2.7 Testing internal controls to gather audit evidence

The auditor would **only** ever test internal controls to gain audit evidence if the initial assessment indicates that the controls are relevant to the financial statement assertions and appear to exist and have operated effectively throughout the period:



Where the results of the tests of control indicate that the internal controls are not effective, the auditor will:

- Report the deficiencies in internal controls to those charged with governance (Chapter 10); and
- Perform full substantive testing.

3 Internal controls in the IT environment

As part of the obtaining an understanding of the entity's information system and communication, the auditor should understand how the entity has responded to the risks arising from information technology (IT). Fundamentally, this will be a matter of assessing whether the entity's IT controls address the risks that arise from IT.

The IT controls which the auditor would expect to find can be considered in two categories:

- General IT controls
- Information processing controls

A rough way to grasp this distinction could be by way of an analogy with a computer - the general IT controls might be the operating system, with the information processing controls being the specific apps being used.

General IT controls and information processing controls are interrelated. Strong general IT controls contribute to the assurance which may be obtained by an auditor in relation to information processing controls. Unsatisfactory general IT controls may undermine strong information processing controls.

3.1 General IT controls



General IT controls: Controls over the entity's IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information processing controls and the integrity of information (ie, the completeness, accuracy and validity of information) in the entity's information system (ISA 315: para. 12(d)).

General IT controls commonly include:

General IT 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-authorized 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

General IT controls	Examples
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

3.2 Information processing controls



Information processing controls: Controls relating to the processing of information in IT applications or manual information processes in the entity's information system that directly address risks to the integrity of information (ie, the completeness, accuracy and validity of transactions and other information) (ISA 315: para. 12(e)).

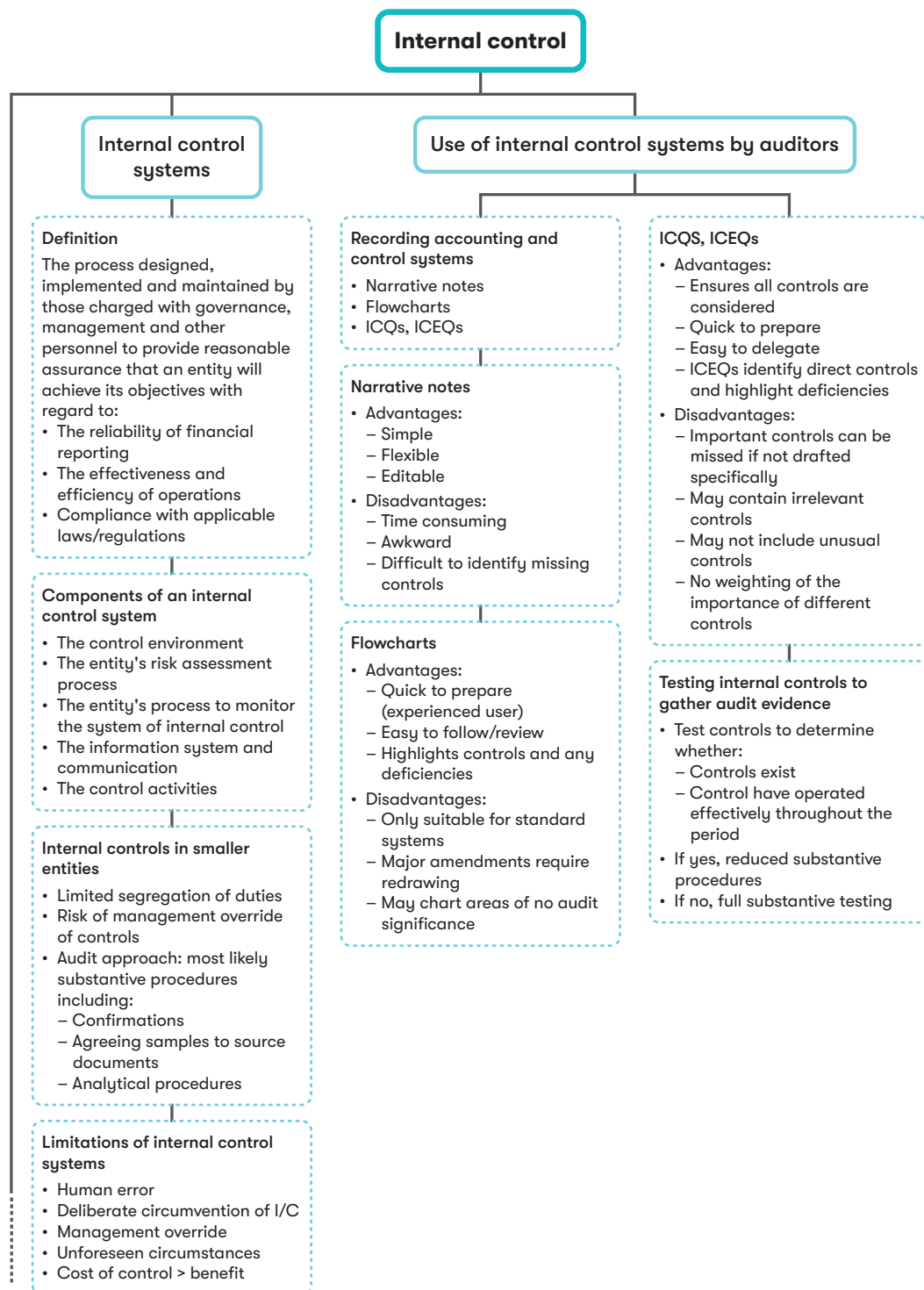
Information processing controls ensure that all transactions are authorised and recorded, and are processed completely, accurately and on a timely basis - or as the ISA puts it, they 'support the effective implementation of the entity's implementation policies' (ISA 315: para. A6).

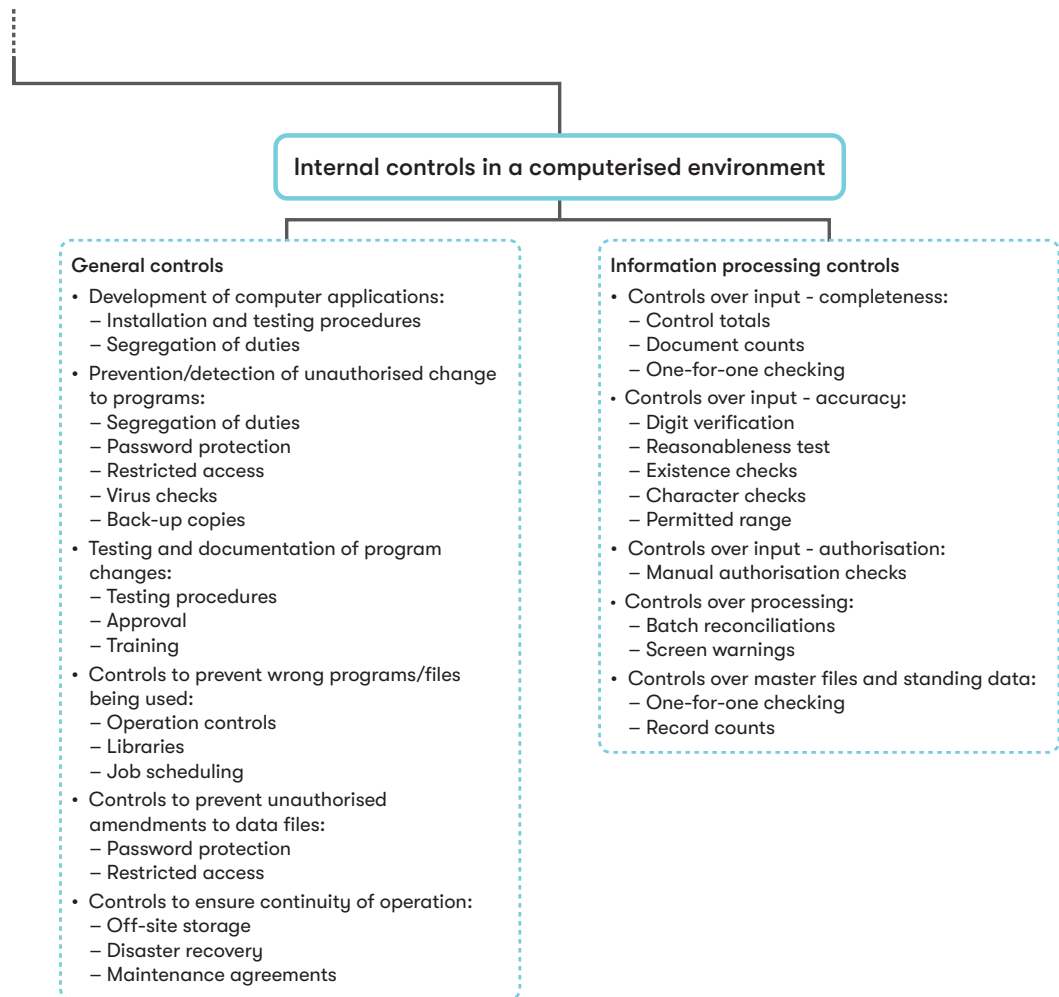
They may include the following.

Control	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	Programs 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

Control	Examples
	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-for-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

Chapter summary





Knowledge diagnostic

1. Components of a system of internal control

A company's **system of internal control** is the board of directors' responsibility and comprises:

- (a) Control environment
- (b) The entity's risk assessment process
- (c) The entity's process to monitor internal control
- (d) The information system and communication
- (e) Control activities

2. Examples of internal controls

Examples of internal controls include approval, authorisation, reconciliations, computer controls (passwords, sequence checks), review and physical controls.

3. Inherent limitations of systems of internal control

There are inherent limitations in any system of internal control which include human error, deliberate circumvention of controls, management override and unforeseen circumstances where no control exists. There are also occasions where the cost of implementing a control outweighs the potential benefit of having the control.

4. Auditor's responsibility relating to internal control

The auditor must **obtain an understanding** of internal control to:

- (a) Assess the adequacy of the accounting systems as a basis for preparing the accounts
- (b) Identify types of potential **misstatement**
- (c) Assess **risks**
- (d) Design appropriate **audit procedures**

5. Documenting controls

The auditor must document their understanding of the company's internal controls using narrative notes, flowcharts, ICQs and/or ICEQs.

6. Use of internal controls in the audit

Where controls appear to operate effectively, the auditor will test the controls to gain audit evidence. Some substantive testing must **always** be done due to the inherent limitations of internal controls.

7. Internal controls in a computerised environment

The auditor needs to consider both **general IT** and **information processing** controls in their assessment of control risk. General IT controls need to be designed and implemented to mitigate risks arising from information technology. Information processing controls are needed to prevent and detect errors that can arise when data is input and processed.

Further study guidance

Question practice

Now try the following from the Further question practice bank [available in the digital edition of the Workbook]:

- Section A Q21 and Q22
- Section B Q59 Internal control systems

Further reading

There are technical articles and study support videos on the ACCA website written/recorded by members of the AA examining team and other tutors which are relevant to some of the topics covered in this chapter that you should read:

Technical article:

- *Risk and understanding the entity*

Study Support Videos:

- *Internal controls (part 1)* (<https://www.youtube.com/watch?v=2HxZJk7j5VA>)
- *Internal controls (part 2)* (<https://www.youtube.com/watch?v=7JmyiQDzf6k&feature=youtu.be>)

Own research

Consider the internal controls that operate in your place of work (or even your home). What are the processes and policies that you need to follow and what documentation are you required to complete? Are any checks made to determine whether the processes and policies have been accurately followed?

Activity answers

Activity 1: Examples of internal control

1	The postman knocks at your front door and hands you a letter which has been sent by recorded delivery.	You should be required to sign for the letter on the postman's handset.
2	You submit a claim for expenses to your line manager.	You should need to evidence the claim by presenting the receipt; the line manager should sign the claim form to authorise payment.
3	You need to work an extra day over and above your normal hours to clear a backlog of work and will expect to be paid overtime for this.	You should submit a request that the overtime be authorised prior to it being completed and this authorisation request should be signed by your line manager.
4	You are responsible for maintaining the cash book and have just been passed the latest bank statement.	You should perform a bank reconciliation to verify the completeness and accuracy of the cash book.
5	You have just received a monthly statement from your main supplier.	You should reconcile the balance per the supplier statement to the purchase ledger balance.
6	You are responsible for payroll processing and you have just received notification from human resources that an employee wants to take advantage of a season ticket loan offered by your company. Your password does not give you permission to amend employee deductions.	You should be provided with a copy of the letter signed by the employee which authorises the deductions and a hierarchical password should be required to amend the standing data.
7	You have just returned from a three month holiday and are trying to log on to your computer.	Your password should have expired, and the computer should automatically require you to change your password.
8	You are preparing to pay an invoice received from a supplier.	You should verify that the goods have been received by checking to a goods received note, vouch the prices to the supplier's price list and recalculate the sales tax and addition of the invoice. The invoice should then be authorised for payment and this evidenced by a signature.
9	You have prepared a bank reconciliation for your supervisor.	Your supervisor should review the bank reconciliation to verify it has been done properly and sign to evidence that the review has taken place.
10	You are entering 75 sales invoices into the accounting records and want to check the accuracy of your posting.	You should perform a batch reconciliation whereby you manually count the number of invoices posted and verify to the system or manually total the value of the invoices and verify that the revenue, sales tax and receivables accounts have increased by the corresponding amounts.

		Provided that the invoices are sequentially numbered, you should also perform a sequence check to determine whether any invoice numbers have been omitted.
11	You have been working on the computer but have now gone away to make a cup of tea, leaving the computer inactive for a period of time.	You should log out/lock your computer prior to leaving your work station. If you do not lock your computer then the computer should 'time out' after a certain period of time and require you to re-enter your log on/ password details before you can resume work.
12	You have a Saturday job operating the till in a small corner shop which is closing for the night.	The cash in the till should be counted at the end of the day and reconciled to the till receipt. Money should be kept in a safe overnight.
13	You work in a shop that sells diamond jewellery; the jeweller is very keen to keep their inventory secure.	The shop should have CCTV in operation, the front door should be locked with a door bell which must be rung to gain entry, jewellery should be kept in locked cabinets and stored overnight in a safe/secure vault and grilles pulled down over the shop windows.

10

Tests of controls

Learning objectives

On completion of this chapter, you should be able to:

Syllabus learning outcomes	Syllabus reference no.
Describe control objectives, control procedures, control activities, direct controls, indirect controls and tests of controls in relation to: • The sales system • The purchases system • The payroll system • The inventory system • The bank and cash system • Non-current assets	C3 (b)
Discuss the requirements and methods of how reporting significant deficiencies in internal control are provided to management and those charged with governance.	C4 (a)
Explain, in a format suitable for inclusion in a management letter, significant deficiencies within a system of internal control and provide control recommendations for overcoming these deficiencies to management.	C4 (b)
Discuss the need for auditors to communicate with those charged with governance.	C4 (c)
Describe the format and content of internal audit review reports and make appropriate recommendations to management and those charged with governance.	C6 (e)

Business and Exam context

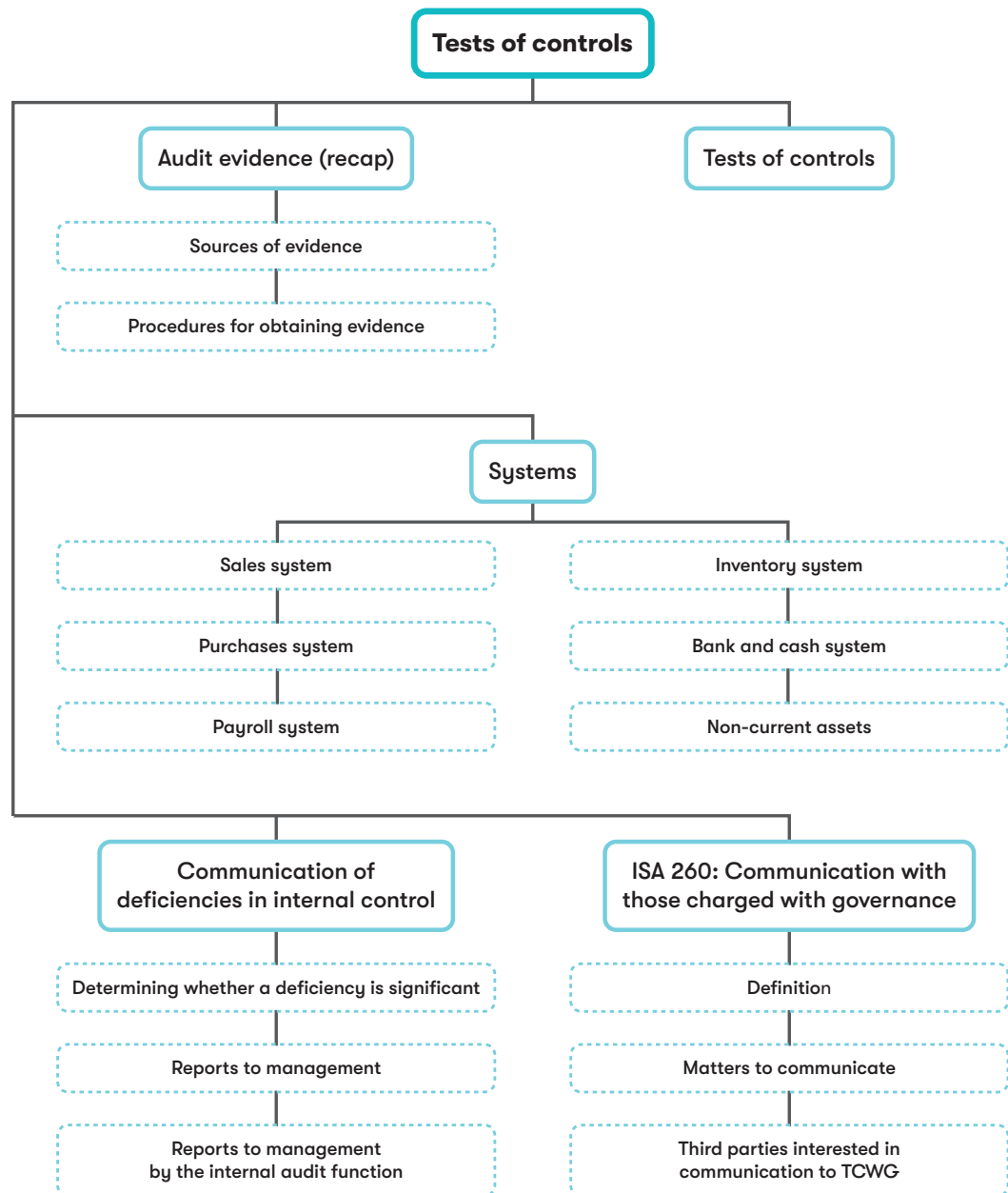
We have already seen that the external auditor is required to understand a client's accounting and internal control systems. Having documented the system, the auditors will decide which controls, if any, they wish to rely on and plan tests of controls to obtain audit evidence to determine whether the controls are properly designed and have operated effectively throughout the period to be audited.

The syllabus examines six systems: sales, purchases, payroll, inventory, cash and non-current assets. The first three of these are covered in the main chapter whilst the final three are included in Chapter 10 of the Essential Reading which is available in Appendix 2 of the digital edition of the Workbook.

For each system, we will identify the main risks which relate to the systems, then look at the controls that the business could put in place to minimise the risks identified. Finally, we will consider the different tests of controls that auditors will carry out to determine whether these controls have operated effectively.

We end this chapter by considering the report to management submitted to the directors and management of an entity and the reports that may be issued by the internal auditors. The report to management summarises the significant deficiencies the auditor has identified in the entity's systems during their testing. It should explain the deficiency and its implication for the entity as well as recommending the appropriate action that should be taken by management and those charged with governance.

Chapter overview



1 Audit evidence (recap)

1.1 Sources of evidence

In Chapter 8 we saw that there are two main ways in which an auditor can gather audit evidence. These were:

- Tests of controls
- Substantive procedures (tests of detail and analytical procedures)

1.2 Procedures for obtaining evidence

The mnemonic **AEIOU** can help generate different audit procedures.

Audit procedure	Description	Type of procedure
Analytical procedures	The evaluation of financial information by a comparison to financial and non-financial data and the investigation of significant differences and relationships which are inconsistent with other information	Substantive procedure
Enquiry (and confirmation)	Seeking information of knowledgeable persons throughout the entity or outside the entity (enquiry) and obtaining representations directly from a third party (confirmation)	Enquiry – both substantive procedure and a test of controls Confirmation – substantive procedure
Inspection	Examining records, documents and tangible assets	Both
Observation	Looking at a process or procedure being performed by others	Test of controls
Recalculation (and re-performance)	Verifying the arithmetical accuracy of documents or records and the auditor's independent execution of procedures and the re-performance of controls	Recalculation – substantive procedure Re-performance – test of controls

This chapter will focus on **tests of controls**.

2 Tests of controls

We saw in Chapter 9 that internal controls are implemented by management and those charged with governance to prevent or detect fraud and error. The auditor must have an understanding of an entity's accounting and internal control systems but will only ever carry out tests of controls if their initial risk assessment suggests that the entity's internal controls **operate effectively**.

If this is the case, the auditor will perform tests of controls to gather audit evidence about relevant financial statement assertions.

The auditor must test that the control:

- Is properly designed;
- Exists; and
- Has operated throughout the period.

Failures of internal controls (or **deviations**) should be recorded and investigated **regardless of the monetary amount involved**. The auditor must assess whether deviations are **isolated departures** or indicate existence of errors in accounting records.

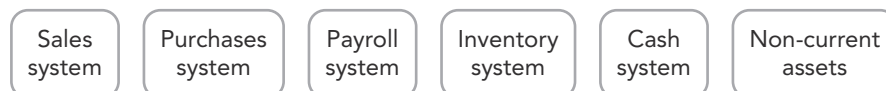
If the results of the tests of control are unsatisfactory, then the auditor's preliminary assessment of control risk is not supported and the auditor must perform extensive substantive procedures.

Tests of controls include **enquiry** in combination with other audit procedures, for example:

- (a) **Inspection** of documents supporting controls or events to gain audit evidence that controls have operated effectively, for example verifying that a transaction has been authorised
- (b) **Observation** of the entity's control procedures, for example observing an inventory count to ensure it is being conducted in accordance with the inventory count instructions
- (c) **Re-performance** of the application of a control to ensure it was performed correctly, for example reperforming a bank reconciliation to verify that it has been done properly
- (d) **Examination** of evidence of management reviews, for example minutes of board meetings
- (e) **Testing of the control activities performed by a computer**, using for example computer-assisted audit techniques (CAATs)

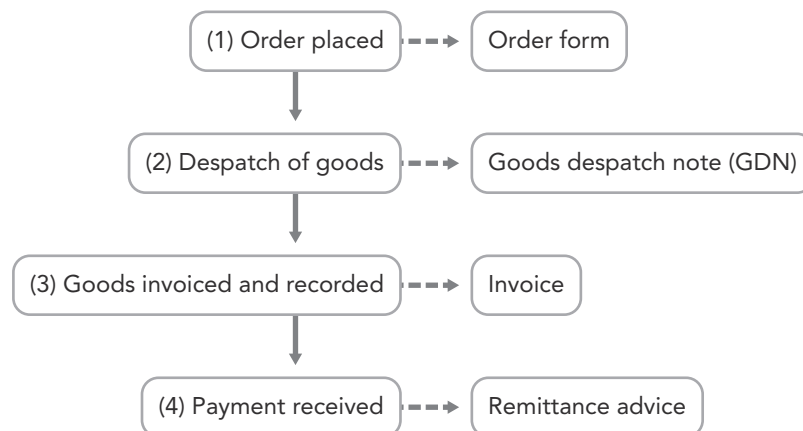
3 Systems

There are six systems detailed in the syllabus:



3.1 Sales system

The sales system consists of four main stages. Each stage has its own key documentation.



Activity 1: Sales system (deficiencies)

Dress You Like Co is a clothing manufacturer, based in the UK, which has been trading for over ten years. It operates from two sites: a factory where the clothes are made and a head office where the administration is carried out. Completed inventory orders are despatched from both the factory and the head office.

In an effort to reduce costs, Dress You Like Co now imports its material from one sole supplier based in China.

Dress You Like Co sells its finished products to small independent retailers and also one major supermarket chain. The supermarket chain often requires additional deliveries without much prior notice and so Dress You Like Co has to maintain a high level of inventory should this occur. Credit terms are normally 30 days, but the supermarket is given 60-day credit terms.

You are an audit senior in Check and Co and you are carrying out the controls work on the sales system for the year ended 30 September 20X6. You have access to the systems notes that Dress

You Like Co provided to its previous auditors for the year ended 30 September 20X5 and you have spoken to several members of Dress You Like Co staff to obtain more information about the sales system.

Extract from Dress You Like Co's sales systems notes for the year ended 30 September 20X5

Order Placed

Customers contact Dress You Like Co by phone or email and inform the sales team which products they require. A member of the sales team completes a standard form with all of the customer details and forwards this to the warehouse for despatch to the customer.

Despatch of Goods

The warehouse manager collates all of the orders from the previous day and passes them to the picking team. This team then picks the items, packages them and produces a goods despatch note detailing all of the products. The warehouse manager then organises delivery of the products for the following day.

Goods Invoiced and Recorded

Each day the finance team receives copies of the GDNs completed by the warehouse staff and uses these to generate invoices. Each invoice has the customer details, the products despatched and the standard prices. The supermarket chain has its own price list, which is significantly discounted on the other retailer prices.

Payment Received

Customers can pay by cash, cheque or BACS and should return a remittance advice with all payments. There is no formal process for monitoring old debts. Bank reconciliations are performed on a weekly basis by the accounts team and monthly by the internal audit department.

Transcripts of conversations with Dress You Like Co staff (available as video clips)

Interview with Jenny Bristow, sales team

You: So Jenny, can you tell me a little more about the standard form that you complete when you receive an order?

Jenny: Sure. The order form is three-part; we complete it by hand using the information the customer has provided by phone or email. We refer back to the standard product list, which all our customers have a copy of, to ensure that we have the correct product codes for each item. Once the form is complete, we send one copy to the customer (either by post or scanned and emailed), one copy is sent to the warehouse and we retain one copy here.

You: OK, is the process any different for the supermarket?

Jenny: No, not really. For the supermarket we send the order straight to the despatch team in the warehouse so the order can be sent quickly, rather than sending it to the warehouse manager.

You: Thanks. Oh, one more question. What happens with new customers?

Jenny: How do you mean?

You: Well, do you have any specific checks on new customers or any prescribed credit limits?

Jenny: Umm, no not really. We just record their details on the form as normal and then pass the order on to the warehouse.

You: Brilliant, thanks very much.

Jenny: You're welcome.

Interview with David Furber, Warehouse Manager

You: Hi David, thank you for taking the time to help me today.

David: Fine, but this had better be quick, I'm very busy.

You: OK. Can you tell me how the process for despatching goods works?

David: Well, I get the orders from the sales team through the day, then at the beginning of the next day I allocate them to the boys in the warehouse to pick and pack while I sort out delivery drivers for the day after. Simple really.

You: Good, well can you give me a bit more detail on the picking and packing? What happens if you are out of stock of any item?

David: The boys pick the goods that are on the customer order and they put them in boxes. Then they write a GDN based on what is in the box. If there is something out of stock they mark it on the customer order and then pass it back to me. I can then allocate that order back out to someone to pick tomorrow or the next day. I keep a file with all of the orders that haven't been fully despatched, and I check it every day. The customer might have to wait a few days, but they always get the whole order in the end.

You: OK, do you check this outstanding file back to any other information?

David: Yes, at the end of each month I sit down with Jenny from the sales team. We go through the outstanding orders file and copies of all of the GDNs to make sure all orders have been captured.

You: Lovely, thank you very much.

David: Great, I can get back to some proper work now.

Interview with Edward Times, Finance Assistant

You: Hi Ed, is now a good time to talk about the invoicing process?

Ed: Sure, no problem, what would you like to know?

You: Well, I understand that you get copies of the GDNs from the warehouse team and you use them to generate invoices, can you give me a bit more detail?

Ed: OK. Every day I get a pile of GDNs from the warehouse for the stuff despatched the day before and I copy the details from here into the invoicing software. I copy across the products despatched and the customer details and then the system automatically applies prices.

You: Does everyone pay the same price?

Ed: No, the supermarket has a special price structure which the system automatically applies when I record the customer details and everyone else pays the same.

You: OK, can you override the prices in any way, say to offer a special discount?

Ed: No, I can't do that, but Katie can.

You: Katie?

Ed: Yes, Katie Escombe, the acting Finance Director/Chief Finance Officer.

You: Oh yes. So, how does she do that?

Ed: She has a special login to the system which then allows her to amend prices; I don't really know much more than that except that any changes she makes are reviewed by another director.

You: Great. I think that's all for now, thanks very much.

Ed: OK, see you later.

Interview with Claire Wilson, Accounts Receivable Clerk

You: Thanks for taking the time to meet me, Claire. I was hoping to find out a bit more about the process for receiving payment for invoices.

Claire: OK. Well, customers send us money either in the post or put it straight into the bank. They should send us remittance advices, so we know what the money is for, but they don't always do it, especially for the payments direct into the bank.

You: So, what do you do if they don't send a remittance advice?

Claire: Well, we try to guess what the amount is for, so if it matches the most recent statement etc we allocate it to those invoices, but if we can't guess we just allocate it to the oldest invoices.

You: Right, so what do you do to make sure old debts are paid?

Claire: Well, I don't really have any formal process. I just look out for customers who haven't paid in a long time and give them a call when I have a chance.

You: Do you send statements or do any aged receivables analysis?

Claire: Oh, I've heard about aged receivables analysis, but I don't know if our system will produce one, I've never tried.

You: OK, one final thing. Do you do bank reconciliations?

Claire: Not me personally but Simon does them each week.

You: Great, I think that's it. Thanks.

Claire: Thanks.

Required

In respect of the internal controls relating to the sales system of Dress You Like Co:

- (1) Identify and explain **THREE** deficiencies; and
- (2) Recommend a control to address each of these deficiencies.

Control deficiency	Control recommendation



Activity 2: Sales system (test of controls)

- In respect of the internal controls relating to the sales system of Dress You Like Co:
- (1) Identify and explain **THREE** direct controls within the sales system; and
 - (2) Describe a TEST OF CONTROLS the external auditors should perform to assess if each of these controls is operating effectively.

Control	Test of controls

Control	Test of controls

Solution

In **exam questions**, it is important to **use the scenario** to generate your answer rather than to learn lots of internal controls and tests of controls by heart.

You should try to complete as many practice questions on this area as possible. To help you in this, we have included some other examples of control objectives, internal controls and tests of controls below.

Stage: Order Placed			
Risk	Control objectives	Controls	Tests of controls
That an order is accepted from and goods despatched to a customer who is not creditworthy	To ensure that goods and services are only supplied to customers with good credit ratings	Conduct a credit check on all new customers prior to accepting an order. The credit check should be undertaken by someone separate from sales department. Once accepted, new customers should be given a credit limit – these should be reviewed regularly.	Inspect a sample of new customer accounts to ensure that credit checks/ references were obtained before the order was accepted. For a sample of customer accounts, attempt to process an order that will take a customer over their credit limit to determine whether the order is rejected.
That an order is not fulfilled	To ensure that all goods	Orders should be completed on sequentially	Using a computer (or manually) test the

Stage: Order Placed

Risk	Control objectives	Controls	Tests of controls
leading to loss of future business from dissatisfied customers	ordered are despatched/fulfilled	numbered order forms and sequentially numbered goods despatched notes (GDN) generated from the same information. A copy of the GN should be passed to the sales department by the warehouse team once the order is despatched. The sales team should regularly review any order forms which are not matched to GDNs.	numerical sequence to ensure it is complete. Review a sample of unfulfilled orders and enquire as to why these remain outstanding.
That the wrong items, wrong quantity or damaged goods are despatched	To ensure that the correct items are despatched in terms of item, quantity and condition	Spot checks should be conducted on goods once they have been packed to ensure the goods packed are in good condition and agree to the order form.	Vouch a sample of items packed to the GDNs and order form to ensure the goods packed are accurate. Physically inspect a sample of goods which have been packed. Review customer complaint files for evidence of incorrectly despatched goods.

Stage: Despatch of goods

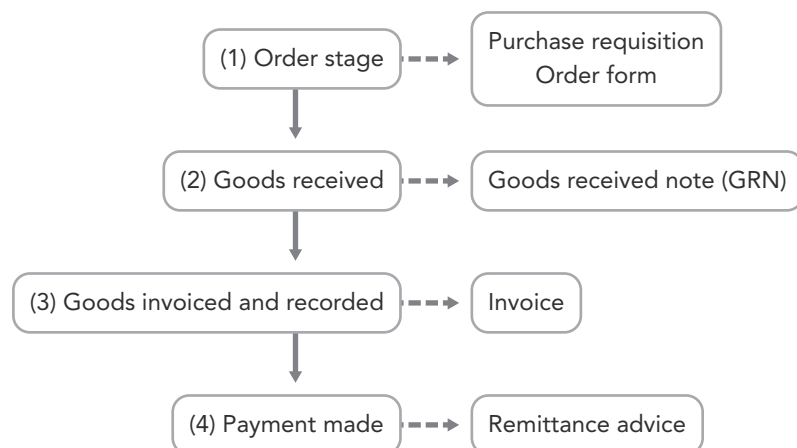
Risk	Control objectives	Controls	Tests of controls
That goods are not despatched to the required destination	To ensure that goods are despatched to the required destination	On receipt of the goods, the customer signs the multi-part GDN. One copy should then be left with the customer and the others returned with the delivery driver (and one copy passed to the sales team, one retained in the warehouse and one passed to the invoicing department).	Review a sample of GDNs for evidence of the customer's signature.

Stage: Goods Invoiced and Recorded			
Risk	Control objectives	Controls	Tests of controls
That goods despatched are not invoiced/not invoiced correctly	To ensure that all goods despatched are correctly invoiced	Invoices should be sequentially numbered and generated using the information on the GDNs. All invoices should be authorised and details agreed to price lists/credit terms.	Match a sample of GDNs with the corresponding invoice. Perform a sequence check of invoices to ensure all invoices are recorded. Compare a sample of invoices with the authorised price list and credit terms to ensure they are accurate.
That invoices are posted to the wrong customer account	To ensure that invoices are posted to the correct customer account	Periodically review customer accounts for any unpaid amounts. Send statements to customers on a monthly basis.	Review customer correspondence files for evidence of any complaints/instances of incorrect invoices being applied to a customer's account.

Stage: Payment Received			
Risk	Control objectives	Controls	Tests of controls
That cash is not received	To ensure that monies are received for invoices raised	Produce an aged receivables report on a monthly basis and actively pursue old/overdue balances.	Review the aged receivables report and discuss the action taken on old/ overdue balances with credit control.
That payments received are misappropriated	To ensure that monies received are safeguard and banked promptly	There should be segregation of duties between those who update receivables ledger and those who: • Raise invoices • Raise credit notes • Follow up statement queries • Open and count cash Cash/cheques should be kept securely and banked promptly.	Observe the procedures in place to ensure segregation of duties. Observe the procedures for banking cash/cheques.

3.2 Purchases system

As with the sales system, the purchases system also consists of four main stages and has key documentation at each stage.



Activity 3: Purchases system (deficiencies)

You are now carrying out the work on the purchases system at Dress You Like Co. You again have access to the systems notes that Dress You Like Co provided to its previous auditors for the year ended 30 September 20X5 and you have spoken to several members of Dress You Like Co staff to obtain more information about the purchases system.

Extract from Dress You Like Co's purchases systems notes for the year ended 30 September 20X5

Order Stage

Reorder levels exist for all items of inventory. When the level of inventory falls to the reorder level, a standard order form is automatically generated by the inventory system to order a set quantity of material. The order form details the name of the buyer responsible for that inventory line and a copy of the order is forwarded to the warehouse where goods are received.

Goods Received

On receipt of the goods, the quality of the materials is checked and then the warehouse manager generates a sequentially numbered, multi-part goods received note.

Goods Invoiced and Recorded

Each day the finance team receives copies of the GRNs completed by the warehouse staff. These are filed in sequential number order to await receipt of the associated invoice.

Payment Made

All invoices in the file are automatically paid at the end of each month. The Chinese supplier sends a monthly statement but this is not reconciled to the purchase ledger account. Bank reconciliations are performed on a weekly basis by the accounts team and monthly by the internal audit department.

Transcripts of conversations with Dress You Like Co staff (available as video clips)

Interview with Ivan Higster, purchasing department

You: So Ivan, can you give me some more information about the reorder levels that are set?

Ivan: Yes, it's quite simple really: because we're involved in the fashion industry we need to make sure our products meet current trends so every season the buyers monitor which items sell well and then adjust the reorder levels for each product in the current season based on our past experience.

You: Thanks. So, what checks do the buyers perform when orders are generated for their inventory lines?

Ivan: None really, we just get the order through and then place it with our supplier. We do forward a copy of the order to the warehouse, though.

You: Great, thanks for your time.

Ivan: No worries!

Interview with David Furber, Warehouse Manager

You: Hi David, sorry to be asking you some more questions but I'm looking at the purchases system now. Have you got five minutes?

David: I wish you auditors would get organised and do all your questions in one go!

You: Sorry David, it shouldn't take long. Would you talk me through what happens when an order for goods is received into the warehouse?

David: Well, the goods arrive with a list of what's in each crate and I get the boys to unpack it. They check the condition of each roll of material and make sure the quality looks satisfactory and that it was packaged securely. Once they've confirmed to me what was received, I generate a sequentially numbered, multi-part goods received note. I send one part of this to the finance team.

You: OK, do you check the details on the goods received note back to any other information?

David: No, all of our deliveries come from our Chinese supplier so I don't need to make any checks.

You: Right, thanks then.

David: That's OK.

Interview with Sadie Thomas, Finance Assistant

You: Hi Sadie, would it be OK to have a quick chat about the process for recording purchase invoices?

Sadie: Hi, yes, I was expecting you!

You: Thanks! David tells me that you get copies of the GRNs from the warehouse team. Can you tell me what happens next in the process?

Sadie: Sure, each day David passes me the GRNs generated by the warehouse for items that have been received from our Chinese supplier the day before. I file these in sequential number order so I have them ready for when the supplier invoice arrives.

You: What happens when the invoice arrives?

Sadie: I identify the GRN that it relates to and check the details to the GRN so I know that we've been invoiced for the right items in terms of product code, quantity and price. I initial the invoice to show that this has been checked and enter the invoice into the accounting system. I allocate each invoice the same number as the related GRN and then staple them together in the file.

You: That sounds very comprehensive. Thanks Sadie.

Sadie: No problem!

Interview with Lauren White, Accounts Payable Clerk

You: Hi Lauren, Sadie gave me your name and said you would be the best person to speak to about the process for paying invoices. Have you got a few minutes?

Lauren: Sure.

You: Great, can you explain to me how invoices get paid?

Lauren: Yes, at the end of each month, I have a look in Sadie's file and identify all of the invoices which are matched to GRNs which are unpaid and then pay them.

You: How do you know which invoices are unpaid?

Lauren: Well there's two ways of knowing really – firstly once I pay an invoice I mark it with a stamp saying 'paid'. Secondly, we always pay all of the invoices received in the month so, for

example, at the end of June I would know that all of the invoices received in June that have been matched to GRNs need to be paid.

You: Do you have set credit terms with the supplier?

Lauren: Yes, they give us 30 days' credit from the end of the month so an invoice dated 14 June would have to be paid by the end of July.

You: OK. Does the supplier send statements?

Lauren: Yes, they send us a statement each month which details all of the transactions we have had with them during the month. I file this in their correspondence file.

You: So how is the actual payment made?

Lauren: We pay by bank transfer. I prepare a schedule detailing the invoices and the total amount we need to pay. Each of the buyers sign off to say that they authorise the payments. I then prepare the bank payment authorisation and give all of this information to Katie to check and authorise the bank transfer.

- 1 From a review of the information above, your audit assistant has highlighted some potential deficiencies in respect of the purchases system at Dress You Like Co.

One such deficiency is that the goods received into the warehouse are not checked back to the order form and your audit assistant feels this deficiency could have implications for the company.

Required

Which TWO of the following statements describe valid implications of the above deficiency?

- ☐ Goods may be accepted which have not been ordered and therefore are not needed by the business.
- ☐ Goods may be accepted by the business which are of insufficient quality.
- ☐ Goods which are actually required for production may have been omitted from the delivery which could lead to stock outs and business interruption.
- ☐ Orders may be placed for goods which are not required

- 2 A second deficiency relates to the fact that the balance per the purchase ledger account is not reconciled to supplier statements.

Required

Which of the following recommendations would NOT be appropriate to address this deficiency?

- ☐ The accounts payable clerk should reconcile the balance per the purchase ledger to the balance per the supplier statement each month.
- ☐ Invoices on the supplier statement which relate to goods received but not invoiced should not be included in the purchase ledger to avoid the payables balance being overstated at the year-end.
- ☐ Any journals processed as a result of the reconciliation should be authorised by the department supervisor.
- ☐ The reconciliation performed by the accounts payable clerk should be reviewed by the department supervisor.

- 3 The report to those charged with governance at Dress You Like Co will recommend that a notification is added to the accounting system which identifies when an invoice is due for payment.

Required

Which of the deficiencies in Dress You Like Co's purchases system will this recommendation BEST address?

- ☐ That supplier invoices are not recorded accurately in the purchase ledger
- ☐ That supplier invoices are incorrectly coded

- ☐ That supplier invoices are paid too late
- ☐ That supplier invoices are paid too early



Activity 4: Purchases system (test of controls)

The following questions relate to the information in Activity 3.

- 1 In order to ensure that Dress You Like Co is only invoiced for items which have been received the finance assistant vouches the details on the invoices to the goods received note.

Required

Which of the following statements is a valid test of controls that the auditor could perform in order to conclude whether this control operates effectively?

- ☐ Observe a sample of goods being received in the warehouse to ensure that the goods received note is completed accurately.
 - ☐ Inspect a sample of invoices recorded in the ledger to verify that they have been allocated the correct product code.
 - ☐ For a sample of invoices which have been matched to goods received notes, reperform the calculations to ensure they have been done properly.
 - ☐ Analytically review the level of purchases made each month to the budget and investigate any significant variances.
- 2 Your audit assistant is planning to inspect a sample of the bank payment authorisation documents for evidence of the Finance Director's signature.

Required

For which of the following internal control objectives would this provide sufficient, appropriate audit evidence?

- ☐ That payments to the supplier are made on a timely basis
- ☐ That payments to the supplier are reviewed and authorised prior to payment
- ☐ That payments to the supplier are accurately recorded in the ledger
- ☐ That payments to the supplier are for valid business expenses only

In **exam questions**, it is important to **use the scenario** to generate your answer rather than learn lots of internal controls and tests of controls by heart.

You should try to complete as many practice questions on this area as possible. To help you in this, we have included some other examples of control objectives, internal controls and tests of controls below.

Stage: Order Stage			
Risk	Control objectives	Controls	Tests of controls
That an order is unauthorised and not for business use	To ensure that orders are only placed once authorised and vetted to ensure they are for business use	Orders should only be raised on receipt of an authorised purchase requisition which is approved by the department manager.	Review a sample of orders for evidence that the purchase requisition was authorised and the goods are for business use.
That the entity does not buy	To ensure that the entity buys	Orders should only be placed with a supplier	For a sample of orders, vouch that the suppliers

Stage: Order Stage			
Risk	Control objectives	Controls	Tests of controls
items at the most competitive price	items at the most competitive price	which is on the entity's list of preferred suppliers which have been approved in terms of cost and quality. For non-standard items, separate quotations may be required.	used are on the preferred supplier listing.

Stage: Goods Received			
Risk	Control objectives	Controls	Tests of controls
That goods ordered are not received, potentially leading to stock outs	To ensure that all goods ordered are received	On receipt of goods the warehouse should raise a multi-part, sequentially numbered goods received note (GRN). One part of the GRN should be passed to the purchasing department to be matched to the order form. Unmatched orders should be reviewed on a periodic basis and suppliers chased	Observe the receipt of goods into the warehouse to ensure all goods are recorded and a GRN generated. Verify that the GRN is matched to the order form by the purchasing department. Enquire as to the action taken where orders are unfulfilled and reperform this process.
That faulty goods are accepted	To ensure that goods are only accepted if they are of the correct quality	On receipt of goods, all items are to be verified to ensure they are in satisfactory condition.	Observe the receipt of goods by staff to confirm the control is carried out.

Stage: Goods Invoiced and Recorded			
Risk	Control objectives	Controls	Tests of controls
That the liability for goods received is not recognised in the accounting records	To ensure that liabilities for goods received are recognised in the accounting records	Another part of the GRN should be passed to the accounts department. Invoices received from suppliers should then be matched to the GRN. Unmatched GRNs should be reviewed periodically and an accrual posted for the associated liability.	For a sample of GRNs trace through to corresponding invoice and verify that the invoice has been recorded in the accounting records. Where no invoice has been received verify that the relevant accrual has been recorded.

Stage: Goods Invoiced and Recorded			
Risk	Control objectives	Controls	Tests of controls
That a liability is recognised for goods which have not been received	To ensure that a liability is only recognised for goods which have been received	Upon receipt of a supplier invoice, it should be matched to the sequentially numbered GRN and order form. The invoice should be allocated the same sequential number.	For a sample of invoices recorded, vouch the details back to the GRN and order form to verify that the goods were received.

Stage: Payment Made			
Risk	Control objectives	Controls	Tests of control
That payments are made to the wrong supplier	That payments are only made to the correct supplier for bona fide purchases	All invoices should be authorised for payment and coded to the relevant supplier by the appropriate budget holder. Authorisation/coding should be evidenced by a signature. Statements received from suppliers should be reconciled to the relevant purchase ledger account on a monthly basis. Any subsequent changes to the accounting records must be authorised.	Inspect a sample of invoices for authorisation and appropriate coding. Review a sample of supplier reconciliations to ensure that they have been completed accurately and any resultant changes authorised.
That an invoice is paid twice/is for the wrong amount	To ensure that suppliers are paid accurately	Prior to being paid all invoices should be agreed to the GRN and order form and calculations such as unit price, sales tax, quantities and discounts agreed to the appropriate records. Once paid the invoice should be stamped 'paid'.	Inspect a sample of invoices for evidence that calculations have been reperformed and the invoice stamped as 'paid'.

3.3 Payroll system

The payroll system has two main areas to consider:

Human Resources (HR) function	Payroll processing function
Includes: Staff appointment Staff removal	Includes: Monthly processing of payroll

Human Resources (HR) function	Payroll processing function
Staff appraisal Notifications of salary changes	

Ideally, these two distinct roles would be **carried out by different** members of staff/ departments; however, this may not be possible in smaller businesses where we have seen that it can be difficult to have sufficient segregation of duties.

There are inherent risks within a payroll system, including:

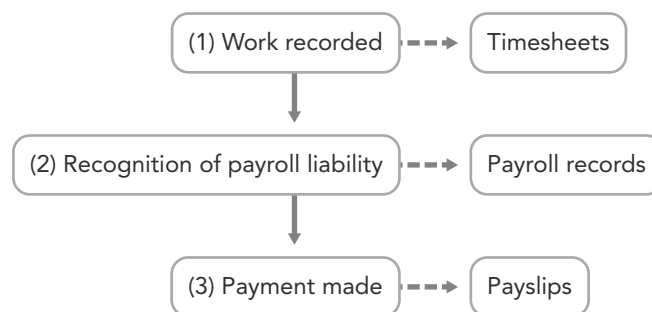
Fraud

- Establishing fake payroll records
- Changing pay rates without authorisation
- Claiming payment for more hours than genuinely worked
- Theft (if wages are paid in cash (rare))

Errors

- Complexities relating to tax
- Other deductions

The payroll system consists of three main stages with documentation at each stage:



Activity 5: Payroll system (deficiencies)

You are now carrying out the work on the wages system at Dress You Like Co. You have been given the following information concerning the wages system for the year ended 30 September 20X6.

- (1) The factory and warehousing staff record the number of hours worked using a clocking in/out system which is observed by a supervisor. On arrival at work each morning and at the end of each day's work, each worker enters their unique employee number on a keypad. Any employee who does not clock out at the end of their shift is automatically clocked out by the system.
- (2) In order to claim overtime, employees need to complete an 'overtime claim' form and submit it to the wages clerk.
- (3) The Wages Clerk, Jake Newman, works in the finance team and is responsible for making amendments to the computerised wages system in respect of employee holidays and illness. He also sets up and maintains all employee records and processes the monthly payroll.
- (4) The computerised wages system calculates deductions from gross pay, such as employee taxes and net pay. Each month a list of net cash payments for each employee is produced and this is reviewed and authorised by the acting finance director before the employees are paid by BACS transfer. Deductions are checked by Jake Newman on a periodic basis.

Required

In respect of the internal controls relating to the payroll system of Dress You Like Co.

- (1) Identify and explain **TWO** deficiencies; and
- (2) Recommend a control to address each of these deficiencies.

Control deficiency	Control recommendation



Activity 6: Payroll system (test of controls)

In respect of the internal controls relating to the payroll system of Dress You Like Co:

- (1) Identify and explain **TWO** controls within the payroll system; and
- (2) Describe **TEST OF CONTROLS** the external auditors should perform to assess if each of these controls is operating effectively.

Control	Test of controls

In **exam questions**, it is important to **use the scenario** to generate your answer rather than learn lots of internal controls and tests of controls by heart.

You should try to complete as many practice questions on this area as possible. To help you in this, we have included some other examples of control objectives, internal controls and tests of controls below.

Stage: Work recorded			
Risk	Control objectives	Controls	Tests of controls
That hours worked are not recorded accurately	To ensure that hours worked are accurately recorded	Hours worked should be recorded using timesheets or a clocking in and out system. Hours recorded to be reviewed by responsible official.	Observe a sample of employees clocking in and out to ensure it is done according to the entity's procedures. Inspect a sample of timesheets for evidence that they have been reviewed by a responsible official.
That additional hours are recorded which have not been worked	To ensure that only overtime which has been completed is recorded and paid	Overtime must be authorised by an appropriate supervisor/manager in advance of the overtime being carried out and an overtime authorisation form completed.	For a sample of overtime payments, trace back to the overtime authorisation form and inspect the form for evidence of the overtime being authorised.

Stage: Recognition of payroll liability			
Risk	Control objectives	Controls	Tests of controls
That fictitious employees are paid	To ensure that only individuals which are bona fide employees are paid	Where new joiners are taken on/ current employees leave Human Resources (HR)/staff manager should complete and sign a joiners/leavers form which should be passed to payroll. Payroll must acknowledge receipt of the form/changes to the payroll system should be made and amendments to the system subsequently reviewed by a supervisor. Personnel files should be held for all employees. Assign unique employee numbers to each employee	Obtain a list of joiners/leavers during the period and trace a sample through to ensure that appropriate HR documentation was completed and the payroll system amendment was made accurately. Select a sample of starters and leavers during the period and determine whether they were genuine employees by tracing employee details back to personnel files. Review procedures for entering and removing employee numbers from the payroll master file.

Stage: Recognition of payroll liability			
Risk	Control objectives	Controls	Tests of controls
		in the payroll master file. Only employees with valid employee numbers can be paid.	
That wages are paid/deductions made at the wrong rate	To ensure that wages are paid/deductions are made at the appropriate rate	Any changes to standing data for payroll (employee salaries/hourly rates/deductions from gross wages/tax codes etc) should be authorised by HR/staff manager using appropriate documentation. A report of changes to standing data should be printed on a monthly basis and reviewed by an appropriate manager to ensure all changes are <i>bona fide</i> and accurately made.	Review a sample of the reports showing changes made to standing data to ensure that changes made were appropriately authorised and accurately made. Recalculate PAYE and other deductions to ensure they have been correctly calculated.

Stage: Payment made			
Risk	Control objectives	Controls	Tests of controls
That employees are not paid the amount that they are due to receive per payroll records/their payslip	To ensure that employees are paid the correct amount according to payroll records/their payslip	Each month, a printout of all amounts due to be paid to employees should be printed and reviewed for any unusual amounts/employees. The total of the amount to be paid should be recast. If employees are paid by BACS transfer then the employees' bank account number should be verified and the amount due to each employee agreed back to the payroll system and payslip.	Review the printout to determine whether any unusual items were followed up. Discuss the outcome with management. Recast the schedule in order to ensure it has been accurately cast. For a sample of employees reperform the controls in place to ensure they have been completed accurately. Vouch the authorisation of the payroll manager/finance director.

Stage: Payment made			
Risk	Control objectives	Controls	Tests of controls
		The BACS transfer should then be authorised by the payroll manager/ finance director. If employees are paid in cash then an additional check should be made that the amount included in the wage packet agrees back to the payslip. Wage packets should be made up by two payroll staff and employees required to sign to confirm receipt of the wage packet.	Observe cash payment process.

3.4 The inventory system

The fourth system included in the syllabus is the inventory system.

The main objectives/stages of the internal controls in this system are to ensure:

- Only goods required by the entity are accepted and are accurately recorded
- Damaged goods are not accepted and inventory is appropriately valued
- The business is not interrupted due to stock outs
- Inventory is kept securely (not damaged or stolen)

Many of these objectives overlap to a large extent with the middle stages of the purchases cycle.

Stage: Only goods required by the entity are accepted and are accurately recorded			
Risk	Control objectives	Controls	Tests of controls
That goods which have not been ordered are accepted	To ensure that only goods which have been ordered are accepted	A copy of the authorised order form should be passed to the warehouse. When goods are received, they should be matched to the order form and only accepted if they were ordered. The GRN should be signed to evidence that it has been vouched back to the order form.	Inspect a sample of GRNs for evidence of a signature verifying that the goods received were traced back to an authorised order form.
That purchases and sales of inventory are recorded in the	To ensure that all purchases and sales of inventory are	All GDNs and GRNs are processed on a daily basis to record the despatch and receipt of inventory.	Inspect documentation to confirm that daily processing of GDNs and GRNs occurs.

Stage: Only goods required by the entity are accepted and are accurately recorded

Risk	Control objectives	Controls	Tests of controls
wrong accounting period	recorded in the correct accounting period		

Stage: Damaged goods are not accepted and inventory is appropriately valued

Risk	Control objectives	Controls	Tests of controls
That damaged/faulty goods are accepted	To ensure that goods are only accepted if they are of the appropriate quality	On receipt of goods, all items are to be verified to ensure they are in satisfactory condition.	Observe the receipt of goods by staff to confirm the control is carried out.
That inventory is not valued at the lower of cost and net realisable value	To ensure that inventory is properly stated at the lower of cost and net realisable value	Standard costs are to be regularly reviewed by management to ensure they are kept up to date. Inventory managers should review inventory regularly to identify slow-moving, obsolete and excess inventory.	Review the entity's procedures for updating standard costs and test a sample of standard costs to determine whether they approximate to current cost. Discuss the procedure for reviewing inventory with management and observe the review process/inspect any reports which management have issued after the review has taken place.

Stage: The business is not interrupted due to stock outs

Risk	Control objectives	Controls	Tests of controls
That goods ordered are not received, potentially leading to stock outs	To ensure that goods ordered are received	On receipt of goods, the warehouse should raise a multi-part, sequentially numbered goods received note (GRN). One part of the GRN should be passed to the purchasing department to be matched to the order form.	Observe the receipt of goods into the warehouse to ensure all goods are recorded and a GRN generated. Verify that the GRN is matched to the order form by the purchasing department.

Stage: The business is not interrupted due to stock outs			
Risk	Control objectives	Controls	Tests of controls
		Unmatched orders should be reviewed on a periodic basis and suppliers chased.	Enquire as to the action taken where orders are unfulfilled and reperform this process.

Stage: Inventory is kept securely (not damaged or stolen)			
Risk	Control objectives	Controls	Tests of controls
That inventory is damaged/stolen	To ensure that inventory is safeguarded	Inventory should be stored in an appropriate environment (for example, perishable inventory should be kept at the right temperature/ refrigerated if necessary). Access to inventory should only be granted to the appropriate personnel. Items should only be issued from inventory if accompanied by a copy of a customer sales order form.	Inspect the environment in which inventory is stored to ensure it is suitable for the nature of the inventory. Inspect the identity cards of employees working within the inventory area. Inspect a sample of GDNs to verify that they relate to bona fide customer orders.
That inventory movements are not adequately monitored	To ensure that all inventory movements are authorised and recorded	Inventory should only be moved if it is accompanied by a pre-numbered GDN or GRN. Regular reconciliations performed of inventory records with the general ledger. Segregation of duties to exist in terms of the responsibilities for the maintenance of inventory records and the custodianship of inventory.	For a sample of inventory movements, inspect GDNs and GRNs to determine whether inventory is being moved for valid reasons. Review a sample of reconciliations to confirm that they have been accurately prepared and reviewed by a manger/supervisor. Observe the recording of inventory and discuss inventory procedures with relevant staff to ensure that proper segregation of duties is operating.

3.5 The bank and cash system

The fifth system included in the syllabus is the cash system.

The main objectives/stages of the internal controls in this system are to ensure:

- All monies received are recorded
- All monies received are banked
- Cash and cheques are safeguarded against loss or theft
- All payments are authorised, made to correct payees and recorded
- Payments are not made twice for the same liability

Many of these objectives overlap to a large extent with the final stages of the sales and purchases systems.

Stage: All monies received are recorded			
Risk	Control objectives	Controls	Tests of controls
That monies are received but not recorded	That all monies received are recorded	There should be a segregation of duties in place between those receiving the monies and those recording them in the accounting system. Two people should open the post and record the amounts received on a 'receipts listing'. This information should then be passed to another member of staff who will then record the entries in the cash book and write out the bank paying in slip. Another member of staff should be responsible for banking any monies received.	Observe the process of the post being opened and monies received recorded to ensure that the entity's internal controls are being adhered to. Inspect documentation such as the bank paying in slip for evidence of each staff member carrying out their separate part of the process.

Stage: All monies received are banked			
Risk	Control objectives	Controls	Tests of controls
That monies received are not banked	To ensure that monies received are banked	Bank reconciliations should be performed on a weekly/monthly basis by someone not responsible for the banking and the reconciliation reviewed by a supervisor/manager. Customer statements should be prepared and sent out on a regular (monthly) basis.	Reperform the bank reconciliation to ensure it has been done accurately. Review the bank reconciliation for evidence of the supervisor/manager review being performed. Enquire from management as to whether customer statements are sent out on a regular basis and review customer correspondence in order to determine the level of errors identified as a result of customer statements being sent out.

Stage: Cash and cheques are safeguarded against loss or theft			
Risk	Control objectives	Controls	Tests of controls
That cash/cheques are misappropriated	To ensure that cash/cheques are safeguarded against loss or theft.	Unbanked receipts should be kept in a locked safe at all times. Cheque books should be kept by a supervisor/manager and stored in a secure location such as a locked drawer/cash tin or safe.	Physically verify the location of unbanked receipts/cheque books to ensure they are kept securely.

Stage: All payments are authorised, made to correct payees and recorded			
Risk	Control objectives	Controls	Tests of controls
That invoices are paid without being authorised/paid to the wrong supplier and not recorded accurately in the accounting records	To ensure that invoices are only paid once authorised and that payment is made to the correct payee and recorded	All invoices should be authorised for payment and coded to the relevant supplier by the appropriate budget holder prior to the invoice being paid. Authorisation/coding should be evidenced by a signature.	Inspect a sample of invoices for authorisation and appropriate coding.

Stage: All payments are authorised, made to correct payees and recorded			
Risk	Control objectives	Controls	Tests of controls
		Statements received from suppliers should be reconciled to the relevant purchase ledger account on a monthly basis. Any subsequent changes to the accounting records must be authorised.	Review a sample of supplier statement reconciliations to ensure that they have been completed accurately and any resultant changes authorised.

Stage: Payments are not made twice for the same liability			
Risk	Control objectives	Controls	Tests of controls
That an invoice is paid twice	To ensure that invoices are not paid twice for the same liability	Once paid the invoice should be stamped 'paid'. Purchase invoices should be sequentially numbered and the invoice recorded as 'paid' on the system so that the computer will not allow the same invoice to be paid twice.	Inspect a sample of invoices for evidence that calculations have been reperformed and the invoice stamped as 'paid'. Attempt to process a payment for an invoice which has previously been paid to determine whether the system will block the payment.

3.6 Non-current assets

The sixth system included in the syllabus is non-current assets. This system relates to capital expenditure.

Many of the objectives overlap with the initial stage of the purchases system where an entity must ensure that only goods required are ordered and that all orders are authorised.

The principal internal controls in this system which have not already been detailed in the purchases system are to ensure:

- That capital expenditure is appropriately classified in the accounting records
- That capital items are recorded in the non-current asset register
- That there is safe custody of assets

Stage: That capital expenditure is appropriately classified in the accounting records

Risk	Control objectives	Controls	Tests of controls
That revenue expenditure is recorded as capital expenditure or vice versa	To ensure that capital expenditure is appropriately classified in the accounting records	Separate order forms should be used for the purchase of inventory items (see purchases cycle) and capital items. For capital items, the order should be authorised by one or two managers/ directors depending on the value of items ordered. The order should be coded to the appropriate non-current asset account. Periodically, review the revenue and capital expenditure nominal ledger accounts for evidence of large/unusual items which may have been incorrectly recorded.	Inspect a sample of orders for capital items. Vouch that the appropriate level of authorisation has been made and evidenced by a signature. Verify that the account code relates to the item ordered. Discuss with management the outcome of the nominal ledger reviews. Inspect any journals made to correct errors to ensure that they have been authorised.

Stage: That capital items are recorded in the non-current asset register

Risk	Control objectives	Controls	Tests of controls
That capital items are not recorded in the non-current asset register	To ensure that capital items are recorded in the non-current asset register	Periodically review the non-current assets held by the business and trace them through to verify that they are recorded in the non-current asset register. On a monthly basis, reconcile the totals on the non-current asset nominal ledger codes to the balance per the non-current asset register. Investigate any differences. Authorise all adjustments.	For a sample of non-current assets, inspect the non-current asset register to ensure that they have been included. Review the reconciliation to see the level of adjustments required. Discuss with management why errors have occurred and the action being taken to reduce future errors.

Stage: That there is safe custody of assets			
Risk	Control objectives	Controls	Tests of controls
That capital items are misappropriated	To ensure that there is safe custody of assets	Establish physical safeguards over non-current assets such as locks, safes, keypads, CCTV, security guards in order to reduce the risk of theft. Maintain adequate insurance over non-current assets.	Test the operation of the physical controls, for example obtain to gain access to a restricted area without following security procedures. For a sample of assets, inspect insurance documents to determine whether insurance is adequate and up to date.

4 Communication of deficiencies in internal control

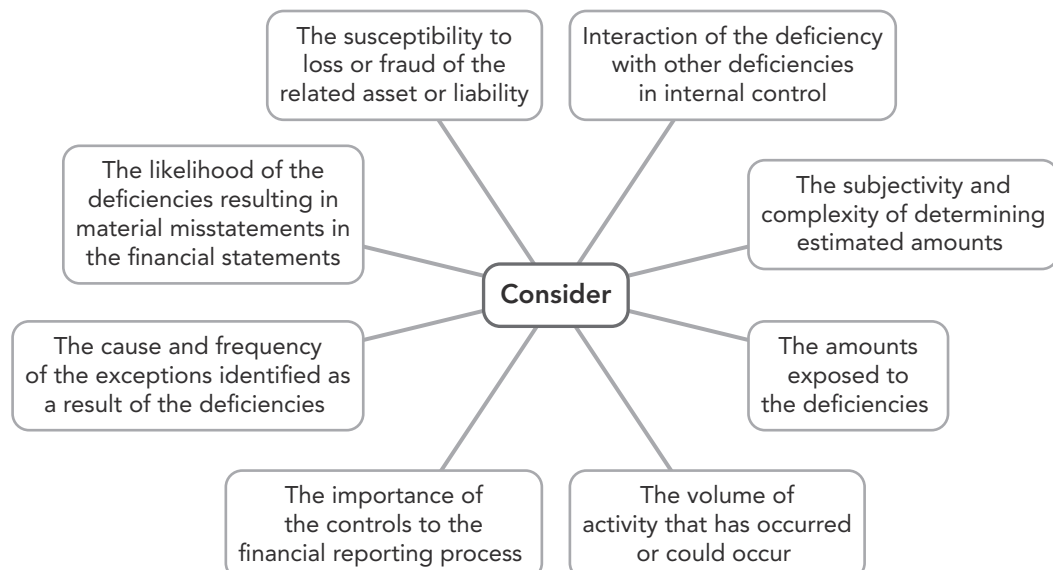
ISA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* states that **significant deficiencies in internal control** should be communicated in writing to those charged with governance.

This will take the form of a **report to management**.

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.

4.1 Determining whether a deficiency is significant

The auditor should consider the following matters when determining whether a deficiency in internal control is a significant deficiency:



4.2 Reports to management

Once the auditor has decided that there are significant deficiencies which need to be communicated to those charged with governance, they should include this information in a **report to management**.

In the exam you may be asked **only** to identify and explain deficiencies in internal control and to make a recommendation to address these.

Alternatively, you may be asked to include the above information in a report to management.

An example format for a report to management is included below:

	Check and Co Auditor's Address
Board of Directors Dress You Like Co	
	Date: exam date
Dear Sirs, Audit of Dress You Like Co for the year ended 30 September 20X6 Please find enclosed the report to management on significant deficiencies in internal controls identified during the audit for the year ended 30 September 20X6. The Appendix to the report identifies and explains deficiencies in the sales system and provides recommendations to address those deficiencies. Please note that this report only addresses any significant deficiencies identified during the audit and if further testing had been performed then more deficiencies may have been reported. It is not therefore a comprehensive list of all deficiencies. This report is solely for the use of management and if you have any further questions then please do not hesitate to contact us. Yours faithfully, Check and Co	
Appendix:	
Control deficiency No credit checks are made before new customers are accepted and credit limits are not prescribed. The company may well accept an order and despatch goods to a bad credit risk. This may mean that goods are sold to a customer who cannot pay for them, leading to a loss of revenue and inventory.	Control recommendation A standard new customer form should be created which must be completed before orders are accepted from new customers. This form should require a credit check to be made in relation to the customer and a credit limit allocated. Standard tiers of credit limits could be applied for different customers. All completed new customer forms should be authorised by Edward Times or Katie Escombe prior to goods being despatched. The authorisation should be evidenced on the form.

4.3 Reports to management by the internal audit function

In the example above, the report to management was produced by the external auditor.

In Chapter 5 we saw that one of the roles of the internal audit function is often to review an entity's internal controls and to report their findings (including any deficiencies) to management.

It is very possible therefore that a report on deficiencies, implications and recommendations might be prepared by the internal audit function. The format of such a report will be determined by management and is much more flexible than the above report by the external auditor.



Essential reading

See Chapter 10 of the Essential reading for an example internal auditor's report.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

5 ISA 260 (Revised): Communication with those charged with governance

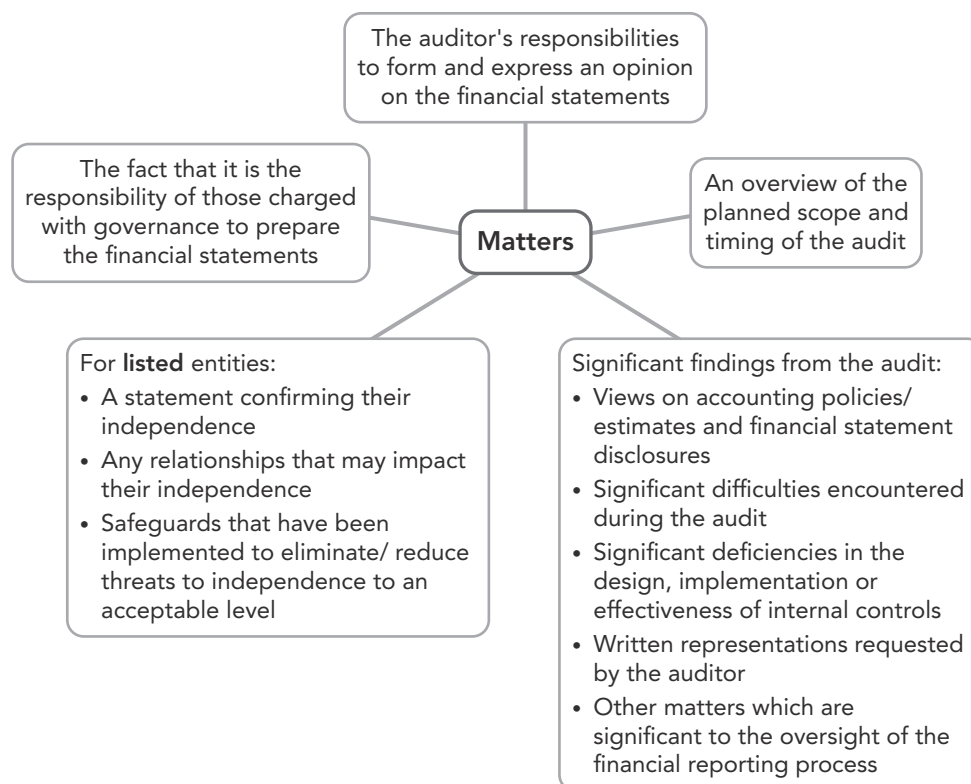
In this chapter and also Chapters 3 and 4, we have seen that there are often occasions where the external auditor needs to communicate audit matters with those charged with governance.

5.1 Definition



Those charged with governance: are the person(s) or organisation(s) with responsibility for overseeing the strategic direction of the entity and obligations relating to the accountability of the entity (ISA 260 (Revised): para. 10a).

5.2 Matters the auditor would communicate to those charged with governance



5.3 Third parties interested in communications to those charged with governance

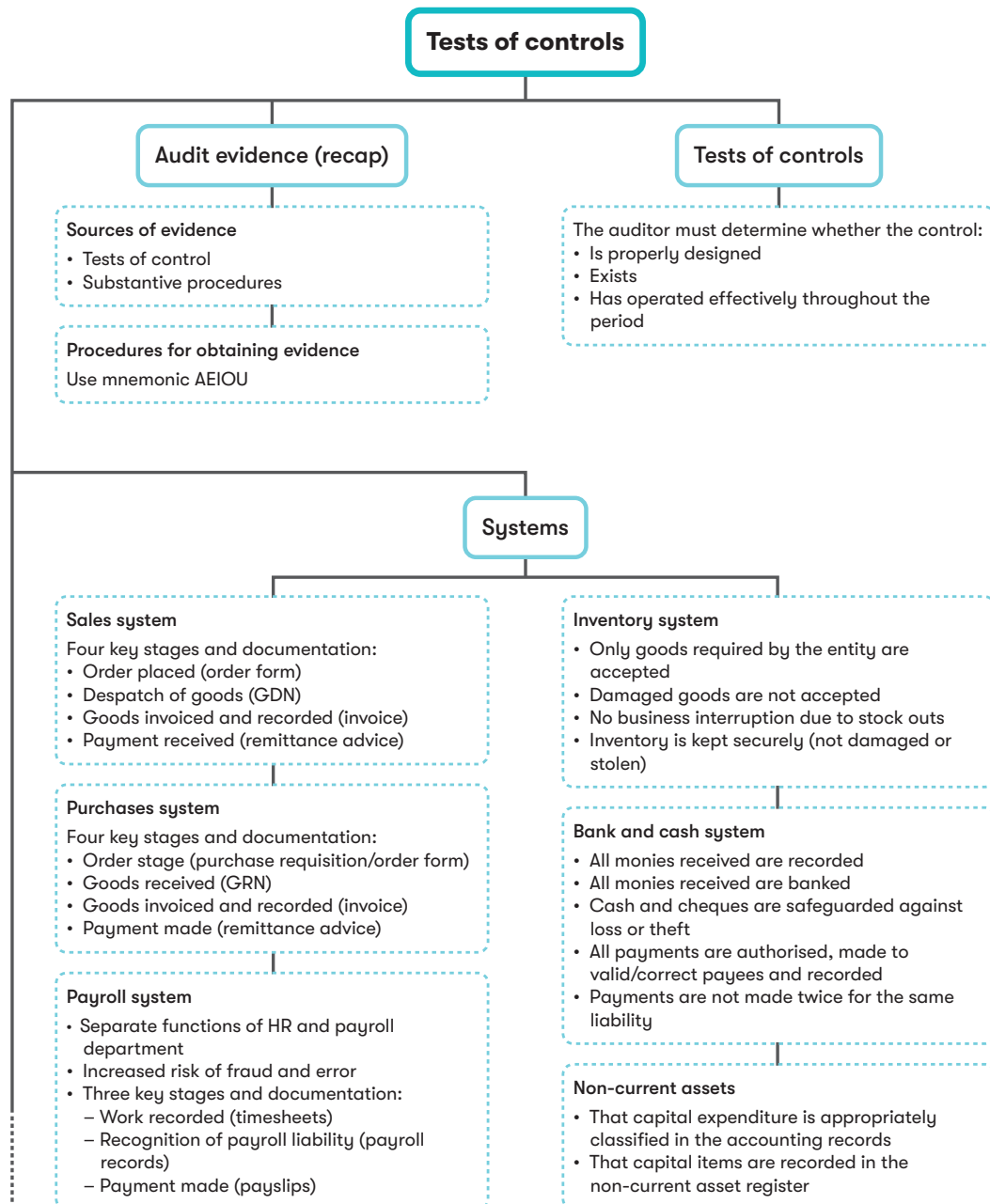
Occasionally, those charged with governance may wish to provide third parties, for example bankers or certain regulatory authorities, with copies of a written communication from the auditors.

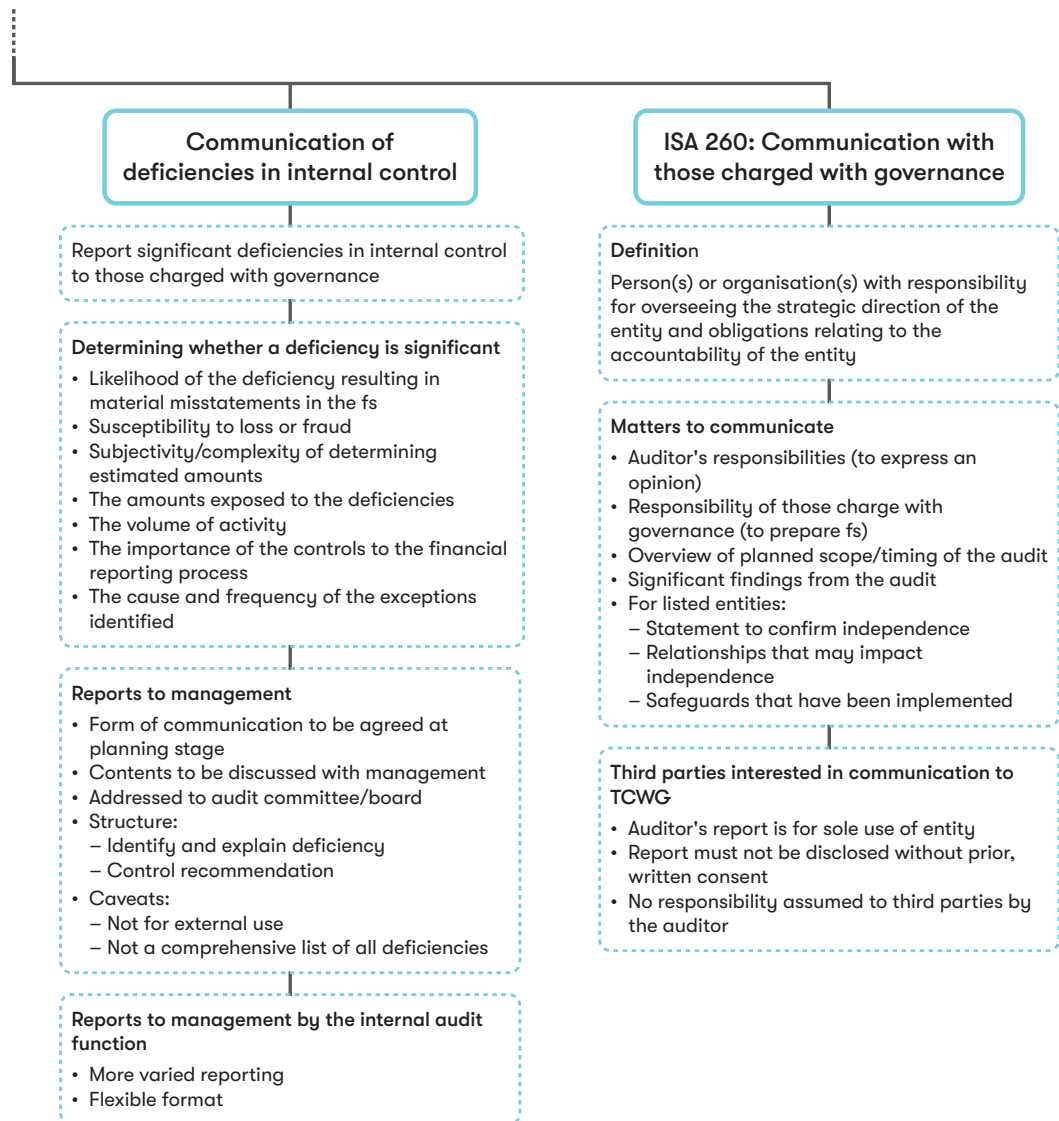
It is important that the auditor ensures that third parties who see the communication understand that it was not prepared with them in mind.

To that effect, written communication from the auditors will include certain caveats:

- The report has been prepared for the sole use of the entity;
- It must not be disclosed to a third party, or quoted or referred to, without the written consent of the auditors; and
- No responsibility is assumed by the auditors to any other person.

Chapter summary





Knowledge diagnostic

1. Types of audit procedures

Audit evidence can be gained using tests of controls and/or substantive procedures.

2. Tests of controls

Tests of controls involve repeatedly testing specific internal controls to ensure that they are properly designed, exist and have operated throughout the period.

3. Methods to test controls

Internal controls can be tested using enquiry, inspection, observation and reperformance.

4. Examinable systems

There are six systems in the syllabus: sales, purchases, payroll, inventory, cash and non-current assets. A business should establish internal controls in each system.

5. Exam questions

Questions on this area will be **scenario based** and so you need to be able to identify internal controls and/or internal control deficiencies from a given scenario.

6. Significant deficiencies

Significant deficiencies in internal control noted by the auditor will be communicated via a report to management. You may need to produce this in the exam and so will need to be familiar with its contents.

7. Reports on internal control deficiencies

Reports on internal control deficiencies may also be one of the areas of work undertaken by the internal audit function.

8. Internal auditor's reports

Whenever the internal audit function carries out an assignment, they are likely to produce a report which details their findings. The reports will vary according to the type of assignment the internal audit function has performed. You should be able to describe the form and content of internal auditor's reports.

9. Communicating with those charged with governance

There are many different matters which the external auditor may communicate with those charged with governance. These range from responsibilities for the financial statements, planning issues, audit issues, internal control deficiencies and the auditor's independence.

Further study guidance

Question practice

Now try the following from the Further question practice bank [available in the digital edition of the Workbook]:

- Section A Q23 to Q27
- Section B Q60(a) Fenton Distributors
- Section B Q61 Cheque payments and petty cash

Further reading

There are study support videos on the ACCA website recorded by members of the AA examining team and other tutors which are relevant to some of the topics covered in this chapter that you should read:

Study Support Videos:

- Internal controls (part 1) (<https://www.youtube.com/watch?v=2HxZJk7j5VA>)
- Internal controls (part 2) (<https://www.youtube.com/watch?v=7JmyiQDzf6k&feature=youtu.be>)

Own research

As we saw in Chapter 9, it would be helpful for you to consider the internal controls that operate in your place of work (or even your home). What are the processes and policies that you need to follow and what documentation are you required to complete? Are any checks made to determine whether the processes and policies have been accurately followed?

Activity answers

Activity 1: Sales system (deficiencies)

Control deficiency	Control recommendation
Many parts of the sales system process are completed by hand/manually. For example, the order form is completed by hand and is then passed (by hand) to the warehouse. Completing items by hand could lead to an increased risk of manual error in filling out the form, or errors in processing if handwriting cannot easily be read. Additional time is also taken photocopying/scanning orders which are then posted/emailed to customers. There could also be delays in passing the order to the warehouse.	The computer system should generate a blank, sequentially numbered standard order form for the sales team to complete electronically which will ensure all required information is captured. Once completed, this should be emailed to the customer and sent electronically to the warehouse. Periodic sequence checks should be undertaken in order to ensure that all orders have been recorded.
The goods despatched note (GDN) is not generated from the order form but is simply written up from what is packed in the boxes. There is also no double-check that the items on the GDN are those items packed in the boxes. If errors are made in the packing process, the customer could be despatched items that they did not order or may not receive items they did order, even if they are not out of stock.	The GDN should be generated as an electronic copy of the order form and detail the product code and quantity ordered. Where an item is not in stock this should be recorded on the GDN to provide a record of items which are missing. Spot checks should be carried out to verify that the contents packed agree to the order form.
Monies received from customers are not always accompanied by a remittance advice and so cannot always be allocated to specific outstanding invoices. Sometimes monies are simply allocated to the oldest invoices. The company does not have an accurate record of outstanding invoices and so cannot chase overdue amounts efficiently. This will also mean that disputed invoices are not necessarily identified. This could lead to a loss of cash flow and/or irrecoverable debts.	Monies received with remittance advices should be allocated against the specific invoices which are being paid. Where a remittance advice is not received, the accounts receivables clerk should contact the customer by telephone to determine the breakdown of invoices being paid.
Note. Only THREE deficiencies were required for this activity. However, there were many other deficiencies in the activity and these are detailed below for completeness:	
The order form is not pre-numbered. The situation may arise where more than one order is given the same order number causing confusion in the sales team when dealing with customer queries. If the order forms are not pre-numbered then	Order forms should be pre-numbered and sequentially numbered in order to be able to determine whether any order forms are missing.

Control deficiency	Control recommendation
it is also more difficult to file them in a logical order and thus resolve any customer queries quickly and efficiently.	
Orders for the supermarket chain are sent directly to the despatch team and not to the warehouse manager. The warehouse manager has responsibility to ensure that all orders received are allocated to a team of pickers. He also monitors that orders are subsequently fulfilled where items are initially out of stock. Passing the order directly to the despatch team may mean that these unfulfilled orders are not later despatched leading to dissatisfaction from the company's major customer.	All orders should be passed to the warehouse manager who can then allocate the jobs to the despatch team on a timely basis.
No credit checks are made before new customers are accepted and credit limits are not prescribed. The company may well accept an order and despatch goods to a bad credit risk. This may mean that goods are sold to a customer who cannot pay for them, leading to a loss of revenue and inventory.	A standard 'new customer' form should be created which must be completed before orders are accepted from new customers. This form should require a credit check to be made in relation to the customer and a credit limit allocated. Standard tiers of credit limits could be applied for different customers. All completed 'new customer' forms should be authorised by Edward Times or Katie Escombe prior to goods being despatched. The authorisation should be evidenced on the form.
The invoice process is also completed manually and the items to be invoiced are manually input from the details on the GDN. Any errors in the GDN will result in errors on the invoice. This will lead to staff time being taken up to correct the errors and could lead to customer dissatisfaction if the level of errors is high.	An electronic invoice should be generated from the electronic order form and GDN using the standard product codes and prices in order to improve the accuracy of information.
The prices charged to the supermarket are automatically generated by the system without any checks being made. Any errors in the pricing standing data will mean that the supermarket could be charged for goods at too low a price, thus losing the entity revenue, or at too high a price which would potentially lead to customer dissatisfaction.	Each time that prices change, a report showing the pricing standing data should be generated and reviewed by a supervisor/manager to ensure all changes are accurate and to reduce the risk of unauthorised changes being made. This review should be evidenced by a signature.
There is no formal process to monitor overdue amounts. Customer statements are not sent each month and no aged receivables analysis is produced. If overdue amounts are not chased as soon as they fall overdue then there is an increased	A formal process should be adopted to chase outstanding customer balances. Statements should be prepared on a monthly basis and sent to each customer detailing the transactions with the customer during the month and the balance outstanding at the

Control deficiency	Control recommendation
risk of non-payment.	end of the month. The aged receivables report should also be produced on a monthly or at least quarterly basis to identify amounts which have been overdue for some time. Customers with overdue accounts should be contacted by telephone as soon as possible and a letter requesting payment sent if no payment is received. Accounts should be placed 'on stop' if a customer exceeds their credit limit until such time that the balance is repaid.

Activity 2: Sales system (test of controls)

Control	Test of controls
When completing an order form, the sales team refer to the standard product list in order to verify that the correct product codes have been used and that the order is accurate.	For a sample of orders throughout the year, vouch the product codes on the order form to the standard product list to verify that the correct product codes have been used.
Any changes to standard data, such as discounts, require hierarchical authorisation by the acting finance director. This will prevent unauthorised changes being made to the standard data.	For a sample of customers who are not entitled to a discount, attempt to process a discount to determine whether a prompt will be received requesting an appropriate login.
Bank reconciliations are performed each week to monitor the completeness, accuracy and validity of the information held in the cash book. The reconciliations are also performed by someone other than the accounts receivables clerk which strengthens the control due to the segregation of duties.	For a sample of bank reconciliations, reperform the reconciliation to ensure it has been completed properly. Vouch the balances per the bank statement and cash book to the bank statement and the accounting records and recast the arithmetical accuracy of the reconciliation. Trace through any reconciling items to ensure that they are reasonable. If the bank reconciliation was reviewed, inspect the reconciliation for evidence of the review taking place.
Note. Only three controls were required for this activity. However, there were several other controls in the activity and these are detailed below for completeness.	
Orders which have been received but have not been completed because the item is out of stock are reviewed daily to ensure that customer orders are completed as efficiently as possible. A full review of outstanding orders is also done each month with the sales team.	Observe the warehouse manager review these orders and follow up to ensure that they have been allocated to a picking team and fulfilled within an appropriate timescale. Observe the review of outstanding orders to ensure it is conducted each month.
Invoicing is carried out daily once the GDNs are received from the warehouse. This ensures that goods despatched are invoiced on a	For a sample of GDNs trace through to the related invoice and vouch the date to ensure that the invoice was sent out shortly after the

Control	Test of controls
timely basis thus improving cash flow.	goods were despatched.

Activity 3: Purchases system (deficiencies)

1 The correct answers are:

- Goods may be accepted which have not been ordered and therefore are not needed by the business.
- Goods which are actually required for production may have been omitted from the delivery which could lead to stock outs and business interruption.

Goods received should be vouched to the order form in order to ensure that the business receives exactly what it ordered; however, this process will not stop orders being processed unnecessarily. Furthermore, a separate quality check should be performed on the goods received.

2 The correct answer is: Invoices on the supplier statement which relate to goods received but not invoiced should not be included in the purchase ledger to avoid the payables balance being overstated at the year-end.

Where goods have been received before the month-end/year-end a corresponding liability should be recognised even if the invoice has not been received.

3 The correct answer is: That supplier invoices are paid too early

At Dress You Like Co supplier invoices are currently being paid in the month in which they are received rather than when they fall due. Therefore, having some sort of prompt/notification in the accounting system which identifies when each invoice needs to be paid according to the supplier's credit terms will reduce the risk that invoices are paid too early.

Activity 4: Purchases system (test of controls)

1 The correct answer is: For a sample of invoices which have been matched to goods received notes, reperform the calculations to ensure they have been done properly.

Reperforming the calculations will enable the auditor to conclude whether the finance assistant has accurately vouched the details on the invoice to the goods received note.

Note that analytical review is a substantive procedure, not a test of controls.

2 The correct answer is: That payments to the supplier are reviewed and authorised prior to payment

The Finance Director signs the bank payment authorisation to demonstrate that she has reviewed the list of invoices being paid and approves the payment.

Activity 5: Payroll system (deficiencies)

Control deficiency	Control recommendation
Overtime does not have to be authorised by a supervisor/ manager in order to be paid. Employees could claim for overtime which has not been worked. Also, the entity cannot budget its cash flow properly if overtime is not planned in advance and authorised.	The entity should establish a 'request for overtime' form. This should be completed by the employee after discussion with the department manager to determine why and whether overtime is necessary. The department manager should sign to evidence their authorisation for the overtime to be performed which will prevent unauthorised overtime being completed/paid. Once the overtime has been completed, both the 'request for overtime' and 'overtime claim'

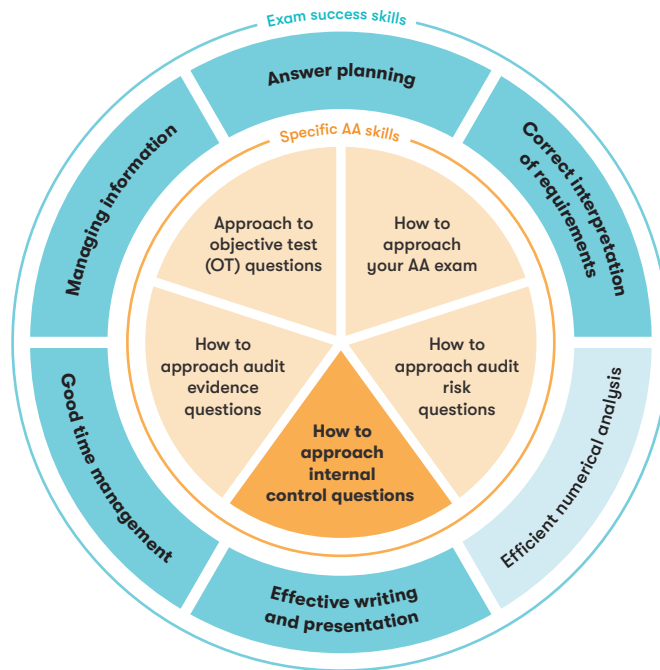
Control deficiency	Control recommendation
	forms should be signed by the department manager and forwarded to the wages clerk.
The wages clerk is able to amend the standing data on the payroll system and also processes payroll on a day to day basis. The wages clerk has too much influence over the payroll system and could carry out fraudulent activity such as setting up fictitious employees and changing rates of pay if he wanted to.	At least two people should be involved in the payroll process. One person should have responsibility for amending standing data and joiners and leavers and the second person should process the day to day payroll in order to improve segregation of duties and increase the likelihood of errors being detected. All amendments to standing data should be authorised before they are made and an exception report of changes made should be printed each month and reviewed for any unexpected changes in order to reduce the risk of unauthorised changes being made.

Activity 6: Payroll system (test of controls)

Control	Test of controls
Hours worked are recorded by a clocking in/out system, with each employee using their unique employee number. Employees are automatically clocked out at the end of their shift, reducing the risk that employees are paid for hours not worked.	Observe the clocking in/out process to ensure that each employee has to enter their own employee number. Attempt to clock in using an incorrect employee number to verify that the system will not allow the entry. For a valid employee number, do not clock out at the end of the day and inspect the system records to ensure that the employee has been logged out by the system.
The listing of employee pay details is reviewed by the acting finance director before payments are made to the employees. This reduces the risk of fraudulent/erroneous payments.	Observe the monthly payroll being processed and reviewed by the acting finance director. Inspect a copy of the payroll listing to vouch the finance director's signature authorising the payment.

Skills checkpoint 3

How to approach internal control questions



Introduction

Both the external auditor and the internal auditor have a role to play in relation to an entity's internal control systems.

The external auditor needs to have an understanding of an entity's internal control relevant to the audit. This means that they need an understanding of the policies and procedures which are relevant to the financial statements regardless as to whether or not they want to gather audit evidence via tests of controls.

The internal auditor may be involved in developing an entity's internal control system or in testing the system.

Whatever their involvement, it is likely that both the external and the internal auditors will be in a position to identify deficiencies in an entity's internal control systems and they should report those deficiencies to management/those charged with governance. Conversely, they are both in a position to be able to identify direct controls which operate within the internal control system and can then test them.

Consequently, questions on internal control feature regularly in the Audit and Assurance exam. There are several types of questions which may be tested:

- Identify and explain control deficiencies and make recommendations to address each deficiency;

- Explain direct controls and describe tests of control to ensure the controls are operating effectively; and
- Control deficiencies, recommendations and tests of control.

Where such questions feature in Section B of the exam, they tend to be scenario based.

The Examiner's reports imply that candidates' performance in Section B questions on internal control is better than that on audit risk but that there is still room for improvement in terms of fully explaining both deficiencies and controls.

This skills checkpoint will therefore consider how you should approach such questions. We will use the example of the first type of question although the same approach should be applied to all three types.

Skills Checkpoint 3: How to approach internal control questions

AA Skill: How to approach internal control questions

A step-by-step technique for ensuring that your approach to internal control questions uses the scenario provided in the exam and maximises your marks is outlined below. Each step will be explained in more detail in the following sections, and illustrated by answering a requirement from a past exam question.

STEP 1:

Allow some of your allotted time to read the requirements and the scenario.
Don't rush into starting to write your answer.



STEP 2:

Re-read the scenario and start to develop an answer plan.
Use the table headings provided (Control deficiency and Control recommendation) and as you read through the scenario for the second time, write down a few words or a bullet point each time you identify a potential internal control deficiency in the scenario.
Use these as headings in your answer.



STEP 3:

Re-read the requirement to confirm how many control deficiencies you need to explain. You may have written down more headings than required, in which case decide which ideas you can explain most easily and include those in your answer.
When you write your answer the deficiency should describe the specific impact that the issue might have on the entity (ie they may pay employees for more hours than have been worked). Next describe the internal control you would recommend management implement to address the deficiency.

Exam success skills

The following illustration is based on an extract from a past exam question, about a pharmaceutical manufacturer, called 'Oregano'. This extract was worth 12 marks.

For this question, we will also focus on the following **exam success skills**:

- **Managing information.** It is easy for the amount of information contained in scenario-based questions to feel overwhelming. To manage this, focus on the requirement first – noting the key

exam verbs to ensure you answer the question properly. Then read the rest of the question, noting important and relevant information from the scenario

- **Correct interpretation of requirements.** Here you need to **both** identify and explain the deficiency **and** recommend an internal control to address the deficiency.
- **Answer planning.** Everyone will have a preferred style for an answer plan. For example, it may be highlighting, bullet-pointed lists, or simply making notes. Choose the approach that you feel most comfortable with or, if you are not sure, try out different approaches for different questions until you have found your preferred style.
- **Effective writing and presentation.** Often the examining team will specify the format your answer should take. If you follow this then you stand the best chance of maximising your marks. You may also wish to use sub-headings in your answer. You could use a separate sub-heading for each deficiency you identify in the scenario and then go on to explain the internal control that would address the deficiency. Underline or embolden your headings and sub-headings, and use full sentences, ensuring your style is professional.
- **Good time management.** It is essential that you do not overrun on the constructed response questions in Section B and so you must always keep an eye on time. Note down the time you should finish the question.

STEP 1 Allow some of your allotted time to read the requirement and the scenario. Don't rush into starting to write your answer.

Start by analysing the requirements so that you know what you are looking for when you read the scenario.

(c) Identify and explain SIX deficiencies in Oregano Co's sales and dispatch system and provide a recommendation to address each of these deficiencies.

Note. Prepare your answer using two columns headed Control deficiency and Control recommendation respectively.

12 marks

Required

The first part of the requirement is to 'identify and explain SIX deficiencies'. Here you need to use the scenario to generate six issues that could impact the smooth running of the business. It may be that the entity should have an internal control but no control is operational (if a control is not mentioned in the scenario then assume that it does not operate) or that the entity has an internal control but it doesn't operate effectively.

The second part of the requirement is to 'provide a recommendation to address each deficiency'. Here you should describe in detail the internal control that management should implement to prevent the deficiency recurring or to detect it should it happen again.

This requirement is worth 12 marks and at 1.8 minutes a mark, should take 21 minutes to both plan and write the solution.

Question – Oregano (12 marks)

You are a member of the recently formed internal audit department of Oregano Co (Oregano). The company manufactures tinned fruit and vegetables which are supplied to large and small food retailers. Management and those charged with governance of Oregano have concerns about the effectiveness of their sales and dispatch system and have asked internal audit to document and review the system.

Sales and dispatch system

Sales orders are mainly placed through Oregano's website but some are made via telephone. Online orders are automatically checked against inventory records for availability; telephone orders, however, are checked manually by order clerks after the call. A follow-up call is usually made to customers if there is insufficient inventory. When taking telephone orders, clerks note down the details on plain paper and afterwards they complete a three-part pre-printed order form. These order forms are not sequentially numbered and are sent manually to both dispatch and the accounts department.

As the company is expanding, customers are able to place online orders which will exceed their agreed credit limit by 10%. Online orders are automatically forwarded to the dispatch and accounts department.

A daily pick list is printed by the dispatch department and this is used by the warehouse team to dispatch goods. The goods are accompanied by a dispatch note and all customers are required to sign a copy of this. On return, the signed dispatch notes are given to the warehouse team to file.

The sales quantities are entered from the dispatch notes and the authorised sales prices are generated by the invoicing system. If a discount has been given, this has to be manually entered by the sales clerk onto the invoice. Due to the expansion of the company, and as there is a large number of sales invoices, extra accounts staff have been asked to help out temporarily with producing the sales invoices. Normally it is only two sales clerks who produce the sales invoices.

STEP 1 Now you should be ready to re-read the scenario and set out an answer plan using the deficiencies you identify as you read through.

Use headings.

Work through each paragraph of the scenario identifying specific deficiencies. Each deficiency is worth one mark and the recommendation is also worth one mark, hence why you need six properly explained deficiencies and recommendations to gain 12 marks.

Completed answer plan

Having worked through each paragraph, an answer plan can now be completed.

A possible answer plan is shown here.

You are a member of the recently formed internal audit department of Oregano Co (Oregano). The company manufactures tinned fruit and vegetables which are supplied to large and small food retailers. Management and those charged with governance of Oregano have concerns about the effectiveness of their sales and dispatch system and have asked internal audit to document and review the system.

Sales and dispatch system

Sales orders are mainly placed through Oregano's website but some are made via telephone. Online orders are automatically checked against inventory records for availability; telephone orders, however, are checked manually²⁰ by order clerks after the call. A follow-up call is usually made to customers if there is insufficient inventory. When taking telephone orders, clerks note down the details on plain paper and afterwards²¹ they complete a three-part pre-printed order form.

²⁰ Deficiency – manual check (risk of errors) after order taken (risk of goods being unavailable and dissatisfied customers) Recommendation - use same system for both types of order

²¹ Deficiency – order form not completed at time of order (risk of errors/lost orders) Recommendation - complete order form at time of order and confirm details with customer

These order forms are not sequentially numbered²² and are sent manually to both dispatch and the accounts department.

As the company is expanding, customers are able to place online orders which will exceed their agreed credit limit by 10%²³. Online orders are automatically forwarded to the dispatch and accounts department.

A daily pick list²⁴ is printed by the dispatch department and this is used by the warehouse team to dispatch goods. The goods are accompanied by a dispatch note and all customers are required to sign a copy of this. On return, the signed dispatch notes are given to the warehouse team²⁵ to file.

The sales quantities are entered from the dispatch notes and the authorised sales prices are generated by the invoicing system. If a discount²⁶ has been given, this has to be manually entered by the sales clerk onto the invoice. Due to the expansion of the company, and as there is a large number of sales invoices, extra accounts staff have been asked to help out temporarily²⁷ with producing the sales invoices. Normally it is only two sales clerks who produce the sales invoices.

STEP 2 You will see that there are more than six deficiencies, therefore choose the six for which you can provide a recommended control.

Use your headings to write your answer, explain the deficiency in terms of its impact on the entity. Also remember to explain the recommendation, what internal control should be implemented and by whom. Start each point in a new paragraph.

Suggested solution

Control deficiency — Telephone orders are checked manually²⁸ after an order has been placed.

This creates a risk of goods for which orders have been placed being unavailable, leading to unfulfilled orders. This gives rise to dissatisfaction from customers and has a negative impact on the company's reputation.

Control recommendation — Orders should not be confirmed before the availability of the product has been checked.

²² Deficiency – order forms not sequentially numbered (risk of lost orders as can't check completeness)
Recommendation – create sequentially numbered system

²³ Deficiency – exceeding credit limits increase risk of non-payment
Recommendation – orders to be rejected if they cause credit limits to be exceeded

²⁴ Deficiency – pick list not agreed to order forms (wrong goods could be sent)
Recommendation – pick list to be supported by order forms

²⁵ Deficiency – no copy of GDN to accounts dept (delays in invoicing)
Recommendation – multi-part document, copy sent to accounts dept on dispatch of goods

²⁶ Deficiency – discounts entered manually (scope for fraud/error)
Recommendation – discount levels authorised by mgt and recorded on customer file

²⁷ Deficiency – lack of experience/training increases scope for error
Recommendation – consider secondment/recruitment of staff

²⁸ Identify – manual process Explain – unfulfilled orders/customer dissatisfaction

To ensure that orders are fulfilled consistently, telephone orders and online orders should ideally be processed through the same system²⁹, with automatic notifications to the customer who has placed the order once product availability has been checked.

²⁹ Practical recommendation

Control deficiency — Order forms for telephone orders are completed after³⁰ an order has been placed.

³⁰ Identify – completed AFTER Explain – risk of errors

This increases the risk that information on the order forms is incorrect or incomplete, leading to errors in fulfilling the order.

Control recommendation — All order forms should be completed at the time the order is placed. For telephone orders, the order clerk should confirm with the customer³¹ that all details are correct.

³¹ Practical recommendation

Control deficiency — Customers are able to exceed their agreed credit limit by 10%³² when they place their orders online.

³² Identify – exceed credit limit by 10% Explain – risk of irrecoverable debts

This increases the risk that customers with bad credit histories are accepted, leading to slow-moving or irrecoverable debts.

Control recommendation — The online ordering system should be modified to reject orders³³ which would cause credit limits to be exceeded.

³³ Practical recommendation

Customers' credit limits should be assessed on a regular basis by a responsible official. Credit limits could be extended for customers with good credit histories.

Control deficiency — The signed dispatch notes are not sent to the accounts department.

This could result in delays in invoicing³⁴, leading to loss of revenue.

³⁴ Identify – dispatch note not sent to accounts Explain – delays in invoicing

Control recommendation — Copies of the signed dispatch notes should be forwarded to the accounts department³⁵ once the goods have been delivered. Invoices should be raised based on the dispatch notes in a timely manner, and the dispatch notes filed by the accounts team along with evidence that the related invoices have been processed.

³⁵ Practical recommendation

Control deficiency — Discounts are manually entered by the sales clerk onto the invoice.

This creates the risk of discounts being omitted by error.

More importantly, the lack of authorisation³⁶ process increases the risk of unauthorised discounts being given, leading to loss of revenue.

³⁶ Identify – manual entry, not authorised Explain – risk of fraud/error

Control recommendation — Discounts should be approved by a responsible official. The authorised discount levels should be recorded automatically³⁷ in the customer master file, so that they appear on the invoices without manual input.

³⁷ Practical recommendation

The invoicing system should be modified to prevent the manual processing of discounts.

Control deficiency — Extra accounts staff have been allocated to produce the sales invoices.

The extra staff's lack of experience and training increases the risk of errors³⁸ on the invoices, resulting in customers being over- or undercharged.

³⁸ Identify – lack of appropriately trained staff. Explain – risk of errors

Control recommendation — Only sales clerks with the appropriate experience should be allowed to produce sales invoices. Oregano could consider recruiting and training³⁹ permanent staff with the appropriate experience.

³⁹ Practical recommendation

Exam success skills diagnostic

Every time you complete a question, use the diagnostic below to assess how effectively you demonstrated the exam success skills in answering the question. The table has been completed below for the 'Oregano' activity to give you an idea of how to complete the diagnostic.

Exam success skills	Your reflections/observations
Managing information	Did you identify internal control deficiencies in the scenario?
Correct interpretation of requirements	Did you identify that you only need six deficiencies and six (related) recommendations to gain 12 marks?
Answer planning	Did you draw up an answer plan using your preferred approach (eg highlighting, bullet-pointed list)? Did your plan help to create a structure for your answer?
Effective writing and presentation	Did you use headings (key words from requirements)? Did you use full sentences? And most importantly –did you explain why your points constituted a

Exam success skills	Your reflections/observations
	deficiency?
Good time management	Did you manage to read, plan and write out your solution in the allotted time?
Most important action points to apply to your next question	

Summary

You are likely to see a scenario based question on internal control deficiencies and recommendations, direct controls and tests of control or deficiencies, recommendations and tests of control in the exam. You cannot prepare for every type of business and all internal controls but you can equip yourself with the skills to attempt internal control questions, by using the information given in the question to guide the structure of your answer. A key skill is then applying this back to the given scenario. You will not be able to pass these questions unless you answer ALL parts of the question (for example explain both the deficiency and provide a recommendation). It is therefore essential that you try to create a practical answer that is relevant to the scenario, and/or addresses the issues identified in the scenario, instead of simply producing rote-learned deficiencies/controls/tests of control.

As you move into practising questions as part of your final revision, you will need to practise taking in information from a scenario quickly (using active reading), accurately understanding the requirements, and creating an answer plan and a final answer that addresses the requirements in the context of the scenario.

11

Audit sampling and automated tools and techniques

Learning objectives

On completion of this chapter, you should be able to:

Syllabus learning outcomes	Syllabus reference no.
Define audit sampling and explain the need for sampling.	D3 (a)
Identify and discuss the differences between statistical and non-statistical sampling.	D3 (b)
Discuss and provide relevant examples of the application of the basic principles of statistical sampling and other selective testing procedures.	D3 (c)
Discuss the results of statistical sampling, including consideration of whether additional testing is required.	D3 (d)
Explain the use of automated tools and techniques in the context of an audit, including the use of audit software, test data and other data analytics tools.	D5 (a)
Discuss and provide relevant examples of the use of automated tools and techniques including test data, audit software and other data analytics tools.	D5 (b)

Business and Exam context

In this chapter, we look at the use of audit sampling and automated tools and techniques.

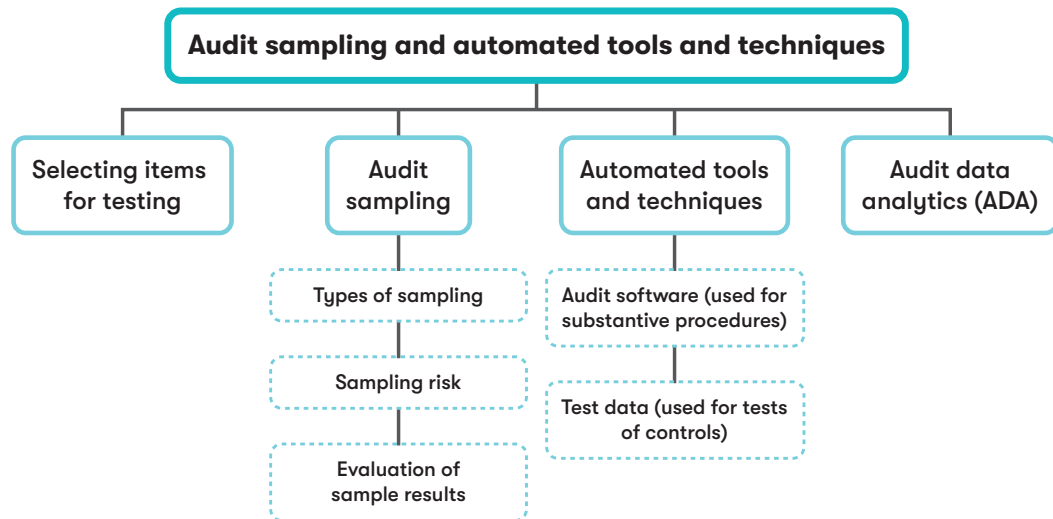
We will look in detail at audit sampling, which is an important aspect of the audit. We consider different types of audit sampling and the evaluation of errors.

Automated tools and techniques are an important tool in the audit and we examine the two main types: audit software and test data. Use of computers on audits is common practice. In answering questions on obtaining evidence, remember to include reference to automated tools and techniques if they seem relevant.

Your AA syllabus does not require you to have a detailed knowledge of data analytics, but this is a topical area. The AA examining team has stated that candidates will only be expected to have a broad understanding of what data analytics is, how it may be used in an audit and how it may improve audit efficiency.

Both sampling and the use of automated tools and techniques could come up in OTQs in Section A, or as part of Section B. Questions could require you to explain different sampling methods, for example.

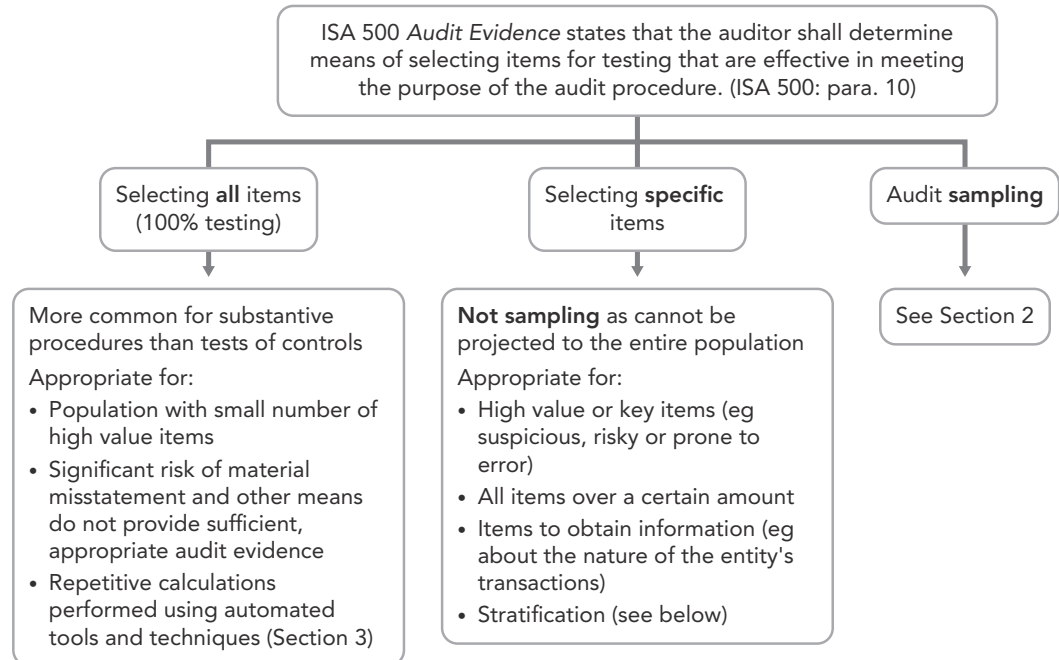
Chapter overview



1 Selecting items for testing

The overall aim of the external audit is for the auditor to give an opinion as to whether the financial statements are free from material misstatement (present fairly).

The auditor does not test everything as it would be impractical to do so and so they need to decide on the extent of testing they will perform.



Sometimes, the auditor may want to ensure that they test certain items within a population. For example, they may decide they want to review the monies received post year-end from the client's 10 largest receivables balances in order to gather evidence over the valuation of receivables. The receivables population is then divided into two discrete sub-populations. One sub-population has the ten largest balances in it and each of these will be tested. The second sub-population contains all remaining receivables and the auditor may also test a sample of these balances. This is called **stratification**.

2 Audit sampling



Audit sampling: means “the application of audit procedures to **less than 100%** of the items within a population of audit relevance such that all sampling units have **an equal chance of selection**, in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population” (ISA 530: para. 5(a)).

Population: is “the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions” (ISA 530: para. 5(b)).

2.1 Types of sampling

There are two types of sampling: **statistical** sampling and **non-statistical** sampling.

Non-statistical sampling does not use any mathematical basis for selecting a sample. Examples of non-statistical sampling include:

Haphazard selection

Here the auditor selects the items to be included in the sample without following a structured technique but which avoids any conscious bias or predictability (for example the auditor should not exclude items which are difficult to locate from the sample purely because of the inconvenience).

Block selection

This 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. However, block sampling may 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 therefore the errors found cannot be projected onto the rest of the population.

Statistical sampling uses:

- Mathematical number tables to choose a sample which is **free from bias**; and
- Probability theory to evaluate the results of the testing.

Examples of statistical sampling methods include:

Random selection

This process uses random number tables (or a computerised random number generator) to select the items in the sample. It ensures that all items in the population have an equal chance of selection

Systematic selection

This involves selecting items using a constant interval between selections, the first interval having a random start. For example, if the auditor has a population with 1,000 items and requires a sample containing 200 items then the sampling interval is 5 ($1,000 \div 200$). A random starting point within the first 5 is then determined (say 2) and the auditor will test every 5th item after item number 2 (ie 2 then 7 and so on).

Value weighted selection (or monetary unit sampling (MUS))

Here the population is randomly ordered and items are selected for sampling by weighting the items in proportion to their value.

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 2.2). 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.



Activity 1: Preparation

Check & Co is intending to audit the trade receivables of Dress You Like Co by circularising a sample of the year-end balances. This audit test involves obtaining a written confirmation of the balance owing from a sample of Dress You Like's trade receivables (you will learn about this test in more detail in Chapter 14).

Trade receivables at Dress You Like Co total \$12.5m at the year end, of which \$11.8m relate to one large supermarket. Check & Co have decided to use stratification for selecting their sample. The \$11.8m relating to the supermarket will be circularised and a sample of seven other trade receivables will be selected for circularisation from the remaining \$0.7m using value weighted selection (MUS).

The overall materiality level for the audit is \$100,000.

The trade receivables listed below have been randomly tabulated.

Required

State which receivable balances will be selected for sampling using value weighted selection (MUS).

Customer	Balance \$'000	Cumulative total \$'000	Selected (Y/N)
Safari Schoolwear	28		
Clothing Terrain	33		
Everyday Wear	(6)		
All About Clothes	21		
Jim's Jumpers	38		
Look the Part	124		
Freya's Threads	8		
Holly Aristocrat	73		
Girls on the Go	13		
Odd One Out	67		
Upward Trends	17		
Ivory Gowns	2		
Skirts and all sorts	57		
Dress for the Occasion	92		
Holiday Accessories	5		
Ties with a Difference	12		
Up and Out	9		
In all Weather	16		
Duncan's Dresses	3		
Ewan Trading	29		
We're Going Exploring	12		
Fred's Fashions	<u>47</u>		
	<u>700</u>		

Solution

2.1.1 Advantages and disadvantages of monetary unit sampling (MUS)

Advantages	Disadvantages
• The auditor can design and evaluate the sample quickly and in a cost-effective way using automated tools and techniques (Section 3). • All material items are automatically selected ensuring all material items are tested.	• Selecting the sample can be time consuming if automated tools and techniques cannot be used to select the sample. • MUS does not cope where there are negatively valued items in the population. • MUS will not be effective if the population is not randomly ordered.

2.2 Sampling risk



Sampling risk: is the risk that the auditor's conclusion, based on a sample, may be different from the conclusion if the entire population were subjected to the same audit procedure. (ISA 530: para. 5(c))

The auditor must determine a sample size that will reduce sampling risk to an **acceptably low level**.

If the auditor judges that sampling risk is high then they will need to select a larger sample in order to have reasonable assurance that the results are free from material misstatement. There is therefore a direct relationship between sampling risk and sample size.

Other factors which affect **sample size** include:

Factor	Effect on sample size
Risk of material misstatement	If the auditor assesses the level of inherent risk and control risk to be high, then detection risk needs to be low in order to reduce audit risk to an acceptably low level. Detection risk includes both sampling and non-sampling risk and in order for sampling risk to be low a larger sample size is needed.
Required confidence level	This describes how confident the auditor needs to be that the sample results are representative of the population as a whole. The greater the degree of confidence the auditor requires, the larger the sample size needs to be.
Expected error	This relates to the level of errors the auditor expects to find in the population. If the level of expected error is high then the sample size will need to be larger in order to

Factor	Effect on sample size
	make a reasonable estimate of the actual amount of the error in the population.
Tolerable error/ misstatement	This relates to the level of error or misstatement that the auditor can accept in the population before he is concerned that there is a material misstatement. The lower the level of tolerable errors that can be accepted, the larger the sample size needs to be.

2.3 Evaluation of sample results

Once the audit procedures have been carried out on the sample, the auditor should evaluate the sample results to determine whether they are satisfactory or whether further work is required.

Where there are **errors** in the sample, the auditor should consider:

- The nature and cause of the error
- Whether the error is a 'one-off' (anomalous) error or a recurrent issue
- Whether the error effects the purpose of the audit procedure
- Whether the error affects other areas of the audit



Anomaly: "a misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population" (ISA 530: para. 5(e)).

Tolerable misstatement: "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" (ISA 530: para. 5(i)).

Tolerable rate of deviation: "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: para. 5(j)).

2.3.1 Tests of details

Where sampling has been used to perform tests of details, the auditor should project the **monetary errors** found in the sample to the population as a whole and compare this to the level of tolerable misstatement.

Where an error has been established as an anomaly, it may be excluded when projecting sample errors to the population (but it still needs to be considered overall in addition to the projection of the non-anomalous errors).



Activity 2: Results – tests of detail

For this activity **only**, imagine that Dress You Like Co was a much smaller manufacturer and did not have the supermarket as a major customer. Hypothetically, the entire trade receivables would total \$700,000 at 30 September 20X6. As stratification would not be used, any error could be projected to the entire population.

You have obtained the following results based on your sample:

Total value of the population	\$700,000
Number of items in the population	22
Number of items tested	7

Value of items tested	\$407,000
Error in the sample	\$20,000

Required

Consider the results of the testing as follows:

- 1 Assuming the errors are not anomalous ones, calculate the expected error in the population.
- 2 Assuming that tolerable misstatement was set at \$30,000, explain what action should be taken.

Solution

2.3.2 Tests of controls

When sampling has been used to test controls, no explicit projection of errors is necessary since the sample **deviation (or error) rate** is also the projected deviation rate for the population as a whole.

For example, if the auditor has performed tests of controls on a sample of 20 items and has found two deviations, this represents an error rate of 10% ($\frac{2}{20} \times 100$). The auditor must then decide if this error rate is acceptable.



Activity 3: Tests of controls

You are auditing the internal controls relating to the authorisation of adjustments made to Dress You Like Co's inventory system in order to determine the accuracy and validity of the adjustments. You have obtained the following results based on your sample:

Total number of adjustments made to inventory records during the year	1,500
Number of adjustments tested in the sample	225
Number of occasions when adjustments tested were not authorised	18

Required

Consider the results of the testing as follows:

- (1) Assuming the errors are not anomalous ones, calculate the error rate in the population.
- (2) Assuming that tolerable rate of deviation was set at 13%, explain what action should be taken.

Solution

If the evaluation of sample results indicates that there may be significant issues, the auditor may:

- (a) Request management to investigate identified errors and the potential for further errors and make any necessary adjustments;
- (b) Modify the nature, timing and extent of further audit procedures; and/or
- (c) Consider the effect on the auditor's report



PER alert

Being able to apply the techniques of audit sampling discussed in this section will assist you in achieving PER Objective 19 on preparing for and collecting evidence for audit.



Essential reading

See Chapter 11 of the Essential reading for further details on the requirements of ISA 530 *Audit Sampling*.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

3 Automated tools and techniques



Automated tools and techniques: are “applications of auditing procedures using the computer as an audit tool”.

Automated tools and techniques involve using a computer to perform audit work. Computers can be used to perform either substantive procedures or tests of controls. There are two particularly common types: **audit software** and **test data**.



Activity 4: Automated tools and techniques

Can you think of any advantages or disadvantages of using automated tools and techniques in an audit?

Advantages	Disadvantages

3.1 Audit software (used for substantive procedures)



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

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.

Audit software can be used to:

Select information

Examples

- A sample of suppliers to circularise to test completeness of the payables balance (perhaps using MUS)
- To identify missing, large or unusual items or items outside specified parameters

Perform calculations

Examples

- To calculate variances and ratios used in analytical review
- To check the accuracy of the casting of the trial balance or ledger listings

Read and extract data from a client's system and produce a report in a specified format

Examples

- The auditor could download the client's sales ledger onto their own software, and use their own (trusted) software to produce an aged receivables listing; this can then be used as a basis for testing the valuation of receivables
- Or an aged inventory report

Print reports in specified formats

Example

- Letters to be sent out in a receivables confirmation

3.2 Test data (used for tests of controls)



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.

Test data is a fictitious set of test transactions which are input into the client's system in order to determine whether the internal controls within the entity's computer systems have operated effectively throughout the period.

Should an auditor wish to gather audit evidence using test data, they will need significant co-operation from their client, especially in terms of the time required to access their computer systems.

There are two typical uses of test data:

(a) Test data used to test specific controls in computer programs

For example, an auditor could try to access data or areas of the computer system which are password protected in order to determine whether the control is operating effectively.

(b) Test transactions

Here the auditor processes a series of transactions and monitors the output from the computer systems in order to determine whether the transactions have been processed correctly.

This can be conducted 'live' (when the computer systems are operational) or 'dead' (when the computer system is not in business use). Test transactions normally involve submitting both **valid and invalid data** for processing.

Invalid data could include, for example, zero quantity items, negative prices or extraordinarily high prices. The auditor would expect the valid data to be processed properly and the invalid data to be rejected.

Some computer systems have an **embedded test facility**. This may comprise a 'dummy unit' to which test transactions are posted throughout the period or a systems control and review file (SCARF) where real transactions are replicated and stored for later review by the auditor.



PER alert

Two of the PER performance objectives require the use information and communications technology (PO2 and PO5). The use of automated tools and techniques by you during an audit assignment will help to achieve this objective.



Essential reading

See Chapter 11 of the Essential reading to read about using automated tools and techniques plus the benefits and difficulties of using audit software and test data.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

4 Audit data analytics (ADA)



Big data: is a broad term for the larger, more complex datasets that can be held by modern computers. The term refers to a qualitative shift in the amount of data that is available in comparison with the past.

Data analytics: is the examination of data to try to identify patterns, trends or correlations. As the quantity of data has increased, it has become more and more necessary to evolve ways of processing and making sense of it.

In recent years, many fields have undergone a revolution at the hands of big data, and the audit profession is no different. The introduction of big data in the form of audit data analytics (ADA) routines has the potential to revolutionise the audit process. Current ISAs are based on a risk management approach to audit, whereby the auditor does not test 100% of an entity's transactions, but instead focuses audit work on the riskiest areas. In contrast to this, data analytics offers the chance of examining all of an entity's data. This could eventually revolutionise the way audits are conducted, together with the approach advocated by auditing standards.

The use of data analytics software will initially involve **significant costs** on the part of the auditor and **extensive training**, however it could offer auditors the ability to **examine all of an entity's data** and **test entire populations**. This in turn should improve both **audit efficiency** and **audit quality**. Large quantities of data can be interrogated relatively quickly, allowing auditors to focus immediately on the riskiest areas, and thus obtain evidence to reduce audit risk.

Examples of how auditors might use data analytics include:

- Analyse patterns relating to revenue or costs per product or per customer
- Trace the matching of orders to goods despatched/goods received documentation and to the invoice, in order to determine whether revenue and costs should be recognised
- Interrogate journals to determine whether there are any patterns (regarding who has processed certain journals) where fraud is suspected



Activity 5: Data analytics

Which TWO of the following are examples of how data analytics might be used by audit firms?

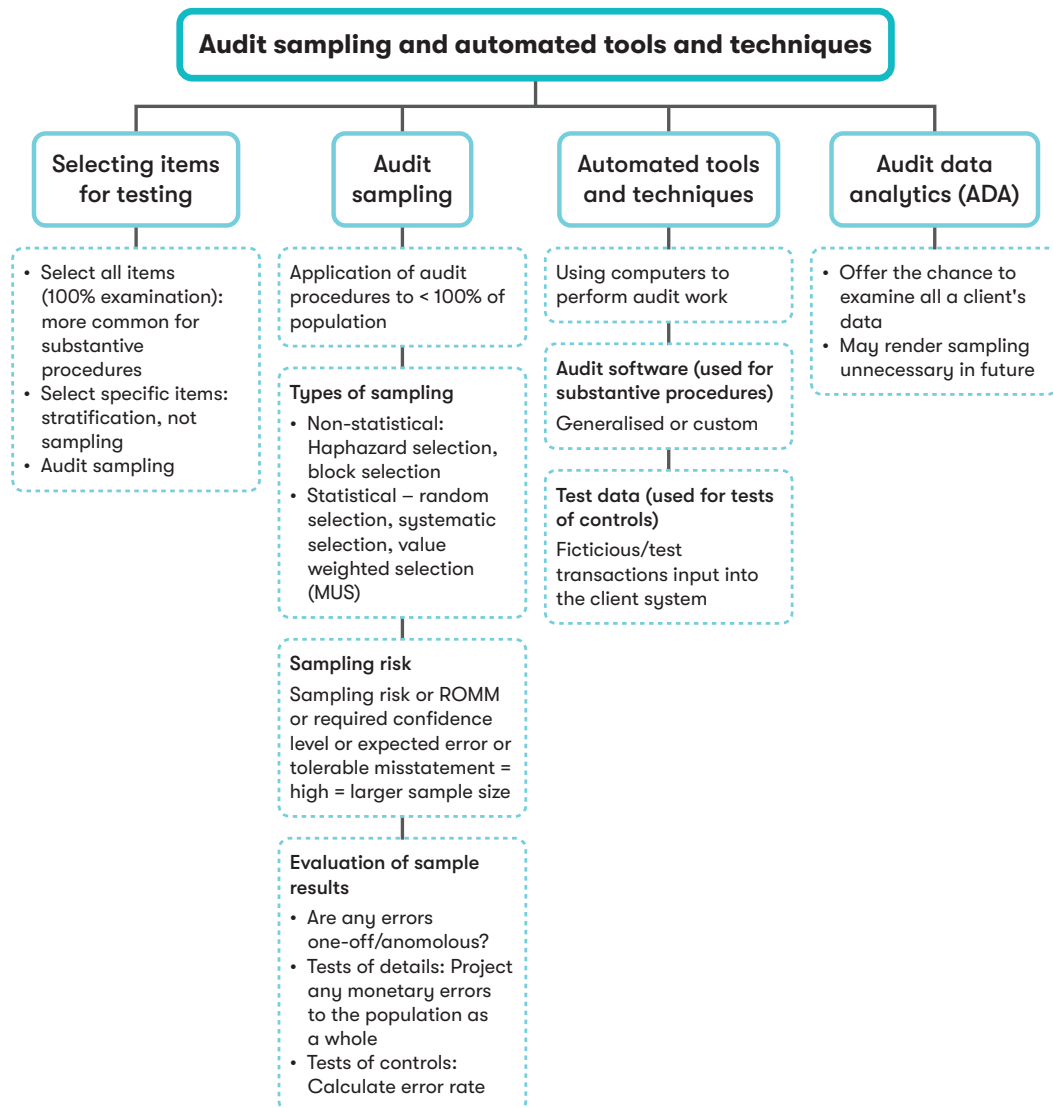
- ☐ To predict market trends
- ☐ To calculate inventory ageing and how many days inventory is in stock by item
- ☐ Detailed recalculations of depreciation on non-current assets by item
- ☐ To analyse customer feedback in relation to products sold



Essential reading

See Chapter 11 of the Essential reading for further information on audit data analytics.
The Essential reading is available as an Appendix of the digital edition of the Workbook.

Chapter summary



Knowledge diagnostic

1. Selecting items for testing

The auditor needs to decide which items they will select for testing. It is most common for the auditor to carry out sampling; however, there may be situations where they test 100% of items or where they stratify the population in order to test specific items.

2. Sampling

Sampling relates to the application of audit procedures to less than 100% of the population in order to form a conclusion on the population as a whole.

3. Statistical sampling

Statistical sampling methods provide more comfort that the sample is free from bias and the sampling results representative of the population as a whole.

4. Extrapolating errors

Any errors identified in the sample must be **extrapolated** and the impact on the population as a whole considered.

5. Automated tools and techniques

Automated tools and techniques describe any process where the auditor uses a computer to help them carry out their audit procedures.

6. Different types of automated tools and techniques

Automated tools and techniques used to perform tests of details (substantive procedures) are known as **audit software** whilst automated tools and techniques used to carry out tests of controls are called **test data**.

7. Data analytics

Data analytics is the examination of data to try to identify patterns, trends or correlations

8. The impact of data analytics on the audit

The emergence of **data analytics** should lead to increased auditor efficiency and reduced audit risk.

Further study guidance

Question practice

Now try the following from the Further question practice bank [available in the digital edition of the Workbook]:

- Section A Q30
- Section B Q63 'Elsams'

Further reading

There are some technical articles on the ACCA website written by members of the AA examining team which are relevant to some of the topics covered in this chapter that you should read:

- *Audit sampling* (www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/audit-sampling.html)
- *Specific aspects of auditing in a computer-based environment* (www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p7/technical-articles/auditing-computer-environment.html)
- *Auditing in a computer-based environment (2)* (www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p7/technical-articles/auditing-computer-based-environment2.html)

Own research

The IAASB set up a Data Analytics Working Group (DAWG) in 2015. In 2018, this group published a Feedback Statement entitled 'Exploring the Growing Use of Technology in the Audit, with a Focus on Data Analytics'.

You can read the Feedback Statement at <https://www.iaasb.org/publications-resources/feedback-statement-exploring-growing-use-technology-audit-focus-data>

Note that this is not an examinable document for AA.

Activity answers

Activity 1: Preparation

Customer	Balance \$'000	Cumulative total \$'000	Selected (Y/N)
Safari Schoolwear	28	28	N
Clothing Terrain	33	61	N
Everyday Wear	(6)	55	N
All About Clothes	21	76	N
Jim's Jumpers	38	114	Y
Look the Part	124	238	Y
Freya's Threads	8	246	N
Holly Aristocrat	73	319	Y
Girls on the Go	13	332	N
Odd One Out	67	399	N
Upward Trends	17	416	Y
Ivory Gowns	2	418	N
Skirts and all sorts	57	475	N
Dress for the Occasion	92	567	Y
Holiday Accessories	5	572	N
Ties with a Difference	12	584	N
Up and Out	9	593	N
In all Weather	16	609	Y
Duncan's Dresses	3	612	N
Ewan Trading	29	641	N
We're Going Exploring	12	653	N
Fred's Fashions	<u>47</u>	700	Y
	<u>700</u>	700	

Activity 2: Results – tests of detail

- Error rate in sample $\times$ total value of population: $(\$20,000/\$407,000) \times \$700,000 = \$34,398$
- The projected misstatement is above the tolerable misstatement limit. This means that further evidence is needed. This could be done by:
 - Extending the sample tested in the procedure and then reperforming the extrapolation; or
 - Designing and performing additional substantive procedures

If the further evidence allows the auditor to conclude that the actual misstatement in the population does not exceed tolerable misstatement, then the auditor will conclude that no

adjustment is necessary, although the error of \$20,000 will be noted on a schedule of uncorrected misstatements.

If the further evidence indicates that there is a misstatement that exceeds tolerable misstatement then the auditor will ask the client to make an adjustment to the financial statements.

Activity 3: Tests of controls

Error rate in sample

$$(18/225) = 8\%$$

This means that the internal control is believed to have operated effectively throughout the period and the auditor can rely on it when assessing the accuracy and validity of adjustments made to the inventory system.

No further testing is required; however, any monetary errors resulting from the 18 failures of the internal control should be noted on the schedule of uncorrected misstatements.

Activity 4: Automated tools and techniques

Advantages	Disadvantages
Auditors can test program controls as well as general internal controls associated with computers.	Setting up the software needed for automated tools and techniques can be time consuming and expensive.
Auditors can test a greater number of items more quickly and accurately than would be the case otherwise.	Audit staff will need to be trained so they have a sufficient level of IT knowledge to apply automated tools and techniques.
Auditors can test transactions rather than paper records of transactions that could be incorrect.	Not all client systems will be compatible with the software used with automated tools and techniques.
Automated tools and techniques are cost effective in the long term if the client does not change its systems.	There is a risk that live client data is corrupted and lost during the use of automated tools and techniques.
Results from automated tools and techniques can be compared with results from traditional testing – if the results correlate, overall confidence is increased.	-

Activity 5: Data analytics

The correct answers are:

- To calculate inventory ageing and how many days inventory is in stock by item
- Detailed recalculations of depreciation on non-current assets by item

The other two options are examples of how data analytics may be used in a business and not by auditors.

12

Non-current assets

Learning objectives

On completion of this chapter, you should be able to:

Syllabus learning outcomes	Syllabus reference no.
Explain the audit objectives and the audit procedures to obtain sufficient, appropriate evidence in relation to: Tangible and intangible non-current assets (a) Evidence in relation to non-current assets, (b) Depreciation, and (c) Profit/ loss on disposal	D4 (e)
Discuss why auditors rely on the work of others	D6 (a)
Discuss the extent to which external auditors are able to rely on the work of experts, including the work of internal audit the extent to which external auditors are able to rely on the work of experts, including the work of internal audit.	D6 (b)
Discuss the problems associated with the audit and review of accounting estimates.	D2 (c)

Business and Exam context

Many candidates who sit the ACCA Audit and Assurance (AA) exam do not work in audit practice. This can make it harder to see the practical nature of the subject and to learn to apply the knowledge learned. Consequently, we have tried to make this chapter relating to substantive procedures as practical as possible, so that you can apply your knowledge to exam scenarios.

This chapter, Non-current assets, highlights the key objectives for each major component of non-current assets. You must understand what objectives the various audit procedures are designed to achieve in relation to the financial statement assertions.

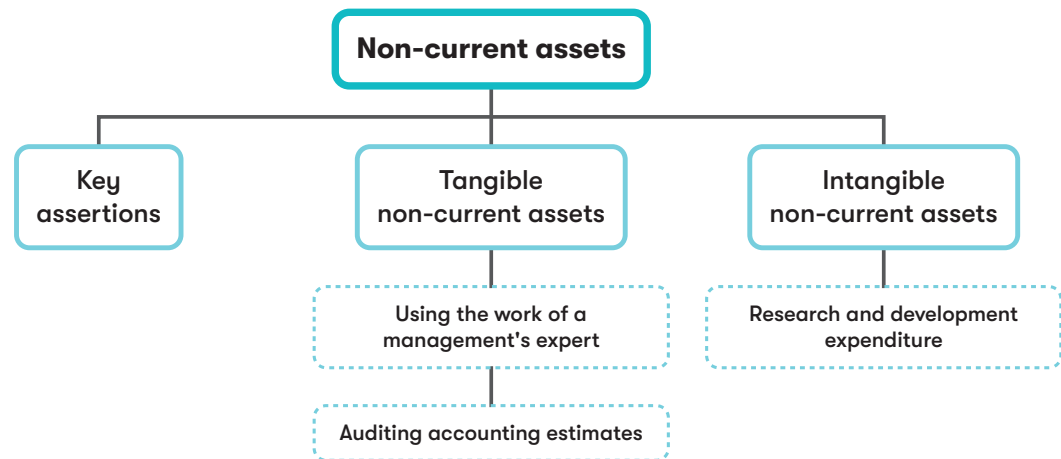
Assertions could be the focus of questions: you could be asked to describe audit procedures to test one particular assertion, or to identify the assertions relevant to the audit of tangible non-current assets, or indeed both. Both audit procedures and assertions can be tested in the form of OTQs in Section A as well as in the long scenario questions in Section B. Make sure you can distinguish the assertions relating to the statement of financial position and statement of profit and loss.

Valuation is an important assertion. The auditors will concentrate on testing any external valuations made during the year, and also whether other values appear reasonable given asset usage and condition. An important aspect of testing valuation is reviewing depreciation rates. A

topic we cover, using the work of an expert, may well be important in the audit of non-current assets in respect of valuation.

You will need knowledge of the accounting standards you learnt in your Fundamentals in Financial Accounting (FFA) relating to tangible and intangible non-current assets for this chapter.

Chapter overview



1 Key assertions

You have already studied assertions in Chapter 8 of this workbook, Introduction to Audit Evidence. In this chapter you will learn which of these assertions relate to non-current assets and the audit procedures required to cover these assertions. These can apply to both tangible or intangible non-current assets.



Essential reading

See Chapter 12 of the Essential reading for the assertions that apply to non-current assets.

The Essential reading is available as an Appendix of the digital edition of the Workbook.



Activity 1: Assertions

- 1 Which of the following audit procedures would provide audit evidence as to the existence of a tangible non-current asset?
 - ☐ Inspecting board minutes approving authorisation of the asset
 - ☐ Physically inspecting the asset
 - ☐ Reviewing the non-current asset register for inclusion of the asset
 - ☐ Inspecting the invoice and purchase order documentation of the asset
- 2 Inspecting the title deeds of a building provides audit evidence concerning which one of the following financial statement assertions?
 - ☐ Existence
 - ☐ Valuation
 - ☐ Rights and obligations
 - ☐ Completeness

2 Tangible non-current assets



Activity 2: Opening balances

Throughout this chapter, we will continue to use the audit of Dress You Like Co for the year ended 30 September 20X6. The audit team has prepared the following lead schedule for the audit of non-current assets of Dress You Like Co for the current year:

Reference:

Client: Dress You Like Co

Prepared by:

Reviewed by:

Date 30/10/X6

	Land and buildings	Plant and machinery	IT equipment	Motor vehicles	Total
	\$'000	\$'000	\$'000	\$'000	\$'000
Cost or valuation					
As at 1 October 20X5	7,520	775	215	41	8,551
Additions		65	31	80	176
Disposals				(41)	(41)
Revaluation increase	1,200				1,200
As at 30 September 20X6	8,720	840	246	80	9,886
Depreciation					
As at 1 October 20X5	3,057	485	70	24	3,636
Depreciation charge for the year	201	75	62	10	348
Disposals				(24)	(24)
As at 30 September 20X6	3,258	560	132	10	3,960
Carrying amount					
As at 30 September 20X6	5,462	280	114	70	5,926
As at 30 September 20X5	4,463	290	145	17	4,915

Required

Can you suggest an audit procedure for the balances given in the two lines on the schedule which are labelled 'As at 1 October 20X5' documenting the reason for this procedure?

Solution



Example – The non-current assets register

An entity's non-current assets are listed on a 'non-current asset register' which exists outside the double entry system and reconciles to the balances on the statement of financial position.

The following is an extract of the non-current asset register of Dress You Like Co:

EXTRACT – NON-CURRENT ASSET REGISTER FOR DRESS YOU LIKE CO

YEAR END 30 SEPTEMBER 20X6

Asset	Purchase date	Depreciation rate	Cost	Accumulated depreciation	Carrying amount
			\$	\$	\$
Computer A	1.1.X5	3 years SL	3,000	1,000	2,000
Computer B	1.1.X4	3 years SL	3,000	2,000	1,000
Computer C	1.1.X5	3 years SL	3,000	1,000	2,000
Machinery A	1.1.X2	5 years SL	50,000	40,000	10,000
Office furniture	1.1.X3	5 years SL	25,000	15,000	10,000
			84,000	59,000	25,000

As part of their substantive procedures, Check & Co should 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 Check & Co should agree that they are recorded in the non-current asset register to ensure completeness.

They should also agree a sample of assets from the non-current asset register to the physical assets to ensure existence.



Activity 3: Additions

Dress You Like Co has provided the following listing of all additions to non-current assets in the year:

Description	Date	Cost	Notes
Photocopier/printer	16/11/20X5	4,000	
Software	20/12/20X5	5,000	
Server equipment	2/01/20X6	12,000	
Cutting machinery	25/01/20X6	15,000	
Cutting machinery - set up cost	25/01/20X6	2,500	

Cutting machinery – training cost	30/01/20X6	2,500
Delivery vehicle × 4	08/03/20X6	80,000
Laptops	16/04/20X6	10,000

Deposit of \$20,000 paid on
1/09/20X6

Outstanding \$25,000 paid on
delivery of machine on
10/10/20X6

Sewing equipment	1/09/20X6	45,000
Total		176,000

Required

Consider the above information with regards to additions at Dress You Like Co.

- 1 Identify two additions where the accounting treatment may be incorrect and explain why an adjustment to the financial statements may be required.
- 2 Describe the substantive procedures Check & Co should perform to obtain sufficient and appropriate evidence in relation to Dress You Like Co's additions to non-current assets. Ensure you document the reason for each procedure.

Solution



Activity 4: Disposals

During the year ending 30 September 20X6, Dress You Like Co replaced all its delivery vehicles with electric vans. The old delivery vehicles were purchased for a total of \$41,000 in March 20X0 and had accumulated depreciation of \$24,000 on their disposal in March 20X6 when they were sold for \$10,000.

Required

Describe the substantive procedures Check & Co should perform to obtain sufficient and appropriate evidence in relation to the disposal of the old delivery vehicles. Ensure you document the reason for each procedure.

Solution

2.1 Using the work of a management's expert

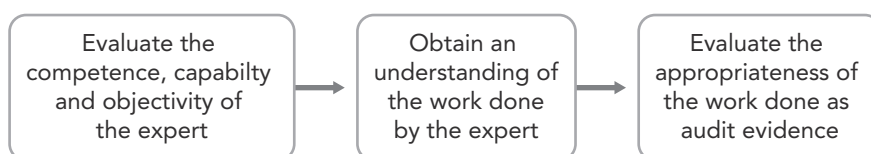
Sometimes an entity will use an **expert**, for example an actuary or chartered surveyor to assist them in the preparation of the financial statements.



Management's expert: an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements (ISA 500: para. 5(d)).

The auditors may be able use the work of a management's expert as audit evidence for the valuation of non-current assets as well as other areas of the audit such as inventory valuation.

ISA 500 (para. 8) 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:



If the auditors find they are unable to rely on a management's expert, they may consider hiring their own expert to get the audit evidence required. This expert is called an auditor's expert. We will cover the use of auditor's experts in Chapter 13.



Essential reading

See Chapter 12 of the Essential reading for further information on using the work of a management's expert.

The Essential reading is available as an Appendix of the digital edition of the Workbook.



Activity 5: Revaluation

During the year ended 30 September 20X6, Dress You Like Co engaged a specialist to revalue its factory and head office sites. The revaluation resulted in a total increase of \$1.2m to Dress You Like Co's properties.

Required

Describe the substantive procedures Check & Co should perform to obtain sufficient and appropriate evidence in relation to the revaluation of the factory and head office sites. Ensure you document the reason for each procedure.

Solution

2.2 Auditing accounting estimates

Ascertaining an estimated useful life for a non-current asset is an example of an accounting estimate. Other examples of accounting estimates are:

- Allowance for receivables
- Provisions for litigation settlements
- Inventory obsolescence
- Accrued revenue
- Warranty obligations

Management often make these estimates in conditions of uncertainty over outcomes and with the use of judgement. The risk of misstatement is increased, and the evidence available to detect a material misstatement will often be more difficult to obtain and less persuasive than that relating to other items in the financial statements.

The auditor is required to obtain sufficient appropriate evidence about whether the accounting estimates and related disclosures are reasonable. ISA 540 (Revised) *Auditing Accounting Estimates and Related Disclosures* provides guidance on the audit of accounting estimates contained in financial statements.



Essential reading

See Chapter 12 of the Essential reading for further information on how to audit accounting estimates.

The Essential reading is available as an Appendix of the digital edition of the Workbook.



Activity 6: Depreciation

Dress You Like Co calculates depreciation on a straight-line basis over the estimated useful life of its assets. Estimated useful lives are as follows:

Buildings – 50 years

Plant and machinery – 10 years

IT equipment – 4 years

Motor vehicles – 8 years

Required

Describe the substantive procedures Check & Co should perform to obtain sufficient and appropriate evidence in relation to the depreciation charge for the year ended 30 September 20X6 at Dress You Like Co. Ensure you document the reason for each procedure.

Solution



Essential reading

See Chapter 18 of the Essential reading for a summary of the accounting knowledge relevant to IAS 16: *Property, plant and equipment* which is brought forward to this paper from your earlier Fundamentals in Financial Accounting studies.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

3 Intangible non-current assets

Intangible assets are identifiable non-monetary assets without physical substance. Examples of intangible assets include patents, franchises, licences, computer software and royalties. The accounting for intangibles is prescribed in IAS 38 *Intangible Assets*. Intangible assets with finite useful lives will be amortised.

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 IAS 38. 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.

3.1 Research and development expenditure

Accounting for research and development is included within IAS 38.



Research: original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Development: the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

Research **cannot** be capitalised as an intangible asset and must be **expensed** to the statement of profit or loss.

Remember that, under IAS 38, an entity **must** capitalise development expenditure if it satisfies **all** of the following criteria:

P	Probable future economic benefits
I	Intention to complete and use/sell asset
R	Resources adequate and available to complete and use/sell asset
A	Ability to use/sell the asset
T	Technical feasibility of completing asset for use/sale
E	Expenditure can be measured reliably

The audit work undertaken must serve to ensure that any development expenditure meets the IAS 38 *Intangible Assets* criteria.



Example - Intangible Assets

Company A is a packaging company which has been in operation for 30 years. The company has been developing a new form of packaging for fruits and vegetables as an alternative to the plastics commonly used in supermarkets. Several large supermarket chains have expressed an interest in using the packaging when it becomes available. Company A expects the packaging will be available for sale in one year.

The substantive procedures the auditors need to perform are as follows:

- Review the accounting records to ensure that the expenditure can be readily measured, eg separate cost centre or nominal ledger code.
- Review invoices to verify expenditure by Company A on the project.
- Verify wages' costs to supporting documentation such as timesheets.
- Discuss the stage of development of the new packaging with Company A's directors.
- Discuss the technical feasibility of the project with Company A's technical staff.
- Consider probability of future economic benefits (ie commercial viability) and ability to sell or use the packaging in relation to market research results, advance orders, budgets and forecasts.
- Review budgeted revenues and costs. Ensure that they are reasonable based on results to date, discussion with directors, production forecasts and advance orders.
- Review cash flow forecasts to ensure that adequate resources exist to complete the project. Discuss any shortfalls with the directors of Company A.

- Obtain written representations from management of their intention to complete the packaging and either use or sell it.
- Ensure any development costs capitalised are disclosed and presented in line with the requirements of IAS 38 *Intangible Assets*



Essential reading

See Chapter 18 of the Essential reading for a summary of the accounting knowledge relevant to IAS 38: *Intangible assets* which is brought forward to this paper from your earlier Fundamentals in Financial Accounting studies.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

3.2 Audit procedures for non-current assets

The following table contains audit procedures for non-current assets (tangible and intangible) matched to the financial statement assertions they test. This table is for reference only, the procedures should not be learned by heart, but may be useful when practising exam questions.

Tangible non-current assets:

Financial statement assertion	Audit procedure
Completeness	• Obtain or prepare a summary of tangible non-current assets showing how the following reconcile with the opening position. - Gross carrying amount - Accumulated depreciation - Carrying amount • 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.

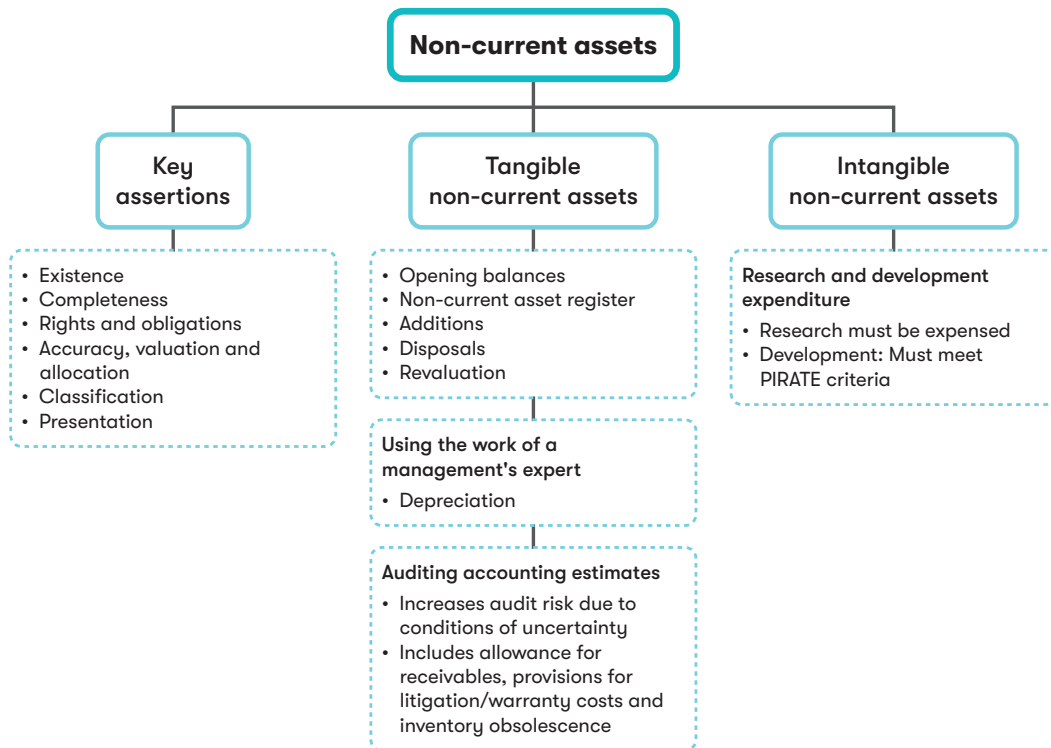
Financial statement assertion	Audit procedure
Valuation	• Verify valuation to valuation certificate. • Consider reasonableness of valuation, reviewing: - Experience of valuer - Scope of work - Methods and assumptions used - Valuation bases are in line with accounting standards • Reperform calculation of revaluation surplus. • Confirm whether valuations of all assets that have been revalued have been updated regularly so that the asset's carrying amount is not materially different from its fair value by asking the Finance Director and inspecting the previous financial statements. • Inspect draft accounts to check that client has recognised revaluation losses in the statement of profit or loss 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.
Valuation - 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 finite 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. • Repperform calculation of depreciation rates to ensure it is accurate. • 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

Financial statement assertion	Audit procedure
	- 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. • 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: 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. • Verify that additions have been recorded by scrutinising the non-current asset register and general ledger.
Disposals: rights and obligations, completeness and accuracy	• Verify disposals with supporting documentation, checking transfer of title, sales price and dates of completion and payment • Recalculate gain 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	• 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.

Intangible non-current assets:

Financial statement assertion	Audit procedure
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 (R&D) 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.

Chapter summary



Knowledge diagnostic

1. Key financial statement assertions

Completeness, existence, valuation and rights and obligations are the key tangible non-current asset assertions.

2. Non-current assets register

Entities should have a tangible non-current assets register that lists all the tangible non-current assets owned.

3. Key audit areas

Key areas of tangible non-current assets for auditors to test are additions, disposals, revaluations and depreciation.

4. Management's expert

Auditors may need to place reliance on the work of a management's expert when auditing a revaluation of a non-current asset.

5. Accounting estimates

Accounting estimates such as depreciation and amortisation involve judgements and so can be high-risk items in the financial statements.

6. Intangible assets

The audit of intangible non-current assets is likely to focus on development expenditure and the capitalisation criteria of IAS 38.

Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

- Section A Q2 (items 1 and 2) and Q33 cover tangible non-current assets
- Section A Q40 examines intangible assets
- Section B Q55 (d) and (e) 'Heels' look at estimates
- Section B Q65 'Boston Manufacturing' focuses on tangible non-current assets

Further reading

There are technical articles on the ACCA website written by members of the AA examining team which are relevant to some of the topics covered in this chapter that you should read:

- *The audit of financial statement assertions*: <https://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/assertions.html>
- *Examining evidence*: <https://www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p7/technical-articles/examining-evidence.html>

Own research

Obtain a recent set of financial statements for an organisation and look for the non-current asset notes.

Are there any figures in the financial statements where management might need to have used an expert?

Can you find any figures in the financial statements that have been estimated?

Activity answers

Activity 1: Assertions

- 1 The correct answer is: Physically inspecting the asset
- 2 The correct answer is: Rights and obligations

Activity 2: Opening balances

The opening balances should be agreed to the signed financial statements and any breakdown provided by the client to ensure they have been carried forward accurately from the previous year.

We would normally also agree the opening balances to the previous year's audit file, however, given that this is the first year that we have audited Dress You Like Co and so it is not possible to conduct this audit procedure.

Non-current assets comprise a cumulative figure in the statement of financial position. If the balances from the prior year have not been brought forward accurately to the current year, there may be a material misstatement in the non-current assets balance in the financial statements. The depreciation charge may also be calculated incorrectly and could be over or understated on the statement of financial position.

Activity 3: Additions

- 1 IAS 16 states that training costs are not allowed to be included in the cost of any non-current assets. The cutting machinery training costs of \$2,500 should not be included as an addition to non-current assets. If this cost is not removed, non-current assets will be overstated in the statement of financial position and expenses will be understated in the statement of profit or loss. The sewing equipment was not actually in the company's possession and use at the year end. The deposit of \$20,000 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. The balance of \$45,000 must be removed from the additions listing or non-current assets will be overstated.
- 2
 - The total of the list of additions should be recalculated to ensure its accuracy.
 - The total of Dress You Like's additions list should be agreed to the non-current asset note in the financial statements.
 - A sample of additions should be selected and their cost should be traced to invoices or contracts to confirm that the value of the addition is accurate. Inspect invoice/contract to confirm the amount capitalised excludes any recoverable sales tax.
 - A sample of additions should be selected and Check & Co should inspect whether invoices or contracts are addressed to Dress You Like Co to ensure the company holds the rights and obligations for the assets.
 - Check & Co should examine motor vehicle registration documentation and inspect whether it is in Dress You Like Co's name to ensure the company holds the rights and obligations for the delivery vehicles.
 - A sample of additions should be selected and physically verified to confirm their existence and condition.
 - For a sample of additions, confirm that they have been included in the non-current assets register at Dress You Like Co to ensure they have been recorded properly.
 - Review the additions listing to ensure there are no other items that have been capitalised which should have been expensed.

- Review items in relevant expense categories (such as repairs, motor expenses, sundry expenses) to ensure that items have not been expensed which should have been capitalised to ensure completeness of additions.
- Examine invoices received after year end, orders and board minutes for evidence of capital commitments which may not have been included in the financial statements. This test ensures the completeness of non-current assets.

Activity 4: Disposals

- Obtain a list of all disposals from Dress You Like Co and cast to ensure accuracy.
- Agree the total of the disposals listing to the financial statements.
- Confirm that all disposals have been removed from Dress You Like Co's non-current asset register to ensure existence.
- Verify the valuation of the disposals with supporting documentation such as an invoice issued to the buyer of the delivery vehicles, checking transfer of title, sales price and dates of completion and payment.
- Check & Co should recalculate the loss on disposal and agree this amount to the nominal ledger and financial statements of Dress You Like Co. On disposal, the delivery vehicles had a carrying amount of \$17,000 (\$41,000-\$24,000). Since the vehicles were sold for \$10,000, this results in a loss on disposal of \$17,000.
- Consider whether proceeds from disposal of the delivery vehicles are reasonable.
- Recalculate the depreciation up to the date of disposal, based on the company's accounting policy to ensure this has been calculated correctly.
- Trace the proceeds from sale of the vehicles to the cash book and the bank statement.

Activity 5: Revaluation

- Trace the revalued amount to the valuer's report and confirm that the surplus is \$1,200,000.
- Agree that the \$1,200,000 has been transferred to a revaluation reserve through scrutiny of the nominal ledger.
- Agree the basis of valuation to the valuer's report. Verify the disclosure of this to the notes to the financial statements.
- Assess the competence, capability and objectivity of the specialist engaged to perform the revaluation by considering:
 - Experience of the specialist
 - Qualifications of the specialist
 - Reputation of the specialist
 - Scope of work
 - Methods and assumptions used
 - Whether the basis of the valuation is in line with accounting standards
- Assess the reasonableness of the valuation by comparison with any similar properties which may have recently changed hands on the open market.
- Recalculate depreciation to confirm that it is based on the revalued amount.
- Review the notes to the financial statements to confirm that the revaluation has been disclosed in line with the requirements of IAS 16.

Activity 6: Depreciation

- Obtain details of the depreciation accounting policy from the notes to the financial statements and confirm that there have been no changes to this policy.

- Review the depreciation policy disclosure in the notes to the financial statements to confirm this is presented in accordance with the requirements of IAS 16.
- Review the depreciation rates in the policy and consider whether they are reasonable. Take the following into consideration:
 - Asset lives
 - Residual values
 - Replacement policy
 - Past experience of gains and losses on disposal
 - Consistency with prior years and accounting policy
 - Possible obsolescence
- Compare ratios of depreciation to non-current assets (by category) with:
 - Previous years
 - Depreciation policy rates
- Review the non-current assets register to ensure that depreciation has been charged on all assets with a limited useful life.
- Recalculate the depreciation on a sample of assets. Compare the calculations to the depreciation charge in the non-current assets register for each item in the sample.
- For the two revalued sites, ensure that the charge for depreciation is based on the revalued amount by recalculating it.
- Alternatively perform a proof in total of depreciation charge for each category of asset by taking the average cost balance $((\text{opening cost} + \text{closing cost})/2)$ and multiplying by depreciation rate. Enquire of management the reason for any significant differences to the actual depreciation charged.

Learning objectives

On completion of this chapter, you should be able to:

Syllabus learning outcomes	Syllabus reference no.
Explain the audit objectives and the audit procedures to obtain sufficient, appropriate evidence in relation to: Inventory	D4 (b)
(a) Inventory counting procedures in relation to year-end and continuous inventory systems	
(b) Cut-off testing	
(c) Auditor's attendance at inventory counting	
(d) Direct confirmation of inventory held by third parties	
(e) Valuation, and	
(f) Other evidence in relation to inventory	
Discuss the extent to which external auditors are able to rely on the work of experts, including the work of internal audit.	D6 (b)
Explain the extent to which reference to the work of others can be made in the independent auditor's report.	D6 (d)

Business and exam context

No area of the statement of financial position creates more potential problems for the auditors than that of inventory. Closing inventory does not normally form an integrated part of the double entry bookkeeping system and hence a misstatement (under or overstatement) may not be detected from tests in other audit areas.

Many candidates who sit the ACCA AA exam do not work in audit practice. This can make it harder to see the practical nature of the subject and to learn to apply the knowledge learned. Consequently, we have tried to make this chapter relating to substantive procedures as practical as possible, so that you can apply your knowledge to exam scenarios.

You may be asked to list and explain audit procedures you would perform to confirm specific assertions relating to inventory.

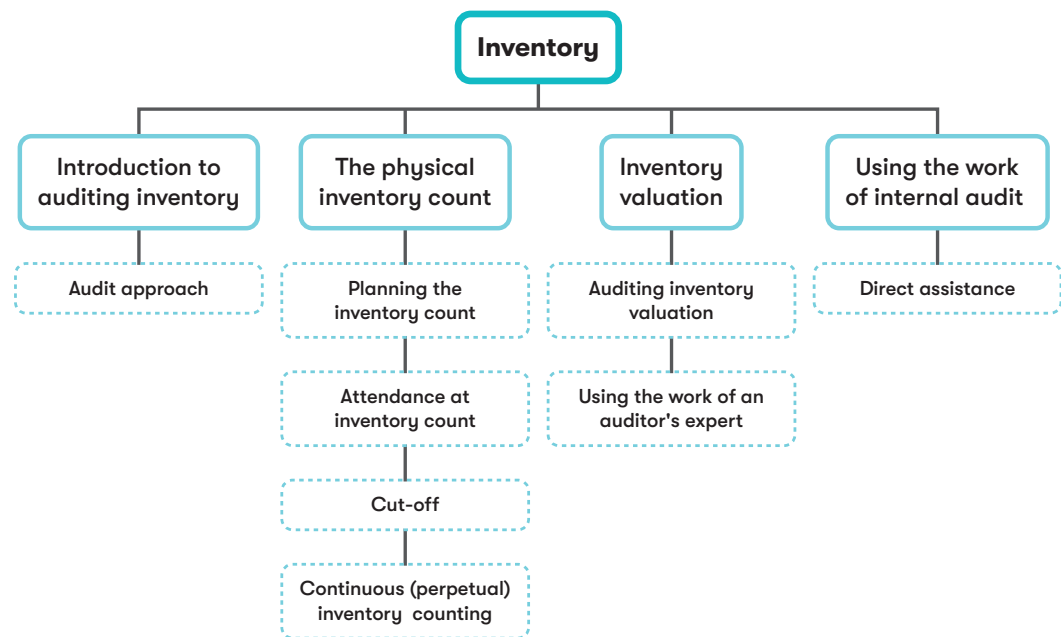
You could be asked to do the following, for example:

- Describe the audit procedures to perform before, during and after attending the inventory count.
- Describe the audit procedures to be applied in respect of specific financial statement assertions related to inventory (including work in progress).

- The financial statement assertions and their related audit procedures could also constitute the subject of mini-case OT questions in Section A.

The requirement to consider valuation of inventory is also a topic which is regularly examined. If asked for procedures in this area, 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.

Chapter overview



1 Introduction to auditing inventory

1.1 Assertions

You have already studied assertions in Chapter 8 of this workbook, Introduction to Audit Evidence. In this chapter you will learn which of these assertions relate to inventory and the audit procedures undertaken to provide audit evidence to support these assertions.



Essential reading

See Chapter 13 of the Essential reading for the assertions that apply to inventory.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

1.2 Audit approach

The audit approach must consider the following with regards to inventory:

Quantity – normally arrived at by a year-end inventory count (unless solely a perpetual system)

Valuation – must apply IAS 2 *Inventories*

Disclosure

We saw in Chapter 10 that the approach taken to the audit of inventory depends on the control system in place over inventory.

Remember, if the entity has a perpetual inventory system in place (where inventory is counted continuously throughout the year) and a year-end count is not undertaken, a **controls-based approach** is feasible as long as the controls over the system are appropriately designed. In fact, a controls-based approach may actually be more efficient.

However, where inventory quantities will be determined by an inventory count at the year-end date, a largely **substantive approach** is taken. We look at both year-end inventory counts and periodic counts in support of perpetual inventory systems in this chapter.



Exercise: Inventory lead schedule

Throughout the chapter, we will continue to use the audit of Dress You Like Co for the year ended 30 September 20X6.

The audit team has prepared the following lead schedule for the audit of inventory of Dress You Like Co for the current year.

Reference:

Client: Dress You Like Co

Prepared by:

Reviewed by:

Date: 30/10/X6

	Draft 20X6 \$'000	Dr \$'000	Cr \$'000	Final 20X6 \$'000	Actual 20X5 \$'000
Inventories:					
Raw materials (at cost)	12,952				4,600
Work in progress (at cost)	20,699				15,201

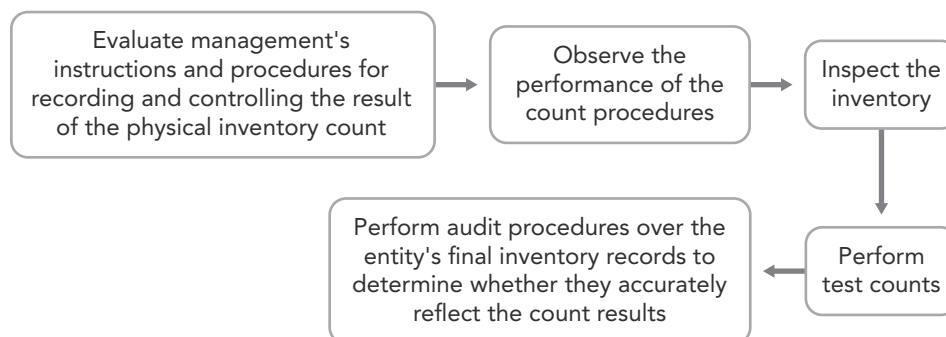
	Draft 20X6 \$'000	Dr \$'000	Cr \$'000	Final 20X6 \$'000	Actual 20X5 \$'000
Finished goods	<u>13,800</u>				<u>4,900</u>
Total inventory	<u><u>47,451</u></u>				<u><u>24,701</u></u>

2 The physical inventory count

2.1 Introduction

A particular technique to verify **quantity and conditions** of inventories is for the auditor to attend the client's inventory count. Physical inventory count procedures are vital, as they provide evidence which cannot be obtained elsewhere or at any other time about the quantities and conditions of inventories and work-in-progress.

ISA 501 Audit Evidence – Specific Considerations for Selected Items (para. 4) provides guidance for auditors on attending the physical inventory count. It states that where inventory is **material**, auditors shall obtain sufficient appropriate audit evidence regarding its **existence** and **condition** by attending the physical inventory count (unless this is impracticable). The following process is to be performed:



Attendance at the inventory count can serve as **either substantive procedures or tests of controls**, depending on the auditor's risk assessment, planned approach and specific procedures carried out.

2.2 Planning the inventory count

Before the physical inventory count the auditors should ensure audit **coverage** of the count is appropriate, and that the client's count instructions have been reviewed.

Factors to consider when planning attendance at the inventory count include the following:

- The **risks of material misstatement** of inventory
- **Internal controls** related to inventory
- Whether **adequate procedures** are expected to be established and **proper instructions** issued for counting
- The **timing** of the count
- Whether the entity maintains a **perpetual inventory system**
- **Locations** at which inventory is held (including any material **amounts held by third parties**)
- Whether the assistance of an **auditor's expert** is required

(ISA 510: para. A3)

2.2.1 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) (ISA 501: para. 8)



Essential reading

See Chapter 13 of the Essential reading for further considerations of the auditor when planning to attend the inventory count. This section also explains the other audit procedures the auditor might need to plan and perform where a material portion of the audit client's inventory is located with a third-party.

The Essential reading is available as an Appendix of the digital edition of the Workbook.



Activity 1: Inventory count instructions

Check & Co have been provided with the following inventory count instructions by Dress You Like Co:

- Sadie Thomas, Finance Assistant, has overall responsibility for the inventory count but she is to be assisted by Mr David Furber, the warehouse manager, to whom the inventory counting teams are to report, and who will be responsible for the detailed organisation of the count.
- Five inventory count teams are to carry out the actual count, each team to be responsible for a predetermined section of the warehouse. Each team comprises two persons: one from the accounting department and the other from the warehouse.
- Each inventory count team is to meet David Furber at 07:30am on 30 September 20X6 and will be provided with pre-numbered and pre-printed inventory sheets for the section of the warehouse for which they are responsible. These inventory sheets have been prepared by the inventory control department and show the balance of each inventory item on hand as shown on the inventory records held independently of the warehouse.
- Each inventory count sheet is to be signed by the senior member of the count team and the bin or rack cards held in the warehouse are to be adjusted, if necessary, to actual quantities counted. All cards are to be initialled to show that the count has been made.
- Any goods that appear to be in poor condition are to be noted on the inventory sheets, such action to be supported by initials of the senior member of the count team.
- Any queries during the count are to be referred to David Furber to whom inventory sheets are to be returned at the conclusion of the count. David Furber is responsible for ensuring that all inventory count sheets have been returned and forwarded to Sadie Thomas for valuation.

Required

Identify THREE matters that will require action by management if the inventory count is to be effective. Explain how the matters could be rectified.

2.3 Attendance at inventory count

During the inventory count the auditors should **observe** whether the count is being carried out according to instructions, carry out **test counts**, and watch out for **third-party inventory** and **slow-moving inventory** and **cut-off problems**.

2.3.1 Audit procedures during attendance at the inventory count

Audit procedures include:

- **Observe** whether the **client's staff are following inventory count instructions** to ensure the count is complete and accurate
- **Perform test counts** to ensure procedures and internal controls are operating effectively, and to gain evidence over the existence and completeness of inventory
- Ensure that the **procedures for identifying damaged, obsolete and slow-moving inventory** operate effectively to confirm **valuation** of inventory:
 - Obtain information about the inventory's condition, age and usage
 - Obtain information concerning the stage of completion of work-in-progress
- **Confirm** that **inventory held on behalf of third parties is separately identified and accounted for** to ensure that inventory is not overstated
- **Obtain** copies of the **last goods received note (GRN)** and the **last goods despatch note (GDN)** in order to confirm **cut-off** of inventory
- Conclude whether any amendment is necessary to subsequent audit procedures
- Gain an **overall impression** of the levels and values of inventories held in order to be able to judge whether the inventory figure in the financial statements appears reasonable

2.3.2 Performing test counts

The auditors **perform test counts** to ensure procedures and internal controls are working properly. The auditor should test counts from the inventories to the inventory sheets (to gain evidence of **completeness**) and from the inventory sheets to the inventories (to prove **existence**). Tests should concentrate on **high value** inventory. If the results of the test counts are not satisfactory, the auditors may request that inventory be **recounted**.

2.3.3 Documentation of audit work performed during the count

The auditors' working papers should include the following:

- Details of their **observations** and **procedures performed**
- The manner in which points that are relevant and material to the inventory being counted or measured have been dealt with by the client
- Instances where the **client's procedures have not been satisfactorily carried out**
- **Items for subsequent testing**, such as photocopies of (or extracts from) rough inventory sheets
- **Details of the sequence of inventory sheets**
- The **auditors' conclusions**



Activity 2: Completeness

You are the audit manager at Check & Co and are planning the audit procedures for inventory for the year ending 30 September 20X6.

Required

Which ONE of the following audit procedures provides evidence of the completeness of inventory?

- ☐ Test counts from inventory in the warehouse to the inventory records
 - ☐ Review an aged inventory listing and identify any slow moving items of inventory
 - ☐ Test counts from the inventory records to the inventory in the warehouse
 - ☐ Observe the location of any inventories held by third parties and that they are not being included in the inventory count
-

2.4 After the inventory count

After the count the auditors should check that **final inventory sheets** have been **properly compiled** from count records and that **book inventory** has been **appropriately adjusted**.

Key tests include the following:

- **Trace items** that were **test counted** to final inventory sheets.
- **Agree sequence** of inventory sheets
- **Observe** whether all count records have been included in final inventory sheets.
- Inspect final inventory sheets to ensure they are supported by count records.
- Confirm that continuous inventory records have been adjusted to the amounts physically counted or measured, and that differences have been investigated.
- Confirm cut-off by using details of the last serial number of GRN and GDN and details of movements during the count.
- Review replies from third parties about inventory held by or for them.
- Reperform client's computation of the final inventory figure to ensure it has been calculated correctly.
- Follow up queries and notify problems to management.
- Confirm necessary adjustments to book inventories have been made by inspecting the client's ledgers.



Activity 3: Test counts

The following are extracts from the inventory count sheets of Dress You Like Co for the year ending 30 September 20X6:

COUNT SHEET 45

Date: 30 September 20X6

Counter: AL

Approved by: DF

Location: Factory, Aisle 14, shelf
B7

Inventory code	Quantity as per inventory records	Quantity counted	Notes
DYL563536P	12	12	
DYL455666L	50	50	
DYL883722G	125	50	
DYL829427T	78	78	
			Blue dye has rubbed onto all these White shirts from nearby denim. (Noted DF)
DYL879239X	100	100	
DYL875621P	65	65	
DYL261567L	87	88	
DYL822782K	150	150	

Required

Answer the following questions:

- 1 Note down any items from the inventory count sheet that might require investigation. Why have you chosen these items?
- 2 Rewrite the information above as an audit procedure, documenting the reason for the procedure.

Solution

2.5 Cut-off

Cut-off testing is a specific audit procedure performed after the inventory count to ensure that all of the company's transactions have been **included in the correct period**. Cut-off is usually tested by obtaining a sample of GRNs and GDNs either side of the year end and then matching them to purchase/sales invoices to ensure they have been included in the correct account balance(s). The auditor should have obtained the samples of GRNs and GDNs when attending the inventory count.

Purchases cut-off

- All purchases for which goods have been received before the year end must be included in the financial statements as a liability, expense and closing inventories.
- Goods received after the year end should not be included in the financial statements.

Revenue cut-off

- Revenue for where the goods have left the warehouse should be included within the revenue and trade receivables at the year end, but not in closing inventories.
- Revenue made after the year end must not be included in the financial statements but should be included in closing inventories.

Year end			
Before		After	
Purchase	GRN	GRN	Purchase
	Included in?	Included in?	
	• Purchases ✓ • Payables ✓ • Inventories ✓	• Purchases ✗ • Payables ✗ • Inventories ✗	
Revenue	GDN	GDN	Revenue
	Included in?	Included in?	
	• Revenue ✓ • Receivables ✓ • Inventories ✗	• Revenue ✗ • Receivables ✗ • Inventories ✓	



Essential reading

See Chapter 13 of the Essential reading for further details on the importance of cut-off testing and management's cut-off procedures.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2.6 Continuous (perpetual) inventory counting

A business may count inventory by one or a combination of the following methods:

Physical inventory counts at the year end

- From the viewpoint of the auditor, this is often the best method.

Physical inventory counts before or after the year end

- This will provide audit evidence of varying reliability depending on:
- The length of time between the physical inventory count and the year-end (the greater the time period, the less the value of audit evidence)
- The business's system of internal controls
- The quality of records of inventory movements in the period between the physical inventory count and the year end (the auditors will need to perform roll back or roll forward tests on these records)

Continuous (or perpetual) inventory

- Management has a programme of inventory counting throughout the year.
- Continuous systems make use of modern computing power to link inventory records to information about sales and purchases, as well as to management information such as an item's location within the entity.
- This is the preferred method of monitoring inventory levels throughout the year, but its weakness is that over time the **actual inventory level** will tend to **diverge from what** the computer says it **should be**, as a result of unrecorded transactions or theft.
- As a result of this divergence, it will be necessary to perform physical inventory counts of selected inventory lines throughout the year to determine the extent of the system's divergence from actual inventory levels. All inventory lines should be subject to a physical count at least once a year.

The audit work when continuous (or perpetual) inventory counting is used focuses on tests of controls rather than substantive audit work. Nevertheless, the auditor will also need to do some further substantive audit work on completeness and existence at the year end.



Essential reading

See Chapter 13 of the Essential reading for further details on the auditor's actions when attending a physical inventory count where an audit client uses a continuous system.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

3 Inventory valuation

3.1 Accounting for inventory

IAS 2 *Inventories* requires inventory to be stated at the **lower of cost and net realisable value** (IAS 2: para. 9).



Cost: Cost is defined by IAS 2 (para. 10) as comprising all costs of purchase and other costs incurred in bringing inventory to its present location and condition.

Net realisable value (NRV): Net realisable value (NRV) is the estimated selling price in the ordinary course of business, less the estimated cost of completion and the estimated costs necessary to make the sale (IAS 2: para. 6).

Broadly speaking, this means that inventory should be stated at cost, because companies tend to sell inventory for more than it costs. It is possible, however, that the inventory is not worth what it costs – perhaps because it is damaged or obsolete – in which case it should be stated at what it is worth, ie its net realisable value.

Auditors must understand how the company determines the cost of an item for inventory valuation purposes. Costs should include an appropriate proportion of overheads, in accordance with IAS 2 (para. 12).

An entity may use **standard costs** to value inventory provided that the standard costs **approximate to actual cost**.

3.2 Auditing inventory valuation

Auditing the **valuation** of inventory has the following aims.



Essential reading

See Chapter 13 of the Essential reading for further details on inventory accounting as per IAS 2 and auditing the valuation of inventory.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

Estimating the net realisable value of inventory requires **judgement** and can involve **uncertainty**. The rules of ISA 540 (Revised) *Auditing Accounting Estimates and Related Disclosures* will apply to the audit of NRV. The standard mentions that inventory obsolescence is an example of an accounting estimate. The audit of accounting estimates has already been studied in Chapter 12 *Non-current Assets*.



Activity 4: Cost of inventory

The following is an extract of Dress You Like Co's breakdown of the cost of finished inventory for the year ending 30 September 20X6. The full breakdown lists the same information for the several thousand product lines held in finished inventory.

Inventory Code	Quantity	Raw material cost (\$)	Labour cost (\$)	Overheads (\$)	Total cost (\$)	Total cost per unit (\$)
DYL120004P	1,000	5,648	1,010	500	7,158	7
DYL120005P	5,000	20,597	5,641	2,500	28,738	6
DYL120006P	750	3,652	800	350	4,802	6
DYL120007P	2,500	12,456	2,900	1,755	17,111	7
DYL120008P	800	6,054	1,655	5,000	12,709	16
DYL120009P	500	2,648	544	250	3,442	7

Required

List the audit procedures you would perform on the full breakdown of the cost of finished inventory when auditing the valuation of inventory. Document the reason for each procedure.



Activity 5: Cost vs NRV

The following is an extract from a schedule prepared by Dress You Like Co for year ending 30 September 20X6. The schedule details the total cost per unit of inventory versus the actual price at which the inventory was sold per unit after the year-end.

Inventory Code	Total cost per unit (\$)	Selling price per unit (\$)
DYL120004P	7	20
DYL120005P	6	15
DYL120006P	6	16
DYL120007P	7	14
DYL120008P	16	10
DYL120009P	7	20

Required

Answer the following questions:

- 1 Note down any items from this schedule that might require investigation. Why have you chosen these items?
- 2 Rewrite the information above as an audit procedure, documenting the reason for the procedure.

Solution

3.2.1 Audit procedures for inventory

The following table contains audit procedures for inventory matched to the financial statement assertions they test. This table is for reference only, the procedures should not be learned by heart, but may be useful when practising exam questions.

Financial statement assertion	Audit procedure
Completeness	• Trace test counts to the detailed inventory listing. • Where inventory is held in third-party locations, physically inspect this inventory or review confirmations received from the third party and match to the general ledger. • Compare the gross profit percentage to the previous year or industry data and investigate any unexpected variations.
Existence	• Observe the physical inventory count
Rights and obligations	• Verify that any inventory held for third parties is not included in the year-end inventory figure by being appropriately segregated during the inventory count. • For any 'bill and hold' inventory (ie where the inventory has been sold but is being held by the entity until the customer requires it), identify such inventory and ensure that it is segregated during the inventory count so that it is not included in the year-end inventory figure. • Confirm that any inventory held at third-party locations is included in the year-end inventory figure by reviewing the inventory listing.
Accuracy, valuation and allocation	• Obtain a copy of the inventory listing and agree the totals to the general ledger. • Cast the inventory listing to ensure it is mathematically correct. • Vouch a sample of inventory items to suppliers' invoices to ensure it is correctly valued. • Where standard costing is used, obtain a copy of the standard cost card, vouch a sample of purchases costs to invoices and labour rates to payroll records and discuss the amount of labour time taken per unit/batch with production staff to ensure the standard cost is correctly valued. • For materials, agree the valuation of raw materials to invoices and price lists. • Confirm that an appropriate basis of valuation (eg FIFO) is being used by discussing with management. • For labour costs, agree costs to wage records. • Review standard labour costs in the light of actual costs and production. • Reconcile labour hours to time summaries. • Where inventory relates to work in progress, discuss the stage of completion with production management and recalculate inventory values. Consider whether an expert is required. • Make enquiries of management to ascertain any slow-moving or obsolete inventory that should be written down. • Examine prices at which finished goods have been sold after the year end to ascertain whether any finished goods need to be written down.

Financial statement assertion	Audit procedure
	- If significant levels of finished goods remain unsold for an unusual period of time, discuss with management and consider the need to make allowance. Compare the gross profit percentage to the previous year or industry data. Compare raw material, finished goods and inventory collection period to the previous year and industry averages. Compare inventory holding period with the previous year and industry average. Compare the current year standard costs to the previous year after considering current conditions. Compare actual manufacturing overhead costs with budgeted or standard manufacturing overhead costs. - Obtain a copy of the inventory listing and cast it, and test the mathematical extensions of quantity multiplied by price. Trace test counts back to the inventory listing. - If the entity has adjusted the general ledger to agree with the physical inventory count amounts, agree the two amounts. - Where a continuous (perpetual) inventory system is maintained, agree the total on the inventory listing to the continuous inventory records, using automated tools and techniques.
Cut-off	Note the numbers of the last GDNs and GRNs before the year end and the first GDNs and GRNs after the year end and check that these have been included in the correct financial year.
Classification	Review the inventory listing to ensure that inventory has been properly classified between raw materials, work-in-progress and finished goods. Read the notes to the accounts relating to inventory to ensure they are understandable.
Presentation	- Complete the disclosure checklist to ensure that all the disclosures relevant to inventory have been made. Review the financial statements to confirm whether the cost method used to value inventory is accurately disclosed. Read the notes to the financial statements to ensure that the information is accurate and properly presented at the appropriate amounts.

3.3 Using the work of an auditor's expert

An expert may be used to assist with auditing the valuation of inventory, for example in valuing precious stones or assessing the stage of completion of WIP. You have already studied the use of a management's expert in Chapter 12 on non-current assets. In this section, we will look at the situation where an expert is employed by the auditor, rather than the audit client. Guidance on this area is provided by ISA 620 *Using the Work of an Auditor's Expert*.



Auditor's expert: An Auditor's expert is "an individual or organisation possessing expertise in a field other than accounting or auditing, 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 either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm) or an auditor's external expert" (ISA 620: para. 6(a)).

Be mindful that auditors' experts can be employed to assist with areas other than inventory valuation, such as the valuation of land and buildings or legal opinions concerning interpretations of agreements, statutes and regulations, or on the outcome of litigation or disputes .

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).



Essential reading

See Chapter 13 of the Essential reading for further details on using an auditor's expert.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

4 Using the work of internal audit

Another party that the auditors can rely upon in the audit of inventory is the internal audit function at a client (note that the internal auditors will cover many areas, not just inventory). During the course of their planning, the external auditors should perform an assessment of the internal audit function if they consider that it may be possible, and desirable, to rely on some of internal audit's work. If the external auditor can rely on the work conducted by the internal auditor, the volume of detailed work undertaken by the external auditor may be reduced.



Internal audit function: Internal audit function is "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" (ISA 610 (Revised): para. 14(a)).

ISA 610 (Revised) *Using the Work of Internal Auditors* provides guidance for 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.

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 (ISA 610 (Revised): para. 11). The external auditor cannot make reference to work done by the internal auditor in their auditor's report.

ISA 610 ((Revised): para. 22) 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

(ISA 610 (Revised): para. 23)

The **nature and extent** of the audit procedures performed on specific work of the internal auditors will depend on 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): para. 24) 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

(ISA 610 (Revised): para. A30)

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 (ISA 610 (Revised): para. 25).

4.1 Direct assistance



Direct assistance: Direct assistance refers to “the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor” (ISA 610 (Revised): para. 14(b)).

ISA 610 ((Revised): para. 30) **prohibits** the use of internal auditors to provide direct assistance to perform procedures that:

Involve making **significant judgements** 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



Essential reading

See Chapter 13 of the Essential reading for further details on using the work of internal audit including the use of direct assistance.

The Essential reading is available as an Appendix of the digital edition of the Workbook.



Activity 6: Reliance on internal audit

For the first eight months of the year ended 30 September 20X6, Dress You Like Co outsourced their internal audit function to Pricey & Co, an external audit firm. Callum Lewis, the son of Gary Lewis, the Chairman of Dress You Like Co, is an audit junior at Pricey & Co.

During the eight months to February 20X6, Dress You Like Co specifically requested the internal auditor's document and test the controls that ensure all customers receive their goods within one week of making an order. No other controls over inventory were tested.

Required

Which of the following statements, if any, are true?

- (1) Check & Co cannot use the work of the internal auditor because they were not engaged by Dress You Like Co for the entire year being audited.
 - (2) Check & Co cannot rely on the work of Pricey & Co because Callum Lewis is an audit junior there and they lack objectivity.
 - (3) Check & Co can rely on the work of Dress You Like Co for auditing the existence and completeness of inventory.
- ☐ (1) only
 - ☐ (3) only
 - ☐ (1) and (2)
 - ☐ Neither (1) nor (2) nor (3)
-

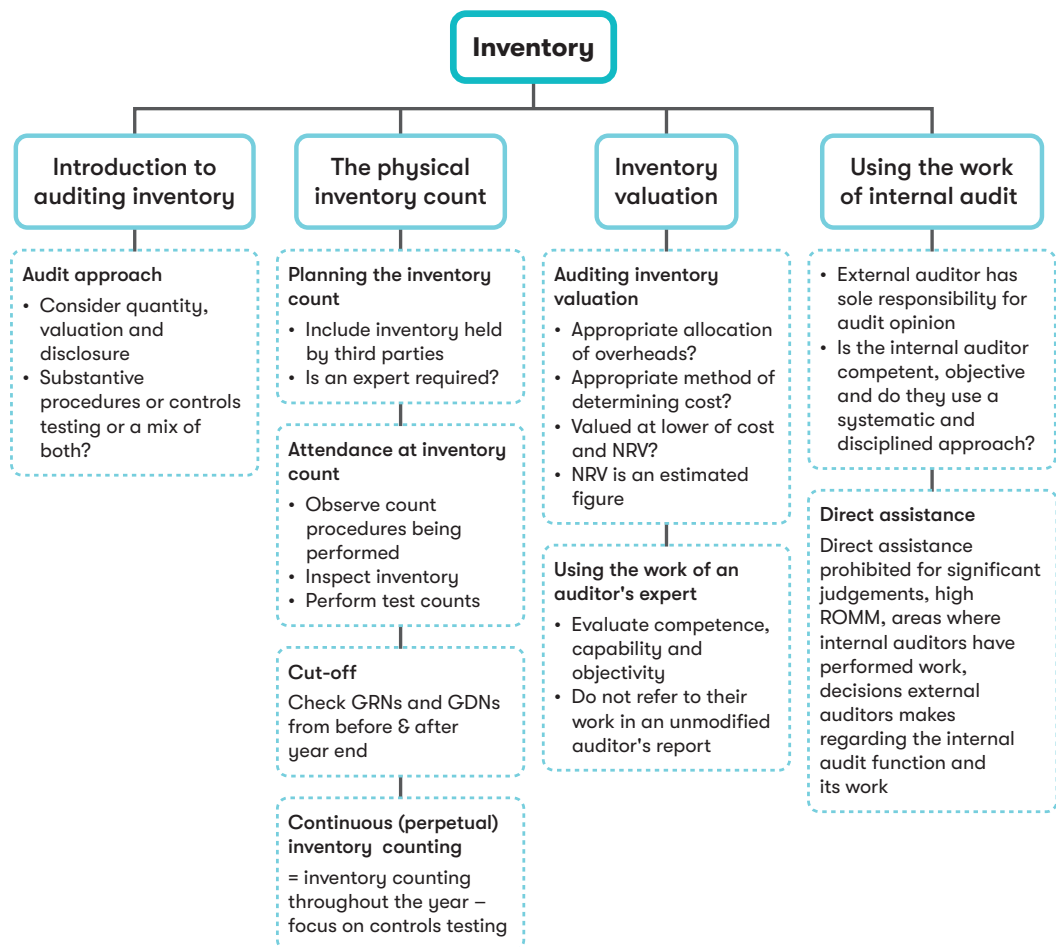


Essential reading

See Chapter 18 of the Essential reading for a summary of the accounting knowledge relevant to IAS 2: *Inventories* which is brought forward to this paper from your earlier Financial Accounting studies.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

Chapter summary



Knowledge diagnostic

1. Inventory quantity

Procedures to verify the quantity of inventory will depend on whether the client uses a **year-end** inventory count or a **continuous** inventory system.

2. Inventory count

Physical inventory count procedures are vital, as they provide evidence which cannot be obtained elsewhere or at any other time about the quantities and conditions of inventory and WIP.

3. Auditor attendance at the inventory count

The auditor will **attend** the inventory count to:

- (a) Perform tests of controls (observation)
- (b) Obtain substantive evidence of quantity (test counts, cut-off details)
- (c) Obtain preliminary evidence of valuation (note damaged or obsolete inventories)

4. Inventory cut-off

Cut-off tests are used to ensure that transactions have been recorded in the correct accounting period.

5. Cut-off testing

Auditors should test cut-off by noting the serial numbers of GDNs and GRNs received and despatched just before and after the year-end, and subsequently testing that they have been included in the correct period.

6. IAS 2 Inventories

The **valuation** and **disclosure** rules for inventory are laid down in IAS 2 *Inventories*. Inventory should be valued at the **lower of cost and net realisable value**.

7. Inventory valuation

Auditing the valuation of inventory includes:

- (a) Testing the **allocation of overheads** is appropriate
- (b) Confirming inventory is carried at the lower of cost and net realisable value

8. Using the work of an expert

External auditors may make use of the work of an auditor's expert or internal audit when carrying out audit procedures.

Further study guidance

Question practice

Now try the following from the Further question practice bank [available in the digital edition of the Workbook]:

- Section A Q32 on the external auditor's reliance on the internal audit function
- Section A Q34 on cut off
- Section B Q62(b) on using the work of an auditor's expert
- Section B Q63(a) 'Elsams' on use of computers when auditing inventory
- Section B Q64 'ZPM' on using the work of internal auditors
- Section B Q66 'Wandsworth Wholesalers' on the inventory count
- Section B Q67 'Snu' on perpetual inventory counting
- Section B Q68 'Sitting Pretty' on the inventory count, inventory valuation and cut-off

Further reading

There are technical articles on the ACCA website written by members of the AA examining team which are relevant to some of the topics covered in this chapter that you should read:

- *The audit of financial statement assertions*: www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/assertions.html
- *Examining evidence*: www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p7/technical-articles/examining-evidence.html
- *Using the work of internal auditors*: www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/internal-auditors.html

Own research

- Obtain a recent set of financial statements for an organisation and look for the inventory balance. Do you think the auditors might have used an expert to audit the valuation of this inventory?
- The tools and techniques auditors use to audit inventory are changing with the development of new technologies. This article looks at how drones can be used to in the audit of inventory: www.accaglobal.com/us/en/student/sa/features/drones.html

Activity answers

Activity 1: Inventory count instructions

Three matters which will require action by management if the inventory count is to be effective together with corrective action are:

- (1) By allowing David Furber to take responsibility for the detailed organisation of the count, the present instructions permit the person with day-to-day responsibility for the inventory area to supervise one of the most important control checks on that area. This represents a deficiency in the company's system of internal control, since the opportunity is afforded to David Furber to cover up any inadequacies there may be in the operational efficiency of controls in the area of inventories.

Sadie Thomas should take more direct responsibility for the detailed organisation of the count.

- (2) By giving to those members of staff responsible for the physical count of the inventories an indication of the quantity, which is expected to be in inventory, there is a risk that this may prejudice their opinion in the event of there being a discrepancy. More importantly, it will tend to reduce the benefits which it is intended to derive from having an independent check on the inventory records by having to reconcile them with the quantities determined by a physical count.

The pre-printed inventory sheets should not show the balance of each inventory item on hand as shown on the inventory records held independently of the warehouse.

- (3) There are no members of staff recounting a sample of inventory that has already been counted. This is an important control over the inventory count.

A number of teams of checkers (two or three) should be appointed to go around after the counters. The task of these checkers would be to:

- Carry out sample tests on the accuracy of the original counters
- Ensure that inventory count completion tags have been left by the counters at each inventory location

The appointment of checkers will improve the efficiency of the overall count by acting as a check on both the accuracy and completeness of the count.

Activity 2: Completeness

The correct answer is: Test counts from inventory in the warehouse to the inventory records

Activity 3: Test counts

- 1 The quantity of item DYL883722G is 125 in the inventory records but only 50 items have been counted. This item will need investigating as it could be indicative of an overstatement of inventory in the statement of financial position.

Item DYL879239X appears to have been damaged. This will need investigating since the inventory may need to be written off if the blue dye cannot be removed from the white shirts. If the inventory cannot be brought back to a saleable standard then it might be overstated in the statement of financial position and an adjustment may need to be made.

A total of 88 items was counted for inventory code DYL261567L but only 87 items are recorded in the inventory records. This small difference may be a counting error and should be looked into to ensure the completeness of the inventory balance.

- 2 Inspect the inventory count sheets for any notes on damaged inventory and enquire with management as to whether this inventory has been sold or scrapped since the year end. If any of this inventory has been sold since the year end, agree to sales invoices to ensure the accuracy of the valuation. If neither sold or scrapped, discuss the saleability of the damaged inventory with management to ensure the valuation of inventory is the lower of cost and net realisable value

Inspect the inventory count sheets and note any differences between the quantities recorded in the inventory records and the quantities counted in the inventory count. Enquire whether management has followed up on any differences and agree that any necessary adjustments have been made in the client's ledgers. This will ensure the existence and completeness of the inventory balance.

Activity 4: Cost of inventory

- Recalculate the total of the breakdown to ensure it has been calculated correctly.
- Agree the total of the breakdown to the finished goods figure to the trial balance and financial statements to ensure the accuracy, completeness and existence of the figure in the financial statements.
- For a sample of inventory codes, agree the cost of raw materials to purchase invoices to ensure the valuation of the raw material cost is accurate.
- For a sample of inventory codes, agree the labour cost to underlying documentation, such as time sheets, to ensure the valuation of the labour cost is accurate.
- Enquire of management as to the basis of the overhead calculation and compare this to previous years in order to assess the reasonableness of the calculation.
- For a sample of inventory codes, agree the overhead cost to supporting documentation such as invoices for electricity. Ensure that any overhead costs included are attributable to production.

Activity 5: Cost vs NRV

- 1 Item DYL120008P cost \$16 to manufacture but only sold for \$10. The cost is greater than the net realisable value and so the item needs to be written down or inventory will be overstated in the statement of financial position.
- 2 For a sample of inventory codes, agree the selling price after year-end to sales invoices and recalculate the unit price to ensure it is calculated correctly.

Compare the cost of the inventory per unit to the selling price per unit to assess whether any inventory needs to be written down to net realisable value.

Activity 6: Reliance on internal audit

The correct answer is: Neither (1) nor (2) nor (3)

Check & Co could use the work of the internal auditors for the first 8 months of the year, if they were found to be objective, competent and having a systematic and disciplined approach during that time. As long as Callum Lewis was not in the internal audit team, the objectivity of Pricey & Co should not be affected. The tests performed by Pricey & Co do not provide evidence of the completeness or existence of inventory.

Learning objectives

On completion of this chapter, you should be able to:

Syllabus learning outcomes	Syllabus reference no.
Explain the audit objectives and the audit procedures to obtain sufficient, appropriate evidence in relation to: Receivables	D4 (a)
(a) Direct confirmation of accounts receivable	
(b) Other evidence in relation to receivables and prepayments	
(c) Other evidence in relation to current assets	
(d) Completeness and occurrence of revenue	

Business and Exam context

Many candidates who sit the ACCA AA exam do not work in audit practice. This can make it harder to see the practical nature of the subject and to learn to apply the knowledge learned. Consequently, we have tried to make this chapter relating to substantive procedures as practical as possible, so that you can apply your knowledge to exam scenarios.

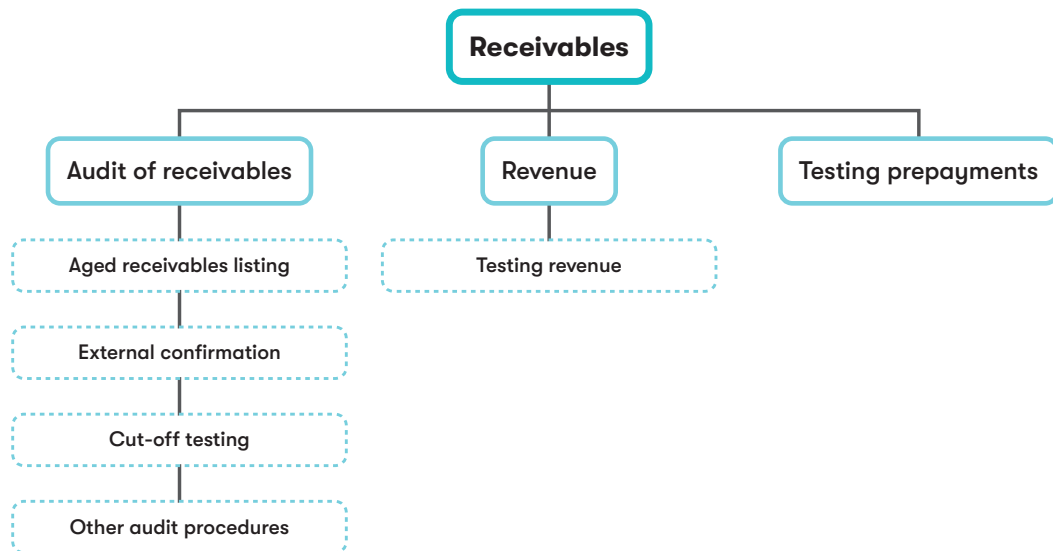
Receivables can be tested in Section A or Section B of the exam. Section B of the exam may ask you to describe the substantive audit procedures you would perform to obtain sufficient and appropriate evidence for assertions relating to receivables. Alternatively, a Section A question could ask you to select an appropriate procedure from a list of procedures to provide evidence over a particular assertion.

It is worth noting that where an exam question asks specifically for audit procedures for receivables, no marks would be awarded if you identify audit procedures relevant only for prepayments, for example.

You must ensure that you are fully conversant with the 'standard' procedures, such as the confirmation of receivables. The receivables confirmation is primarily designed to test the client's entitlement to receive the debt, not the customer's ability to pay. Auditors also need to consider cut-off for receivables. Revenue testing is often carried out in conjunction with the audit of receivables, as the two are linked. We also briefly consider the audit of prepayments.

You will need knowledge of the accounting standards you learnt in your Fundamentals in Financial Accounting (FFA) exam relating to receivables for this chapter.

Chapter overview



1 Audit of receivables

1.1 Assertions

You have already studied assertions in Chapter 8 of this workbook, Introduction to Audit Evidence. In this chapter you will learn which of these assertions relate to receivables and the audit procedures required to cover these assertions. These can cover the receivables balance at the year-end or allowances for receivables.



Essential reading

See Chapter 14 of the Essential reading for the assertions that apply to receivables.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

Throughout this chapter, we will continue to use the audit of Dress You Like Co for the year ended 30 September 20X6. Remember that the company normally allows credit terms of 30 days, but the supermarket is given 60-day credit terms.

The audit team has prepared the following lead schedule for the audit of receivables of Dress You Like Co for the current year.

Reference:

Client: Dress You Like Co

Prepared by:

Reviewed by:

Date: 30/10/X6

	Draft 20X6 \$'000	Dr \$'000	Cr \$'000	Final 20X6 \$'000	Actual 20X5 \$'000
Trade receivables:					
Supermarket	11,800				8,300
Other	<u>700</u>				<u>600</u>
	<u>12,500</u>				<u>8,900</u>

1.2 Aged receivables listing



Activity 1: Aged receivables listing

The following is a copy of the aged receivables listing of Dress You Like Co as at 30 September 20X6:

Customer	Total \$'000	30 days \$'000	60 days \$'000	90 days \$'000	> 90 days \$'000
Jasco Supermarket	11,800	3,100	2,800	3,600	2,300
All About Clothes	21	4	12	5	-
Clothing Terrain	33	26	5	-	2
Dress for the Occasion	92	41	39	12	-

Customer	Total	30 days	60 days	90 days	> 90 days
	\$'000	\$'000	\$'000	\$'000	\$'000
Duncan's Dresses	3	3	-	-	-
Everyday Wear	(6)	-	-	-	(6)
Ewan Trading	29	14	15	-	-
Fred's Fashions	47	37	6	-	4
Freya's Threads	8	8	-	-	-
Girls on the Go	13	4	9	-	-
Holly Aristocrat	73	41	19	1	12
Holiday Accessories	5	-	5	-	-
In all Weather	16	2	13	1	-
Ivory Gowns	2	-	-	-	2
Look the Part	124	79	38	7	1
Jim's Jumpers	38	30	8	-	-
Odd One Out	67	52	15	-	-
Safari School wear	28	-	28	-	-
Skirts and all sorts	57	15	30	12	-
Ties with a Difference	12	12	-	-	-
Upward Trends	17	17	-	-	-
Up and Out	9	-	9	-	-
We're Going Exploring	12	5	-	7	-
	<u>12,500</u>	<u>3,490</u>	<u>3,051</u>	<u>3,645</u>	<u>2,314</u>

Required

- 1 Note down any items in the aged receivables listing that might require investigation. Why have you chosen these items?
- 2 Rewrite the information in part (1) as an audit procedure, documenting the reason for the audit procedure.

Solution

1.2.1 Monies received post year end

The auditor review after date cash received to test existence and valuation of receivables.



Activity 2: Post year end cash receipts

Below is an extract from the cash book receipts of Dress You Like Co during October and November 20X6. All the following amounts received have also cleared on the bank statement:

Customer	Amount received \$'000	Balance owed at year-end \$'000
Jasco Supermarket	5,680	11,800
All About Clothes	21	21
Clothing Terrain	31	33
Dress for the Occasion	92	92
Duncan's Dresses	3	3
Everyday Wear	0	(6)
Ewan Trading	29	29
Fred's Fashions	43	47
Freya's Threads	8	8
Girls on the Go	13	13
Holly Aristocrat	63	73
Holiday Accessories	5	5
In all Weather	16	16
Ivory Gowns	0	2
Look the Part	124	124
Jim's Jumpers	38	38
Odd One Out	62	67
Safari School wear	28	28
Skirts and all sorts	57	57
Ties with a Difference	12	12
Upward Trends	17	17
Up and Out	9	9
We're Going Exploring	5	12
	<u>6,356</u>	<u>12,500</u>

Required

- 1 Consider the information above in relation to the balances owed by each customer at the year-end. Which balances might require further investigation?

- 2 Rewrite the information in part (1) as an audit procedure stating the objective of the audit procedure.

Solution

1.2.2 Credit notes issued post year-end



Activity 3: Post year end credit notes

The following is a list of the credit notes issued by Dress You Like Co during October and November 20X6:

Customer	Total	Description
	\$'000	
Jasco Supermarket	220	Issued in relation to a disputed invoice (invoice no 126425) which was due > 90 days
Holly Aristocrat	10	Issued in relation to the amount of \$12,000 due > 90 days
Odd One Out	5	Issued in relation to an invoice sent in error

Required

- 1 Consider the information above. What further evidence does it provide about the receivables balance at the year-end?
- 2 Write out the audit procedure you have conducted in part (1) stating the objective of the audit procedure.

1.3 External confirmation

A specific technique used to test for the existence and rights and obligations of receivables is an external confirmation (alternatively called 'circularisation'). ISA 505 *External Confirmations* covers the confirmation of amounts by third parties, including the confirmation of amounts by receivables.



External confirmations: Audit evidence obtained as a direct written response to the auditor from a third-party (the confirming party), in paper form, or by electronic or other medium.

An external confirmation will produce a written statement from each respondent that the amount owed at the date of the confirmation is correct. The audit evidence obtained is reliable since it is from an **independent source** and in **documentary** form.

The confirmation letter must be written on the client's headed paper and signed by the client with a copy of the current statement attached. It shall request that the **reply be sent directly to the auditor** and a prepaid envelope is included for this purpose.

There are two types of confirmation:

A **positive** confirmation request is where the confirming party responds directly to the auditor, indicating whether they agree with the information in the request or provides the requested information

A **negative** confirmation request is where the confirming party responds directly to the auditor only if they disagree with the information in the request

The positive method is generally preferable, as it is designed to encourage definite replies from those contacted.

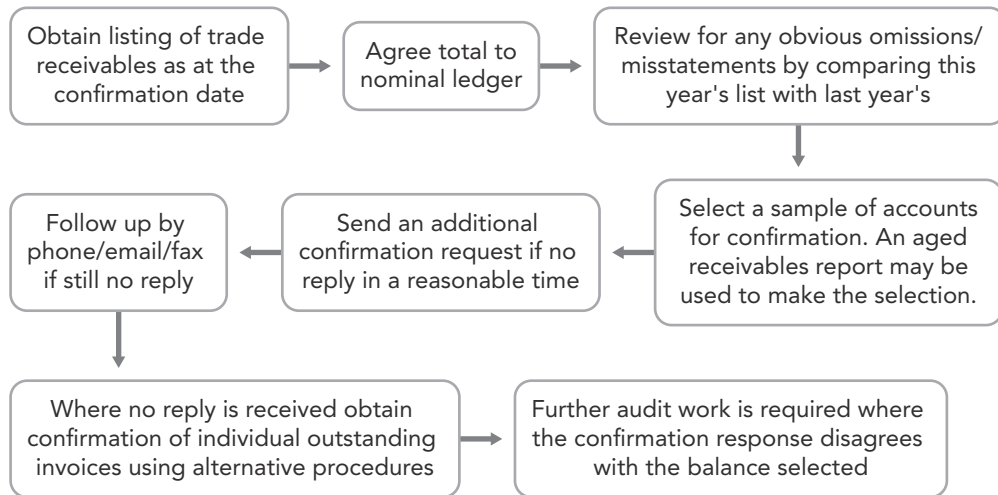
The negative method provides less persuasive audit evidence and shall not be used as the sole substantive procedure to audit receivables unless all of the following are present:

- 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.

(ISA 505: para. 15)

An external confirmation for receivables is conducted as follows:



The following balances should be included in the sample of accounts for confirmation:

- Old, unpaid accounts
- Accounts written-off during the period under review
- Accounts with credit balances
- Accounts settled by round sum payments
- Accounts with large balances
- Accounts with nil balances



Essential reading

See Chapter 14 of the Essential reading for an example of a positive confirmation request letter, and details of the auditor's response when management refuses to send a confirmation request.

The Essential reading is available as an Appendix of the digital edition of the Workbook.



Activity 4: Audit procedures

The audit assistant at Check & Co is about to begin testing of the receivables balance for Dress You Like Co and you are keen for them to use automated tools and techniques in order to save time and cost. They have approached you with a list of procedures they intend to perform using automated tools and techniques.

Required

Which of the following procedures could NOT be performed using automated tools and techniques?

- ☐ Selection of a sample of receivables for confirmation
- ☐ Calculation of receivables days
- ☐ Evaluation of the adequacy of the allowance for receivables
- ☐ Production of receivables confirmation letters

1.3.1 Exceptions and non-responses



Exception: “A response that indicates a difference between information requested to be confirmed, or contained in the entity’s records, and information provided by the confirming party.” (ISA 505: para. 6(e))

Non-response: “A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.” (ISA 505: para. 6d))

External confirmation response disagrees with the balance stated (positive and negative confirmation), resulting in an **exception**

- Exceptions may indicate **misstatements** or potential misstatements in the financial statements and must be **investigated** by the auditor
- The auditor must evaluate whether misstatements identified are **indicative of fraud** (in line with ISA 240)
- Exceptions might also indicate a **deficiency in internal control**
- Not all exceptions represent misstatements (eg timing or clerical errors)

Non-response to external confirmation

- Where no response is received, the auditor shall perform **alternative audit procedures** to obtain relevant and reliable audit evidence
 - Verify outstanding items to back up documentation, eg invoices, GDNs and customer orders
 - Review cash received after year end
 - Discuss with responsible company official



Essential reading

Chapter 14 of the Essential reading examines the reasons why exceptions may occur and the appropriate response from the auditor. It also looks at the appropriate response from the auditor where the reply is unreliable.

The Essential reading is available as an Appendix of the digital edition of the Workbook.



Activity 5: External confirmation

The following are the results from the external confirmation carried out at 30 September 20X6 for Dress You Like Co:

Customer	Balance per ledger	Balance per response	Reason for the difference
	\$'000	\$'000	
Dress for the Occasion	92	53	Cash in transit (\$39,000)
Ewan Trading	29	29	-
Fred's Fashions	47	43	Disputed invoice (\$4,000)
Girls on the Go	13	11	Goods not received at year end (GDN no.127057)
In all Weather	16	16	-
Look the Part	124	124	-
Upward Trends	17	8	Goods not received at year end (GDN no.127058)

Customer	Balance per ledger	Balance per response	Reason for the difference
	\$'000	\$'000	
Jasco Supermarket	11,800	11,580	Disputed invoice (invoice no.126425)

Required

Detail the audit procedures you would perform on each of these responses.

Solution

1.4 Cut-off testing

If a set of financial statements is to 'present fairly' the activities of a business, it is important that transactions and events have been recorded in the correct accounting period. Consequently, an auditor would perform 'cut-off' testing. Cut-off testing for receivables and revenue is linked. You will cover the audit of revenue in Section 2 of this chapter.



Example

The following is a schedule which summarises the results of the 'cut-off' testing performed in relation to Dress You Like Co's revenue at 30 September 20X6:

Details of the last three goods despatched notes (GDNs) issued on 30 September 20X6

GDN #	Date	Invoice #	Date	Accounted for in y/e	Correctly recorded ?
127056	30.9.X6	127056	30.9.X6	30.9.X6	Y
127057	30.9.X6	127057	30.9.X6	30.9.X6	Y
127058	1.10.X6	127058	1.10.X6	30.9.X6	N

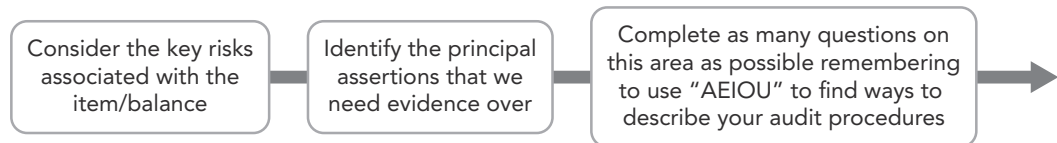
Details of the first three goods despatched notes (GDNs) issued on 1 October 20X6

GDN #	Date	Invoice #	Date	Accounted for in y/e	Correctly recorded ?
127059	1.10.X6	127059	1.10.X6	30.9.X6	N
127060	1.10.X6	127060	1.10.X6	30.9.X7	Y
127061	2.10.X6	127061	2.10.X6	30.9.X7	Y

1.5 Other audit procedures

The external confirmation is not the only means by which evidence is gained.

The best way to generate a wide range of audit procedures relating to receivables is to:



The following table contains substantive audit procedures (other than external confirmation) for receivables matched to the financial statement assertions they test. This table is for reference only, the procedures should not be learned by heart, but may be useful when practising exam questions.

It is worth noting that some of the audit procedures test for **more than one assertion**. For example:

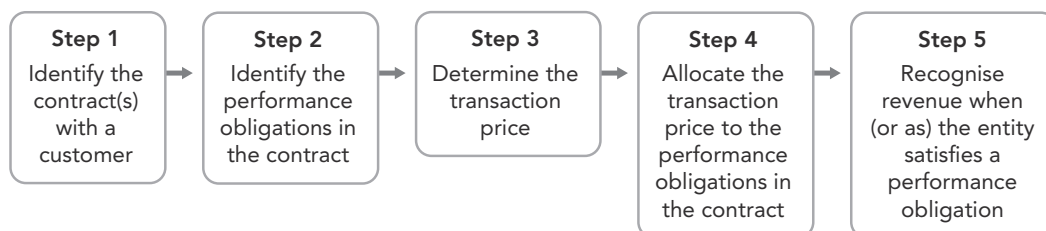
- Reviewing after-date cash receipts is an excellent test for both valuation and existence.
- Comparing the gross profit per product line with the previous year tests for the existence and completeness of receivables, as well as the occurrence and accuracy of sales and the completeness, occurrence, accuracy and classification of cost of sales.

Completeness	- Obtain a breakdown of the trade receivables figure per customer for both the current and the previous period and compare the level of trade receivables year on year. Discuss any obvious omissions/unusual trends with management. (Note that this procedure can also be carried out in relation to items such as prepayments). - Select a sample of GDNs issued during the year and vouch them to the relevant sales invoice. Inspect the revenue and receivables accounts in the nominal ledger to ensure that the invoice has been accurately recorded in the correct accounting period. - Obtain a copy of the aged receivables listing, re-cast the total to ensure it is accurate. Agree the balance on the aged receivables listing to the nominal ledger and trace through to the financial statements to ensure all balances are recorded.
Rights and obligations	- Review monies received post year-end for evidence of the balance owed being paid to the audit client, therefore confirming that the debt was due to them. - Inspect the responses from the direct confirmation for evidence of the customer's name and address to verify that the customer has confirmed that the outstanding balance is due to the audit client. - For a sample of balances due at the year-end vouch the outstanding balance back to sales invoices and GDNs to verify that the goods were delivered and that the amount is due to the audit client.

Accuracy, valuation and allocation	• Inspect the aged receivables listing for old and overdue amounts. Discuss the recoverability of these amounts with management and consider whether any write offs or allowances are necessary. • Compare the receivables collection period ratio for the current and prior year and discuss any significant variations with management. • Agree monies received post year end from receivables at the year to the cash book, therefore confirming that the balance is recoverable. • Examine credit notes issued post year end and determine whether they relate to pre year sales and if so whether an allowance should be made against that balance. • Review the adequacy of the allowance for receivables through discussion with management and the review of correspondence from customers.
Existence	• For a sample of balances owed at the year-end, carry out a direct confirmation of receivables, investigate any balances which do not agree and vouch explanations to supporting documentation. • Review monies received post year-end to confirm that the balance existed at the year-end. • Inspect customer correspondence/complaints files to identify any concerns over the existence of receivables.

2 Revenue

Receivables will often be tested in conjunction with revenue. The audit of revenue requires an awareness of IFRS 15 *Revenue from Contracts with Customers* which sets out the process of recognising revenue using the following five steps:



The key assertions for revenue are occurrence, completeness and accuracy. Auditors are seeking to obtain evidence that revenue exists and pertains to the entity (**occurrence**) and is completely and accurately recorded (**completeness and accuracy**).

It is also important to test that revenue is recorded in the correct period (**cut-off**). This has already been covered in Section 1.4 of this chapter.

2.1 Testing revenue

Analytical procedures are important when testing completeness of revenue. A client is likely to have a great deal of information about company revenue and should be able to explain any fluctuations and variances. Auditors should consider the following:

- The **level of revenue** over the year, compared on a month-by-month basis with the previous year
- The effect on revenue value of **changes in quantities** sold
- The effect on revenue value of **changes in products or prices**
- The level of goods **returned, allowances** and **discounts**
- The **efficiency of labour** as expressed in revenue or profit before tax per employee

- 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 procedures, 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 revenue (**GDNs** or **till rolls** for example) and trace revenue 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 GDNs.

You must remember the direction of this test. Since we are checking the completeness of recording of revenue in the sales ledger, we cannot take a sample from the ledger because the sample would not include what has not been recorded.



Example - Revenue completeness testing

The following is a schedule which summarises the results of the completeness testing performed in relation to Dress You Like Co's revenue at 30 September 20X6:

Standard Order Form #	Standard Order Form \$	GDN #	GDN \$	Sales invoice #	Sales invoice \$	Revenue correctly recorded in receivables ledger?	Notes
125847	10,600	154845	10,600	100652	10,600	Y	
126245	6,500	155352	6,500	101542	6,500	Y	
127546	2,699	156875	2,699	102356	2,699	Y	
128362	8,125	157545	8,125	103222	8,152	N	\$27 difference
							Order was delivered by 2 deliveries
		158005,	17,800				\$1,000 difference
128998	25,800	158966	7,000	103965	24,800	N	
129875	17,775	159655	17,775	104567	17,775	Y	
130055	5,225	160058	5,225	105278	5,225	Y	
130854	21,600	160847	21,600	106147	21,600	Y	

The following table contains substantive audit procedures (other than those discussed previously) for revenue matched to the financial statement assertions they test. This table is for reference only, the procedures should not be learned by heart, but may be useful when practising exam questions.

Completeness	• Obtain a breakdown of revenue for the period on a month by month basis, a product by product basis and/or per customer and compare to prior period/budget. Discuss any significant differences with management. • Compare the gross product percentage by product line with the previous year and/or industry data. Discuss any significant differences with management.
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.
Cut-off	• For a sample of invoices around the year end, inspect the dates and compare with the dates of despatch 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. • Perform analytical procedures on sales returns, comparing the ratio of sales returns to sales.
Occurrence	• For a sample of sales transactions recorded in the ledger, vouch the sales invoice back to customer orders and despatch documentation.

3 Testing prepayments

The following procedures should be considered when testing prepayments:

Completeness

- **Compare** the level of prepayments to the previous year to ensure the figure is reasonable and complete
- **Review detailed statement of financial position** to ensure all likely prepayments have been included

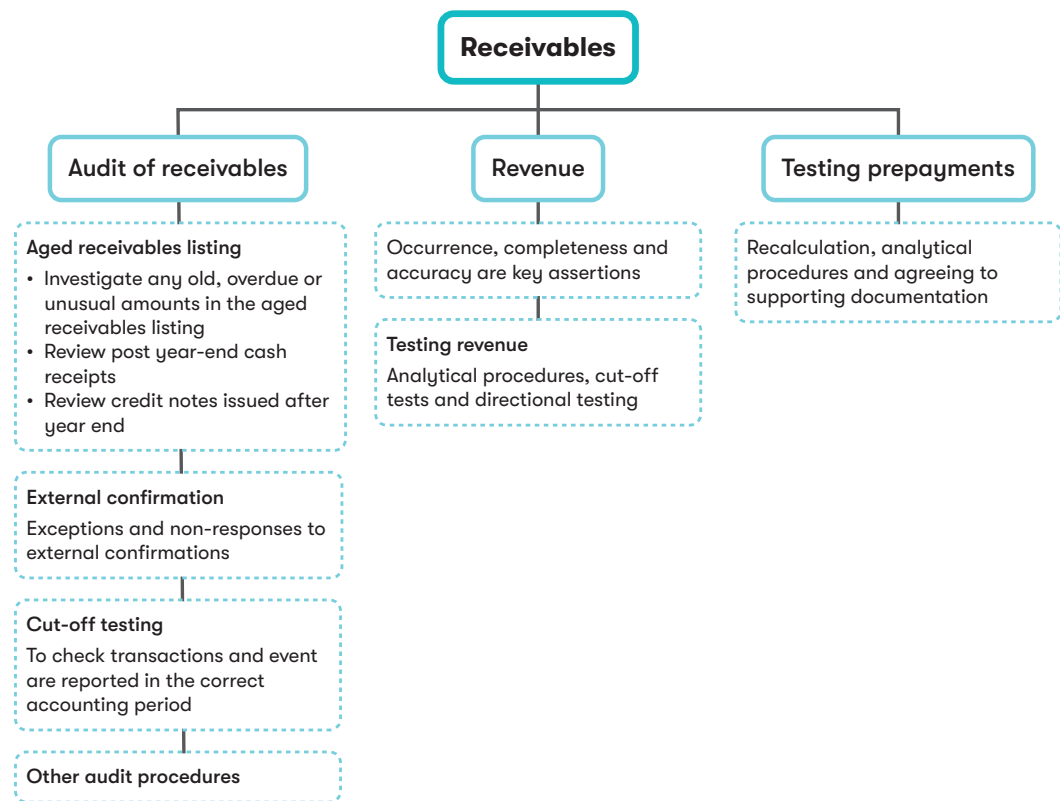
Accuracy, valuation and allocation

- For a sample of prepayments from the prepayments' listing, **recalculate** the amount prepaid to ensure that it has been accurately calculated

Existence

- Verify by reference to invoices, cash book and correspondence

Chapter summary



Knowledge diagnostic

1. Receivables confirmation

External confirmation of receivables is a key procedure. Exceptions must be investigated as these may indicate misstatements. Further audit procedures must be performed for any non-response.

2. Other procedures

External confirmation does not give evidence on all the relevant assertions. Other important procedures are cut-off tests and tests to determine recoverability such as looking at cash receipts after the year-end.

3. Key assertions

Key assertions for revenue are occurrence, completeness and accuracy.

4. Key audit procedures for revenue

Analytical procedures are a way of detecting unexpected fluctuations or variances that could indicate misstatements in revenue. Other key tests are cut-off tests and directional testing (for completeness).

5. Key audit procedures for prepayments

Key procedures for prepayments are recalculation, analytical procedures and vouching to supporting documentation such as external invoices.

Further study guidance

Question practice

Now try the following from the Further question practice bank [available in the digital edition of the Workbook]:

Section A Q2 items 4 and 5, and Q31 on trade receivables

Section A Q28 on revenue

Section B 'Bright Sparks' on trade receivables procedures

Further reading

There is one technical article on the ACCA website written by members of the AA examining team which are relevant to some of the topics covered in this chapter that you should read:

- *The audit of financial statement assertions* <https://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/assertions.html>

Own research

You could read ISA 505 *External Confirmations* available on the IFAC website <https://www.iaasb.org/publications/2020-handbook-international-quality-control-auditing-review-other-assurance-and-related-services>

Activity answers

Activity 1: Aged receivables listing

- 1 The balance of \$11,800,000 due from Jasco Supermarket is the largest balance owed and \$5,900,000 of this has been outstanding for 90 days or more. The supermarket gets 60-days credit but any issues with the recoverability of this amount could impact the financial statements.

There are old balances due from:

- Clothing Terrain (\$2,000)
- Fred's Fashions (\$4,000)
- Holly Aristocrat (\$12,000)
- Ivory Gowns (\$2,000)
- Look the Part (\$1,000)

These balances would need to be investigated to assess the likelihood of payment being received.

Everyday Wear has a credit balance of \$6,000 of their account. Why is this and should this amount be shown as a payable rather than a receivable?

- 2 Inspect/review the aged receivables listing for old, overdue and unusual amounts. Discuss the recoverability/accounting treatment of these items with management to ensure that receivables are appropriately valued in the financial statements.

Activity 2: Post year end cash receipts

- 1 Jasco Supermarket has only paid \$5,680,000 out of the \$11,800,000 owed at the year-end. However, because the supermarket gets 60-days credit, the amount which should have been paid in October and November is \$5,900,000 (\$2,300,000 + \$3,600,000). This means that there is an amount of \$220,000 which should have been paid but which has not.

Clothing Terrain has paid all but \$2,000 of the amount due at the year-end. The \$2,000 outstanding may well relate to the balance due > 90 days and so the recoverability of this amount could be doubtful.

There has been no movement on the \$6,000 credit balance of Everyday Wear.

Fred's Fashions Terrain has paid all but \$4,000 of the amount due at the year-end. The \$4,000 outstanding may well relate to the balance due > 90 days and so the recoverability of this amount could be doubtful.

Holly Aristocrat has paid all but \$10,000 of the amount due at the year-end. There was a balance of \$12,000 due > 90 days at the year end. Again, the recoverability of this amount could be doubtful.

Ivory Gowns has not paid any of the \$2,000 due at the year-end. This balance is already due > 90 days and it does not look like there has been any continued trade with the customer. The recoverability of this amount is likely to be doubtful.

Odd One Out has paid all but \$5,000 of the amount due at the year-end. There does not appear to be any particular reason for this.

We're Going Exploring does not appear to have paid the \$7,000 which has been due for 90 days. The reason for this needs to be investigated.

- 2 Review post year-end cash receipts for evidence that the balance exists, is due to the audit client and is recoverable.

Activity 3: Post year end credit notes

- 1 The \$220,000 which should have been paid by Jasco Supermarket in October/November but was not related to a disputed invoice. Given that a credit has been issued for this amount post year-end, the balance was not an asset at the year-end and an adjustment should be made to the financial statements to reduce both revenue and receivables by \$220,000. The same point applies to the credit notes issued to Holly Aristocrat and Odd One Out. These amounts should be removed from revenue and receivables at the year-end.
- 2 Review credit notes issued to customers post year-end. Where the credit note relates to a pre year-end invoice, discuss the need for an adjustment in the financial statements in order to ensure that receivables are appropriately valued at the year-end.

Activity 4: Audit procedures

The correct answer is: Evaluation of the adequacy of the allowance for receivables

Automated tools and techniques can be used to extract samples and perform calculations but they cannot evaluate this information.

Activity 5: External confirmation

Dress for the Occasion:

- Trace the cash in transit of \$39,000 to the cash receipts book post year-end. Vouch that it was received within a few days of the year-end.

Fred's Fashions and Jasco Supermarket:

- Discuss the reason for the disputed invoice with management and review the customer correspondence file for any additional information.
- Enquire from management whether a credit note has been issued post year-end in relation to this and physically verify the credit note.
- If no credit note has been issued, discuss recoverability of the amount with credit control/management.

Girls on the Go and Upward Trends:

- Inspect the GDNs numbers 127057 and 127058, and determine the date on which the goods were dispatched. If goods were not dispatched until after the year-end, request that management remove the amount from revenue and receivables and record the goods as inventory at the year-end.

Learning objectives

On completion of this chapter, you should be able to:

Syllabus learning outcomes	Syllabus reference no.
Explain the audit objectives and the audit procedures to obtain sufficient, appropriate evidence in relation to: Bank and cash:	D4 (d)
(a) Bank confirmation reports used in obtaining evidence in relation to bank and cash	
(b) Other evidence in relation to bank	
(c) Other evidence in relation to cash	

Business and Exam context

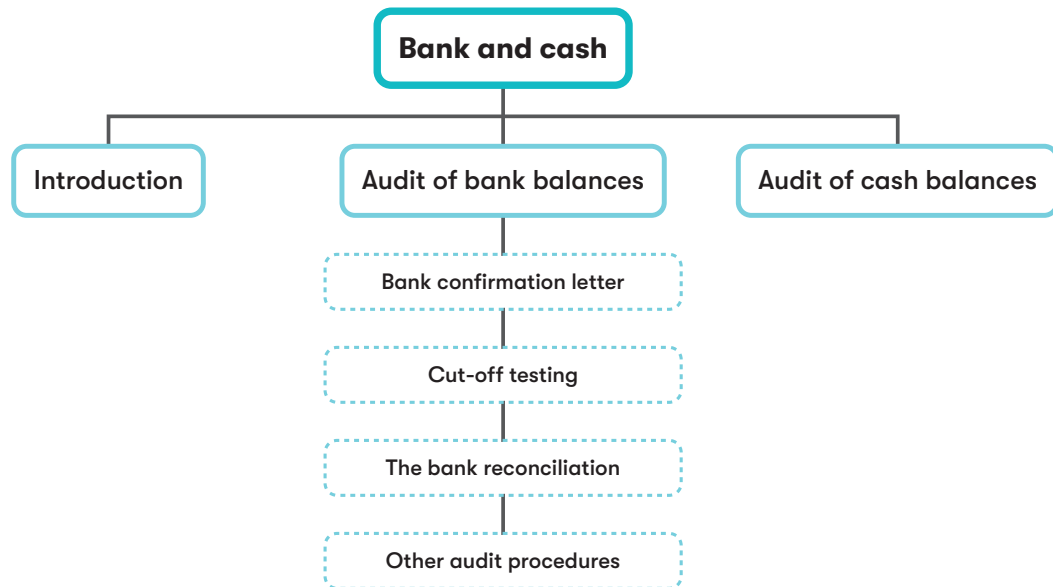
Many candidates who sit the ACCA Audit and Assurance (AA) exam do not work in audit practice. This can make it harder to see the practical nature of the subject and to learn to apply the knowledge learned. Consequently, we have tried to make this chapter relating to substantive procedures as practical as possible, so that you can apply your knowledge to exam scenarios.

Work on cash and bank will concentrate on the completeness and valuation assertions using the bank reconciliation, bank confirmation letter and counting of cash as key audit tests.

In the exam you may be asked to identify and explain audit procedures you would perform to confirm specific assertions relating to cash and bank. Shorter constructed response question requirements and OT questions in Section A may also ask for audit procedures specifically used to obtain bank confirmation letters.

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.

Chapter overview



1 Introduction

'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. In this chapter, we will consider the substantive audit testing applied to the year-end cash figure.



Essential reading

See Chapter 15 of the Essential reading for the assertions that apply to bank and cash.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2 Audit of bank balances

Throughout the chapter, we will continue to use the audit of Dress You Like Co for the year ended 30 September 20X6. The audit team has prepared the following lead schedule for the bank balances of Dress You Like Co for the current year audit:

Reference:

Client: Dress You Like Co

Prepared by:

Reviewed by:

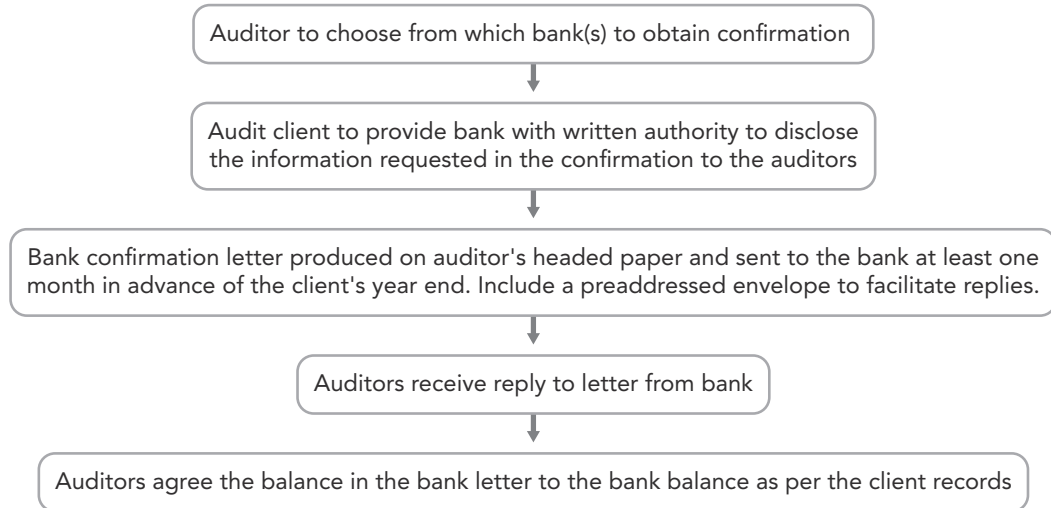
	Draft 20X6	Dr	Cr	Final 20X6	Actual 20X5
	\$'000	\$'000	\$'000	\$'000	\$'000
Bank	0				200
Bank overdraft	(750)				0
	<u>(750)</u>				<u>200</u>

2.1 Bank confirmation letter

A common procedure for the audit of an entity's bank balances is for the auditor to obtain direct confirmation from the entity's banker(s) of balances and other amounts which appear in the statement of financial position and of other information which may be disclosed in the notes to the financial statements, for example guarantees.

Bank confirmation letters are a valuable source of audit evidence because they come directly from an **independent source** and, therefore, provide greater assurance of reliability than evidence obtained solely from the client's own records. They are mentioned in ISA 505 *External Confirmations* (para. A1).

The procedure is carried out as follows:



2.1.1 Choosing where to send a confirmation request

The following matters will impact the auditor's decision as to which of the audit client's bank or banks to send a bank confirmation letter to:

- Size of balance
- Volume of activity
- Degree of reliance on internal control
- Materiality to the financial statements

2.1.2 Written authority

Banks require written authority from their customers to disclose the information requested by the auditors in a bank confirmation letter. This often takes the form of an ongoing standing authority rather than a separate authority each time information is requested.

The auditors' request must refer to the client's letter of authority and the date given in it. Alternatively, it may be countersigned by the client or it may be accompanied by a specific letter of authority. In the case of joint bank accounts, letters of authority signed by all parties will be necessary.

2.1.3 Preparation and despatch of the bank confirmation letter

Control over the content and dispatch of confirmation requests is the responsibility of the auditor.

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

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. 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, of 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 letters and bills. Banks often hold securities and other items in safe custody on behalf of customers. A request letter may therefore ask for confirmation of such items held by the bank.



Essential reading

See Chapter 15 of the Essential reading for further details and an example of a bank confirmation request letter.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2.1.4 Replies

Replies should be returned directly to the auditors and the auditors should check that the bank's response covers all the information requested. 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 request a response only if the information submitted is incorrect or incomplete.

2.1.5 Agreement to client records

For any response received, the auditors must agree the amounts in the bank confirmation letter to the bank balance in the client's accounting records. Any differences will need to be investigated as they could indicate a misstatement in the cash figure given in the financial statements.

2.2 Cut-off testing

When auditing cash balances, 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 despatched 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 despatch occurred after the year end.

As you can see, performing cut-off testing for transactions at the end of the reporting period gives assurance over the **completeness** and **existence** of cash balances at that date.



Activity 1: Bank reconciliation

Below is the bank reconciliation of Dress You Like Co as at 30 September 20X6:

Dress You Like Co

Bank Reconciliation 30 September 20X6

	\$	\$
Balance per bank statement 30 September 20X6		(758,389)
Add: deposits outstanding		
29 September (ref 1122)	10,222	
30 September (ref 1123)	25,000	<u>35,222</u>
		(723,167)
Less: outstanding cheques		
2411	10,250	
2721	2,300	
2722	5,000	
2723	1,345	
2724	1,900	
2726	2,200	
2728	1,006	
2729	1,577	
2730	1,255	<u>26,833</u>
Balance per bank in the general ledger		<u><u>(750,000)</u></u>

- 1 Consider the information in the bank reconciliation above.

Required

- (a) Which of the outstanding cheques might require investigation and why?
 - (b) Describe an audit procedure you would perform in relation to the outstanding cheques, documenting the reason for this procedure.
- 2 Describe audit procedures you would perform in relation to the deposits outstanding, documenting the reason for these procedures.
 - 3 Describe any other audit procedures you would carry out on the bank reconciliation of Dress You Like Co, making sure you document the reason for each procedure.

Solution

2.3 Audit procedures for bank

The following table contains audit procedures for bank matched to the financial statement assertions they test. This table is for reference only, the procedures should not be learned by heart, but may be useful when practising exam questions.

Financial statement assertion	Audit procedure
Completeness and existence	• Obtain standard bank confirmations from each bank with which the client conducted business during the audit period. • 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. • 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.
Valuation	• Reperform arithmetic of bank reconciliation. • 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. • Verify contra items appearing in the cash book or bank statements with the 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 re-presentation or that other appropriate steps have been taken to effect recovery of the amount due.

Financial statement assertion	Audit procedure
	• 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.
Rights and obligations	• Determine whether the bank accounts are subject to any restrictions by enquiries with management.
Classification	• 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. • Review draft accounts to ensure that disclosures for bank are complete and accurate and in accordance with accounting standards.

3 Audit of cash balances

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**, 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.

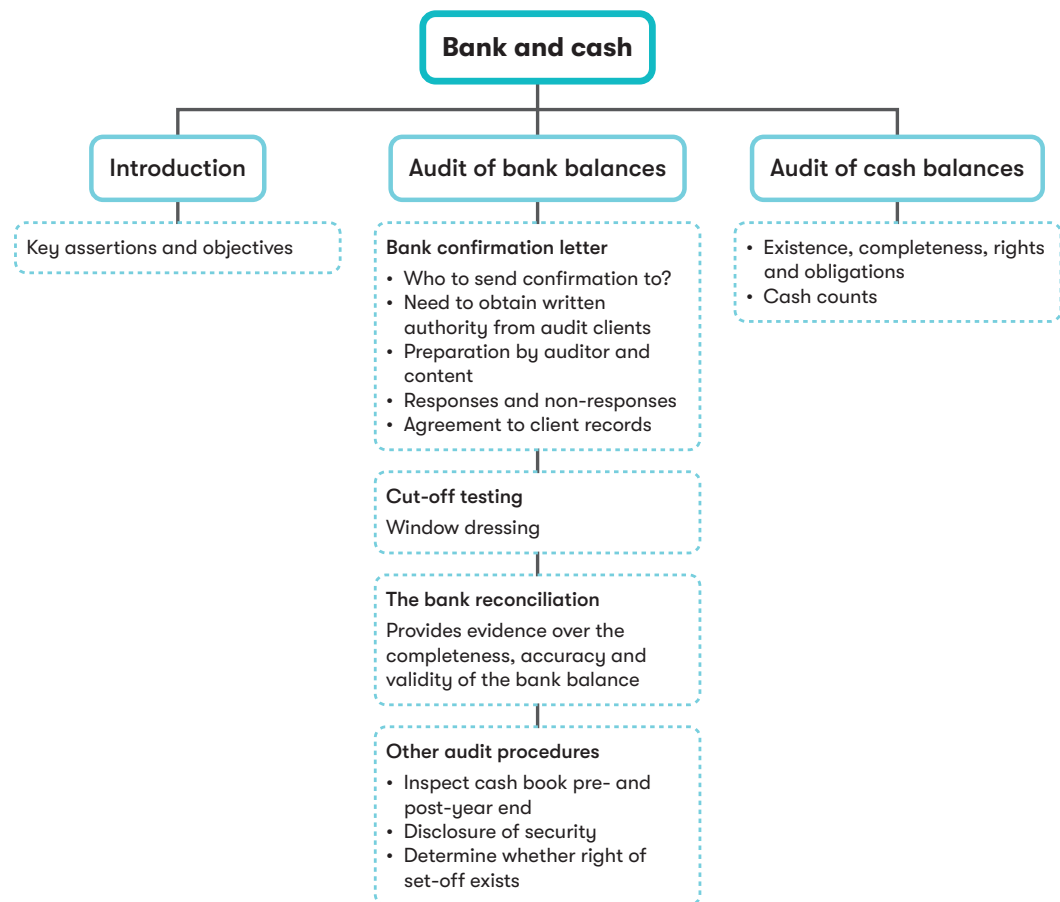


Essential reading

See Chapter 15 of the Essential reading for details of planning, performing and following up a cash count.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

Chapter summary



Knowledge diagnostic

1. Definition of cash

'Cash' in the financial statements represents cash-in-hand and cash on deposit in bank accounts.

2. Bank confirmation letters

Bank confirmation letters are a reliable source of evidence in respect of the main financial statement assertions relating to bank and cash.

3. Bank authority letter

Audit clients must provide **written authority** to their banks so the banks can respond to the auditor's confirmation request.

4. Bank reconciliation

The client's **bank reconciliation** must also be tested in detail, in order to verify that reconciling items are genuine.

5. Cash counts

If cash-in-hand is material the auditor will perform a cash count.

Further study guidance

Question practice

Now try the following from the Further question practice bank [available in the digital edition of the Workbook]:

- Section B Q70 on the audit of cash and bank

Further reading

There is one technical article on the ACCA website written by members of the AA examining team which are relevant to some of the topics covered in this chapter that you should read:

- *Examining evidence* (www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p7/technical-articles/examining-evidence.html)

Own research

The audit failure exposed at Satyam Computers in India in 2009 demonstrates what can happen if bank and cash are not audited in line with the auditing standards.

You can read more about how the auditors failed to audit bank and cash effectively in this case at www.nytimes.com/2011/04/06/business/global/06audit.html

Activity answers

Activity 1: Bank reconciliation

1 Considerations:

- (a) 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.
- (b) Trace the cheques shown as outstanding on the bank reconciliation to the cash book prior to the year end. Ensure they have cleared the bank by looking at the after-date bank statements to ensure that the bank balance is not understated. Obtain explanations for any that have not cleared at the time of the audit.

2 Verify that the uncleared bankings (deposits outstanding – ref 1122 and 1123) were paid in prior to the year-end by checking paying-in slips to ensure that they should be recorded in the year being audited.

Review whether the uncleared bankings cleared quickly after the year end. Any that have not cleared soon after the year end should be investigated as they could indicate window-dressing and an overstatement of the cash balance.

3 Agree the balance per bank statement at 30 September 20X6 as shown on the reconciliation (\$758,389) to the bank statement and to the amount for that account shown on the bank confirmation letter.

Test arithmetic of bank reconciliation by recasting it.

Review the bank reconciliation previous to the year-end bank reconciliation (31 August 20X6 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 30 September 20X6.

Verify that the year-end balance per the general ledger according to the reconciliation (\$750,000) agrees with the general ledger account balance at 30 September 20X6 and that this has been properly reflected in the financial statements.

16

Payables and accruals

Learning objectives

On completion of this chapter, you should be able to:

Syllabus learning outcomes	Syllabus reference no.
Explain the audit objectives and the audit procedures to obtain sufficient, appropriate evidence in relation to: Payables and accruals: (a) Supplier statement reconciliations and direct confirmation of accounts payable (b) Obtain evidence in relation to payables and accruals (c) Obtain evidence in relation to current liabilities (d) Purchases and other expenses, including payroll	D4 (c)
Explain the audit considerations relating to entities using service organisations.	D6 (c)

Business and Exam context

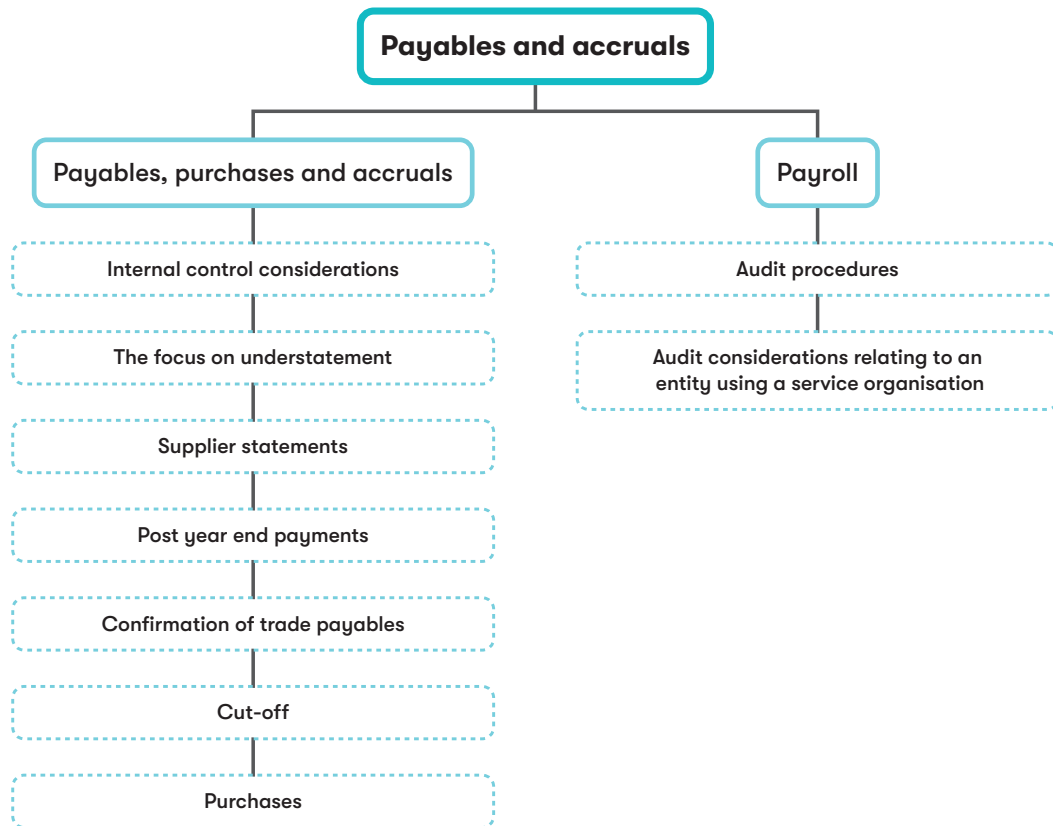
Many candidates who sit the ACCA AA exam do not work in audit practice. This can make it harder to see the practical nature of the subject and to learn to apply the knowledge learned. Consequently, we have tried to make this chapter relating to substantive procedures as practical as possible, so that you can apply your knowledge to exam scenarios.

In this chapter, we examine the audit of payables, purchases, accruals and payroll. When auditing payables, the auditor must test for understatement (ie completeness). Rather than circularising payables, it is more common to obtain audit evidence from suppliers' statements.

You may be asked to identify and explain audit procedures you would perform to confirm specific assertions relating to payables and accruals. For example, you may be asked for the substantive audit procedures in respect of payroll or administrative expenses.

Every type of liability covered in this chapter can form the basis of a constructed response question in the exam, either in full or in part. The audit procedures and financial statement assertions can also be tested in the form of OT questions in Section A.

Chapter overview



1 Payables, purchases and accruals

1.1 Internal control considerations

The audit of payables is closely linked to the purchases system. We looked at controls over the purchases system in Section 3 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.

1.2 The focus on understatement

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.

However, auditors should 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?



Essential reading

See Chapter 16 of the Essential reading for further details on the assertions that apply to trade payables, purchases and accruals.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

Throughout this chapter we will continue to use the audit of Dress You Like Co for the year ended 30 September 20X6. The audit team has prepared the following lead schedule for the audit of payables and accruals of Dress You Like Co for the current year:

Reference:

Client: Dress You Like Co

Prepared by:

Reviewed by:

Date: 1/11/X6

	Draft 20X6	Dr	Cr	Final 20X6	Actual 20X5
	\$'000	\$'000	\$'000	\$'000	\$'000
Payables:					
Trade	2,060				1,470
Other	<u>500</u>				<u>450</u>
	<u>2,560</u>				<u>1,920</u>

1.3 Supplier statements



Activity 1: Supplier statements

Dress You Like Co receives supplier statements on a monthly basis from all suppliers, including the main supplier in China, Li Huang Textiles Ltd (LHT Ltd). Other small suppliers provide mainly sundry items such as zips, buttons and threads. The supplier statement from LHT Ltd is reconciled to the purchase ledger account but supplier statements from the other suppliers are not. Check & Co have selected balances from a sample of suppliers as at 30 September 20X6.

Supplier name	Supplier statement balance	Purchase ledger balance
	\$'000	\$'000
Freda's Fabrics	155	92
Threads for You	78	78
Material Matters	85	85
Wickhams Wools	33	33
David Designs	32	32
Fabricated	200	106
Sang Silks	25	25
Dot's Cottons	102	102
Three Linens Ltd	100	65
Penelope Prints Shop	198	142
LHT Ltd	<u>1,300</u>	<u>1,300</u>
Total	<u>2,308</u>	<u>2,060</u>

Required

- 1 Which of the payables balances would you investigate and why?
- 2 Write out the audit procedure you have conducted above documenting the reason for the audit procedure.

Solution



Essential reading

See Chapter 16 of the Essential reading for further details on supplier statement testing. The Essential reading is available as an Appendix of the digital edition of the Workbook.

1.4 Post year end payments



Activity 2: Post year end payments

The following is a schedule of work performed on post year end payments by the audit team at Dress You Like Co. The work covers the period immediately after the year-end:

Date of payment	Amount paid \$'000	Explanation	Included in purchase ledger or accruals?
1/10/20X6	25		Yes
1/10/20X6	36	Payment for invoice to Freda's Fabrics dated 12/09/20X6	No
2/10/20X6	44		Yes
2/10/20X6	21		Yes
3/10/20X6	15		Yes
3/10/20X6	98		Yes
4/10/20X6	63		Yes
4/10/20X6	51		Yes
5/10/20X6	35	Payment for invoice to Three Linens Ltd dated 29/09/20X6	No
5/10/20X6	79	Payment for invoice to Fabricated	No

Date of payment	Amount paid \$'000	Explanation dated 1/10/20X6	Included in purchase ledger or accruals?
6/10/20X6	20		Yes
6/10/20X6	75		Yes
7/10/20X6	65		Yes
7/10/20X6	8	Payment for internet, July-September 20X6	No

Required

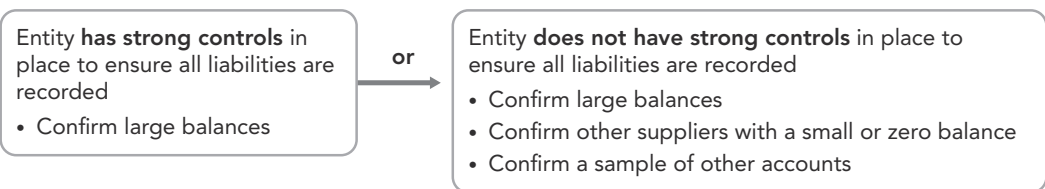
- 1 Consider the information in the schedule above. What evidence does it provide about the payables balance at the year end?
- 2 Write out the audit procedure you have conducted above documenting the reason for the audit procedure.

Solution

1.5 Confirmation of trade payables

We have already discussed the receivables confirmation 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 statements.

However, where an entity's internal controls are assessed as deficient, 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.



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. Differences between the balance confirmed and that on the payables ledger are likely to be for reasons that are similar to those for the receivables confirmation, ie goods in transit, cash in transit, or disputed invoices. Any differences should be **investigated** and **reconciled**.

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.

1.6 Cut-off

If a set of financial statements is to 'present fairly' the activities of a business, it is important that transactions and events have been recorded in the correct accounting period. Consequently, an auditor would perform 'cut-off' testing. Cut-off testing for trade payables is similar to the cut-off testing for revenue and inventory you have already learnt about in earlier chapters.



Example - Cut-off testing

From the inventory count working papers of Dress You Like Co, the number of the last GRN that was issued before the year-end was noted. Check & Co selected a sample of GRNs issued in the period at least two weeks either side of the year-end.

Before year end

GRN #	Date	Included in purchases ledger at 30/09/20X6	Correctly recorded
165258	30.9.X6	Yes	Yes
165259	30.9.X6	Yes	Yes
165260	30.9.X6	No	No

After year end

GRN #	Date	Included in purchases ledger at 30/09/20X6	Correctly recorded
165261	1.10.X6	Yes	No
165262	1.10.X6	No	Yes
165263	2.10.X6	No	Yes

1.6.1 Other audit procedures: payables and accruals

The following table contains audit procedures for payables and accruals matched to the financial statement assertions they test. This table is for reference only, the procedures should not be learned by heart, but may be useful when practising exam questions.

Financial statement assertion	
Completeness and existence	Perform analytical procedures comparing payables and accruals to previous year-end, budgets or industry data, eg calculating payables payment period or compare accruals listing to prior year
Rights and obligations	Vouch selected amounts from the trade accounts payables listing and accruals listing to supporting documentation such as purchase orders and suppliers' invoices
Valuation	For a sample of accruals, recalculating the amount of the accrual to ensure the amount accrued is correct
Classification	Review the trade accounts payables listing to identify and large debits (which should be reclassified as receivables or deposits) or long-term liabilities which should be disclosed separately
Presentation	Read the disclosure notes relevant to payables and accruals in the draft financial statements to ensure the information is accurate and properly presented at the appropriate amounts

1.7 Purchases

Auditing payables provides some evidence over the purchases expense but we would also perform other procedures such as analytical procedures.



Example – Analytical review of purchases

Check & Co have prepared the below schedule which compares the purchases of Dress You Like Co for the year ending 30 September 20X6 with the purchases for the year ending 30 September 20X5. Performing analytical procedures on expenses can enable Check & Co to identify areas where further audit procedures may be required.

Purchase	30/09/20X6	30/09/20X5	Difference	Difference
	\$'000	\$'000	\$'000	%
Fabric	45,276	37,912	7,364	19%
Buckles, hooks and clips	75	75	-	0%
Thread	185	180	5	3%
Buttons	89	89	-	0%
Zips	50	75	(25)	-33%
Beads and sequins	102	66	36	55%
Payroll	12,677	11,721	956	8%
Telephone and internet	50	49	1	2%
Electricity	85	82	3	4%
Insurance	33	32	1	3%

Purchase	30/09/20X6	30/09/20X5	Difference	Difference
	\$'000	\$'000	\$'000	%
Equipment maintenance	39	25	14	56%
Transportation costs	145	189	(44)	-23%
Other purchases	469	485	16	-3%
Total cost of sales	59,275	50,980	8,295	16%

Looking at the schedule, we can see that the largest purchase for Dress You Like Co is fabric. This has increased by 19% since the prior year. The auditors will need to ascertain why this is. Perhaps the cost of fabrics has increased or Dress You Like Co is manufacturing more products and extra fabric is required. Or alternatively, there has been a misstatement and the figure for purchases of fabric is too high, due to an issue with cut-off of purchases, for example. Check & Co need to obtain evidence that the increase is genuine.

Further down the schedule, we can see that the purchases of zips have fallen by 33% which is unusual. Transportation costs have also fallen by 23% which seems strange. Both these variances will need further investigation by the auditors. There may be some costs missing which have been allocated incorrectly.

The figure for equipment maintenance has increased by 56% year on year. This may be a legitimate increase as the company's equipment ages over time. Or the increase might be due to a misclassification of costs from another area that should not be included in cost of sales. The same applies to the 55% increase in the cost of beads and sequins. Check & Co will need to look into both these increases.

Payroll has increased by 8% year on year and will be covered in the next section of this workbook.

1.7.1 Other audit procedures: purchases and other expenses

The following are procedures specifically related to the audit of purchases and other expenses:

- Inspect a sample of purchase invoices to ensure they agree to the amount posted to the general ledger.
- 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.
- Enquire 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)
- Recalculate accruals and prepayments to gain evidence that other expenses are not over or understated.
- Compare gross profit margin with the previous year, the gross margin per the budget and expectations. Investigate any unexpected fluctuations.

2 Payroll

One expense that may make up a significant proportion of expenses is the wages cost included in the statement of profit or loss. It is important you know procedures that can be used when auditing this area.



Activity 3: Payroll Expense

The management accounts of Dress You Like Co contain the following schedule which compares the payroll expense for the years ending 30 September 20X6 and 30 September 20X5:

Payroll expense

	Oct	Nov	Dec	Jan	Feb	Mar	
	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000	
20X4-20X5	933	1,165	1,180	936	937	937	
20X5-20X6	980	1,254	1,508	990	995	989	
	Apr	May	Jun	Jul	Aug	Sep	Total
	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000
20X4-20X5	937	937	937	940	942	940	11,721
20X5-20X6	988	991	992	993	999	998	12,677

Required

- 1 Consider the information in the above schedule. Explain any matters that might require investigation.
- 2 Write out the audit procedure you have conducted above stating the objective of the audit procedure.
- 3 Can you suggest any other audit procedures you would perform on this schedule?

Solution



Activity 4: Payroll

The audit team at Check & Co have selected a sample of employees from the payroll records at Dress You Like Co. For each employee selected, Check & Co has agreed the monthly remuneration in the payroll records to the personnel records detailing salaries.

Required

Over which of the following assertions would the audit procedure detailed above provide evidence?

- ☐ Completeness
- ☐ Rights and obligations
- ☐ Occurrence
- ☐ Existence

2.1 Other audit procedures: payroll

Other audit procedures that auditors may perform on payroll are as follows:

- (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. Investigate any significant differences by discussing with management.
- (f) Reperform calculations of statutory deductions to establish whether valid deductions have been included in the payroll expense
- (g) Select a sample of employees from the payroll and recalculate their gross and net pay.
- (h) Select a sample of employees from the payroll and agree their pay in the payroll records to personnel records such as employment contracts
- (i) Select a sample of employees who have joined or left the organisation during the year. Agree their start/leaving date to supporting documentation such as an employment contract or resignation letter. Ensure that the employee has been added to/removed from the payroll in the correct month. Recalculate the payroll for the month of joining/leaving to ensure its accuracy.

2.2 Audit considerations relating to an entity using a service organisation

Many companies now outsource some aspects of their business activities to external service organisations, including payroll.



Service organisation: "A third-party organisation that provides services to user entities that are part of those entities' information systems relevant to financial reporting." (ISA 402: para. 8(e))

User entity: "An entity that uses a service organisation and whose financial statements are being audited." (ISA 402: para. 8(i))

User auditor: “An auditor who audits and reports on the financial statements of a user entity.” (ISA 402: para. 8(h))

Service auditor: “An auditor who, at the request of the service organisation, provides an assurance report on the controls of a service organisation.” (ISA 402: para. 8(d))

Other examples of where service organisations may be used include the maintenance of accounting records, credit control and data entry or information processing.

ISA 402 *Audit Considerations Relating to an Entity Using a Service Organisation* provides guidance to auditors whose clients use such an organisation.

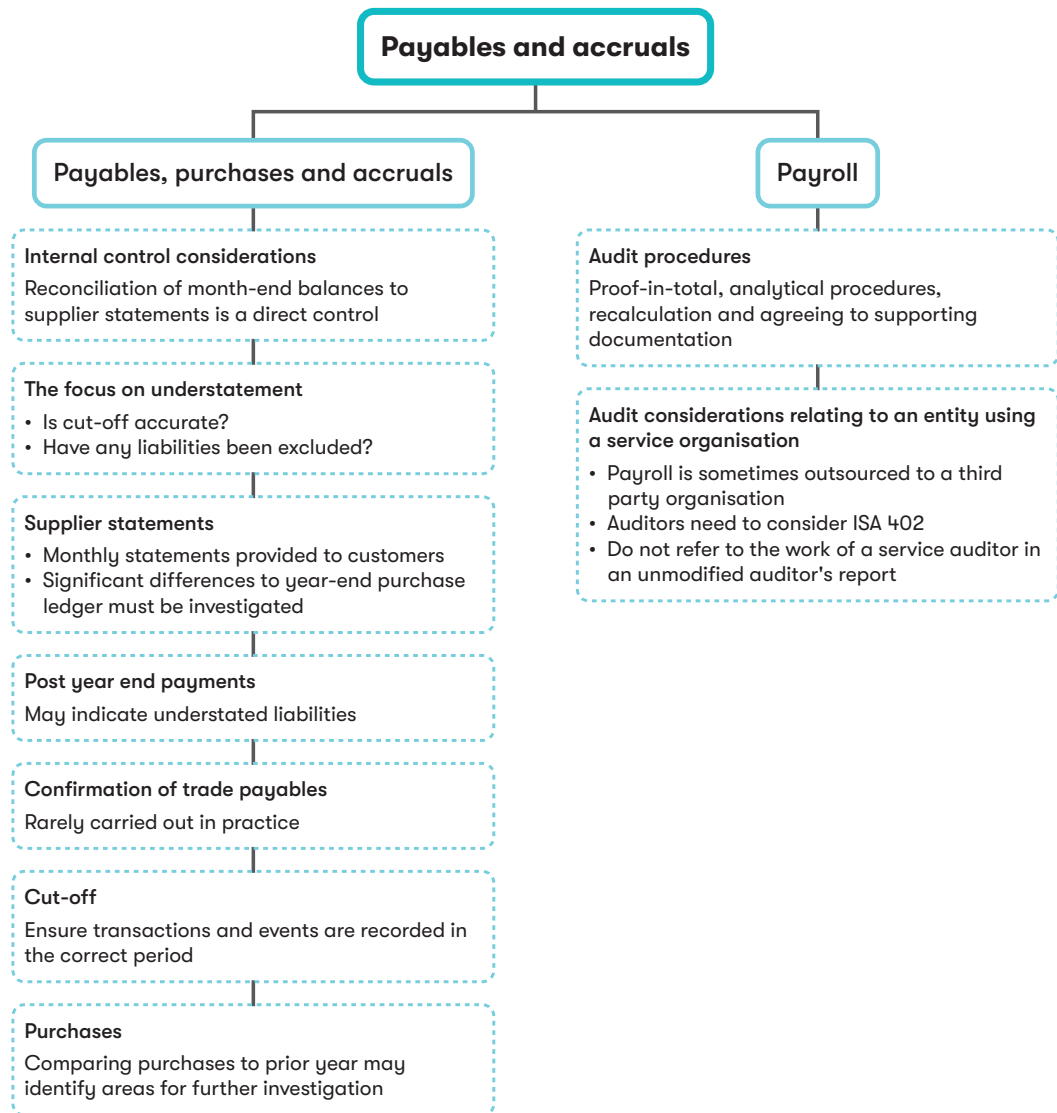


Essential reading

See Chapter 16 of the Essential reading for further details regarding audit considerations relating to an entity using a service organisation.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

Chapter summary



Knowledge diagnostic

1. Key assertion

Substantive tests on liabilities will cover all the financial statement assertions for payables and accruals but with an emphasis on testing for **understatement**, ie completeness.

2. Supplier statement reconciliations

The largest figure in **current liabilities** will normally be **trade accounts payable** which is generally audited by comparison of **suppliers' statements** with **purchase ledger accounts**.

3. Payables confirmation

A trade payables confirmation may be carried out but is often not necessary as **supplier statements** will provide documentary evidence from third parties.

4. Auditing payroll

Key payroll audit procedures include analytical review, a proof-in-total, recalculation and agreement of key figures to supporting documentation.

5. Use of a service organisation

A **service organisation** provides services to user entities, such as processing payroll. There may be special considerations for the auditor of a user entity when that entity makes use of a service organisation.

Further study guidance

Question practice

Now try the following from the Further question practice bank [available in the digital edition of the Workbook]:

Section A Q34 on cut-off

Section B Q60b(i) 'Fenton Distributors' on audit procedures to verify the accuracy of purchases

Section B Q71 'Understatement' on payables and accruals

Further reading

There are technical articles on the ACCA website written by members of the AA examining team which are relevant to some of the topics covered in this chapter that you should read:

- *The audit of financial statement assertions*: www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/assertions.html
- *Examining evidence*: www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p7/technical-articles/examining-evidence.html
- *The audit of wages*: www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/the-audit-of-wages.html

Own research

Obtain a recent set of financial statements for an organisation and look for the trade payables, accruals and payroll balances.

Consider the business where you are employed. Does the business make use of a service organisation for payroll? Or any other areas?

Activity answers

Activity 1: Supplier statements

- 1 The purchase ledger balances for Freda's Fabrics, Fabricated, Three Linens Ltd and Penelope Prints Shop are higher than the balances in the supplier statements and should all be investigated. The difference totals \$248k which is 12% of the total purchase ledger balance. The reason for each difference should be investigated as they could be indicative of an understatement of trade payables.
- 2 For a sample of suppliers, reconcile the year-end balance on the purchase ledger to the relevant supplier statement and investigate any differences. This will ensure completeness, existence and valuation of trade payables.

Activity 2: Post year end payments

- 1 The payments to Freda's Fabrics and Three Linens Ltd both relate to invoices that were dated before the year end but have not been included in the year-end purchase ledger. This means the purchase ledger is understated by \$71,000 and purchases are understated by the same amount. An adjustment should be proposed to include the \$71,000 in payables and purchases. The payment to Fabricated is correctly excluded from the purchases ledger at year-end since it relates to an invoice received after the year-end. The \$8,000 payment for internet has not been included in the accruals listing. Since it relates to the provision of internet during the year ending 30 September 20X6, this indicates an understatement of accruals. An adjustment to include the \$8,000 in accruals and expenses should be proposed.
- 2 For a sample of post year end payments in the cash book, determine whether these relate to the year ending 30 September 20X6. If they do, vouch that these amounts have been included in the purchases ledger or accruals listing to ensure completeness of payables and accruals. This test looks for unrecorded liabilities.

Activity 3: Payroll Expense

- 1 The payroll expense for November and December is significantly higher than the other months in both periods and will need investigation to ensure there is not a misstatement of the expense in these months. The increase could have a legitimate explanation such as the payment of bonuses, overtime or hiring of temporary staff for a busy period. The payroll expense for December 20X5 is \$1,508,000 and seems particularly high, being 28% higher than the expense in December 20X4. This will need investigation to determine whether the increase is genuine or a potential material misstatement. Excluding November and December, the total payroll expense has increased by 6%. The reason for this needs to be investigated to ensure it is for a genuine reason (eg annual salary increases, increased number of staff) rather than a material misstatement.
- 2 Perform analytical procedures on the monthly payroll expense, comparing to the prior year and investigate any significant differences.
- 3
 - Cast the figures in the payroll expense schedule to ensure its accuracy
 - Agree the total payroll figure in the schedule to the trial balance.
 - Agree the 20X4-20X5 payroll figure to the prior year financial statements and audit documentation.
 - Agree the total payroll expense for all months in the schedule to the computerised wages system at Dress You Like Co.
 - Agree the total payroll expense for all months in the schedule to the bank statements and cash book of Dress You Like Co

- Compare the 20X5-20X6 monthly payroll expense to budgeted figures and enquire of management the reason for any significant differences.

Activity 4: Payroll

The correct answer is: Occurrence

Testing occurrence provides evidence that the transactions and events that have been recorded or disclosed have occurred and pertain to the entity. Note that existence is an assertion relating to account balances and related disclosures at the period end.

17

Non-current liabilities, capital and directors' emoluments

Learning objectives

On completion of this chapter, you should be able to:

Syllabus learning outcomes	Syllabus reference no.
Explain the audit objectives and the audit procedures to obtain sufficient, appropriate evidence in relation to:	
Non-current liabilities, provisions and contingencies	D4 (f)
(a) Evidence in relation to non-current liabilities, and	
(b) Provisions and contingencies.	
Share capital, reserves and directors' emoluments:	D4 (g)
(a) Evidence in relation to share capital, reserves and directors' emoluments.	

Business and Exam context

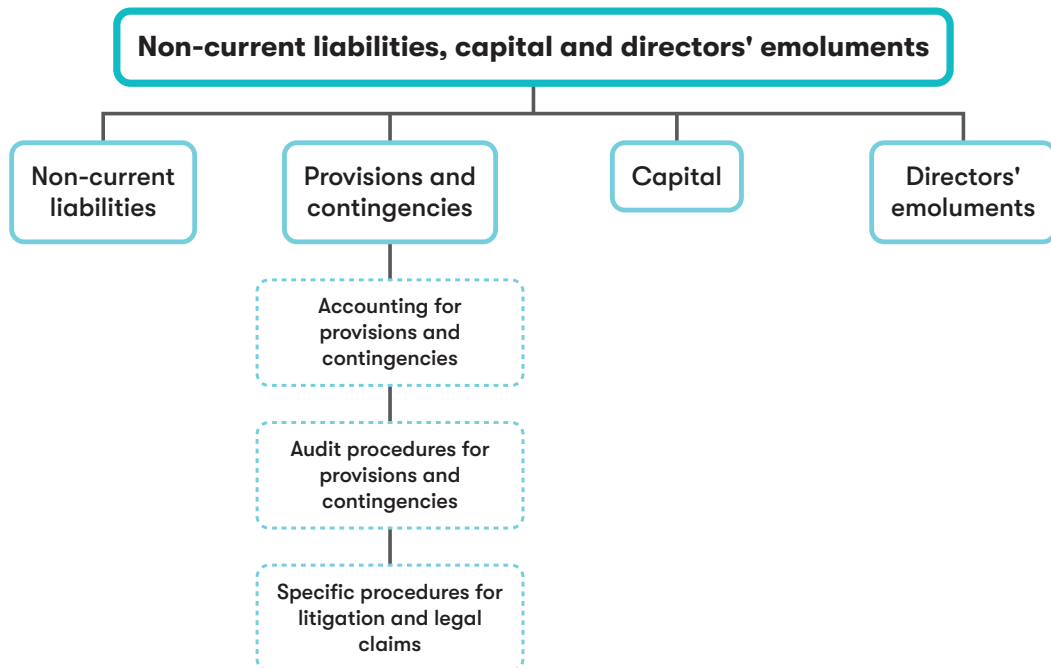
Many candidates who sit the ACCA Audit and Assurance (AA) exam do not work in audit practice. This can make it harder to see the practical nature of the subject and to learn to apply the knowledge learned. Consequently, we have tried to make this chapter relating to substantive procedures as practical as possible, so that you can apply your knowledge to exam scenarios.

In this chapter, we begin with the audit of non-current liabilities and provisions. Questions on long-term liabilities such as long-term loans may be linked to other areas you have studied in the AA syllabus. For example, as part of a question on going concern you may be required to list procedures to audit the ability of the company to repay a long-term loan. Procedures detailed in this chapter will be relevant, for instance, confirming the terms of the loan to a loan agreement or evidence of whether any covenants exist.

The audit of provisions is notoriously complex because of the degree of judgement used and the availability of sufficient audit evidence. This is likely to be tested in a mini scenario question so you must be able to apply your knowledge to the question's circumstances. For example, you may be asked for the substantive audit procedures in respect of a provision for legal claims.

The chapter ends looking at the audit of share capital, reserves and directors' emoluments. Every type of liability covered in this chapter can form the basis of a constructed response question in the exam, in full or in part. The audit procedures and financial statement assertions can also be tested in the form of OT questions in Section A or a longer Section B question.

Chapter overview



1 Non-current liabilities

Non-current liabilities include bank loans, debentures, and other loans repayable **more than one year after the year-end date**.

Auditors will primarily try to 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:** whether long-term loans and interest have been correctly disclosed in the financial statements

Audit procedures for non-current liabilities are as follows:

Objective	Example tests
Existence	• Obtain direct confirmation from banks and other lenders of the amounts outstanding, accrued interest and what security they hold.
Rights and obligations	• Review direct confirmation letters from lenders.
Completeness	• Obtain breakdown of liabilities, compare to prior year audit working papers and for any items no longer included agree to: - Repayment amount in cash book - Inclusion as current liability if reclassified • Review board minutes for evidence of any new borrowings which might not be recorded. • Review cash book to ensure all new loans have been recorded.
Accuracy, valuation and allocation	• Perform proof in total of finance charges. • Agree capital and interest amounts to confirmation letters. • Recalculate finance charges agreeing interest rates to loan agreements.
Classification and presentation	• Review draft accounts and agree that liabilities are correctly classified as current/non-current by reference to the repayment dates in the loan agreements. • Ensure disclosures are correct and in line with accounting standards by comparing disclosure to required disclosure per an accounting disclosure checklist.



Activity 1: Non-current liabilities

Dress You Like Co has provided Check & Co with the following schedule of non-current liabilities for the year ending 30 September 20X6:

Non-current liabilities

	Draft 20X6	Actual 20X5
	\$'000	\$'000
Loan with CR Bank	2,597	2,896
	2,597	2,896

Required

Which TWO of the following audit procedures would provide sufficient and appropriate audit evidence over the COMPLETENESS of this schedule?

- ☐ Review board minutes for discussions regarding long term borrowings
- ☐ Agree the loan interest rate to the loan agreement with CR Bank
- ☐ Review prior year audit working papers for any non-current liabilities no longer included
- ☐ Trace loan repayments to entries in the cash book



Essential reading

See Chapter 17 of the Essential reading for additional considerations that should be made when auditing non-current liabilities.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2 Provisions and contingencies

2.1 Accounting for provisions and contingencies



Essential reading

See Chapter 18 of the Essential reading for a summary of the accounting knowledge relevant to IAS 37: *Provisions, Contingent Liabilities and Contingent Assets* which is brought forward to this paper from your earlier Financial Accounting studies.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

Accounting for provisions and contingencies is dictated by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* which provides the following definitions.



KEY
TERM

Provision: a liability of uncertain timing or amount.

Liability: 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.

Obligating event: an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

Legal obligation: an obligation that derives from:

- (a) A contract (through its explicit or implicit terms);
- (b) Legislation; or

- (c) Other operation of law.

Constructive obligation: 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.
- (b) As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Contingent liability:

- (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.

Contingent asset: 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 (IAS 37: para. 10).

2.2 Audit procedures for provisions and contingencies

Provisions and contingencies are examples of accounting estimates. They are particularly difficult to audit due to the degree of judgment required and the risk of manipulation. The audit of accounting estimates was covered in Chapter 12 Non-current Assets.



Activity 2: Warranty provision

Check & Co have been provided with the following extracts of the draft accounts of Dress You Like Co for the year ending 30 September 20X6. Dress You Like Co make a warranty provision for faulty goods every year.

Extract from the draft statement of profit and loss for the year ended 30 September 20X6

	Draft 20X6	Actual 20X5
	\$'000	\$'000
Revenue (supermarket)	53,500	49,000
Revenue (other)	<u>8,200</u>	<u>6,700</u>
Total revenue	<u>61,700</u>	<u>55,700</u>

Extract from the draft statement of financial position as on 30 September 20X6

	Draft 20X6	Actual 20X5
	\$'000	\$'000
Warranty provision	263	279

Required

- 1 Which TWO of the following statements are MOST LIKELY to be true?
 - ☐ There is a potential understatement of the warranty provision in the draft statement of financial position.
 - ☐ There is a potential overstatement of the warranty provision in the draft statement of financial position.

- ☐ There is a potential understatement of the expense in the draft statement of profit and loss.
 - ☐ There is a potential overstatement of the expense in the draft statement of profit and loss.
- 2 Which of the following audit procedures provides evidence over the completeness of the warranty provision?
- ☐ Enquiring of management as to why the warranty provision has fallen since the prior year
 - ☐ Reviewing customer correspondence after year end for discussions relating to warranty claims
 - ☐ Recalculation of the warranty provision
 - ☐ Obtaining a copy of the warranty policy at Dress You Like Co and discussing this with management to gain a thorough understanding
-



Essential reading

See Chapter 17 of the Essential reading for detailed audit procedures for provisions and contingencies.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2.3 Specific procedures for litigation and legal claims

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 or disclosure in those financial statements.



Essential reading

See Chapter 17 of the Essential reading for details of the audit procedures given in ISA 501 with regards to litigation and claims.

The Essential reading is available as an Appendix of the digital edition of the Workbook.



Activity 3: Litigation

As part of a cost-cutting exercise at Dress You Like Co, the company froze the finance director's salary in 20X6 despite giving other directors a 5% salary increase. This decision was made based on the fact that the finance role was no more demanding than in previous years. Vinay Patel, the finance director, was not happy about this decision and left the company in March 20X6. He is now suing the company for constructive dismissal. Dress You Like Co has not made any provision or disclosure of this as they do not believe the ongoing claim has any merit.

Required

Describe the substantive procedures Check & Co should perform to obtain sufficient and appropriate evidence in relation to this litigation. Ensure you document the reason for each procedure.

3 Capital

Capital includes share capital, distributions and reserves 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.

The main concern with share capital and reserves is that the company has complied with the law. 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 procedures for share capital, distributions and reserves are as follows:

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.
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 that appropriate disclosures of movements on reserves are made in the company's accounts by inspection of the financial statements.

4 Directors' emoluments

Directors' emoluments are a sensitive area and would therefore be deemed to be material by their **nature**. It is important therefore that the disclosure of directors' emoluments is made accurately.

The table below lists some valid audit procedures when auditing directors' emoluments:

Assertion	Example audit procedures
Existence	• Agree the directors' emoluments disclosed in the financial statements to a schedule of directors' emoluments for the year for each director. The schedule should show separately the individual components of emoluments: salary, bonuses, benefits, pension contributions and any other amounts such as 'golden hellos'. • Vouch salary and pension contribution amounts to monthly payroll records and bank statements. • Vouch bonuses and any 'one-off' payments to board meeting minutes and payroll records and bank statements.
Rights and obligations	• Verify the emoluments paid to directors during the year to their contracts of employment to ensure the directors' entitlements to these amounts.
Completeness	• Review board meeting/remuneration committee minutes to verify the amounts of any directors' bonuses and any other amounts and also to check that these payments have been appropriately authorised. • Review the cash book during the year and in the post year end period and ensure any significant sums have been appropriately accounted for. • Ask directors to confirm in writing that the emoluments disclosed in the financial statements are complete and accurately recorded.

Assertion	Example audit procedures
	Analytically review the directors' emoluments for each director in comparison to both the prior year emoluments and expected emoluments given the business's activities during the year.
Accuracy, valuation and allocation	- Re-cast the addition of the schedule of directors' emoluments. - Verify that the amounts disclosed in the financial statements agree to this schedule.
Classification and presentation	- Obtain a copy of the returns made to the tax authorities in respect of each director and verify that all benefits have been properly disclosed in the financial statements. - Review the adequacy of the disclosure in the directors' emoluments note to ensure it is in accordance with applicable accounting standards and local law.



Essential reading

See Chapter 17 of the Essential reading for additional considerations relating to director's emoluments.

The Essential reading is available as an Appendix of the digital edition of the Workbook.



Activity 4: Director's emoluments

You are responsible for auditing the directors' emoluments of Dress You Like Co for the year ending 30 September 20X6 and have been provided with the information below:

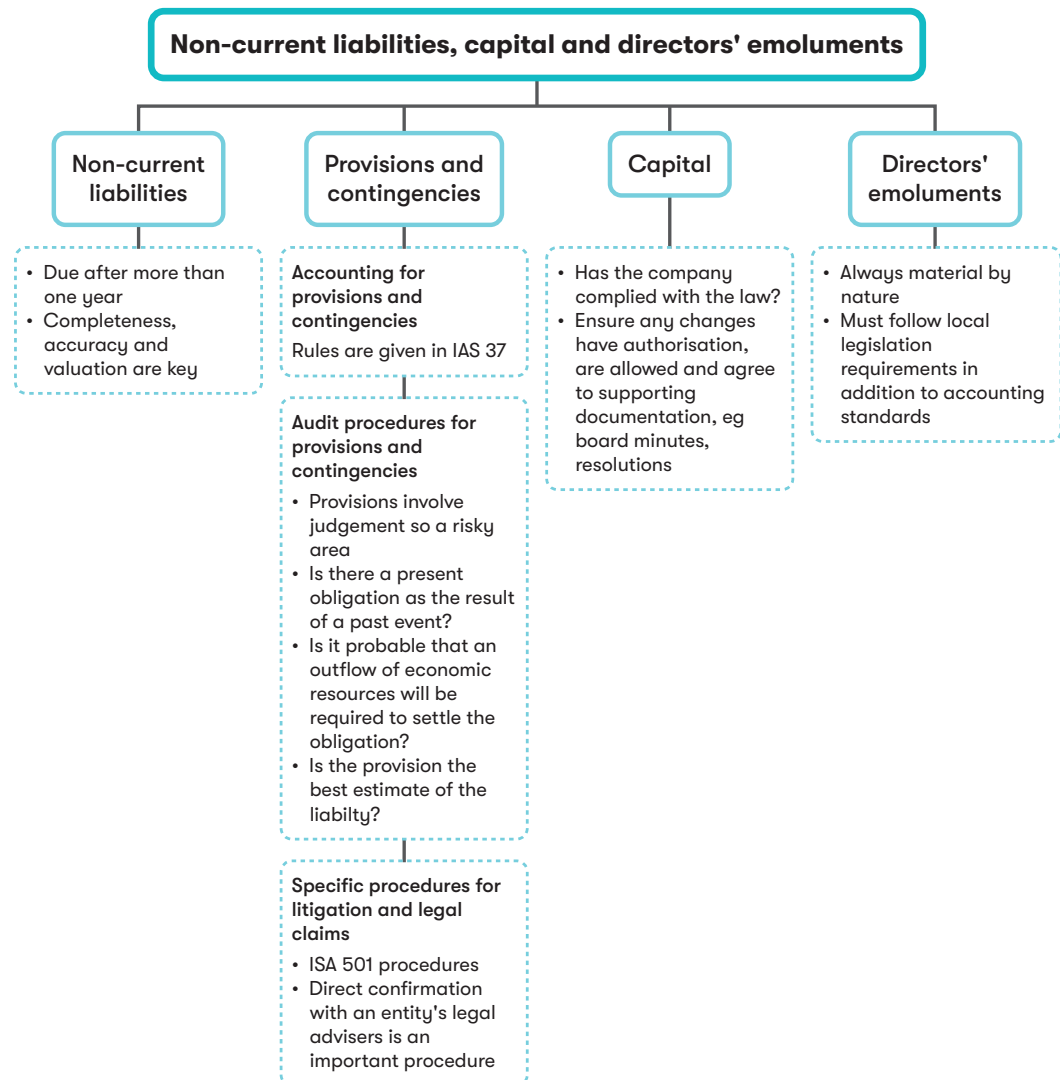
	Fixed remuneration		Variable remuneration		Total
	Salary \$	Pension \$	Bonuses \$	Incentive payments \$	
G Lewis (Chairman)	120,000	40,000	90,000	–	250,000
K Escombe (Chief Finance Officer)	80,000	32,000	50,000	–	162,000
M Batter (CEO)	<u>20,000</u>	<u>6,500</u>	<u>5,000</u>	<u>10,000</u>	<u>41,500</u>
	<u>220,000</u>	<u>78,500</u>	<u>145,000</u>	<u>10,000</u>	<u>453,500</u>

Required

List the substantive procedures Check & Co should perform to obtain sufficient and appropriate evidence in relation to director's emoluments. Ensure you document the reason for each procedure.

Solution

Chapter summary



Knowledge diagnostic

1. Non-current liabilities

Non-current liabilities are usually authorised by the board and should be well documented.

2. Key documentation relating to non-current liabilities

Bank letters and **loan agreements** will be key evidence in respect of loans.

3. Auditing provisions and contingencies

The accounting treatments for provisions and contingencies are complex and involve judgement and this can make them difficult to audit.

4. IAS 37 criteria

Procedures on provisions and contingencies will focus on the criteria established in accounting standards for their recognition, ie:

- Is there a **present obligation** as a result of past events?
- Is an outflow of benefits **probable**?
- Has the amount been **estimated reasonably**?

5. Share capital and reserves

The main concern with share capital and reserves is that the company has complied with the law.

6. Director's emoluments

Directors' emoluments are **material by their nature**.

7. Disclosure of directors' emoluments

The auditor will need to make sure the **disclosure** of directors' emoluments is complete, accurate and compliant with both applicable accounting standards and local legislation.

Further study guidance

Question practice

Now try the following from the Further question practice bank [available in the digital edition of the Workbook]:

- Section A Q2 (item 3) 'Food Poisoning' looks at litigation and claims
- Section B Q11(e) 'Heels' covers audit procedures for a provision

Further reading

There are technical articles on the ACCA website written by members of the AA examining team which are relevant to some of the topics covered in this chapter that you should read:

- *The audit of financial statement assertions*: <https://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/assertions.html>
- *Examining evidence*: <https://www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p7/technical-articles/examining-evidence.html>

Own research

- Think of a listed company you know. Look on their website for a copy of the report on their directors' remuneration.
- For the same company, find a copy of their most recent financial statements on their website. Does the company have any provisions or contingencies? Think about the audit procedures that might have been used to audit these. Are the provisions mentioned in the key audit matters section of the audit report?

Activity answers

Activity 1: Non-current liabilities

The correct answers are:

- Review board minutes for discussions regarding long term borrowings
- Review prior year audit working papers for any non-current liabilities no longer included

Activity 2: Warranty provision

1 The correct answers are:

- There is a potential understatement of the warranty provision in the draft statement of financial position.
- There is a potential understatement of the expense in the draft statement of profit and loss.

In 20X5 the warranty provision was 0.005% of total revenue. In 20X6 the revenue was higher than the previous year, however the warranty provision fell and is only 0.004% of total revenue. We would expect the warranty provision to increase in line with revenue unless there is a valid reason, eg an improvement in the quality of goods due to using higher quality fabrics.

2 The correct answer is: Reviewing customer correspondence after year end for discussions relating to warranty claims

This procedure would enable Check & Co to consider the level of claims made against Dress You Like Co after the end of the reporting period and therefore assess whether the level of warranty provision made is sufficient, namely is it complete.

Activity 3: Litigation

- With management's permission, send a letter of enquiry to Dress You Like Co's external legal advisers requesting their opinion of the likely outcome of the case and an estimation of the financial implications. Note that most third parties, such as legal advisers, will not meet with the external auditor and so an enquiry letter is usually sent.
- Review correspondence after year end between Dress You Like Co and their external legal advisers to see if there is any indication of the outcome of the litigation.
- Read the board minutes after year end looking for discussion of the litigation which may provide evidence about its likely outcome.
- Review correspondence with Vinay Patel relating to the litigation in order to establish the likely outcome of the claim.
- Discuss the appropriate accounting treatment for the litigation with the current directors of Dress You Like Co.

Activity 4: Director's emoluments

Salary:

- Vouch salary amounts to monthly payroll records and bank statements to ensure the amounts are accurate.
- For Mary Batter, obtain her start date from the HR department and vouch this to board meeting minutes. Recalculate her salary on a pro-rata basis to ensure it is accurately recorded.

Pension:

- Vouch the pension amounts to monthly payroll records and bank statements to ensure the amounts are accurate.

Bonuses:

- Vouch the level of bonuses awarded to board meeting minutes, payroll records and bank statements to ensure they have been authorised and are accurately recorded.

Incentive payments:

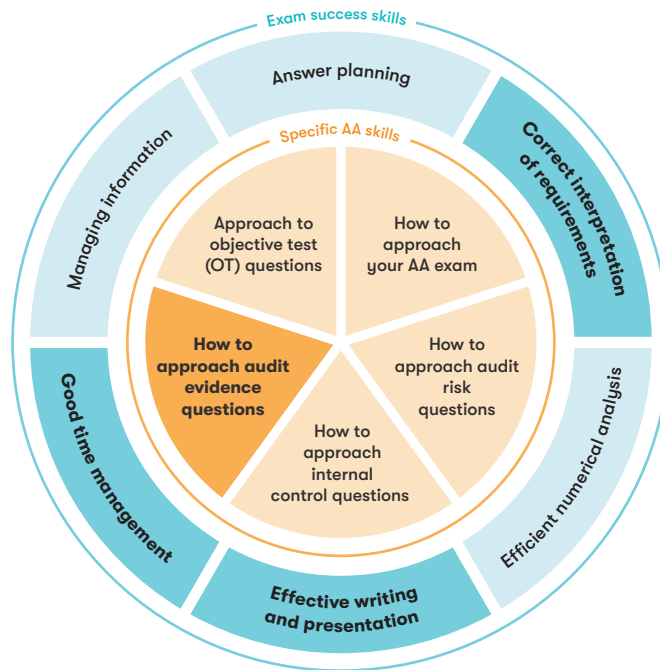
- Review the employment contract for Mary Batter to verify that there is a clause outlining that this payment is applicable.
- Vouch the level of this payment to board meeting minutes, payroll records and bank statements.

General:

- Recast the schedule to ensure the note is accurate.
- Review the disclosure to ensure that it is in accordance with applicable law and accounting standards.

Skills checkpoint 4

How to approach audit evidence questions



Introduction

The external auditor must obtain sufficient appropriate audit evidence to support their auditor's opinion, they do this by conducting audit procedures.

Audit procedures can feature in both sections of the exam. In Section A, you may be required to choose the most appropriate audit procedure from a list of options or to explain the specific assertion that evidence may be gathered over by conducting a particular audit procedure. In Section B, you will need to draft audit procedures which are relevant to the requirement which may or may not specify an audit assertion.

There are two types of audit procedures: tests of controls and substantive procedures.

You must read the question requirement very carefully because if the requirement states 'describe audit procedures' then you can answer with either tests of controls OR substantive procedures. However, if you include tests of controls in a solution to a requirement that asks for substantive procedures, those tests will not score any marks.

Candidates' biggest weakness in audit evidence questions is that they fail to describe the audit procedure in sufficient detail. A well-explained procedure will score one mark but very often candidates only score ½ mark because their procedure is not fully explained.

We recommend that you use a '**verb-document-reason**' approach to describing audit procedures in order to be assured of gaining one mark per point.

This skills checkpoint will therefore focus on how you can achieve this.

Skills Checkpoint 4: How to approach audit evidence questions

AA Skill: How to approach audit evidence questions

A step-by-step technique for ensuring that your approach to audit evidence questions the 'verb-document-reason' technique is outlined below. Each step will be explained in more detail in the following sections and illustrated using requirements from a selection of past exam questions.

STEP 1:

Identify exactly what is being asked in the requirement: audit procedures, tests of controls or substantive procedures?
Are specific assertions being tested?



STEP 2:

Consider how you might generate your answer.
Is there a scenario you should use?
Can you remember the accounting treatment for the item? Would that give you a starting point?
What audit procedures have you learnt/used at work?
Can you use the mnemonic AEIOU to help you to generate audit procedures?



STEP 3:

Write out your audit procedure using the 'verb-document-reason' approach.
What do you want to be done (eg recalculate, agree, vouch)?
To which document (eg invoice, physical asset, board minutes)?
Why (eg to ensure that receivables are recoverable (valuation))? You might choose to link this to an assertion

Exam success skills

The following illustration provides examples from a series of past exam questions.

For this question, we will also focus on the following exam success skills:

- **Correct interpretation of requirements.** Here you need to identify whether you are being asked for audit procedures (tests of controls or substantive procedures) or just one of them. You should also identify whether you need to describe audit procedures which are relevant to a specific financial statement assertion.
- **Effective writing and presentation.** A well-explained audit procedure will earn you one mark. Use the 'verb-document-reason' approach to maximise your marks.
- **Good time management.** When answering audit evidence questions, spend some time thinking and constructing a detailed audit procedure rather than writing out any and every test you can think of.

Skill Activity

STEP 1 Identify exactly what you are being asked for in the requirement: audit procedures, tests of controls or substantive procedures.

Also identify whether the requirement is testing audit procedures that relate to a particular assertion.

Required

- (a) Describe substantive procedures you should perform to obtain sufficient appropriate evidence in relation to:

- (i) Inventory held at the third-party warehouses;
and
- (ii) Use of standard costs for inventory valuation.

(4 marks)

- (b) Describe substantive procedures the auditor should perform in relation to the **COMPLETENESS** of the year-end trade payables of ABC Co. **(5 marks)**

- (c) List **THREE** substantive analytical procedures you should perform on the shift managers' salary system. **(3 marks)**

- (d) Describe the audit procedures you should perform to ensure that jewellery inventory is valued correctly. **(4 marks)**

- (e) **Intangible assets**

During the year, DEF Co obtained a patent from a competitor. The directors have discussed the accounting treatment with your firm and you are satisfied that it is appropriate to treat this as an intangible asset. As they purchased the patent at what they believe to be below market value, the directors wish to carry it at its fair value which they estimate to be substantially above the cost price. They have estimated that the useful life of the patent is 20 years.

Describe substantive procedures you would perform to obtain sufficient and appropriate audit evidence in relation to the above matter. **(4 marks)**

Whilst each of the separate requirements is testing audit evidence, they are each worded slightly differently and you should therefore analyse the requirement before writing your answer.

Requirement	Analysis
(1)	Substantive procedures: • Tests of detail and/or • Analytical procedures Relating to: • Inventory held by third parties • The use of standard costs to value inventory
(2)	Substantive procedures relating to: • COMPLETENESS of trade payables

Requirement	Analysis
(3)	Substantive analytical procedures
(4)	Audit procedures: • Tests of control and/or • Substantive procedures Relating to: • Valuation
(5)	Substantive procedures relating to: • Information in the scenario

STEP 2 Now that you have understood what the requirement demands, you are much better placed to answer it. Consider the following:

- Is there a scenario you should use?
- Can you remember the accounting treatment for the item? Would that give you a starting point?
- What audit procedures have you learnt/used at work?
- Can you use the mnemonic AEIOU to help you to generate audit procedures?

Completed answer plan

Required

Let's consider two of the requirements:

(2) Describe substantive procedures⁴⁰ the auditor should perform in relation to the **COMPLETENESS** of the year-end trade payables of ABC Co. **(5 marks)**

(5) Intangible assets

During the year, DEF Co obtained a patent from a competitor. The directors have discussed the accounting treatment with your firm and you are satisfied that it is appropriate⁴¹ to treat this as an intangible asset. As they purchased the patent at what they believe to be below market value, the directors wish to carry it at its fair value which they estimate to be substantially above the cost price. They have estimated that the useful life of the patent is 20 years.

Describe substantive procedures you would perform to obtain sufficient and appropriate audit evidence in relation to the above matter. **(4 marks)**

STEP 3 Write out your audit procedure using the 'verb-document-reason' approach.

- What do you want to be done (eg recalculate, agree, vouch)?
- To which document (eg invoice, physical asset, board minutes)?

⁴⁰ Tests of detail/analytical procedures. No scenario. No particular accounting treatment to be aware of. AEIOU: Analytical procedures: Review balances owed to each supplier year on year to identify any that look unusually low. Compare payables payment period year on year to identify any unexpected change. Inspection: Inspect cash book payments post y/e to identify large payments where the liability did not exist at the y/e. Inspect invoices received post y/e and agree to GRN for evidence of any unrecorded liabilities. Recalculation: Reconcile a sample of trade payable balances to supplier statements to identify any unrecorded liabilities

⁴¹ Use scenario: Accounting treatment as an intangible agreed so no marks for audit procedures re IAS 38 criteria. Accounting treatment: Initially recognise at cost (vouch purchase price to invoice and cash book payments to determine whether capitalised cost is appropriate). Plans to revalue patent (vouch to external valuer's report/use of an expert/trace accounting entries). Amortisation (company to industry benchmarks to determine if useful life is reasonable)/recalculate amortisation.

- Why (eg to ensure that receivables are recoverable (valuation))? You might choose to link this to an assertion.

Start each audit procedure on a new line.

STEP 4

Suggested solution

(2) Substantive procedures relating to COMPLETENESS of year-end trade payables

- Compare⁴² the list of trade payables balances⁴³ with the previous year to identify any potentially significant omissions.⁴⁴
 - ⁴² verb
 - ⁴³ document
 - ⁴⁴ reason
- Compare⁴⁵ the payables payment period⁴⁶ with the previous year to identify any unexpected change.⁴⁷
 - ⁴⁵ verb
 - ⁴⁶ document
 - ⁴⁷ reason
- Review⁴⁸ the cash book payments/bank statements after the end of the year⁴⁹ for payments which could indicate the existence of unrecorded trade payables.⁵⁰
 - ⁴⁸ verb
 - ⁴⁹ document
 - ⁵⁰ reason
- Inspect⁵¹ invoices received post year-end⁵² and agree to goods received notes for evidence of unrecorded liabilities.⁵³
 - ⁵¹ verb
 - ⁵² document
 - ⁵³ reason
- Reconcile⁵⁴ a sample of payables balances to supplier statements⁵⁵ and investigate differences which could indicate significant unrecorded liabilities.⁵⁶
 - ⁵⁴ verb
 - ⁵⁵ document
 - ⁵⁶ reason

(5) Intangible assets

- Obtain⁵⁷ purchase documents⁵⁸ to verify the cost⁵⁹ of the intangible asset
 - ⁵⁷ verb
 - ⁵⁸ document
 - ⁵⁹ reason
- Review⁶⁰ the directors' estimate of fair value⁶¹ of the patent and consider the assumptions made⁶² for reasonableness/ Obtain third-party evidence concerning valuation to assess the fair value for reasonableness
 - ⁶⁰ verb
 - ⁶¹ document
 - ⁶² reason
- Consider⁶³ whether the length of useful life⁶⁴ is reasonable⁶⁵ in relation to the legal terms of the patent.
 - ⁶³ verb
 - ⁶⁴ document
 - ⁶⁵ reason
- Recalculate⁶⁶ amortisation charge⁶⁷ for the period to ensure it is calculated according to the entity's policy⁶⁸.
 - ⁶⁶ verb
 - ⁶⁷ document
 - ⁶⁸ reason

Exam success skills diagnostic

Every time you complete a question, use the diagnostic below to assess how effectively you demonstrated the exam success skills in answering the question. The table has been completed below for the examples used above to give you an idea of how to complete the diagnostic.

Exam success skills	Your reflections/observations
Correct interpretation of requirements	Did you identify the type of audit procedures you were required to describe?
Effective writing and presentation	Did you fully explain your procedure using the 'verb-document-reason' approach in order to secure one mark per procedure?
Good time management	Did you spend enough time thinking about what was required in order to produce your best answer in the time available?
Most important action points to apply to your next question	

Summary

You are likely to see audit evidence questions in both Section A and Section B of the exam. You must know the difference between tests of controls and substantive procedures and be confident as to which audit procedures provide evidence over which financial statement assertions.

As you move into practising questions as part of your final revision, you will need to practise taking in information from a scenario quickly (using active reading), accurately understanding the requirements, and creating an answer plan and a final answer that addresses the requirements in the context of the scenario.

Learning objectives

On completion of this chapter, you should be able to:

Syllabus learning outcomes	Syllabus reference no.
Apply audit techniques to not-for-profit organisations.	D7 (a)

Business and Exam context

This chapter looks at the audit of not-for-profit organisations. Such entities may or may not be required to have a statutory audit under legislation. They may choose to have a non-statutory audit under the terms of a charitable deed or as part of good practice.

The points made in this chapter about the issues inherent in these entities are relevant for any kind of assurance work in not-for-profit organisations. These entities will have particular features, the most obvious being the difference in objectives of the entity, which will affect the way the work is carried out.

In this chapter, we look specifically at the aspects of audit planning, evidence and reporting in not-for-profit organisations and how these differ from for-profit organisations.

An exam question on not-for-profit organisations may come up as a scenario-based question on audit planning or evidence. In this case, use your knowledge of not-for-profit organisations as well as the clues given in the scenario to generate ideas for your answer.

Previous exams have included written requirements relating to audit planning and the system of internal control (such as the control environment) relating specifically to not-for-profit organisations. This topic can equally be examined in the form of OT questions in Section A.

Remember, the issues relating to small companies that we have discussed in this book may also apply to small not-for-profit organisations as well.

Chapter overview



1 Introduction

1.1 Objectives of not-for-profit organisations

Before considering what a not-for-profit organisation's audit will entail, it will be helpful to consider the types of entities that might exist with objectives other than to make a profit and their objectives, as these will impact on the way that they report and the audit that is carried out.

For example, a hospital could operate at a profit by not spending all the money it receives in its budget. However, the key objective of a hospital is to provide health services to the public, not to make a profit. As its income is fixed, it is more likely to focus on **cost saving** so that it can operate within its budget.



Example - Not-for-profit organisations

Type of organisation	Objective	Focus
Charities and friendly societies	To carry out the charitable purpose	May involve fundraising, receiving donations, managing invested funds, controlling costs
Schools	To provide education	Likely to involve managing a tight budget (either from fees or government funds)
Clubs, associations, societies, unions	To further the aims of the club, provide a service for members	May include managing subscriptions paid and keeping costs of running the club down
Housing associations	Managing the related houses and providing facilities for residents	May involve rent collection and maintenance costs or even building costs of future developments.
Local councils, public services	To provide local services to a budget based on public money	Likely to be focused on value for money, as they are in the public eye.

This section can be linked back to the performance measures we covered in Chapter 5 when we looked at value for money (VFM) audits in the context of internal audit. The performance measures were **economy**, **effectiveness** and **efficiency**.

1.2 Audit of not-for-profit organisations

Organisations may fall within the scope of statutory audit if the entities concerned are limited liability companies. Organisations not incorporated may require an assurance engagement due to the requirements of regulatory or governing bodies, eg the Charity Commission.

When carrying out an audit of a not-for-profit organisation, it is vital that the auditor establishes:

- Whether a statutory audit is required
- If a statutory audit is not required, what the objectives of the engagement are
- What the engagement is to report on
- To whom the report should be addressed
- What form the report should take



Essential reading

See Chapter 18 of the Essential reading for further details on the audit of and accounting for not-for-profit organisations.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2 Planning the audit

The planning procedures undertaken for not-for-profit organisations will **differ very little** from those for profit-making organisations. However, the auditor should have specific regard to any laws, regulations or guidelines imposed on the entity by any regulatory body.

The scope of the auditor's work will be detailed in the engagement letter.

2.1 Risk assessment

The auditor should, during the planning stage, fully assess the risks associated with the not-for-profit organisation. There are certain risks applicable to not-for-profit organisations that might not necessarily be applicable to other small companies.

Small not-for-profit organisations will generally suffer from **internal control deficiencies** common to small enterprises, such as **lack of segregation of duties** and the use of **unqualified staff**. Shortcomings may arise from the staff's lack of training and also, if they are volunteers, from their attitude, in that they may resent formal procedures.

The auditors will have to consider particularly carefully whether they will be able to obtain adequate assurance that the accounting records do reflect all the transactions of the enterprise and bear in mind whether there are any related **statutory reporting requirements**.



Essential reading

Chapter 18 of the Essential reading, provides a more detailed discussion on risk assessment for not-for-profit organisations.

The Essential reading is available as an Appendix of the digital edition of the Workbook.



Activity 1: Audit risks

Midvale League is a small association. It runs several local football leagues for various ages and stages. It employs a general administrator and some casual staff to run the bar. Any player who appears in more than 30% of a team's games for the season is required to pay a subscription to the association. The subscriptions pay for the administrator's wages, the referee's fees, team coaches' expenses and a lease on a sports club comprising a clubhouse, changing facilities and three football pitches. The administrator also acts as grounds person. There is a bar in the clubhouse which is run for the benefit of members at a profit which covers bar staff wages and contributes to other expenses of the club. The association pays a local firm of accountants to prepare management accounts every quarter and to produce annual financial statements which it then audits for the benefit of members of the club.

Required

Identify any audit risks arising from The Midvale League.

3 Audit evidence

Obtaining audit evidence from not-for-profit organisations may be a problem, particularly where organisations have informal arrangements and this may impact on the auditor's report.



Activity 2: Charity audit

You have recently been appointed auditor of Links Famine Relief, a registered charity which receives donations from individuals to provide food in famine areas around the world.

The charity is run by a voluntary management committee, which has monthly meetings and employs the following full-time staff:

- (1) A director, Mrs Roberts, who suggests fundraising activities and payments for relief of famine, and implements the policies adopted by the management committee
- (2) A secretary and bookkeeper, Mr Beech, who deals with correspondence and keeps the accounting records

You are planning the audit of income of the charity for the year ended 5 April 20X7 and are considering the controls which should be exercised over this area.

The previous year's financial statements to 5 April 20X6 (which have been audited by another firm) show the following income:

	\$	\$
Gifts under non-taxing arrangements	14,745	
Tax reclaimed on gifts under non-taxing arrangements	<u>4,915</u>	
		19,660
Donations through the post		63,452
Autumn Fair		2,671
Other income		
Legacies	7,538	

	\$	\$
Bank deposit account interest	<u>2,774</u>	
		<u>10,312</u>
		<u><u>96,095</u></u>

Notes.

- 1 Income from gifts under non-taxing arrangements is stated net. Each person who pays by deed of covenant has filled in a special tax form, which is kept by the full-time secretary, Mr Beech.
- 2 All gifts under non-taxing arrangements are paid by banker's order; they are credited directly to the charity's bank account from the donor's bank. Donors make their payments by deed of covenant either monthly or annually.
- 3 The tax reclaimed on these gifts is one-third of the net value of the gifts and relates to income received during the year; as the tax is received after the year-end, an appropriate amount recoverable is included in the statement of financial position. The treasurer, who is a voluntary (unpaid) member of the management committee, completes the form for reclaiming the income tax, using the special tax forms (in Note (a) above) and checks to the secretary's records that each donor has made the full payment in the year required by the arrangement.
- 4 Donations received through the post are dealt with by Mr Beech. These donations are either cheques or cash (bank notes and coins). Mr Beech prepares a daily list of donations received, which lists the cheques received and total cash (divided between the different denominations of bank notes and coins). The total on this form is recorded in the cash book. He then prepares a paying-in slip and banks these donations daily. When there is a special fundraising campaign, Mr Beech receives help in dealing with these donations from voluntary members of the management committee.
- 5 The Autumn Fair takes place every year on a Saturday in October; members of the management committee and other supporters of the charity give items to sell (for example food, garden plants, clothing). A charge is made for entrance to the fair and coffee and biscuits are available at a small charge. At the end of the fair, Mr Beech collects the takings from each of the stalls and he banks them the following Monday.
- 6 Legacies are received irregularly and are usually sent direct to the director of the charity, who gives them to Mr Beech for banking – they are stated separately on the daily bankings form (in Note (d) above).
- 7 Bank deposit account interest is paid gross of income tax by the bank, as the Links Famine Relief is a charity.

Required

List and briefly describe the work you would carry out on the audit of income of the charity, the controls you would expect to see in operation and the problems you may experience for the following sources of income, as detailed in the statement above.

- (1) Gifts under non-taxing arrangements
- (2) Tax reclaimed on gifts made under non-taxing arrangements
- (3) Donations received through the post
- (4) Autumn Fair

Solution



Activity 3: Save the Accountants

'Save the Accountants' is a charitable foundation set up to provide financial assistance to accountants who have fallen on hard times. Its principal sources of income are:

- Cash donations collected on the high streets of major towns
- Regular donations by a number of the largest accountancy firms
- Annual donations by wealthy individuals

Required

What audit procedures would you do to test the completeness of income?

Solution



Essential reading

See Chapter 18 of the Essential reading for a more detailed discussion on audit evidence considerations for not-for-profit organisations.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

4 Audit reporting

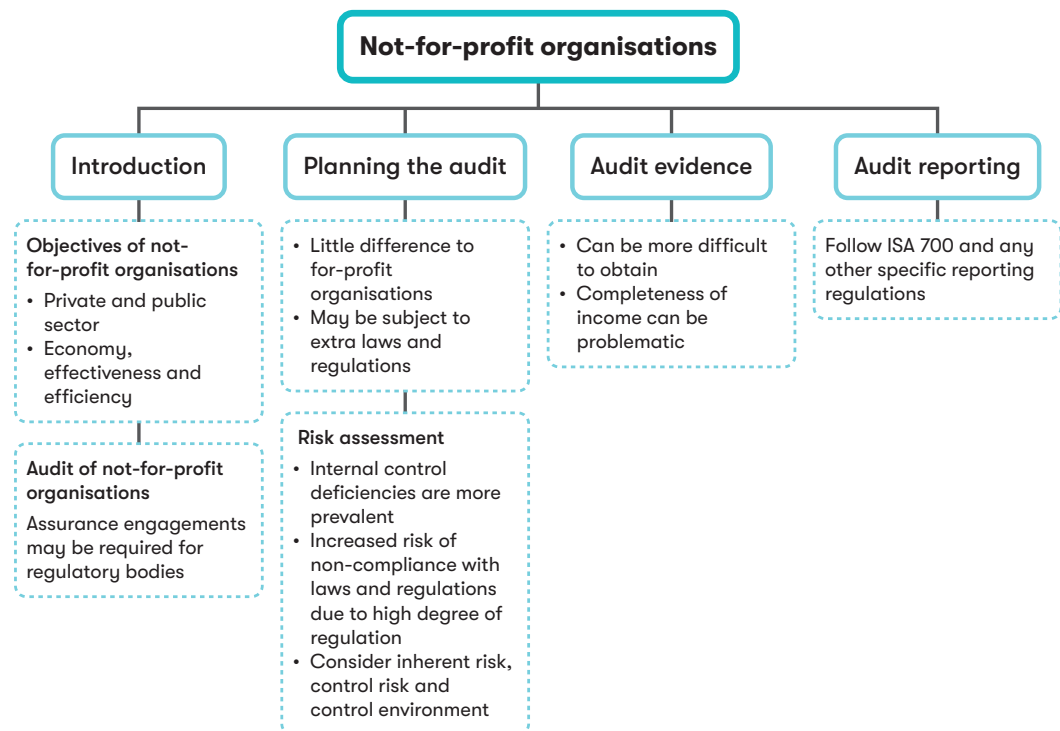
For incorporated not-for-profit organisations, the reporting requirements of ISA 700 *Forming an Opinion and Reporting on Financial Statements* apply. Additionally, the reporting requirements of the governing body will need to be encompassed in the auditor's report.

Where an association or charity is having an audit for the benefit of its members or trustees, or if the entity is government funded and highly regulated, the standard auditor's report may not be required or appropriate. The auditor should bear in mind the objectives of the audit and make suitable references in the auditor's report. However, the ISA 700 format will still be relevant.

The auditor should ensure that they make the following matters clear:

- The addressees of the report
- What the report relates to
- The scope of the engagement
- The respective responsibilities of auditors and management/trustees/directors
- The work done
- The opinion drawn

Chapter summary



Knowledge diagnostic

1. Not-for-profit organisations

There are various types of not-for-profit organisations which do not exist for the purpose of maximising shareholder wealth but which may still require an audit. Not-for-profit organisations include **charities, clubs and societies**.

2. Planning

When planning the audit, all relevant regulations must be understood.

3. Audit risk

The audit risks associated with not-for-profit organisations may well be different from other entities.

4. Risk areas

Particular **risk** areas for the auditor of not-for-profit entities are:

- Complexity of regulation
- High level of cash receipts
- Competence of staff and volunteers
- Segregation of duties

5. Audit approach

The audit approach is likely to be mainly **substantive**.

6. Audit evidence

Obtaining audit evidence may be a problem, particularly where organisations have informal arrangements.

7. Auditor's report

The auditor must consider the requirements of ISA 700 as well as any specific reporting regulations.

Further study guidance

Question practice

Now try the following from the Further question practice bank [available in the digital edition of the Workbook]:

- Section B Q72 'Tap'
- Section B Q74 'Ajio'

Further reading

There are no technical articles on the ACCA website which are relevant to the topics covered in this chapter.

Own research

- (a) Consider a non-for-profit organisation you are familiar with. What is the objective and focus of this organisation? Does the organisation require an audit?
- (b) Can you find the audited financial statements for a large charity on that charity's website? Look through the different income streams. How would you go about auditing these?

Activity answers

Activity 1: Audit risks

The **valuation of Midvale League's club lease** may be problematic, it is certainly likely to be their biggest financial commitment. The auditor will need to determine whether a lease contract exists and if so the premises will need to be included **at cost as a right-of-use asset** on the statement of financial position. The cost of the right-of-use asset is likely to be the initial measurement of the lease liability (ie the present value of future lease payments) plus any initial direct costs incurred by Midvale League. Midvale League will also need to recognise a **lease liability** and this is initially measured at the **present value of lease payments not paid at the commencement date of the lease**. The discount factor used in the calculation of the present value is the interest rate implicit in the lease (or Midvale League's incremental borrowing rate if the interest rate implicit in the lease is not readily determinable). Midvale League may well not have this information which increases audit risk. Over the lease term, the lease liability is increased by the interest on the lease liability and recognised as a finance cost in the statement of profit or loss. The lease liability is reduced by the lease payments (instalments made).

If Midvale League does not have the cash flow to meet the lease payments, this may affect **going concern** as it could lose the facilities and have nowhere from which it can operate its activities in the foreseeable future, in which case the purpose of the association is gone.

Note that the lease is **unlikely** to satisfy the optional recognition exemption criteria from IFRS 16 Leases unless the lease is a short-term lease (lease term less than 12 months) which seems unlikely from the scenario.

The auditors will also have to consider the **role of the general administrator**, who fulfils a number of roles. General administrators are clearly key to the association, and it might have difficulties if they were incapacitated, not least perhaps in affording a replacement and any sickness benefit it was required to pay by law.

It is unclear what degree of financial record-keeping the administrator takes on. The audit firm is hired to produce quarterly management accounts. The association will gain some assurance from the fact that it prepares the accounts, but there is also a risk that **day-to-day transactions are not properly recorded**, as there appears to be **nobody with financial expertise** at Midvale League. Given that the administrator will record or maintain the relevant records to be passed on to the accountancy firm, there is also an issue of **segregation of duties** here.

The auditors should be aware of any legal issues relating to the bearing of a licence for the bar, particularly perhaps the danger that the licence might be jeopardised by the sale of liquor to underage drinkers. The **loss of the licence** to serve alcohol could severely diminish the income of the club to the point where it could no longer function.

The auditors will also need to pay attention to the membership of the association from the point of view of **completeness of income**.

Activity 2: Charity audit

The audit consideration in relation to the various sources of income of the Links Famine Relief charity would be as follows:

(1) **Gifts made under non-taxing arrangements**

This type of income should not present any particular audit problem, as the donations are made by banker's order direct to the charity's bank account and so it would be difficult for such income to be 'intercepted' and misappropriated.

Specific tests required would be as follows:

- (i) Agree a sample of receipts from the bank statements to the cash book to ensure that the income has been properly recorded.
- (ii) Agree a sample of the receipts to the special tax forms to ensure that the full amount due has been received.

Any discrepancies revealed by either of the above tests should be followed up with Mr Beech.

(2) Tax reclaimed on gifts made under non-taxing arrangements

Once again, this income should not pose any particular audit problems. The auditors should inspect the claim form submitted to the tax authorities and calculate whether the amount of the claim represents one third of the net value of the covenants recorded as having been received.

(3) Donations received through the post

There is a serious problem here, as the nature of this income is not predictable and also because of the lack of internal checks, with Mr Beech being almost entirely responsible for the receipt of these monies, the recording of the income and the banking of the cash and cheques received. The auditors may ultimately have to express a qualified opinion in this area.

Notwithstanding the above reservations, specific audit tests required would be as follows:

- (i) Agree the details on the daily listings of donations received to the cash book, bank statements and paying-in slips, observing whether the details agree in all respects and confirming that there is no evidence of any delay in the banking of this income.
- (ii) Agree the donations received by reference to any correspondence which may have been received with the cheques or cash.
- (iii) Consider whether the level of income appears reasonable by performing analytical procedures to make comparison with previous years and in light of any special appeals that the charity is known to have made during the course of the year.
- (iv) Carry out, with permission from the management committee, surprise checks to vouch the completeness and accuracy of the procedures relating to this source of income.

(4) Autumn Fair

Once again, there is a potential problem here because of the level of responsibility vested in one person, namely Mr Beech.

Specific work required would be as follows:

- (i) Attend the event to observe the proper application of procedures laid down and count the cash at the end of the day.
- (ii) Agree any records maintained by individual stallholders to the summary prepared by Mr Beech.
- (iii) Inspect the vouchers supporting any expenditure deducted from the proceeds in order to arrive at the net bankings.
- (iv) Agree the summary prepared by Mr Beech to the entry in the cash book and on the bank statement.

Activity 3: Save the Accountants

Cash collections

- Discuss procedures for cash collection with management and assess risk of fraud, loss, robbery or error.
- Discuss selection criteria for collectors and collection procedures with management.
- Observe the cash collection, recording and banking process.
- Trace a sample of cash received control lists to cash records and bank statements.
- Reperform a reconciliation of total cash received to income.
- Perform an analytical review of cash donations per month vs previous year taking into account factors such as number of collectors and weather.

Regular donations by a number of the largest accountancy firms and wealthy individuals

- Obtain and compare analysis of major/regular contributions with previous year.

- Send circularisation letters to confirm material amounts donated by the large accountancy firms and wealthy individuals.
- Circularise tax authorities to confirm contributions made where tax deductions have been claimed.

Learning objectives

On completion of this chapter, you should be able to:

Syllabus learning outcomes	Syllabus reference no.
Explain the purpose of a subsequent events review.	E1 (a)
Explain the responsibilities of auditors regarding subsequent events.	E1 (b)
Discuss the procedures to be undertaken in performing a subsequent events review.	E1 (c)
Define and discuss the significance of the concept of going concern.	E2 (a)
Explain the importance of and the need for going concern reviews.	E2 (b)
Explain the respective responsibilities of auditors and management regarding going concern.	E2 (c)
Identify and explain potential indicators that an entity is not a going concern.	E2 (d)
Discuss the procedures to be applied in performing going concern reviews.	E2 (e)
Discuss the disclosure requirements in relation to going concern issues.	E2 (f)
Explain the purpose of and procedure for obtaining written representations.	E3 (a)
Discuss the quality and reliability of written representations as audit evidence.	E3 (b)
Discuss the circumstances where written representations are necessary and the matters on which representations are commonly obtained.	E3 (c)
Discuss the importance of the overall review in ensuring that sufficient, appropriate evidence has been obtained.	E4 (a)
Discuss the procedures an auditor should perform in conducting their overall review of financial statements.	E4 (b)

Syllabus learning outcomes	Syllabus reference no.
Explain the significance of uncorrected misstatements.	E4 (c)
Evaluate the effect of dealing with uncorrected misstatements.	E4 (d)

Business and Exam context

This chapter will consider the reviews that take place during the completion stage of the audit, which include subsequent events and going concern. These are both important disclosure issues in the financial statements because, if the disclosures are not correct, this will impact on the auditor's report.

In this chapter, we also consider the use and reliability of written representations from management as audit evidence.

Financial reporting knowledge is particularly important at the review stage of the audit. Auditors need to be able to interpret accounts and understand the requirements of specific accounting standards. Analytical procedures must be used when undertaking the final review of the financial statements.

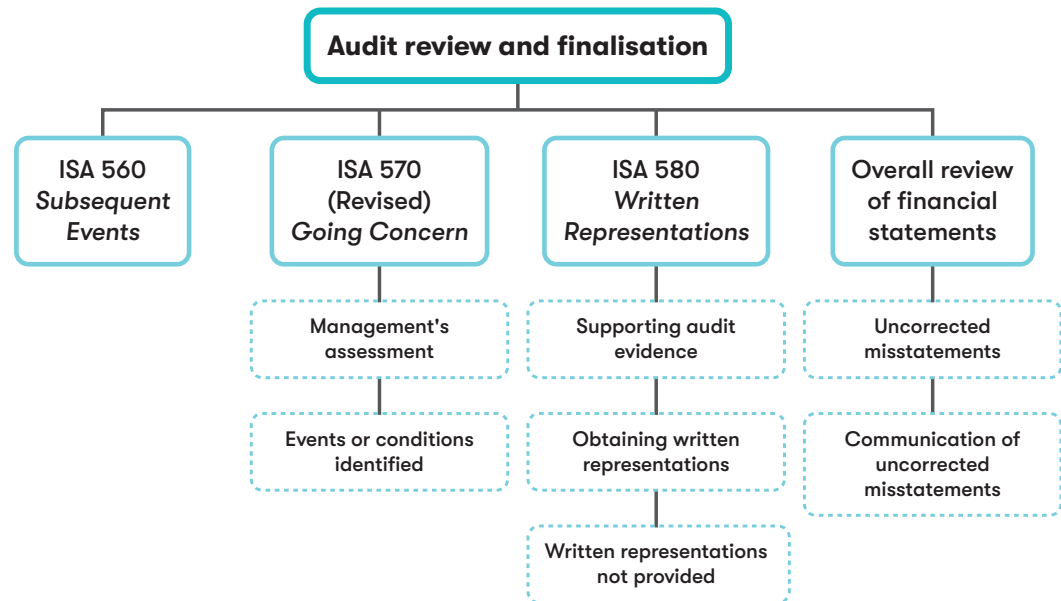
Immaterial misstatements may not be corrected by the audit client. The final part of this chapter looks at how the auditor should respond to uncorrected but immaterial misstatements.

The review stage of the audit is very important and likely to come up in the exam, both in Section A and in Section B. For example, in the exam, you could be asked to describe audit procedures which should be performed in relation to a subsequent event. It is very important that you understand the difference between the review stage of the audit and the earlier testing stage and are able to describe the auditor's responsibility in respect of misstatements.

Other topics likely to be examined include:

- Matters requiring written representations
- Going concern indicators, and audit procedures to test the going concern basis of accounting
- The effect of subsequent events on the auditor's report

Chapter overview



1 ISA 560 Subsequent Events



Subsequent events: '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' (ISA 560: para. 5(e)).

Financial statements may be affected by events that occur after the date of the financial statements. IAS 10 *Events after the Reporting Period* deals with the treatment in the financial statements of events occurring after the period end. For financial reporting purposes, these events are categorised in one of two ways:

Those that provide evidence of conditions that existed **at** the date of the financial statements (**adjusting events**)

Examples:

- Settlement of a court case
- Sale of inventory after year end providing evidence of its net realisable value at year end
- Fraud or error showing the accounts are incorrect

Those that provide evidence of conditions that arose **after** the date of the financial statements (**non-adjusting events**).

Examples:

- Dividends declared after the year end
- Fire causing destruction of major plant
- Announcement of a major restructuring

The auditor should consider the effect of subsequent events on the financial statements and on the auditor's report.

Active duty		Passive duty	
Year end	Auditor's report signed	F/S issued	AGM
Audit procedures undertaken to identify material subsequent events (adjusting and non-adjusting) (a) Review the procedures management has established to ensure that subsequent events are identified. (b) Read board minutes held after the date of the financial statements up to the date of signing the auditor's report. (c) Read the entity's latest available interim financial statements, budgets and cash flow forecasts. (d) Enquire, or extend previous oral or written enquiries, of the entity's legal counsel concerning litigation and claims. (e) Enquire of management as to whether any subsequent events have occurred which might affect the financial statements. (f) Obtain a written representation as to the completeness of subsequent events identified by management.		Auditor becomes aware of a material subsequent event: (a) Discuss matter with management to determine whether the FS need amendment. (b) If management amends FS the auditor should extend audit procedures to the items that require adjustment or disclosure and issue a new, unmodified auditor's report. (c) If management refuses to make amendment in FS then auditor should either: (i) (If not yet released auditor's report) reissue a modified report; or (ii) (If have released auditor's report) seek legal advice.	
		Auditor becomes aware of a material subsequent event: (a) Discuss matter with management (b) If management amends FS auditor should issue a new auditor's report including an emphasis of matter or other matter paragraph to explain the revision to the previously issued FS. (c) If management refuses to make amendment in FS then auditor should seek legal advice.	



Activity 1: Subsequent event

You are an audit senior in Check and Co and you are finalising the audit of Dress You Like Co for the year ending 30 September 20X6. Revenue is \$51,895,000 and profit before tax is \$1,025,000.

During the audit, you learnt that the finance director left the company in March 20X6 and was suing the company for constructive dismissal. After much discussion between the audit partner and directors of Dress You Like Co, the company agreed to make a provision of \$100,000 in relation to this claim.

It is now 18 November 20X6 and the auditor's report has not yet been signed. As part of your finalisation procedures, you have spoken to Dress You Like Co's legal counsel and they have informed you that the finance director has won the case. Dress You Like has been ordered to pay damages of \$500,000 by the court.

Required

Explain whether the financial statements of Dress You Like Co for the year ending 30 September 20X6 will need amending in relation to the result of the court case with the legal director.

Solution



Essential reading

See Chapter 19 of the Essential reading for further detail on subsequent events.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2 ISA 570 (Revised) Going Concern

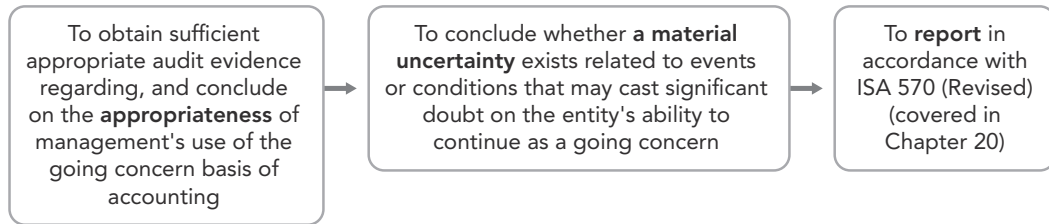


KEY
TERM

Going concern basis of accounting: Under the **going concern basis of accounting**, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. General purpose financial statements are prepared using the going concern basis of accounting, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. (ISA 570 (Revised): para 2)

If the going concern basis is not appropriate, the financial statements are prepared on a **break-up basis**.

ISA 570 (Revised): para 9 states that the objectives of the auditor are:



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.

Examples of events or conditions, which may cast doubt on whether the going concern basis of accounting is appropriate are shown below. These are sometimes referred to as **going concern indicators**.

Financial

- Net liability or net current liability position
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance non-current assets
- Indications of withdrawal of financial support by creditors
- Negative operating cash flows
- Adverse key financial ratios, eg high gearing, low current ratio, poor profit margins
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows
- Arrears or discontinuance of dividends
- Inability to pay creditors on due dates
- Inability to comply with the terms of loan agreements
- Change from credit to cash-on-delivery terms with suppliers
- Inability to obtain new financing

Operational

- Management intention to liquidate the entity or to cease operations
- Loss of key management without replacement
- Loss of a major market, key customer, licence, or principal supplier
- 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 are unlikely to be satisfied
- Changes in legislation or government policy expected to adversely affect the entity
- Uninsured or underinsured catastrophes when they occur

2.1 Management's assessment

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.

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 enquire 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.

Based on the audit evidence obtained, the auditor should determine if, in their judgement, a material uncertainty exists related to events or conditions that, alone or in aggregate, may cast significant doubt on the entity's ability to continue as a going concern.

2.2 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 performing additional audit procedures which shall include the following:

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

Specific **audit procedures** relevant to the above that the auditor could perform include:

Analysing and discussing cash flow, profit and other relevant forecasts with management
Analysing and discussing the entity's latest available interim financial statements
Reading the terms of debentures and loan agreements and determining whether any have been breached
Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties
Enquiring of the entity's lawyer about the existence of litigation and claims, and the reasonableness of management's assessments of their outcome and the estimate of their financial implications
Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds
Considering the entity's plans to deal with unfilled customer orders
Reviewing events after period end to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern
Obtaining and reviewing reports or regulatory actions

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. You will learn about how going concern impacts the auditor's report in Chapter 20.



Activity 2: Truckers

You are planning the audit of another client of Check & Co, Truckers Co. The company's principal activities are road transport and warehousing services, and the repair of commercial vehicles. You have been provided with the draft accounts for the year ended 31 October 20X6.

	<i>Draft 20X6</i>	<i>Actual 20X5</i>
SUMMARY STATEMENT OF PROFIT OR LOSS	\$'000	\$'000
Revenue	10,971	11,560
Cost of sales	<u>(10,203)</u>	<u>(10,474)</u>
Gross profit	768	1,086
Administrative expenses	(782)	(779)
Finance costs	<u>(235)</u>	<u>(185)</u>
Profit/(loss) for the period	<u>(249)</u>	<u>122</u>
SUMMARY STATEMENT OF FINANCIAL POSITION	\$'000	\$'000
<i>Non-current assets</i>	5,178	4,670
<i>Current assets</i>		
Inventories of parts and consumables	95	61
Receivables	<u>2,975</u>	<u>2,369</u>
Total current assets	<u>3,070</u>	<u>2,430</u>
	<u>8,248</u>	<u>7,100</u>
<i>Share capital and reserves</i>	3,544	3,793
<i>Non-current liabilities</i>		
Bank loan	750	1,000
Finance lease liabilities	<u>473</u>	<u>–</u>
	<u>1,223</u>	<u>1,000</u>
<i>Current liabilities</i>		
Bank loan	250	–
Overdraft	1,245	913
Trade payables	1,513	1,245
Finance lease liabilities	207	–
Other payables	<u>203</u>	<u>149</u>
Total current liabilities	<u>3,481</u>	<u>2,307</u>
	<u>8,248</u>	<u>7,100</u>

You have been informed by the managing director that the fall in revenue is due to:

- The loss in July 20X6 of a long-standing customer to a competitor; and
- A decline in trade in the repair of commercial vehicles.

Due to the reduction in the repairs business, the company has decided to close the workshop and sell the equipment and spares inventories. No entries resulting from this decision are reflected in the draft accounts.

During the year, the company replaced a number of vehicles, funding them by a combination of leasing and an increased overdraft facility. The facility is to be reviewed in January 20X7 after the audited accounts are available.

The draft accounts show a loss for 20X6 but the forecasts indicate a return to profitability in 20X7 as the managing director is optimistic about generating additional revenue from new contracts.

Required

From the scenario above identify features which might cause you to have doubts about Truckers' going concern status.

Solution



Essential reading

See Chapter 19 of the Essential reading for further detail on going concern including the responsibilities of management.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

3 ISA 580 Written Representations



Written representations: 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.

There are three main areas where written representations are necessary:

To **confirm that management has fulfilled its responsibilities** for the preparation of the financial statements, that all transactions have been recorded and reflected therein and that all relevant information and access has been provided to the auditor as agreed in the terms of engagement

A number of **ISAs require written representations** (such as fraud, laws and regulations, estimates, going concern, related parties and subsequent events)

To **support other audit evidence** relevant to the financial statements if determined by the auditor

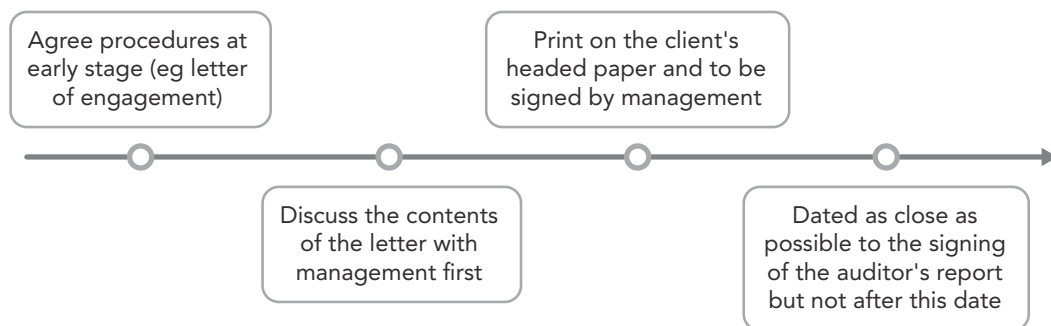
3.1 Supporting audit evidence

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.

The representations should relate to matters where they are necessary to **support** audit evidence. For example:

- Where knowledge of facts is confined to management, eg management's future plans or intentions that may affect the classification of assets or liabilities
- Where the matter is principally one of judgement, eg whether a receivable is a doubtful debt or not

3.2 Obtaining written representations



3.3 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

(ISA 580: para. 19)



Activity 3: Written representations

In which of these situations would a written representation from the management of Dress You Like Co be required?

- (1) To confirm that management has adjusted or disclosed all events subsequent to the date of the financial statements where adjustment or disclosure is required
 - (2) To confirm that management has disclosed any fraud affecting Dress You Like Co
 - (3) To confirm the disposal of delivery vans with a material value
- ☐ (a) only
- ☐ (a) and (c) only
- ☐ (a) and (b) only

- ☐ (b) and (c) only



Essential reading

See Chapter 19 of the Essential reading for further detail on written representations including an example of a written representation letter.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

4 Overall review of financial statements

At the finalisation stage, the financial statements are reviewed to determine whether they are consistent with the auditor's understanding of the entity. ISA 520 *Analytical Procedures* states the auditor shall design and perform analytical procedures to assist in forming that overall conclusion (ISA 520: para. 6).

The review will determine whether:

Financial statements are prepared using **acceptable accounting policies, consistently applied and appropriate** to the entity.

Information included in financial statements is **compatible** with audit findings.

There is adequate **disclosure** and proper classification and presentation of information

Financial statements comply with **statutory requirements** and **other regulations**.

When considering whether the accounting policies are appropriate, auditors should consider:

- Policies commonly adopted in particular industries
- Policies for which there is substantial authoritative support
- Whether any departures from applicable accounting standards are necessary for the financial statements to give a true and fair view
- Whether the financial statements reflect the substance of the underlying transactions and not merely their form

4.1 Uncorrected misstatements



Misstatement: 'A difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud' (ISA 450: para. 4(a)).

An **uncorrected misstatement** is a misstatement that the auditor has accumulated during the audit and that has not been corrected (ISA 450: para. 4(b)).

During the audit, a schedule will have been maintained of misstatements identified that have not been corrected by the client.

Some of these may have been individually immaterial but the schedule must be reviewed at this stage before the audit opinion is finalised. The effect of the uncorrected misstatements must be considered in aggregate as their combined effect may be material and thus could affect the audit opinion.

4.2 Communication of uncorrected misstatements

ISA 450 *Evaluation of Misstatements Identified during the Audit* 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 as to 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.

ISA 450 requires the auditor to document the following information:

- (a) The amount below which misstatements would be regarded as clearly trivial
- (b) All misstatements accumulated during the audit and whether they have been corrected
- (c) The auditor's conclusion as to whether uncorrected misstatements are material and the basis for that conclusion (ISA 450: para. 15)



Example - Uncorrected misstatements

The following schedule illustrates the summary of uncorrected misstatements following the audit of Dress You Like Co for the year ending 30 September 20X6. Revenue is \$51,895,000 and profit before tax is \$1,025,000.

Description	Statement of profit or loss		Statement of financial position	
	DR	CR	DR	CR
Damaged white shirts to be written down	2,500			2,500
Inventory item DYL120008P to be written down to NRV	1,200			1,200
Correction of item DYL120008P cost allocation	6,000			6,000
Write off of aged receivables	5,000			5,000
Invoice #103965 under recorded		1,000	1,000	
Outstanding cheque 2411	10,250			10,250
Accrued internet cost	8,000			8,000
Loan interest miscalculation	7,000			7,000
Transposition error	5,000			5,000
Depreciation correction	8,000			8,000
Total	52,950	1,000	1,000	52,950
Overall total	51,950			51,950

Materiality has been calculated at 5% of profit before tax which is \$51,250 ($\$1,025,000 \times 0.05$) and 0.5% of revenue which is \$259,475 ($\$51,895,000 \times 0.005$).

Individually, none of the uncorrected misstatements in the schedule are material to profit before tax or revenue. However, we can see that overall the impact to the statement of profit and loss is a debit of \$51,950. This is material to profit before tax.

Check & Co must ask the management of Dress You Like Co to correct the misstatements. If the management refuse to do this, the financial statements will be materially misstated and Check & Co will have to modify the opinion in their auditor's report. You will learn more about the different types of modification in the next chapter.

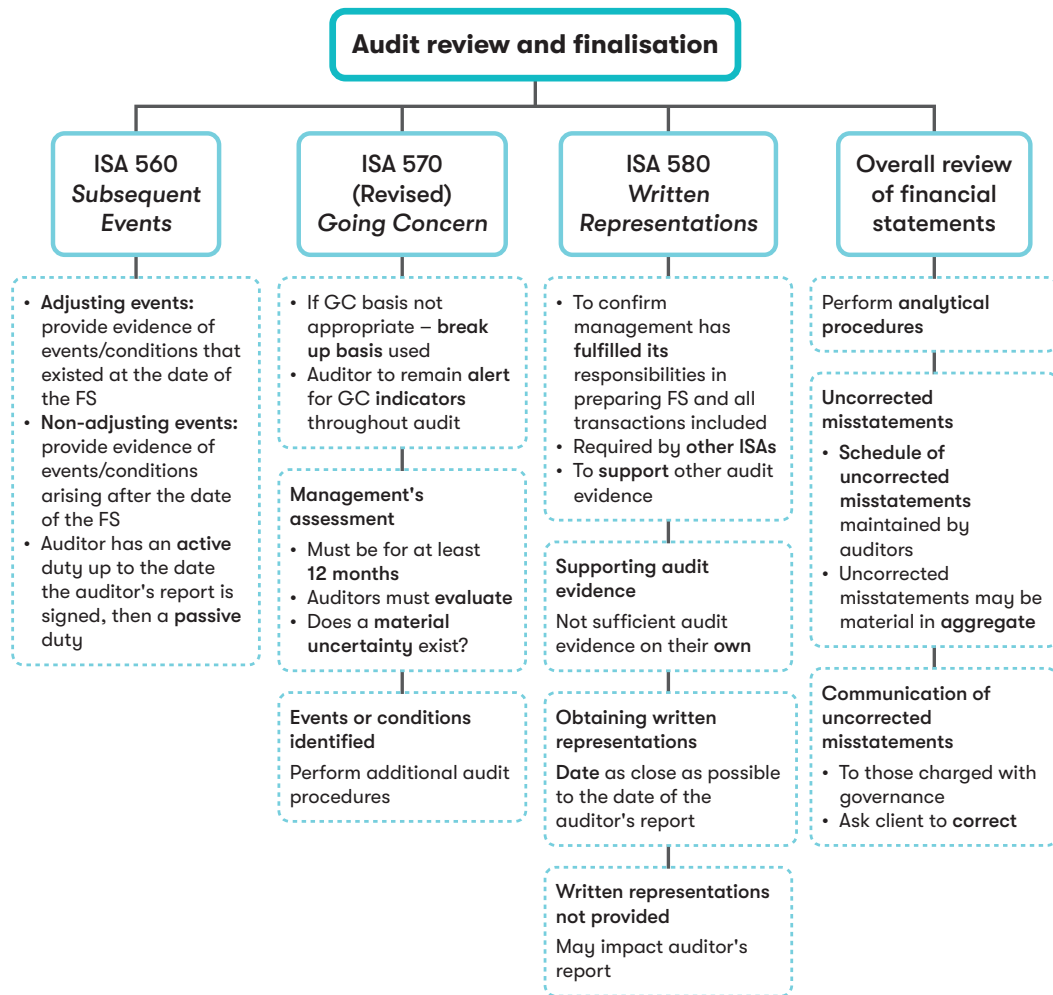


Essential reading

See Chapter 19 of the Essential reading for further detail on the overall review of financial statements.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

Chapter summary



Knowledge diagnostic

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.

2. Subsequent events review

The auditor has a duty to perform procedures to identify **subsequent events** up to the date of the auditor's report.

3. Impact of subsequent events

If further events are discovered after the date of the report, the auditor should discuss with client management and take appropriate action.

4. Going concern

The auditor must consider the appropriateness of the **going concern** basis of accounting.

5. Impact of going concern

If the entity has inappropriately used the going concern basis of accounting or a material uncertainty exists, this may impact on the auditor's report.

6. Written representations

The auditor obtains **written representations** from management concerning its responsibilities and to support other audit evidence where necessary.

7. Overall review of financial statements

Before issuing the audit opinion, the auditor should carry out an **overall review** of the financial statements.

8. Uncorrected misstatements

The auditor must keep a schedule of uncorrected misstatements as these may be material in aggregate.

Further study guidance

Question practice

Now try the following from the Further question practice bank [available in the digital edition of the Workbook]:

- Section A Q3 (items 1-3), Q14, Q35-38
- Section B Q54 (b) (ii) 'Parker' on going concern
- Section B Q75 'Going concern'
- Section B Q76 'Audit review and finalisation'

Further reading

There are some technical articles on the ACCA website written by members of the AA examining team which are relevant to some of the topics covered in this chapter that you should read:

- *Subsequent events*: www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/subsequent-events.html
- *Going concern*: www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/going-concern.html

Own research

Look for financial statements of well-known companies online. Can you find an example of a subsequent event? How has this been dealt with by the auditors?

Activity answers

Activity 1: Subsequent event

Dress You Like Co have made a provision of \$100,000 for a court case but the settlement was for \$500,000 and so the provision is understated by \$400,000 on the statement of financial position. Correspondingly, profit in the statement of profit and loss is overstated by the same amount and expenses are understated by \$400,000. The amount of the misstatement is 0.8% ($\$400,000/\$51,895,000$) of revenue and 39% ($\$400,000/\$1,025,000$) of profit before tax. It is therefore borderline material to revenue but material to profit before tax.

The settlement of a court case between the year-end date and the date the financial statements are signed is an adjusting event. The financial statements of Dress You Like Co for the year ending 30 September 20X6 will need to be adjusted before the auditor's report is signed.

Activity 2: Truckers

The following factors might cause doubt about Trucker's going concern status:

- Fall in gross profit margin (20X6: 7%; 20X5: 9.4%). This will make a return to profitability difficult.
- Truckers is making losses. This will make negotiations with the bank difficult.
- Receivables are taking longer to pay (20X6: 99 days; 20X5: 75 days). This will squeeze cash flow coming into the business. Irrecoverable debts will increase the existing loss.
- A worsening liquidity ratio (0.88 in 20X6; 1.05 in 20X5). Loan and lease commitments may not be met.
- An increasing reliance on short-term finance. The overdraft can be recalled by the bank at any time. It should not be used to finance long-term investment.
- Increased gearing (20X6: 63% [$750 + 250 + 1,245/3,544$]; 20X5: 50% [$1,000 + 913/3,793$]). Interest on debt must be paid from a decreasing cash position.
- Loss of major customer. Other customers may follow, worsening the company's prospects.
- Loss of commercial customers. This represents loss of regular income which means damage to company's reputation.
- Overdraft facility to be reviewed three months after the year-end. This short period is probably not long enough to see any improvement in the company's future prospects and therefore may not be renewed.
- Despite the managing director's optimism, there is no evidence to support the forecasts of additional revenue from new contracts.

Activity 3: Written representations

The correct answer is: (a) and (b) only

Confirming that management has adjusted or disclosed all events subsequent to the date of the financial statements where adjustment or disclosure is required is a requirement of ISA 560 *Subsequent Events*.

ISA 240 *The Auditors' Responsibilities Relating to Fraud in an Audit of Financial Statements* requires a written representation from management which, amongst other things, requires management to confirm that they disclosed any fraud or suspected fraud affecting the entity.

No management representation is required for the disposal of a non-current asset. Sufficient appropriate audit evidence should be available via other means (eg observing contracts, cash received in bank statements etc) and would not need to be supported by a written representation.

Learning objectives

On completion of this chapter, you should be able to:

Syllabus learning outcomes	Syllabus reference no.
Identify and describe the basic elements contained in the independent auditor's report.	E5 (a)
Explain unmodified audit opinions in the auditor's report.	E5 (b)
Explain the circumstances in which a modified audit opinion may be included in the auditor's report.	E5 (c)
Explain the impact on the auditor's report when a modified opinion is issued.	E5 (d)
Describe the format and content of key audit matters, emphasis of matter and other matter paragraphs	E5 (e)
Discuss the reporting implications of the findings of going concern reviews.	E2 (g)

Exam context

The auditor's report is the means by which the external auditors express their opinion on the truth and fairness of a company's financial statements. It is for the benefit of the shareholders principally, but also for other users, as the auditor's report is usually kept on public record with the filed financial statements.

Auditor's reports are covered by the following ISAs:

- ISA 700 (Revised) *Forming an Opinion and Reporting on Financial Statements*
- ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*
- ISA 705 (Revised) *Modifications to the Opinion in the Independent Auditor's Report*
- ISA 706 (Revised) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*
- ISA 720 (Revised) *The Auditor's Responsibilities Relating to Other Information*

These ISAs were revised in 2015. The IAASB believes that the revisions are essential to the continued relevance of the audit profession globally. The aims of the revisions were to respond to users, who said that:

- The audit opinion is valued, but could be more informative
- More relevant information is needed about the entity and the audit

(IAASB, 2016)

You will not be expected to reproduce a full auditor's report in the exam; however, you need to know and understand the elements that make up a standard auditor's report. You might also be required to explain the appropriate modification to the audit opinion for a scenario in a Section A or a Section B question.

If you are given a scenario in a Section B question and asked whether the auditor's report should be modified and why, you should apply the following four steps:

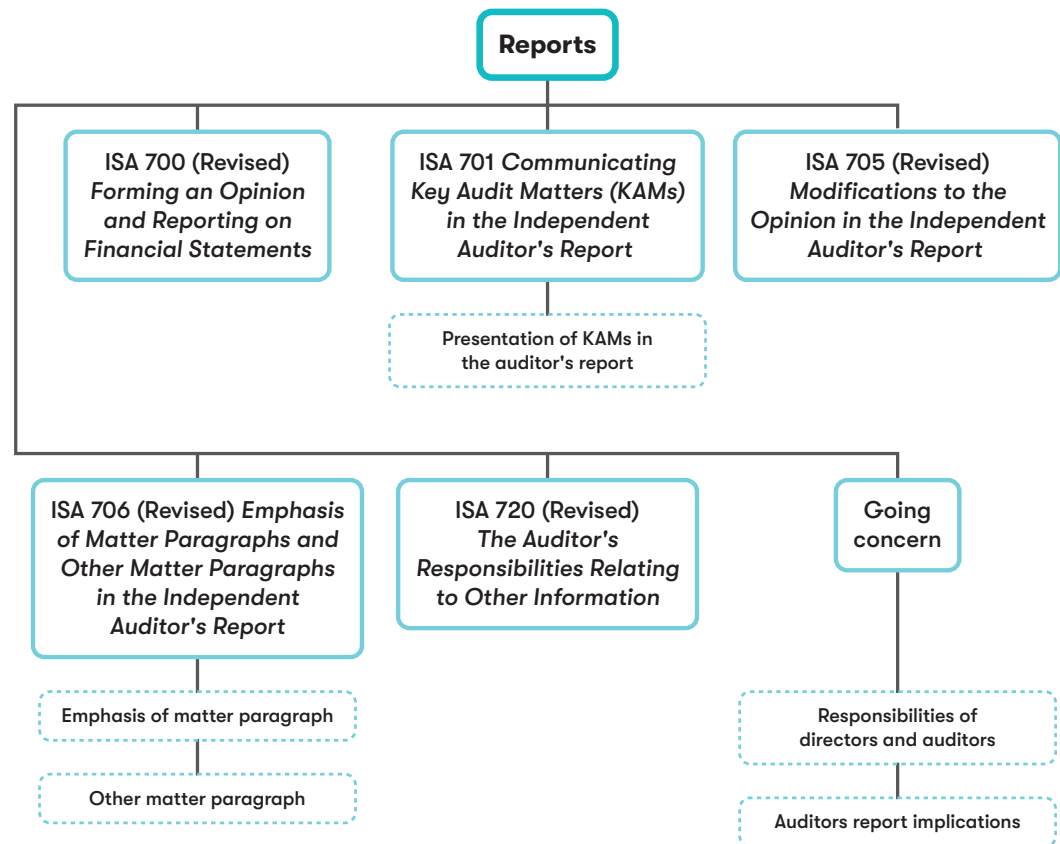
- (a) Discuss the accounting issue
- (b) Assess whether the issue is material (include a calculation)
- (c) Consider the type of modification (ie qualified opinion, adverse opinion or disclaimer of opinion)
- (d) Discuss the impact on the auditor's report

Remember that some issues will only impact the auditor's report (emphasis of matter, other matter) but not the auditor's opinion.

You should also be able to identify the issues which need to be reported in the Key Audit Matters paragraph of the auditor's report.

It is very important that you are aware of the reporting implications detailed in ISA 570 (Revised) *Going Concern* 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 examining team's reports. Do not 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 auditor's report issued will depend on the adequacy of those disclosures.

Chapter overview



1 ISA 700 (Revised) Forming an Opinion and Reporting on Financial Statements



PER alert

Objective 20 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.

ISA 700 (Revised) *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 requires the auditor to give an opinion on whether the financial statements are prepared, in all material respects, **in accordance with the applicable financial reporting framework**.

To do this, the auditor needs to consider the following key points:

Whether sufficient appropriate audit evidence has been obtained (ISA 330)

Whether uncorrected misstatements are material (ISA 450)

1.1 Basic elements of the auditor's report

The auditor's report should include the following basic elements, normally in this order:

- (a) Title
- (b) Addressee
- (c) Auditor's opinion
- (d) Basis for opinion
- (e) Going concern (if relevant)
- (f) Emphasis of matter paragraph (if relevant, can also be placed after key audit matters (KAM) paragraph)
- (g) Key audit matters (KAM) (for audits of **listed** entities only)
- (h) Other matter paragraph (if relevant)
- (i) Responsibilities for the financial statements
- (j) Auditor's responsibilities for the audit of the financial statements
- (k) Report on other legal and regulatory requirements (if relevant)
- (l) Name of audit engagement partner
- (m) Signature of the auditor
- (n) Auditor's address
- (o) Date of the auditor's report

1.2 Unmodified opinion



Unmodified opinion: 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: para. 16).

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 (Revised) *Modifications to the Opinion in the Independent Auditor's Report*. We discuss modifications to the opinion in Section 3 of this chapter.



Example 1 - Unmodified auditor's report with unmodified opinion (listed entity)

The standard report as laid down by ISA 700 (Revised) looks like the following (in overview):

INDEPENDENT AUDITOR'S REPORT

To the shareholders of the company [or other appropriate addressee.]

Opinion

[Includes the individual statements and the reporting period under review for the company being audited. It can use either 'give a true and fair view' or 'presents fairly, in all material respects' and states the relevant GAAP adopted.]

Basis for opinion

[This is always presented after the opinion and explains how the audit was conducted: the role of ISAs and the IESBA *Code of Ethics* as well as the audit evidence being sufficient and appropriate to provide a basis for the auditor's opinion.]

Key audit matters

[As per ISA 701, matters of most significance from the audit; required for all listed entities.]

Other information

[As per ISA 720, communicates that there is nothing to report regarding other information.]

Responsibilities of management and those charged with governance for the financial statements

[Preparation and fair presentation of the financial statements, including internal controls, and the assessment of the company's ability to continue as a going concern.]

Auditor's responsibilities for the audit of the financial statements

[A detailed summary of the auditor's objectives, starting with obtaining reasonable assurance about the financial statements being free from material misstatements due to fraud or error. Stresses the role of professional judgment and scepticism over accounting policies and estimates, judgments, internal controls, presentation, disclosure and communicating key audit matters and other issues with those charged with governance.]

Report on other legal and regulatory requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

Signed

[Auditor's name and/or signature, address and date of the auditor's report.]



Essential reading

See Chapter 20 of the Essential reading for more on the auditor's report including a full reproduction of the auditor's report.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2 ISA 701 Communicating Key Audit Matters (KAMs) in the Independent Auditor's Report

The communication of KAMs is only relevant to the audit of **listed** entities.



Key audit matters: those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

(ISA 701: para. 8)

Examples include:

Areas where the risk of material misstatement has been assessed as high at the planning stage, for example complex accounting transactions

Areas of the financial statements where management have had to exercise significant judgement, for example asset valuations or accounting estimates where there is a high level of uncertainty

The effect on the audit of significant events or transactions that occurred during the period, for example the acquisition of a subsidiary

KAMs relate to matters which are already included in the financial statements.

KAMs do not constitute a modification of the report or of the opinion. No separate audit opinion is issued in relation to each KAM.

2.1 Presentation of KAMs in the auditor's report

Each KAM detailed in the auditor's report should refer to the related disclosure in the financial statements and will explain:

- (a) Why the matter was considered to be significant and therefore a KAM
- (b) How the matter was addressed in the audit

KAMs will be communicated in the auditor's report of a listed entity where there are matters that required significant auditor attention.

Whether the auditor's opinion is unmodified or modified is unrelated to the KAM. The auditor's opinion for a listed entity can be unmodified and a KAM still need to be communicated because of the fact that matters have required significant auditor attention. If the auditor's opinion is modified, KAMs will still be communicated if there are matters that have required significant auditor attention.

Where the auditor's opinion is modified (see Section 3) in relation to a KAM, the issue would **not** be disclosed in the KAM, paragraph but in the 'Basis for modified opinion' paragraph.

Any concerns relating to an entity's ability to continue as a going concern would **not** be disclosed in the KAM, paragraph but in the 'Material uncertainty relating to going concern' paragraph (see Section 6).



Essential reading

See Chapter 20 of the Essential reading for more on KAMs including an example of how they could appear in the auditor's report taken from ISA 701.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

3 ISA 705 (Revised) Modifications to the Opinion in the Independent Auditor's Report

The auditor will give a modified audit opinion when:

- The auditor concludes, based on the evidence obtained, that the financial statements as a whole are not free from material misstatement; or
- The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

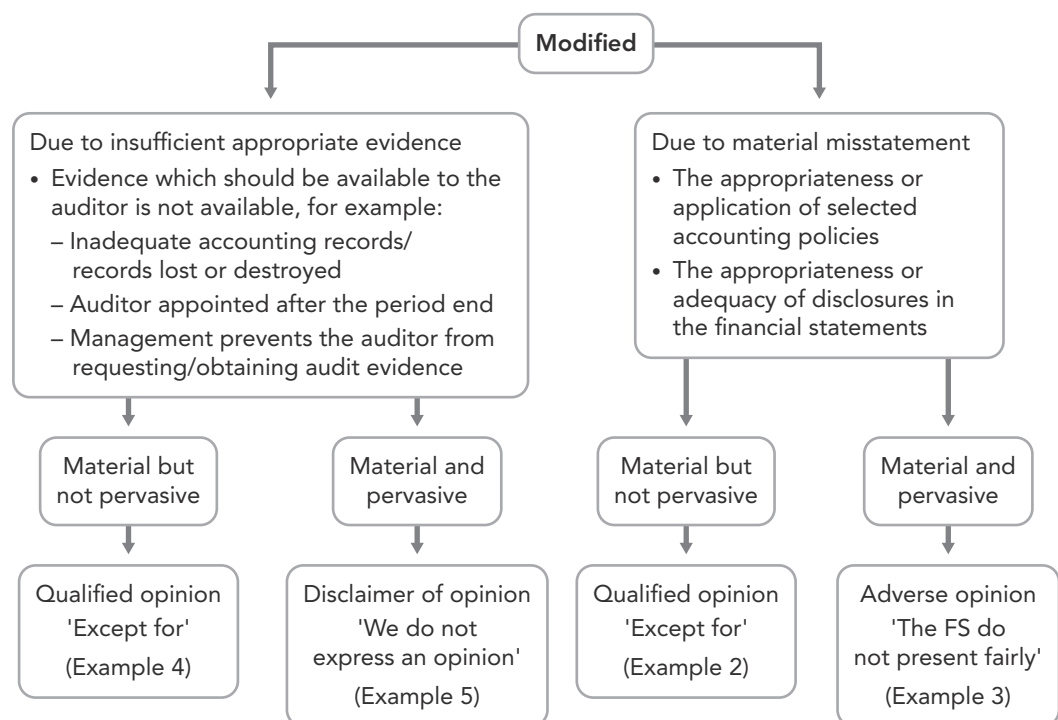
In both circumstances there can be two 'levels' of modified opinion:

- Material but not pervasive**, where the circumstances prompting the misstatement are material
- Material and pervasive**, where the financial statements could be misleading



Pervasiveness: 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 (ISA 705 (Revised): para. 5(a))



Example 2 - Qualified opinion due to material misstatement of inventories (extract from auditor's report)

Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive

income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at 31 December 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

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 IFRSs. 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.



Example 3 - Adverse opinion due to material misstatement with a pervasive effect (extract from auditor's report)

Adverse Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying financial statements do not present fairly (or *do not give a true and fair view of*) the financial position of ABC Company as at 31 December 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with IFRSs.

Basis for Adverse Opinion

As explained in Note X, 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].



Example 4 - Qualified opinion due to inability to obtain sufficient appropriate audit evidence about the carrying amount of inventory (material but not pervasive) (extract from auditor's report)

Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of ABC Company as at 31 December 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with IFRSs.

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 inventories quantities by using other audit procedures.



Example 5 - Disclaimer of opinion due to inability to obtain sufficient appropriate audit evidence about multiple elements of the financial statements (inventories and accounts receivable – material and pervasive) (extract from auditor's report)

Disclaimer of Opinion

We were engaged to audit the financial statements of ABC Company (the Company), which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying financial statements. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

We were not appointed as auditors of the company until after 31 December 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 31 December 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 auditor's 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 31 December 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 income statement, statement of changes in equity and statement of cash flows.



Essential reading

See Chapter 20 of the Essential reading for further details on each type of modification. The Essential reading is available as an Appendix of the digital edition of the Workbook.



Activity 1: The auditor's report

Check & Co is also the auditor of Research Ltd and is currently finalising the audit of its financial statements for the year ending 31 December 20X6. Research Ltd designs, develops and produces medical scanning equipment to be used in hospitals and doctors' surgeries. The financial statements of Research Ltd show revenue of \$98 million, profit before tax of \$20 million and net assets of \$78 million for the year ending 31 December 20X6.

During the audit, the team learnt that Research Ltd capitalised \$2.5 million of development costs in the year, relating to a new portable scanning machine for ambulances. However, the audit team also found evidence that Research Ltd have been unable to sell any of the portable

scanning machines since they are too large to fit in a standard ambulance. Further audit procedures discovered there was no market for the machines elsewhere.

The directors of Research Ltd have refused to remove the development costs from their statement of financial position as they believe that ambulances will probably get bigger in the next few years and they will be able to sell the machines then.

Required

- 1 Explain why the inclusion of the development costs on Research Ltd's statement of financial position for the year ending 31 December 20X6 is an issue for the auditors.
- 2 Provide a calculation to show whether the matter in part (1) is material.
- 3 Assume management refuses to correct the financial statements for the matter in part (1). What modification to the auditor's opinion would Check & Co need to make and why?
- 4 Explain how the modification will impact the structure and form of the auditor's report.

Solution

4 ISA 706 (Revised) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

4.1 Emphasis of matter paragraph



Emphasis of matter: 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 (*ISA 706 (Revised): para. 7(a)*).

Examples of circumstances where the auditor may include an emphasis of matter paragraph are:

An uncertainty relating to the future outcome of exceptional litigation or regulatory action

A significant subsequent event that occurs between the date of the financial statements and

the date of the auditor's report, for example a fire at the entity's production facilities
Early application (where permitted) of a new accounting standard that has a material effect on the financial statements
A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position

An emphasis of matter paragraph is **not** used to highlight any going concern issues. Such issues would be disclosed in a 'material uncertainty related to going concern' paragraph (Section 6).

For **listed** entity audits, the same issue would **not** be included within the emphasis of matter paragraph and the KAM paragraph.

- (a) If the issue is fundamental to users' understanding and has required significant audit attention than it should be disclosed as a key audit matter.
- (b) However, if the issue is fundamental to users' understanding but has not required significant audit attention, for example a subsequent event, then it should be disclosed within the emphasis of matter paragraph.

Where an emphasis of matter paragraph is used:

It can come immediately before or after the key audit matters, depending on the significance of the information
It is entitled 'Emphasis of matter'
The paragraph makes a clear reference to the matter being emphasised and to where the relevant disclosures that fully describe the matter 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



Example 6 - Emphasis of matter paragraph (extract from auditor's report)

Emphasis of Matter

We draw attention to Note X of the financial statements, which describes the effects of a fire in the company's production facilities. **Our opinion is not modified in respect of this matter.**

4.2 Other matter paragraph



Other matter paragraph: 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 (ISA 706 (Revised): para. 7(b)).

Examples of circumstances where the auditor may include another matter paragraph are where the prior year financial statements:

Have not been audited
Have been audited by another auditor

For listed entity audits, the same issue would not be included within the other matter paragraph and the KAM paragraph.

Where another matter paragraph is used:

It usually comes immediately after the key audit matters

It is entitled 'Other matter'



Example 7 - Other matter paragraph (extract from auditor's report)

Other Matter

The financial statements of ABC Company for the year ended 31 December 20X0 were audited by another auditor who expressed an unmodified opinion on those statements on 31 March 20X1.



Essential reading

See Chapter 20 of the Essential reading for further details on emphasis of matter and other matter paragraphs.

The Essential reading is available as an Appendix of the digital edition of the Workbook.



Activity 2: Modified opinions and modified auditor's reports

You are the audit manager of Check & Co and are reviewing the key issues identified in the files of several audit clients, each of which has a year end of 30 September 20X6.

- 1 The first audit client is Little Bees Co (LB). The fieldwork stage for this audit has been completed and the draft financial statements show a profit before tax of \$175,000.
LB has valued a certain inventory line at its total cost price of \$17,000. These inventory items have not been sold for a number of years and it is unlikely that they can be sold in the future unless the price is reduced to \$3,000. The finance director is confident that the issue will be resolved and no write down was made with regards to this balance.

Required

Which of the following options correctly summarises the impact on the auditor's report if the issue remains unresolved?

- ☐ Adverse opinion
- ☐ Disclaimer of opinion
- ☐ Qualified 'except for'
- ☐ Unmodified opinion

- 2 The second audit client is Hayden Co (Hayden).

On 1 January 20X6, Hayden implemented a new accounting system; this was generally a success, with the exception of February 20X6 when one month of Hayden's inventory records were lost. Despite several attempts, the audit team was unable to perform alternative audit procedures to verify material inventory transactions in February 20X6, although the year-end inventory count went smoothly.

Required

Which of the following options correctly summarises the impact on the auditor's report of the above issue?

- ☐ Disclaimer of opinion
- ☐ Qualified 'except for'
- ☐ Unmodified opinion
- ☐ Unmodified opinion with emphasis of matter paragraph

- 3 The third audit client is Maker Co (Maker), a listed construction company which specialises in residential housebuilding. One of Maker's construction workers, Edward Shift, was dismissed in

August 20X6 after turning up for work under the influence of alcohol. In September 20X6, Mr Shift began a case against Maker for unfair dismissal.

Required

Which TWO of the following audit procedures should be performed in order to form a conclusion as to the appropriate accounting treatment of the above claim in the year end year-end financial statements?

- ☐ Recalculate Mr Shift's wages and salaries for the year to verify that he was only paid up to the date of dismissal
 - ☐ Review the construction work performed by Mr Shift in August 20X6 to determine whether there are any concerns over the quality of his work and whether Maker's health and safety procedures were followed
 - ☐ Review legal correspondence relating to the claim in order to determine Maker's lawyers' opinion as to the likely outcome of the claim
 - ☐ Review the post year end cash book in order to determine whether any payments were made to Mr Shift
- 4 Mr Shift has sent such a huge amount of paperwork to Maker detailing the extent of his claim along with supporting medical documentation and character references that the audit team has had to devote a significant amount of audit attention to this area of the audit. The directors have not made any reference to the claim in the financial statements and you agree with Maker's lawyers' indication that it is highly unlikely that Mr Shift will be successful in his claim.

Required

Based on the above information indicate whether the audit opinion should be modified or unmodified and the appropriate disclosure which should be made in the auditor's report:

Audit opinion	Disclosure in the auditor's report
Audit opinion:	Modified
	Unmodified
Disclosure in the auditor's report:	Emphasis of matter paragraph
	Key audit matter paragraph
	Material uncertainty related to going concern paragraph
	No disclosure required
	Other matter paragraph

5 ISA 720 (Revised) The Auditor's Responsibilities Relating to Other Information



Other information: financial or non-financial information (other than the financial statements and the auditor's report thereon) included in an entity's annual report (*ISA 720 (Revised): para. 12(c)*).

Annual report: a document, or combination of documents, prepared typically on an annual basis by management or those charged with governance in accordance with law, regulation or custom. Its purpose is to provide owners (or similar stakeholders) with information on the entity's operations and the entity's financial results and financial position as set out in the financial statements (*ISA 720 (Revised): para. 12(a)*).

A misstatement of the other information: exists when the other information is incorrectly stated or otherwise misleading (including because it omits or obscures information necessary for a proper understanding of a matter disclosed in the other information) (ISA 720 (Revised): para. 12(b)).

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.

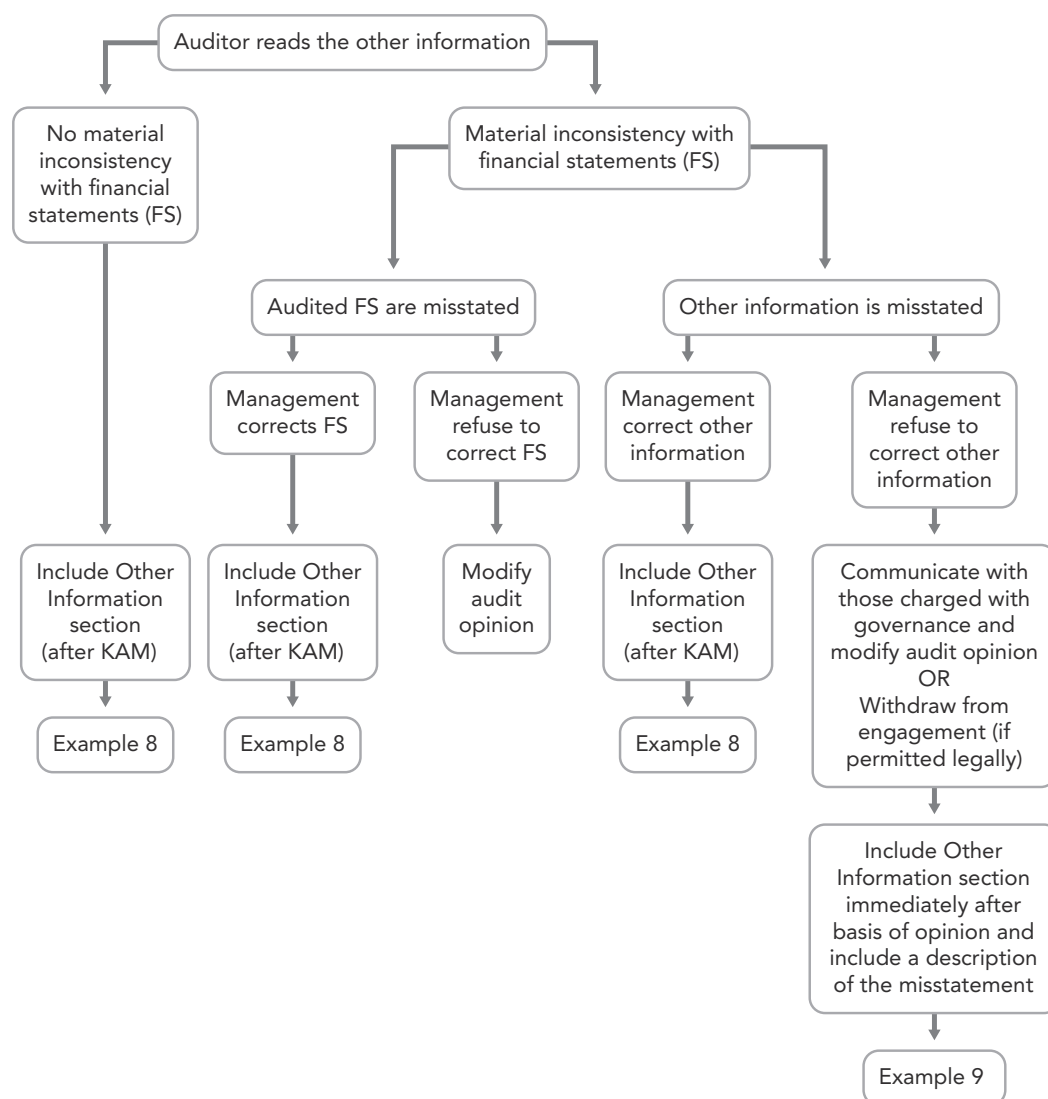
Examples of other amounts or other items that may be included as other information are as follows:

- Overview of strategy
- Financial summaries or highlights
- Planned capital expenditures
- Financial ratios
- Explanations of critical accounting estimates and related assumptions

(ISA 720 (Revised): Appendix 1)

5.1 Material inconsistencies

ISA 720 (Revised) (para. 14) states that the auditor shall read the other information to identify **material inconsistencies** with the audited financial statements. In reading and considering the other information, the auditor should also consider whether the auditor's understanding of the entity and its environment needs to be updated. The process is as follows:



5.2 Reporting

The auditor's report will always include a separate 'Other Information' section when the auditor has obtained some or all of the other information as of the date of the auditor's report. For listed entities, the section is also included if other information is expected to be received after the date of the auditor's report.



Example 8 - Other information section

The Other Information section is placed after the Key Audit Matters section and where the other information is not materially misstated it would be worded as follows:

Other Information

Management is responsible for the other information. The other information comprises the [information included in the X report, but does not include the financial statements and our auditor's report thereon.]

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If based on the work we have performed, we conclude that there is a

material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

(ISA 720 (Revised): Appendix 2)



Example 9 - Material misstatement of other information

If the auditor concludes that there is a material misstatement of the other information, the 'Other Information' section is placed immediately after the basis of opinion section. It will state:

As described below, we have concluded that such a material misstatement of the other information exists.

This statement is followed by a description of the misstatement (ISA 720 (Revised): Appendix 2).

6 Going concern

6.1 Responsibilities of directors and auditors

It is the **directors' responsibility** to determine whether or not an entity is a going concern.

According to ISA 570 (Revised), it is the **auditor's responsibility** to make an assessment as to whether the directors' conclusion is appropriate. This should be based on the results of the going concern review performed by the auditor. The auditor must consider:

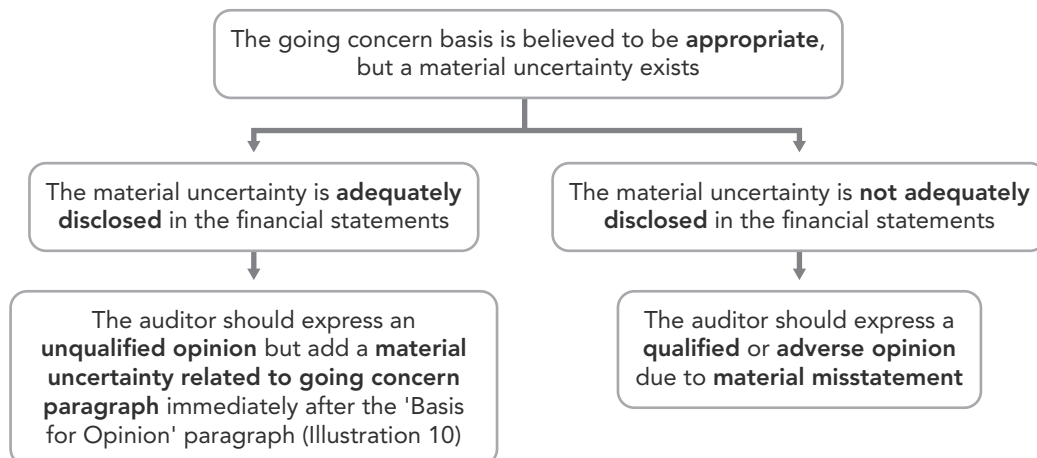
- (a) Whether the use of the **going concern basis is appropriate**;
- (b) Whether **adequate disclosure** has been made of any **material uncertainties** affecting going concern; and
- (c) Whether management's assessment was **adequate**.

If there is concern about any of the items above, then the auditor should consider the implications for their auditor's report.

6.2 Auditor's report implications

There are three main scenarios:

6.2.1 Scenario 1: Going concern basis is appropriate but a material uncertainty exists





Example 10 - Material uncertainty related to going concern (extract from auditor's report)

We draw attention to Note X in the financial statements, which indicates that the company incurred a net loss of \$Z during the year ended 31 December 20X1, and as of that date, the company's current liabilities exceeded its total assets by \$Y. As stated in Note X, these events or conditions, along with other matters as described in Note X, indicate that a material uncertainty exists that may cast significant doubt on the company's ability to continue as a going concern.

Our opinion is not modified in respect of this matter.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the 'material uncertainty related to going concern' section, we have determined the matters described below to be the key audit matters to be communicated in our report.

[Description of each key audit matter in accordance with ISA 701. Note that where a matter is the subject of a 'material uncertainty related to going concern' paragraph, the **same** matter would **not** also be a KAM.]

6.2.2 Scenario 2: Going concern basis inappropriate

The going concern basis is believed to be **inappropriate**



The auditor should express an **adverse opinion** due to **material and pervasive misstatement**

6.2.3 Scenario 3: Management unable or unwilling to make assessment

The directors are unwilling/unable to make an assessment as to whether or not the going concern basis is appropriate



The auditor should express a **qualified or disclaimer of opinion** due to **insufficient appropriate audit evidence**

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
- Where applicable, the implications for the auditor's report

(ISA 570 (Revised): para. 25)



Activity 3: Going concern

Check & Co is the auditor of TH Co (TH). The audit fieldwork is complete; however, your audit senior has raised an outstanding issue.

The directors of TH have made appropriate disclosures relating to worries over going concern in the financial statements. Your audit senior has a significant level of concern regarding the use of the going concern basis but feels the disclosure is appropriate and agrees with the use of the going concern basis. You concur with the audit senior's conclusions.

Required

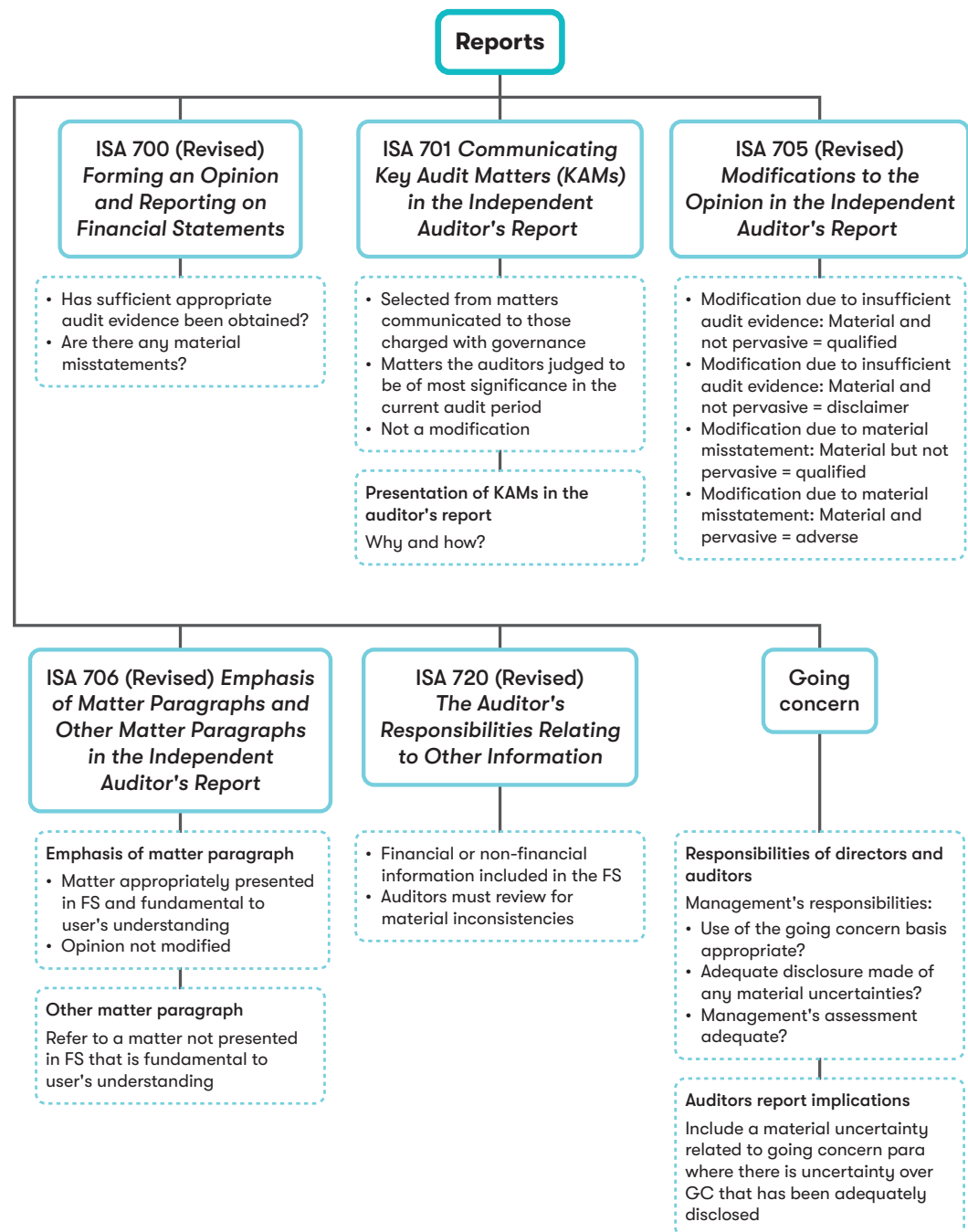
Based on the above information indicate whether the audit opinion should be modified or unmodified and the appropriate disclosure which should be made in the auditor's report:

Audit opinion	Qualified 'except for'	Disclaimer of opinion	Adverse	Unmodified
Disclosure in the auditor's report	Emphasis of matter paragraph	Material uncertainty relating to going concern	No disclosure required	

Audit opinion	Disclosure in the auditor's report

Solution

Chapter summary



Knowledge diagnostic

1. Purpose of auditor's report

The auditor is required to produce an auditor's report at the end of the audit which sets out their 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.

2. Elements of the auditor's report

The elements of the auditor's report are specified by ISA 700 (Revised).

3. Unmodified/modified reports

Auditor's report may be **unmodified** or **modified**.

4. Key audit matters

For listed entity audits the auditor should report areas of the audit which have required significant audit attention as **key audit matters**. These should also be reported to those charged with governance.

5. Modified opinions

Auditors will modify their opinions when the financial statements are not free from **material misstatement** or when they have been **unable to obtain sufficient appropriate evidence**.

6. Types of modified opinion

There are three types of modified opinion: a **qualified** opinion, an **adverse** opinion and a **disclaimer** of opinion.

7. Modified reports

A report may be modified by an **emphasis of matter** or **other matter** paragraph. These do **not** affect the opinion.

8. Other information

Auditors shall review the **other information** to determine whether there are any material **inconsistencies** or whether other information is materially misstated.

9. Going concern

It is the directors' responsibility to determine whether an entity is a going concern and the auditor's responsibility to assess whether this is appropriate.

10. Material uncertainty relating to going concern paragraph

Uncertainty over going concern will lead to the inclusion of a '**Material uncertainty related to going concern**' paragraph being included in the auditor's report (provided that the issue is adequately disclosed).

11. Adverse opinion

Material misstatement in relation to going concern is likely to be one of the rare circumstances where an adverse opinion is issued.

Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

- Section A Q3 (items 4 and 5) and Q39-43
- Section B Q46(b) 'Audit and assurance engagements' on reporting by exception
- Section B Q77 'Wiseguys National Bakeries'
- Section B Q78 'Homes 'r' Us'
- Section B Q79 'Builders Merchants'

Further reading

There are a number of technical articles on the ACCA website written by members of the AA examining team which are relevant to some of the topics covered in this chapter that you should read:

- *The auditor's report* (<https://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/auditor-report.html>)
- *Going concern* (<https://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/going-concern.html>)

Own research

The IAASB has a section on its website devoted to auditor reporting which contains guidance on areas such as key audit matters and details on the development of the current auditing standards. You can view this at <https://www.iaasb.org/focus-areas/new-auditors-report>

Activity answers

Activity 1: The auditor's report

- 1 Research Ltd have included \$2.5 million of development costs on their statement of financial position which do not meet the criteria of IAS 38 *Intangible Assets*. IAS 38 includes a number of criteria which must be satisfied before development costs can be capitalised including commercial feasibility of the asset for sale. Since the machines are currently too large to fit in the ambulances and there is no other market, Research Ltd have not met this criteria and the development costs should not have been capitalised. The \$2.5 million should be expensed to the statement of profit and loss. Otherwise, intangible assets and profits will both be overstated, and expenses will be understated.
- 2 The development costs are 3.2% of net assets, 2.6% of revenue and 12.5% of profit before tax. Therefore, they are material to both the statement of financial position and the statement of profit and loss.
- 3 If management refuse to remove the development costs from the statement of financial position then there is a material misstatement and the opinion will need to be modified. Since this misstatement only affects one area of the financial statements it is not pervasive. A qualified ('except for') opinion will be required.
- 4 The title of the opinion paragraph will be amended to 'Qualified Opinion'. The title of the 'Basis for Opinion' paragraph which immediately follows the opinion paragraph will need to be amended to 'Basis for Qualified Opinion'. This paragraph states the reason for the qualification and quantifies its effect on the financial statements. Its positioning will not change due to the qualification.

Activity 2: Modified opinions and modified auditor's reports

- 1 The correct answer is: Qualified 'except for'
LB has not valued inventory at the lower of cost and net realisable value on a line by line basis, which is contrary to the accounting standard IAS 2 *Inventories*.
If it had, then the inventory line would have been written down by \$14,000 (\$17,000 cost less \$3,000 NRV). Inventory is therefore overstated in the statement of financial position.
The misstatement is material as it represents 8% of profit before tax (\$14,000/\$175,000), so management should correct this misstatement in the financial statements.
As the Finance Director has refused to amend this misstatement then the auditor's opinion will need to be modified. As management has not complied with IAS 2 and the misstatement is material but not pervasive, a qualified opinion 'except for' would be necessary.
The auditor's report would include a qualified opinion section, together with a basis for qualified opinion section explaining both the material misstatement in relation to the inappropriate valuation of inventory and quantifying its effect on the financial statements.
- 2 The correct answer is: Qualified 'except for'
Check & Co has been unable to gather sufficient appropriate audit evidence over the inventory transactions which occurred in February 20X6, and these are considered to be material.
It has, however, been able to gather sufficient appropriate audit evidence over the year-end inventory balance and so this issue is considered to be material but not pervasive.
As such a qualified opinion 'except for' would be expressed, and a basis for qualified opinion section would be included to explain the potential impact of the loss of inventory records.
An emphasis of matter paragraph would not be issued as the issue is not believed to be fundamental to the financial statements.

3 The correct answers are:

- Review legal correspondence relating to the claim in order to determine Maker's lawyers' opinion as to the likely outcome of the claim
- Review the post year end cash book in order to determine whether any payments were made to Mr Shift

Recalculating Mr Shift's wages and salaries for the year to verify that he was only paid up to the date of dismissal and reviewing the construction work performed by Mr Shift in August 20X6 to determine whether there are any concerns over the quality of his work and whether Maker's health and safety procedures were followed are audit procedures relating to wages and salaries and inventory rather than to the accounting treatment of the claim itself.

4 Unmodified audit opinion with a key audit matter paragraph

The directors have not made any reference to the claim in the financial statements. This seems appropriate as you agree with the lawyer's indication that the claim will not be successful. Therefore, an unmodified audit opinion would be issued.

However, Maker is a listed entity and the claim has taken up a significant amount of audit time and so this would be included within the key audit matters section.

The issue would not be included as an emphasis of matter (since it has been dealt with as a key audit matter) and there is no indication that it impacts Maker's ability to continue as a going concern.

Activity 3: Going concern

Unmodified audit opinion with material uncertainty relating to going concern section

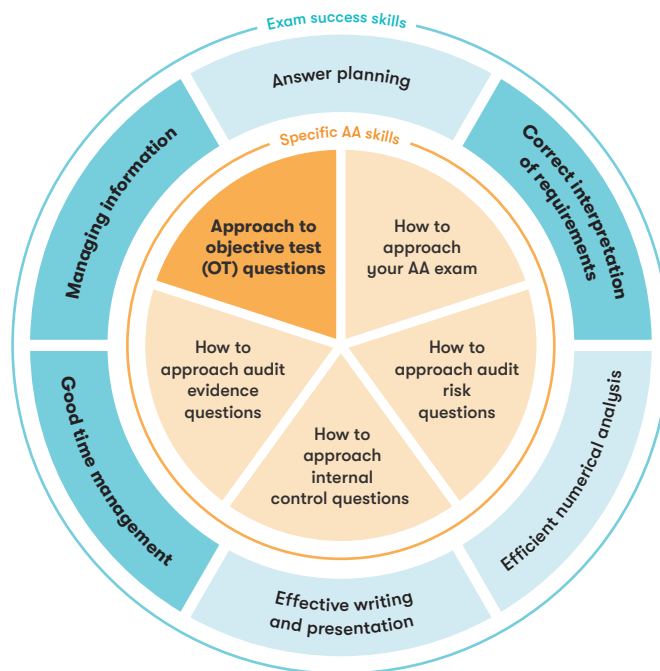
TH's directors have made appropriate disclosures of worries over going concern in the financial statements, and the auditor feels that the disclosure is appropriate. The audit opinion will therefore be unmodified.

However, significant concern over going concern still exists and so the auditor will include a 'material uncertainty relating to going concern' section in their report.

The emphasis of matter paragraph is used to highlight matters which are fundamental to users' understanding of the financial statements, with the exception of matters relating to going concern.

Skills checkpoint 5

Approach to objective test (OT) questions



Introduction

Section A of the Audit and Assurance (AA) exam consists of objective test (OT) case questions.

Section A questions will focus more on syllabus areas A and E but can come from any area of the syllabus. This means that candidates need to study the whole syllabus. Section A will include three OT case questions.

Each OT case question is worth 10 marks and contains a group of five single OT questions (each worth two marks) and based on a single scenario. The questions can be any combination of the OT question types detailed below. OT questions are auto-marked; you must answer the whole question correctly to earn the two marks. There are no partial marks.

OT cases are written so that there are no dependencies between the individual questions. So, if you did get the first question wrong, this does not affect your ability to get the other four correct. The OT case scenario remains on screen so you can see it while answering the questions.

The following types of OT question commonly appear in the AA exam:

Question type	Explanation
Multiple choice (MCQ)	You need to choose one correct answer from four given response options.

Question type	Explanation
Multiple response (MRQ)	These are a kind of multiple choice question, except you need to select more than one answer from a number of given options. The question will specify how many answers need to be selected, but the system won't stop you from selecting more answers than this. It is important to read the requirement carefully.
Fill in the blank (FIB)	This question type requires you to type a numerical answer into a box. The unit of measurement (eg \$) will sit outside the box, and if there are specific rounding requirements these will be displayed.
Drag and drop	Drag and drop questions involve you dragging an answer and dropping it into place. Some questions could involve matching more than one answer to a response area and some questions may have more answer choices than response areas, which means not all available answer choices need to be used.
Drop down list	This question type requires you to select one answer from a drop down list. Some of these questions may contain more than one drop down list and an answer has to be selected from each one. This requires the same skills as a multiple choice question.

Skills Checkpoint 5: Approach to OT questions

AA Skill: Approach to OT questions

A step-by-step technique for approaching OT questions is outlined below. Each step will be explained in more detail in the following sections as the OT case question 'Minnie Co' is answered in stages.

General guidance for approaching OT questions

STEP 1: Answer the questions you know first.

If you're having difficulty answering a question, move on and come back to tackle it once you've answered all the questions you know.

It is often quicker to answer discursive style OT questions first, leaving more time for calculations.



General guidance for approaching OT questions

STEP 2: Answer all questions.

There is no penalty for an incorrect answer in ACCA exams; there is nothing to be gained by leaving an OT question unanswered. If you are stuck on a question, as a last resort, it is worth selecting the option you consider most likely to be correct and moving on. Make a note of the question, so if you have time after you have answered the rest of the questions, you can revisit it.



Guidance for answering specific OT questions

STEP 3: Read the requirement first!

The requirement will be stated in bold text in the exam. Identify what you are being asked to do, any technical knowledge required and what type of OT question you are dealing with. Look for key words in the requirement such as "which **TWO** of the following," or "which of the following is **NOT**".



Guidance for answering specific OT questions

STEP 4: Apply your technical knowledge to the data presented in the question.

Take your time working through the narrative in each distractor as well as any calculations and read through each answer option with care. **OT questions are designed so that each answer option is plausible.** Work through each response option and eliminate those you know are incorrect

Exam success skills

The following question is a Section A OT case question from a past exam worth 10 marks.

For this question, we will also focus on the following exam success skills:

- **Managing information.** It is easy for the amount of information contained in an OT case questions in Section A to feel a little overwhelming. **Active reading** is a useful technique to avoid this. This involves focusing on each of the five requirements first, on the basis that until you have done this the detail in the question will have little meaning and will seem more intimidating as a result.
- Focus on the requirements, highlighting key verbs to ensure you understand the requirement properly, and correctly identify what type of OT question you are dealing with. Then read the rest of the scenario, underlining and annotating important and relevant information, and making notes of any relevant technical information you think you will need.
- **Correct interpretation of requirements.** Identify from the requirement the different types of OT question. This is especially important with multiple response questions to ensure you select the correct number of response options.
- **Good time management.** Complete all OT's in the time available. Each OT is worth two marks and should be allocated 3.6 minutes which means you have 18 minutes for each OT case question.

Skill activity

The following scenario relates to Questions 1 to 5.

You are the audit manager of Daffy & Co and you are briefing your team on the approach to adopt in undertaking the review and finalisation stage of the audit of the financial statements for the year ended 31 December 20X7.

During the audit of Minnie Co, an uncorrected misstatement was identified with regards to a property balance which was revalued during the year. The revaluation was carried out by an independent expert valuer and incorrect assumptions were provided to the valuer. The audit team's audit procedures have determined that the property is overvalued by \$600,000.

STEP 1 The following scenario relates to Questions 1 to 5.

You are the audit manager of Daffy & Co and you are briefing your team on the approach to adopt in undertaking the review and finalisation stage of the audit of the financial statements for the year ended 31 December 20X7.

During the audit of Minnie Co, an uncorrected misstatement was identified with regards to a property balance which was revalued during the year. The revaluation was carried out by an independent expert valuer and incorrect assumptions were provided to the valuer. The audit team's audit procedures have determined that the property is overvalued by \$600,000.

The following additional issues have also arisen during the course of the audit of Minnie Co.

- (a) Depreciation has been calculated on the total of land and buildings. In previous years, it has only been charged on buildings. Total depreciation is \$2.5m and the element charged to land only is \$0.7m.
- (b) Minnie Co's main competitor has filed a lawsuit for \$1m against them alleging a breach of copyright; this case is ongoing and will not be resolved prior to the auditor's report being signed. You have concluded that the outcome of the lawsuit is uncertain. The matter is disclosed as a contingent liability.

Profit before tax for the year ended 31 December 20X7 is \$10m.

1. Which TWO⁶⁹ of the following statements correctly describe the auditor's responsibility in relation to misstatements?

- The auditor must accumulate misstatements over the course of the audit unless they are immaterial.
- As part of their completion procedures, auditors shall consider whether the aggregate of uncorrected misstatements in the financial statements is material.
- In deciding whether the uncorrected misstatements are material, the auditor shall consider the size and nature of the misstatements.
- The auditor is required to consider misstatements relating to transactions and account balances, but not misstatements related to qualitative disclosures.

2. Which of the following steps should you take first in relation to the uncorrected misstatement in respect of the revalued property⁷⁰?

⁶⁹ This is a MRQ where you are required to select TWO options. This is a knowledge based requirement so firstly consider what you know about the auditor's responsibilities in relation to misstatements and then select TWO options which are closest to your initial thoughts.

⁷⁰ This is an MCQ requiring one correct answer to be selected. The property has been overvalued by \$600,000 which is 6% of PBT so this is clearly a material issue. The question asks what is the first step you would take. Modifying the audit opinion would be a last resort after you have exhausted all other avenues.

- Accumulate the misstatement along with other uncorrected misstatements in a schedule of unadjusted audit differences. If the aggregate is material, ask the directors to correct the misstatements.
- Ask the directors to correct the specific misstatement, explaining that it is material to the financial statements.
- Speak to the expert valuer to assess the methodology used in performing the valuation.
- Modify the audit opinion, because the misstatement is material.

3. Select the correct option from the drop down list to summarise the effect of the depreciation charged on land and buildings on the financial statements?⁷¹

⁷¹ This is a drop down list question. Here you need to select the appropriate option for each drop down list. Firstly, you must decide whether the issue with the depreciation is material to the financial statements or not. Then you must decide whether this will lead to assets being overstated or profit being understated. Note that there is no partial marking – you must get both drop downs correct in order to score the 2 marks.

Material Drop down list	No	Yes
Financial statement impact Drop down list	Assets are overstated	Profit is understated

Material	Financial statement impact

4. You have concluded that knowledge of the litigation is not fundamental to understanding the financial statements.

In light of this, drag the appropriate description in to the relevant box to indicate the audit opinion which would be given and how the matter would be disclosed in the auditor's report.

Audit opinion	Adverse	Disclaimer	Qualified	Unmodified
Disclosure in the auditor's report	Basis for adverse opinion	Basis for qualified opinion	No related disclosure	Material uncertainty related to going concern

Audit opinion	Disclosure in the auditor's report

5. Having commenced audit fieldwork on Minnie Co on 1 February 20X8, the audit was completed on 20 February 20X8. The auditor's report is due to be signed on 5 March 20X8. Minnie Co's board plans to issue the financial statements on 30 April 20X8.

1 February 20X8	20 February 20X8	5 March 20X8	30 April 20X8

Skill activity

STEP 1 Answer the questions you know first.

If you are having difficulty answering a question, move on and come back to tackle it once you have answered all the questions you know. It is often quicker to answer discursive style OT questions first, leaving more time for calculations. The AA exam does not have many calculations but you may be asked to calculate financial statement ratios.

All of the questions in Minnie are discursive style questions. However, Questions 2 and 3 require you to calculate materiality and consider the financial amount of the error and so it may make sense to answer Questions 1, 4 and 5 first as it is likely that you will be able to complete them comfortably within the 10.8 minutes allocated to them. Any time saved could then be spent on the calculations required to answer Questions 2 and 3.

STEP 2 Answer all questions.

There is no penalty for an incorrect answer in ACCA exams, there is nothing to be gained by leaving an OT question unanswered. If you are stuck on a question, as a last resort, it is worth selecting the option you consider most likely to be correct, and moving on. Make a note of the question, so if you have time after you have answered the rest of the questions, you can revisit it.

Two of the five questions in the OT case are MCQ's. With an MCQ, you have a 25% chance of getting the question correct so do not leave any unanswered. It is obviously more difficult to get a drop down list or drag and drop question (like Questions 3 and 4) correct by guessing.

STEP 3 Read the requirement first!

The requirement will be stated in bold text in the exam. Identify what you are being asked to do, any technical knowledge required and what type of OT question you are dealing with. Look for key words in the requirement such as "which TWO of the following," or "which of the following is NOT"

Question 1 is a MRQ, you need to follow the instructions carefully and only select two **correct** responsibilities. Read through each statement carefully knowing that you are looking to identify the responsibilities that are **correct**.

STEP 4 Apply your technical knowledge to the data presented in the question.

Work through calculations, taking your time, and read through each answer option carefully. OT questions are designed so that each answer option is plausible. Work through each response option and eliminate those you know are incorrect

To answer Questions 2 and 3, you need to determine whether the error in the property valuation and the depreciation misstatement are material. We would usually use 5% of profit before tax as an estimate to determine whether or not a misstatement is material.

Exam success skills diagnostic

Every time you complete a question, use the diagnostic below to assess how effectively you demonstrated the exam success skills in answering the question. The table has been completed below for the Minnie Co activity to give you an idea of how to complete the diagnostic.

Exam success skills	
Managing information	Did you read each of the five requirements first? Did you actively read the scenario highlighting relevant data required such as the year end date, the property overvaluation, the depreciation amounts, the value of the lawsuit and the profit before tax?
Correct interpretation of requirements	Did you identify the correct technical knowledge needed to answer each requirement? For example, using your knowledge of the auditor's responsibilities in relation to misstatements in question 1 and types of modifications to the audit report in question 5. Did you identify what type of OT question you were dealing with? For example, knowing that only one correct answer is required for a multiple choice question.
Good time management	Did you manage to answer all five questions within 18 mins? Did you manage your time well by answering questions one, four and five first?
Most important action points to apply to your next question	

Summary

30% of the AA exam consist of OT questions. Key skills to focus on throughout your studies will therefore include:

- Always read the requirements first to identify what you are being asked to do and what type of OT question you are dealing with.
- Actively read the scenario highlighting key data needed to answer each requirement.
- Answer OT questions in a sensible order dealing with any easier discursive style questions first.

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1

The concept of audit and other assurance engagements

Essential reading

1 Accountability, stewardship and agency



KEY
TERM

Accountability: the quality or state of being accountable; that is, being required or expected to justify actions and decisions. It suggests an obligation or willingness to accept responsibility for one's actions.

Stewardship: the duties and obligations of a person who manages another person's property.

Agents: the people employed or used to provide a particular service. In the case of a company, the people being used to provide the service of managing the business also have the second role of trying to maximise their personal wealth in their own right.

The key reason for having an audit or review can be seen by working through the following case study.



Case study

Vera decides to set up a business selling flowers. She gets up early in the morning, visits the market and then sets up a stall by the side of the road. For the first year, all goes well. She sells all the flowers she is able to buy and she derives some income from the business.

However, Vera feels that she could sell more flowers if she was able to transport more to the place where she sells them, and she also knows that there are several other roads nearby where she could sell flowers, if she could be in two places at once. She could achieve these two things by buying a van and by employing people to sell flowers in other locations.

Vera needs more money to achieve this expansion of her business. She decides to ask her rich friend Peter to invest in the business.

Peter can see the potential of Vera's business and wants to invest, but he doesn't want to be involved in the management of the business. He also does not want to have ultimate liability for the debts of the business if it fails. He therefore suggests that they set up a limited company. He will own the majority of the shares and be entitled to dividends. Vera will be managing director and be paid a salary for her work.

At the end of the first year of trading as a limited company, Peter receives a copy of the financial statements. Profits are lower than expected, so his dividend will not be as large as he had hoped. He knows that Vera is paid a salary so does not care as much as him that profits are low.

Peter is concerned by the level of profits and feels that he wants further assurance on the accounts. He doesn't know whether they give a true reflection of the last year's trading, particularly as the profits do not seem as high as those Vera had predicted when he agreed to invest.

The solution is that the **assurance** Peter is seeking can be given by an independent **audit or review** of the financial statements.

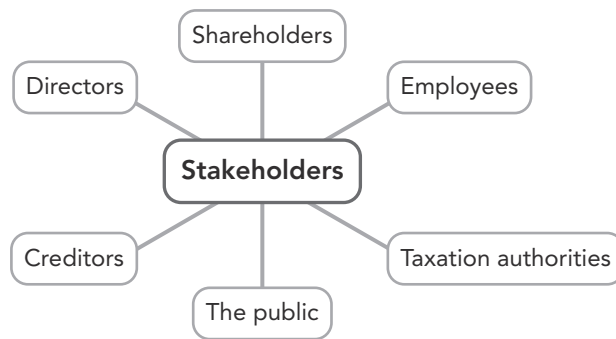
An auditor can provide the two things that Peter requires:

- A **knowledgeable review** of the company's business and of the financial statements
- An **impartial view**, since Vera's view might be biased

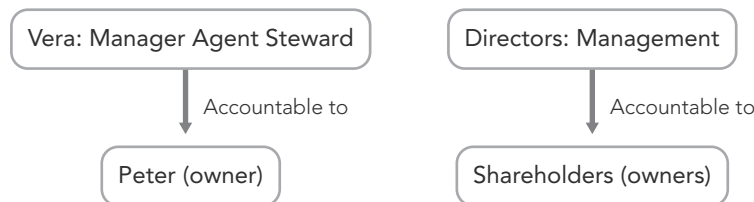
Other people will also view the company's financial statements with interest, for example:

- Creditors of the company
- Taxation authorities

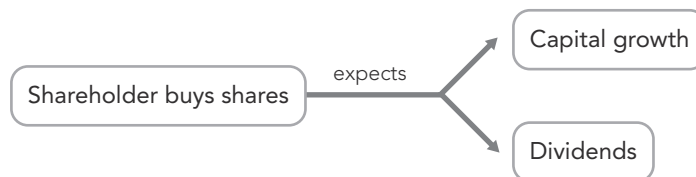
The various parties interested in the financial statements of a company are sometimes referred to as **stakeholders**. Although they will each judge the financial statements by different criteria, they will all **gain assurance** from learning that the financial statements they are reading have been subject to an independent report.



The example above is a simple one. In practice, companies may have thousands of shareholders and may not know the management personally. It is therefore important that directors are **accountable** to shareholders. Directors act as **stewards** of the shareholders' investments. They are **agents** of the shareholders.



The directors are accountable for the **shareholders' investment**. The shareholders have bought shares in that company (they have invested). They **expect a return** from their investment. As the **directors** manage the company, they are **in a position to affect that return**.



The exact nature of the return expected by the shareholder will depend on the type of company they have chosen to invest in as that is part of their investment risk analysis. However, certain issues are true of any such investment. For example, if the directors **mismanage** the company, and it goes **bankrupt**, it will not provide a source of future dividends, nor will it create capital growth in the investment – indeed, the opposite is true and the original investment may even be lost.

Accountability therefore covers a range of issues:



These issues are often discussed under the umbrella title '**corporate governance**', where '**governance**' indicates the management (governing) role of the directors, and '**corporate**'

indicates that the issue relates to companies (bodies corporate). This is illustrated by our scenario, where we saw Vera taking up a corporate governance position in relation to Peter.

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2

Statutory audit and regulation

Essential reading

1 Small company audit exemption

In most countries, the majority of companies are very small, employing few people (if any) and are often owner managed. This is very different from a large business where the owners (the shareholders) devolve the day-to-day running of the business to a group of managers or directors. International auditing standards use the term 'smaller entities'.



Smaller entity: an entity which typically possesses qualitative characteristics, such as:

- (a) Concentration of ownership and management in a small number of individuals (often a single individual); and
- (b) One or more of the following:
 - (i) Straightforward or uncomplicated transactions
 - (ii) Simple record-keeping
 - (iii) Few lines of business and few products within business lines
 - (iv) Few internal controls
 - (v) Few levels of management with responsibility for a broad range of controls
 - (vi) Few personnel, many having a wide range of duties

(IFAC, 2016(b))

There has long been a debate over the benefits of having a statutory audit for small entities. Where such entities are owned by the same people that manage them, there is significantly less value in an independent review of the stewardship of the managers than where management and ownership are separate.

The case for retaining the small company audit rests on the value of the statutory audit to those who have an interest in audited financial statements; that is, the users of the financial statements. From the viewpoint of each type of user, the arguments for and against abolition are summarised in the table below.

User	For abolition	Against abolition
Shareholders	Benefit may not be worth the cost	Provides reassurance to shareholders not involved in managing Assists in fair valuation of share in unquoted companies
Bank and other institutions or lenders	Doubt over whether banks rely on audited financial statements more than unaudited ones	Banks may rely on audited financial statements for making loans and reviewing value of security
Other payables	Limited reliance in practice, as financial statements are filed too late	Provides opportunity to assess strength of customers
Taxation authorities	Little evidence of whether reliance is placed on audited financial statements	Taxation authorities may rely on audited financial statements to calculate corporation tax and check returns
Employees	Little evidence that employees make assessments of financial statements for wage negotiations	Employees entitled to assess financial statements for wage negotiations and considering future viability of their employer

2 Regulation of auditors

2.1 Reasons for regulation

Regulators aim for audits to be valuable both to shareholders and to the wider public. This is done by having audits performed by independent professionals who work in accordance with common standards. This helps to ensure that audits are of a high quality, which enhances the credibility of the financial statements. It is essential therefore that public confidence in the profession is maintained, because this will in turn contribute towards confidence in the financial statements that are audited.

The regulatory framework within which the auditor operates encompasses a range of regulations, including laws, auditing standards, ethical and corporate governance codes and other guidance issued by regulatory bodies.

This framework provides transparency regarding the standards to which the auditor is expected to adhere which can be reviewed and revised if required. For example following a number of corporate scandals including Enron, the audit profession came under close scrutiny from investors, businesses, regulators and the wider public and as a result comprehensive changes were made.

Regulation also provides objective benchmarks against which the audit profession's performance can be assessed. Where auditors do not meet these standards disciplinary steps can be taken, and in this way the integrity of the profession is maintained, enhancing public confidence in the quality of the audit.

2.2 National level

The accounting and auditing profession varies in structure from country to country. In some countries accountants and auditors are subject to strict legislative regulation, while in others the profession is allowed to regulate itself. Some examples are included below:

2.2.1 United Kingdom

In the UK there are a number of different accountancy, or accountancy-related, institutes and associations, such as the Association of Chartered Certified Accountants (ACCA), the Institute of Chartered Accountants in England and Wales (ICAEW) and the Institute of Chartered Accountants of Scotland (ICAS). All these bodies vary from each other but they are all characterised by various attributes:

- Stringent entrance requirements (examinations and practical experience)
- Strict code of ethics
- Technical updating of members

2.2.2 France

In France, the accounting profession is split into two distinct organisations:

- Accountants (*Ordre des Experts Comptables et des Comptables Agréés*)
- Auditors (*Compagnie Nationale des Commissaires aux Comptes*)

Most members of the auditors' organisation are also members of the more important accountants' organisation. Examinations, work experience and articles are similar to those of the UK accountancy bodies. The profession's main influence is through the issue of non-mandatory opinions and recommendations of accounting principles relevant to the implementation of the National Plan.

2.2.3 Germany

The main professional body in Germany is the Institute of Certified Public Accountants (*Institut der Wirtschaftsprüfer*). Members of this institute carry out all the statutory audits, and are required to have very high educational qualifications and experience. The Institute issues a form of auditing standard but this is tied very closely to legislation. As well as auditing, members are mainly involved in tax and business management, with no obvious significant role in establishing

financial accounting principles and practices. There is no independent accounting standard-setting body.

2.2.4 US

In the US, accountants are members of the American Institute of Certified Public Accountants (AICPA), a private sector body. Although the Securities and Exchange Commission in the US can prescribe accounting standards for listed companies, it relies on the Financial Accounting Standards Board (FASB), an independent body, to set such standards. In turn, FASB keeps in close contact with the AICPA, which issues guidance on US standards and is closely involved in their development.

2.2.5 Ghana

In Ghana, the Institute of Chartered Accountants (Ghana), established in 1963, is the sole body charged with the regulation of the accountancy profession. Its members are the only persons recognised under the country's companies' legislation to carry out the audit of company financial statements. The institute is governed by a council of 11 chartered accountants.

2.2.6 Singapore

The Institute of Singapore Chartered Accountants (ISCA) (formerly The Institute of Certified Public Accountants of Singapore) is the national organisation of the accountancy profession in Singapore. It was established in 1963 and its objective is to develop, support and enhance the integrity, status and interests of the accountancy profession in Singapore. ISCA has a Joint Scheme of Examination agreement in place with ACCA.

We can see from the above paragraphs that the accounting and auditing profession in many countries is regulated by legislation to some extent. In the UK and the US the profession effectively regulates itself, i.e. regulation is devolved from statute to the private bodies involved in the accountancy profession. In many European countries, statutory control by governments is much more direct.

2.3 EU member states

Persons carrying out audits in EU member states must have the permission of the relevant authorities. New legislation to improve the quality of statutory audit across the EU was finalised in June 2014. Key measures include strengthening the independence of statutory auditors, making the auditor's report more informative, and improving audit supervision throughout the EU. The new legislation became applicable in mid-2016.

In the UK, the relevant authorities are **Recognised Supervisory Bodies** (RSBs). As well as giving authority, RSBs in the UK supervise and monitor auditors. In other countries, however, supervising and monitoring is carried out by a state body or by the national government.

In the UK an RSB is a body which maintains and enforces rules over various matters including:

- Eligibility of persons for appointment as a statutory auditor
- Conduct of statutory audit work

(Companies Act 2006: Schedule 10)

The following bodies are all RSBs:

- ACCA
- ICAEW
- ICAS
- Chartered Accountants Ireland
- Association of Authorised Public Accountants (AAPA)

Professional qualifications, which will be prerequisites for membership of an RSB, are offered by **Recognised Qualifying Bodies** (RQBs) approved by the Government. RQBs include ACCA, ICAEW and ICAS among others.

2.4 International level

Regulations governing auditors will, in most countries, be most important at the national level. International regulation, however, can play a major part by:

- (a) Setting **minimum standards** and **requirements** for auditors
- (b) Providing **guidance** for those countries without a **well-developed national regulatory framework**
- (c) Aiding **intra-country recognition** of professional accountancy qualifications

2.5 Regulation, monitoring and supervision

Each country's regulation of external audits will differ. Most regimes do have certain common elements:

- (a) **Education and work experience:** IFAC has issued guidance on this (see Section 2.6).
- (b) **Eligibility:** There may well be statutory rules determining who can act as auditors. Membership of an appropriate body is likely to be one criterion.
- (c) **Supervision and monitoring:** These activities initially came under particular scrutiny in a number of countries during the 1990s and these activities are again under the spotlight following the recent global economic crisis. Questions have been asked about why auditors have failed to identify impending corporate failures and whether they were being regulated strongly enough. The supervision regime has come under particular scrutiny in countries where regulation and supervision is done by the auditors' own professional body (self-regulation). Suggestions have been made in these countries that supervision ought to be by external government agencies.

2.6 Education, examinations and experience

IFAC issues guidance to tackle the problems of intra-country recognition of qualifications. It sets minimum standards for accountancy qualifications. The International Accounting Education Standards Board (IAESB) is part of IFAC and its *Framework for International Education Standards for Professional Accountants and Aspiring Professional Accountants* is intended to assist IFAC member bodies, as they have direct or indirect responsibility for the education and development of their members and students.

The IAESB also publishes International Education Standards (IESs) which aim to increase the competence of the global accountancy profession. These documents are not examinable in AA but can provide useful supplementary information and are accessible on the IFAC website. Here we will consider three important areas in general below. (IFAC, 2016(a) and (d))

2.6.1 Education

The theoretical knowledge to be contained in the body of knowledge of accountants should include compulsory subjects (such as audit, consolidated accounts and general accounting) and relevant subjects (such as law and economics). Accountants should have covered these subjects in a breadth and depth sufficient to enable them to perform their duties to the expected standard.

2.6.2 Examinations

Accountants should demonstrate that they have passed an examination of professional competence. This examination must assess not only the necessary level of **theoretical** knowledge but also the ability to apply that knowledge competently in a **practical** situation. Objective evaluation of professional examinations is important.

2.6.3 Experience

It is crucial for any professional to not only have a sound theoretical knowledge, but also be able to apply that knowledge competently in the work place.

Individuals should have completed an appropriate period of approved and properly supervised practical experience primarily in the area of audit and accountancy and in a suitable professional environment.

2.7 Eligibility to act as auditor

Eligibility to act as an auditor is likely to arise from membership of some kind of regulatory body.

Bodies of this type will offer qualifications and set up rules to ensure compliance with any statutory requirements related to auditors. In this way national governments will control who may act as an auditor to limited liability companies, or to any other body requiring a statutory audit.

The regulatory body should have rules to ensure that those eligible for appointment as a company auditor are either:

- **Individuals** holding an **appropriate qualification**, or
- **Firms controlled** by **qualified persons**

Regulatory bodies should also have procedures to maintain the competence of members. The regulatory body's rules should ensure that only **fit and proper** persons are appointed as company auditors and that company audit work is conducted **properly** and with **professional integrity**.

The regulatory body should include rules as to the **technical standards** to be followed when carrying out company audit work (eg following International Standards on Auditing (ISAs)).

The regulatory body should also provide for adequate monitoring and enforcement of compliance with its rules.

Membership of a regulatory body is the main prerequisite for **eligibility** as an auditor.

A person should be **ineligible** for appointment as a company auditor if they are:

- An **officer or employee** of the company
- A **partner or employee** of such a person
- A **partnership** in which such a person is a partner

There may be further rules about connections between the company or its officers and the auditor, depending on local statutory rules.

2.8 Supervisory and monitoring roles

Some kind of supervision and monitoring regime should be implemented by the regulatory body. This should inspect auditors on a regular basis.

The frequency of inspection will depend on the number of partners, number of offices and number of listed company audits (these factors may also be reflected in the size of annual registration fees payable by approved audit firms).

The following features should be apparent in each practice visited by the monitoring regulatory body:

- (a) A **properly structured audit approach**, suitable for the range of clients served and work undertaken by the practice
- (b) **Carefully instituted quality management procedures**, revised and updated constantly, to which the practice as a whole is committed
- (c) Commitment to **ethical guidelines**, with an emphasis on independence issues
- (d) An emphasis on **technical excellence**
- (e) Adherence to the **'fit and proper' criteria** by checking personnel records and references
- (f) Use of internal and, if necessary, external **peer reviews**, consultations etc
- (g) Charging **appropriate fee** per audit assignment

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3

Corporate governance

Essential reading

1 Additional guidance to support corporate governance principles

1.1 Directors

The directors of a company should set company policy, including risk policy, and are responsible for the company's systems and controls. They should make sure they set enough time aside, and that they have the necessary experience and skill, to do this effectively.

1.2 Board leadership and company purpose

The board is responsible for the company's **strategy**. It must therefore assess the basis on which the company generates and preserves value over the long-term, making various statements in the annual report regarding the opportunities and risks for the company.

The board also considers **culture**, which should be aligned with the company's purpose, values and strategy.

The Chair must seek regular engagement with shareholders outside of formal general meetings. If 20% or more of votes go against a board recommendation for a resolution, then the board must consult with shareholders to understand why this was, and must report on this in the annual report.

The board should understand the views of its key stakeholders, and should describe in the annual report how it has discharged its duty (under the Companies Act 2006) to promote the success of the company.

The board also has a responsibility **to engage with the workforce**, eg by:

- Appointing a director from the workforce;
- Creating a formal workforce advisory panel; or
- Appointing a designated non-executive director.

There should also be a way for the workforce to raise concerns in confidence and – if they wish – anonymously.

The board should take action to identify and manage conflicts of interest. If directors have concerns about the board that cannot be resolved, then these concerns must be recorded in the board minutes.

1.3 Chair

The UK Corporate Governance Code requires that there is clear division of responsibility at the head of a company between the chairman and the chief executive. The **Chair and the chief executive cannot be the same individual**, with no one individual having unfettered powers of decision.

There is also a time limit on the Chair's position: the Chair cannot remain in post beyond **nine years**.

The Chair must be independent when they are appointed, and are subject to the same independence criteria as non-executive directors. The Chair **should not** be a former chief executive of the same company except in exceptional circumstances.

1.4 Going concern

The board must state whether it considers it appropriate to adopt the going concern basis of accounting, and should identify any material uncertainties to the company's ability to continue to do so over a period of **at least twelve months** from when the financial statements are approved. The board should also explain how it has assessed the prospects of the company, over what period it has done so and why it considers that period to be appropriate.

1.5 Systems, controls and monitoring

An important element of setting strategies is determining and managing risks, an area where the internal audit may play a significant role. The board should be supplied with information in a timely manner to enable it to carry out its duties.

Directors are responsible for the systems put in place to achieve the company policies and the controls put in place to mitigate risks. Under the Code, boards (through the audit committee) are required to consider annually whether an internal audit department is required. If there is no internal audit function, the reasons for not having one need to be explained in the annual report.

The directors are also responsible for **monitoring** the effectiveness of systems and controls.

Internal auditors have an important role in this area but remember it is the directors that are responsible for determining whether to have an internal audit department to assist them in monitoring in the first place.

In the UK, the FRC's *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* aims to assist companies in applying the UK Corporate Governance Code's provisions on internal control. Companies should:

- Have a **defined process** for the effectiveness of internal control
- Review **regular reports** on internal control
- Consider **key risks** and how they have been managed
- Check the **adequacy of action taken** to remedy weaknesses and incidents
- Consider the **adequacy of monitoring**
- Conduct an **annual assessment** of risks and the effectiveness of internal control
- Make a **statement** on this process in the **annual report**

1.6 Non-executive directors

Non-executive directors are directors who do not have day to day operational responsibility for the company. They are **not employees** of the company or affiliated with it in any other way.

An important recommendation of the principles of the UK Corporate Governance Code is that the board contains some non-executive directors to ensure that it exercises **objective judgement**. The UK Corporate Governance Code requires 'an appropriate combination' of executive and non-executive directors on the board and recommends that **at least half the board** should comprise non-executive directors whom the board considers to be independent.

Such non-executive directors may have a particular role in some sensitive areas, such as company reporting, nomination of directors and remuneration of executive directors. It is important, therefore, that they have the appropriate mix of skills, commitment, experience and independence to carry out their roles effectively. Independence for a non-executive director can be compromised by the following:

- Employment with the company (or group) in the last five years
- Material business relationships with the company within the last three years
- Remuneration beyond the basic fees agreed for the role (this includes share options, bonus schemes and pensions)
- Close family ties with any of the company's advisors, directors or senior employees
- Representing a significant shareholder
- Serving longer than nine years on the board

One of the non-executives should be appointed as the senior independent director who will be available to shareholders if they have concerns.

1.7 Remuneration committee

A **remuneration committee** must be established, made up of **at least three independent non-executive directors** (two in smaller companies). Executive directors do not sit on the remuneration committee. The chair of the board cannot chair the remuneration committee, but they can be a member of it if they were independent on appointment.

The remuneration committee is responsible for:

- Setting remuneration for:
 - Executive directors
 - The Chair
 - Senior management
- Setting the remuneration policy for executive directors
- Reviewing workforce remuneration and policies, which it must take into account when setting executive remuneration

Remuneration of non-executive directors is determined in line with the company's Articles of Association, or by the board. Levels of remuneration should reflect time commitment and the responsibilities of the role. Remuneration for **non-executives should not include share options** or other performance-related elements. Remuneration schemes should promote **long-term shareholdings** by executive directors that support alignment with long-term shareholder interests. When determining executive director remuneration policy and practices, the remuneration committee should consider:

- **clarity** – **arrangements should be transparent** and promote engagement with shareholders and the workforce;
- **simplicity** – remuneration should be simple and **easy to understand**;
- **risk** – remuneration arrangements should mitigate **reputational risks from excessive rewards**, and behavioural risks that can arise from target-based incentive plans;
- **predictability** – the range of possible values of rewards should be identified and explained at the time of approving the policy;
- **proportionality** – **outcomes should not reward poor performance**; and
- **alignment to culture** – incentive schemes should drive behaviours consistent with company purpose, values and strategy.

1.8 Nomination committee

A **nomination committee** should be established to lead the process for making nominations for board appointments. The nomination committee should be made up of a **majority of independent non-executive directors**.

The notice or contract periods for all directors should be **one year or less**. All directors should be subject to **annual re-election** by shareholders.

Because the composition and effectiveness of the board is so important, it is recommended that board evaluation reviews are **externally** facilitated at least every three years for boards of FTSE 350 companies.

2 Audit Committees

Principle M of the UK Corporate Governance Code states that:

The board should establish formal and transparent policies and procedures to ensure the independence and effectiveness of internal and external audit functions and satisfy itself on the integrity of financial and narrative statements.

The detailed provisions relating to this principle are set out in the following table:

Extract of UK Corporate Governance Code provisions relating to the audit committee

The board should establish an **audit committee of independent non-executive directors**, with a minimum membership of three, or in the case of smaller companies, two.

The chair of the board should **not** be a member.

The board should satisfy itself that at least one member has recent and relevant **financial experience**.

Extract of UK Corporate Governance Code provisions relating to the audit committee

The committee as a whole shall have competence relevant to the sector in which the company operates.

The main role and responsibilities should be set out in **written terms of reference** and should include:

- **Monitoring the integrity of the financial statements** of the company and any formal announcements relating to the company's financial performance, and reviewing significant financial reporting judgements contained in them
- **Providing advice** (where requested by the board) on whether the **annual report and accounts**, taken as a whole, is fair, balanced and understandable, and provides the information necessary for shareholders to assess the company's position and performance, business model and strategy
- **Reviewing the company's internal financial controls** and internal control and risk management systems, unless expressly addressed by a separate board risk committee composed of independent non-executive directors, or by the board itself
- Monitoring and reviewing the effectiveness of the company's **internal audit function** or, where there is not one, considering annually whether there is a need for one and making a recommendation to the board
- **Conducting the tender process** and making recommendations to the board, about the appointment, reappointment and removal of the **external auditor**, and approving the remuneration and terms of engagement of the external auditor
- Reviewing and monitoring the **external auditor's independence** and objectivity
- **Reviewing the effectiveness of the external audit** process, taking into consideration relevant UK professional and regulatory requirements
- Developing and implementing **policy on the engagement of the external auditor to supply non-audit services**, ensuring there is prior approval of non-audit services, considering the impact this may have on independence, taking into account the relevant regulations and ethical guidance in this regard, and reporting to the board on any improvement or action required
- Reporting to the board on how it has discharged its responsibilities

The directors should explain in the annual report their responsibility for preparing the annual report and accounts.

(FRC UK Corporate Governance Code: paras. 24, 25, 27).

2.1 Internal control effectiveness

The **directors** of a company are **responsible** for ensuring that a company's **risk management and internal**

controls systems are **effective**.

2.1.1 Importance of internal control and risk management

Internal controls are essential to management, as they contribute to:

- Safeguarding the company's **assets**
- Helping to prevent and detect **fraud**
- Safeguarding the shareholders' **investment**

Good internal control helps the business to run efficiently. A control system reduces identified risks to the

business. It also helps to ensure reliability of reporting and compliance with laws.

2.1.2 Directors' responsibilities for internal control

The **ultimate responsibility** for a company's system of internal controls lies with the **board of directors**. It should set procedures of internal control and regularly monitor that the system operates as it should.

Part of setting up an internal control system will involve **assessing the risks** facing the business, so that the **system** can be **designed** to ensure those **risks are avoided**.

Internal control systems will always have **inherent limitations**, the most important being that a system of internal control cannot eliminate the possibility of human error, or the chance that staff will collude in fraud.

Once the directors have set up a system of internal control, they are responsible for **reviewing** it regularly to ensure that it **still meets its objectives**.

The board may decide that in order to carry out its review function properly it has to employ an **internal audit function** to undertake this task. When deciding whether an internal audit function is required, directors will need to consider the extent of systems and controls, and the relative expense of obtaining checks from other parties, such as the external auditors.

If the board does not see the need for an internal audit function, in the UK, the UK Corporate Governance Code requires companies to consider the need for one at least annually, so that the **need for internal audit is regularly reviewed**.

The Code also recommends that the board of directors **reports** on its **review** of the company's **risk management** and **internal controls** systems as part of the annual report.

The board should carry out a robust **assessment of the company's emerging and principal risks**. The board should monitor the company's **risk management and internal control systems** and, at least annually, carry out a review of their effectiveness and report on that review in the annual report.

The statement should be based on an **annual review of the effectiveness of internal control** which should confirm that the board has considered **all significant aspects** of internal control. In particular the assessment should cover:

- the company's willingness to take on risk (its "**risk appetite**"), the desired culture within the company and whether this culture has been embedded;
- the **operation of the risk management and internal control systems**, covering the design, implementation, monitoring and review and identification of risks and determination of those which are principal to the company;
- the integration of risk management and internal controls with considerations of **strategy and business model**, and with business planning processes;
- the **changes in the nature, likelihood and impact of principal risks**, and the company's ability to respond to changes in its business and the external environment;
- the extent, frequency and quality of the communication of the results of management's monitoring to the board which enables it to build up a cumulative assessment of the state of control in the company and the effectiveness with which risk is being managed or mitigated;
- **issues dealt with in reports** reviewed by the board during the year, in particular the incidence of significant control failings or weaknesses that have been identified at any time during the period and the extent to which they have, or could have, resulted in unforeseen impact; and
- the effectiveness of the company's **public reporting** processes. (FRC Guidance on Risk Management, Internal Control and Related Financial and Business Reporting: para. 43)

2.1.3 Auditors' responsibilities for internal control

The auditors should **review the statements** made concerning internal control in the annual report to ensure that they appear **true** and are **not in conflict** with the audited financial statements.



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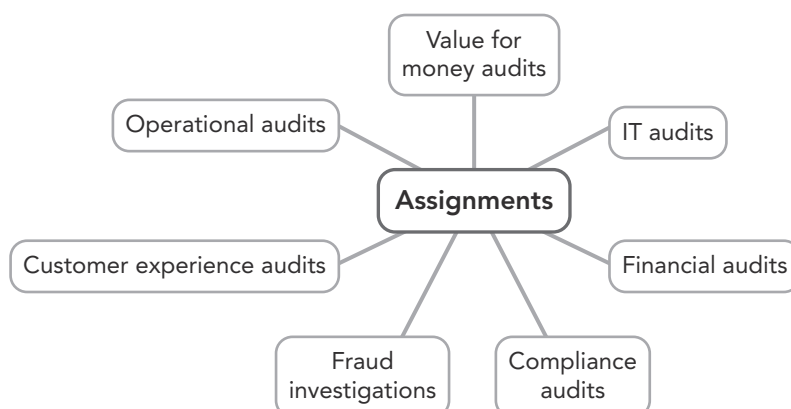
Internal audit

Essential reading

1 Nature and purpose of internal audit assignments

There are several examples of internal audit assignments listed in the Audit and Assurance syllabus.

These are:



1.1 IT audits

Computer, or IT, systems have become increasingly important to businesses and the way in which they are run. It is fundamental therefore that a business knows it has appropriate IT systems in place and that they are operating effectively.

An IT system could simply comprise a standalone computer on which a business maintains its accounting records, produces invoices and sends and receives emails.

Alternatively, IT systems could comprise a database, an integrated inventory control system or a company's e-commerce activities.

Whatever the extent of the IT systems used by a business, it is essential that a company has internal controls in place to make sure that the systems operate effectively.

An IT audit will involve these internal **controls being tested** to ensure that they are operating effectively.

It is likely that an internal audit function will include a computer specialist who can carry out specific tests of controls, especially where the controls are embedded into the computer system.

1.2 Financial audits

The board of directors has a statutory responsibility to prepare financial statements and maintain proper (accounting) books and records. They will also produce management accounts on a monthly basis in order to assess the performance of the business.

Management will make decisions based on this information and therefore need to know that it is reliable.

Financial audits involve the internal audit function reviewing the financial information produced and gathering evidence to substantiate it.

For example, in order to be able to report about the accuracy of the figure for sales revenue, the internal audit function may perform tests of controls to ensure that all orders processed are despatched to customers and then invoiced.

1.3 Compliance audits

Where an entity is heavily regulated non-compliance could have a severe impact on their business. For example an entity may incur **fines** or have its **licence to trade revoked**.

It is essential that management are up to date with the regulatory requirements applicable to their business and put internal controls in place to ensure compliance and detect any instances of non-compliance.

In such businesses, it is likely that the internal audit function will include a member of staff who has specific knowledge and training in these areas so that non-compliance can be prevented and detected.

1.4 Fraud investigations

The board of directors is responsible for assessing the entity's risk from fraud and maintaining a system of internal controls which prevent and detect fraud and error.

1.5 Customer experience audits

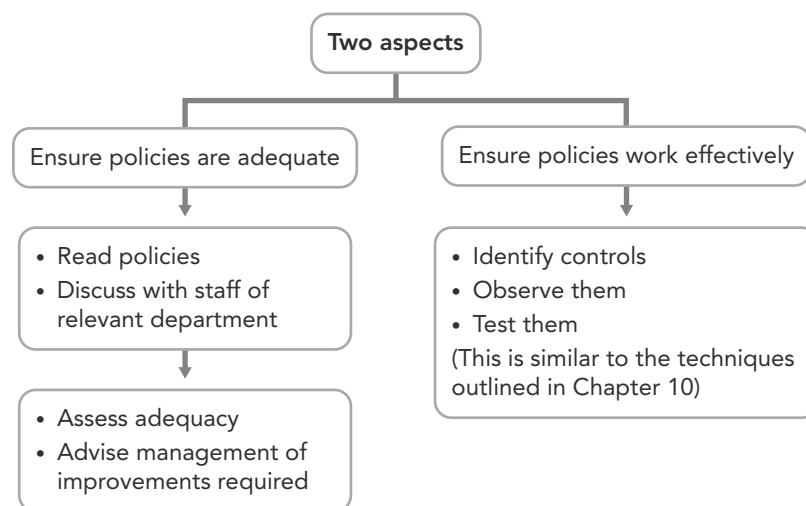
Satisfied customers often mean repeat business for an entity and so many businesses now devote a lot of time and resources to finding out how customers would rate their experience with the entity.

The internal audit function may be involved in conducting such reviews or in collating the feedback obtained and making recommendations regarding changes which could improve customer experience in the future.

1.6 Operational audits

Operational audits are also known as management or efficiency audits and they involve the internal audit function monitoring management's performance to ensure company policy is adhered to.

Approach to operational internal audit assignments:



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5

Professional ethics and quality management procedures

Essential reading

1 Engagement letters

A specimen engagement letter is included below for information purposes. You will not be required to produce an engagement letter in the exam but you should know the key information it contains.

To the appropriate representative of management or those charged with governance of ABC Company:

[The objective and scope of the audit]

You have requested that we audit the financial statements of ABC Company, which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter.

The objectives of our audit are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but it is not a guarantee that an audit conducted in accordance with International Standards on Auditing (ISAs) will always detect a material misstatement when it exists.

Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decision of users taken on the basis of these financial statements.

[The responsibilities of the auditor]

We will conduct our audit in accordance with ISAs. Those standards require that we comply with ethical requirements. As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to frauds or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements, or if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with ISAs.

[The responsibilities of management and identification of the applicable financial reporting framework (for purposes of this example it is assumed that the auditor has not determined that

the law or regulation prescribes those responsibilities in appropriate terms; the descriptions in paragraph 6(b) of this ISA are therefore used).]

Our audit will be conducted on the basis that [management and, where appropriate, those charged with governance] acknowledge and understand that they have responsibility:

- (a) For the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards;
- (b) For such internal control as [management] determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
- (c) To provide us with:
 - (i) Access to all information of which [management] is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
 - (ii) Additional information that we may request from [management] for the purpose of the audit; and
 - (iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence.

As part of our audit process, we will request from [management and, where appropriate, those charged with governance], written confirmation concerning representations made to us in connection with the audit.

We look forward to full co-operation from your staff during our audit.

[Other relevant information]

[Insert other information, such as fee arrangements, billings and other specific terms, as appropriate.]

[Reporting]

[Insert appropriate reference to the expected form and content of the auditor's report including, if applicable, the reporting on other information in accordance with ISA 720 (Revised).]

The form and content of our report may need to be amended in the light of our audit findings.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

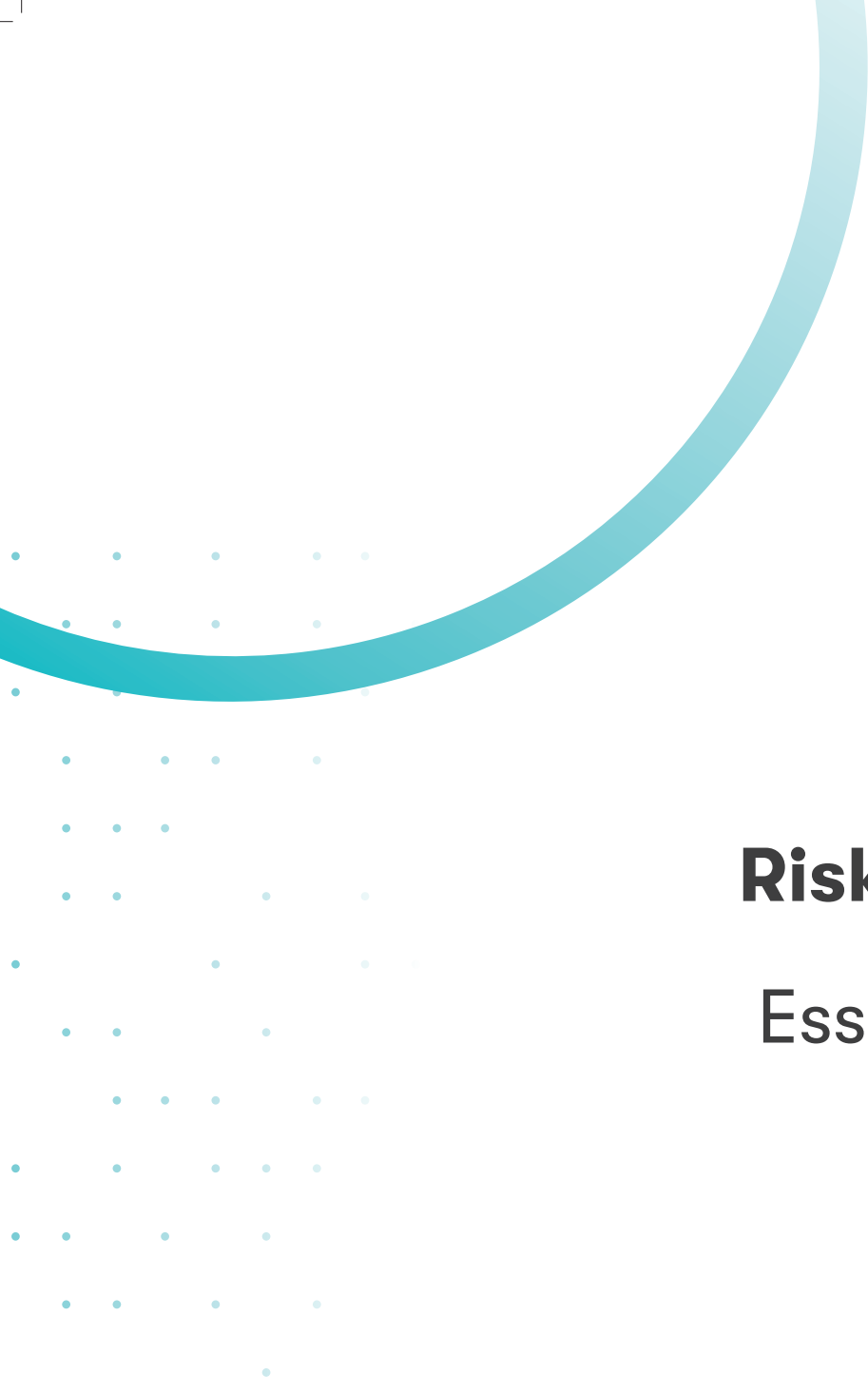
XYZ & Co.

Acknowledged and agreed on behalf of ABC Company by
(signed)

.....

Name and Title

Date



6

Risk assessment

Essential reading

1 Materiality

During planning, the auditor must establish materiality for the financial statements as a whole, but must also set performance materiality levels.

Determining materiality for the financial statements as a whole involves the exercise of professional judgement. Generally, a percentage is applied to a chosen benchmark as a starting point for determining materiality for the financial statements as a whole. The following factors may affect the identification of an appropriate benchmark:

- Elements of the financial statements (eg assets, liabilities, equity, revenue, expenses)
- Whether there are items on which users tend to focus
- Nature of the entity, industry and economic environment
- Entity's ownership structure and financing
- Relative volatility of the benchmark

The following benchmarks and percentages may be appropriate in the calculation of materiality for the financial statements as a whole:

Value	Percentage (%)
Revenue	½ to 1
Total assets	1 to 2
Profit before tax	5 to 10
Gross profit	½ to 1
Net assets	2 to 5

2 Performance materiality

Performance materiality really has two definitions.

It is “the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole”.

It also refers to “the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures”. (ISA 320: para. 9)

This indicates that the auditor sets a level or levels of materiality lower than overall materiality for the purposes of performing procedures in general (for example on a low risk area) and this is just to account for aggregation. However, an even lower level is set for certain balances, transactions or disclosures where there is an increased risk or if qualitative considerations necessitate it.

Determining performance materiality is very much dependent on the auditor's professional judgment. It is affected by:

- The nature and extent of misstatements identified in prior audits
- The auditor's understanding of the entity
- Result of risk assessment procedures

3 Gaining an understanding of the entity and its environment

ISA 315 sets out the methods that the auditor shall use to obtain an understanding of the entity and its environment and these are shown in the Workbook.

Additional information is shown below concerning the use of enquiry and observation and inspection to gain an understanding as well as specific considerations for companies that use e-business.

3.1 Enquiry

The auditors will usually obtain most of the information they require from staff in the accounts department but may also need to make enquiries of other personnel: for example, production staff and those charged with governance.

Those charged with governance may give insight into the environment in which the financial statements are prepared. In-house legal counsel may help with understanding such matters as outstanding litigation and compliance with laws and regulations. Sales and marketing personnel may give information about marketing strategies and sales trends.

If the client has an internal audit function, enquiries should be made of internal auditors as appropriate as part of risk assessment procedures. ISA 315 emphasises the need for the auditor to make enquiries of appropriate individuals within the internal audit function.

3.2 Observation and inspection

These techniques are likely to confirm the answers given to enquiries made of management. They will include observing the normal operations of a company, reading documents or manuals relating to the client's operations and visiting premises and meeting staff.

3.3 Companies that use e-business

When considering the effect on the financial statements of a company using e-commerce, the auditor needs to consider whether the skills and knowledge of team members are appropriate to perform the audit, and also whether an expert is required.

The auditor also needs to have a good understanding of the business to assess the significance of e-commerce and its effect on audit risk. The auditor should consider the following:

- The entity's business activities and industry
- The entity's e-commerce strategy
- The extent of e-commerce activities
- Outsourcing arrangements

Specific risks affecting entities that engage in e-commerce include:

- Loss of transaction integrity
- Security risks
- Improper accounting policies (eg capitalisation of expenditure, translation of foreign currency, allowances for warranties and returns, revenue recognition)
- Non-compliance with taxation and other laws and regulations
- Failure to ensure that contracts are binding
- Overreliance on e-commerce
- Systems and infrastructure failures or crashes

The auditor uses the knowledge of the business gained to identify events, transactions and practices related to business risks arising from e-commerce activities that may result in material misstatements in the financial statements.

The auditor also considers the control environment and control procedures that are relevant to the financial statement assertions, in accordance with ISA 315, in particular those relating to security, transaction integrity and process alignment.

4 Fraud, laws and regulations



Fraudulent financial reporting : **Fraudulent financial reporting** “involves intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users” (ISA 240: para. A2).

This may include:

- Manipulation, falsification or alteration of accounting records/supporting documents
 - Misrepresentation (or omission) of events or transactions in the financial statements
 - Intentional misapplication of accounting principles

(ISA 240: para. A3)

Such fraud may be carried out by overriding controls that would otherwise appear to be operating effectively, for example by recording fictitious journal entries and improperly adjusting assumptions or estimates used in financial reporting (ISA 240: para. A4).

4.1 Misappropriation of assets



Misappropriation of assets: **Misappropriation of assets** “involves the theft of an entity’s assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect” (ISA 240: para. A5).

This is the theft of the entity’s assets (for example, cash and inventory). Employees may be involved in such fraud in small and immaterial amounts, but it can also be carried out on a larger scale by management who may then conceal the misappropriation, for example, by:

- Embezzling receipts (for example, diverting them to private bank accounts)
- Stealing physical assets or intellectual property (inventory, selling data)
- Causing an entity to pay for goods not received (payments to fictitious vendors)
- Using assets for personal use

(ISA 240: para. A5)

4.3 Laws and regulations

In accordance with ISA 315 (Revised), the auditor shall obtain a general understanding of:

- The applicable legal and regulatory framework
- How the entity complies with that framework

(ISA 250 (Revised): para. 13)

The auditor can achieve this understanding by using their existing understanding and updating it, and making enquiries of management about other laws and regulations that may affect the entity, and about its policies and procedures for ensuring compliance and about its policies and procedures for identifying, evaluating and accounting for litigation claims.

The auditor shall remain alert throughout the audit to the possibility that other audit procedures may bring instances of non-compliance or suspected non-compliance to the auditor’s attention. These audit procedures could include:

- Reading minutes
- Making enquiries of management and in-house/external legal advisers regarding litigation, claims and assessments
- Performing substantive tests of details of classes of transactions, account balances or disclosures

(ISA 250 (Revised): para. A15)

The auditor shall request written representations from management that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be

considered when preparing the financial statements have been disclosed to the auditor (ISA 250 (Revised): para. 16).

The following factors may indicate non-compliance with laws and regulations:

- Investigations by regulatory authorities and government departments
- Payment of fines or penalties
- Payments for unspecified services or loans to consultants, related parties, employees or government employees
- Sales commissions or agents' fees that appear excessive
- Purchasing at prices significantly above/below market price
- Unusual payments in cash
- Unusual transactions with companies registered in tax havens
- Payment for goods and services made to a country different to the one in which the goods and services originated
- Payments without proper exchange control documentation
- Existence of an information system that fails to provide an adequate audit trail or sufficient evidence
- Unauthorised transactions or improperly recorded transactions
- Adverse media comment
- Matters raised by 'whistle-blowers'

(ISA 250 (Revised): paras. A17-18)

The following table summarises audit procedures to be performed when non-compliance is identified or suspected (ISA 250 (Revised): paras. A20-25):

Non-compliance: Audit procedures
Obtain an understanding of the nature of any acts and circumstances.
Obtain further information to evaluate the possible effect on the financial statements.
Discuss with management and those charged with governance unless laws and regulations in the jurisdiction concerned prohibit such communication (for example, avoiding tipping off in cases of suspected money laundering) meaning legal advice may need to be sought by the auditor before proceeding with such enquiries.
Consider the need to obtain legal advice (or consult with others inside or connected to the firm) anyway if sufficient information is not provided and the matter is material.
Evaluate the effect on the auditor's opinion if sufficient information is not obtained.
Evaluate the implications of any identified or suspected non-compliance on risk assessment and the reliability of any written representations (especially if the auditor possesses evidence of either management or those charged with governance being involved in this non-compliance in some way).

The auditor shall communicate suspected non-compliance with those charged with governance but, if the auditor suspects that those charged with governance are involved, the auditor shall communicate with the next highest level of authority, such as the audit committee or supervisory board.

If this does not exist, the auditor shall consider the need to obtain legal advice (ISA 250 (Revised): paras. 23–25). The auditor shall consider the impact of any identified or suspected non-compliance (including those related to other reporting responsibilities beyond ISAs and any associated with key audit matters) on the auditor's report if they conclude that the non-compliance has a material effect on the financial statements and has not been adequately reflected or is prevented by management and those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance is material to the financial statements (ISA 250 (Revised): paras. 26–28).

The auditor shall determine whether identified or suspected non-compliance has to be reported to an appropriate authority outside the entity in line with law, regulation or relevant ethical requirements. This responsibility requires the auditor to make an assessment of when it may be appropriate to report to such an authority (ISA 250 (Revised): para. 29).

However, in some jurisdictions, reporting or communicating any identified or suspected non-compliance may be prohibited (for example, investigations into an entity by a regulatory authority which may be prejudiced by such disclosure). In any event, legal advice should be sought by the auditor when deciding on how best to discharge reporting and disclosure responsibilities (ISA 250 (Revised): paras. A26-33).

If legally permitted, withdrawal from an audit engagement may be an option for an auditor who believes that any identified or suspected non-compliance is sufficient to raise questions about the client's integrity. However, this should only be undertaken after obtaining legal advice and should not be seen as a way of avoiding other requirements (such as informing an appropriate authority or even an incoming auditor) (ISA 250 (Revised): para A25).



7

Audit planning and documentation

Essential reading

1 Impact of interim audit work on the final audit

The benefit of spreading audit procedures over an interim and final audit is that it is possible to provide shareholders and other users of the financial statements with the audited accounts sooner than if all audit procedures were carried out at a final audit taking place after the year end.

Performing audit procedures before the period end can **assist in identifying significant matters at an early stage** of the audit and help resolve them with management's assistance or develop an effective audit approach to address them. This **reduces the time taken at the final audit** to gain the remaining sufficient appropriate audit evidence needed.

1.1 Impact of interim audit work relating to internal controls on the final audit

If the auditors are to place reliance on internal controls they must obtain evidence that controls have operated effectively throughout the period. If the auditor obtains audit evidence about the operating effectiveness of controls at the interim audit, when it comes to the final audit, instead of having to gain evidence over controls covering the whole year the auditor can focus on:

- Obtaining audit evidence about significant changes to those controls subsequent to the interim period
- Determining the additional audit evidence to be obtained for the remaining period

While at the final audit, the amount of work needed to gain additional audit evidence about controls that were operating during the period between the interim audit and the year end will depend on:

- The significance of the assessed risks of material misstatement at the assertion level
- The specific controls that were tested during the interim period, and significant changes to them since they were tested, including changes in the information system, processes and personnel
- The degree to which audit evidence about the operating effectiveness of those controls was obtained
- The length of the remaining period
- The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls
- The control environment

(ISA 330: para. 33)

1.2 Impact of substantive procedures performed during the interim audit on the final audit

If substantive procedures are performed at an interim date, the auditor must cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls for the intervening period. (ISA 330: para. 22)

Conclusions will have been reached on the testing carried out at the interim audit and the auditor essentially has to carry out any procedures necessary to provide a reasonable basis for extending the audit conclusions from the interim date to the period end.

One approach an auditor who has carried out an interim audit can take is to compare and reconcile information concerning the balance at the period end with the comparable information at the interim date (ISA 330: para. A55). Essentially, because the interim balance has been audited, the auditor can focus on auditing the movements in the balance between the interim date and the year end.

A point to note is that when misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor may need to modify the planned nature, timing or extent of substantive procedures covering the remaining period (ISA 330: para. 23). This may result in repeating the procedures in full that were performed at the

interim date. Therefore, part of the expected benefit of carrying out the interim audit will have been lost.

2 Examples of working papers

Auditors are required to document their audit work so that they have a written record of work done which supports the auditor's opinion.

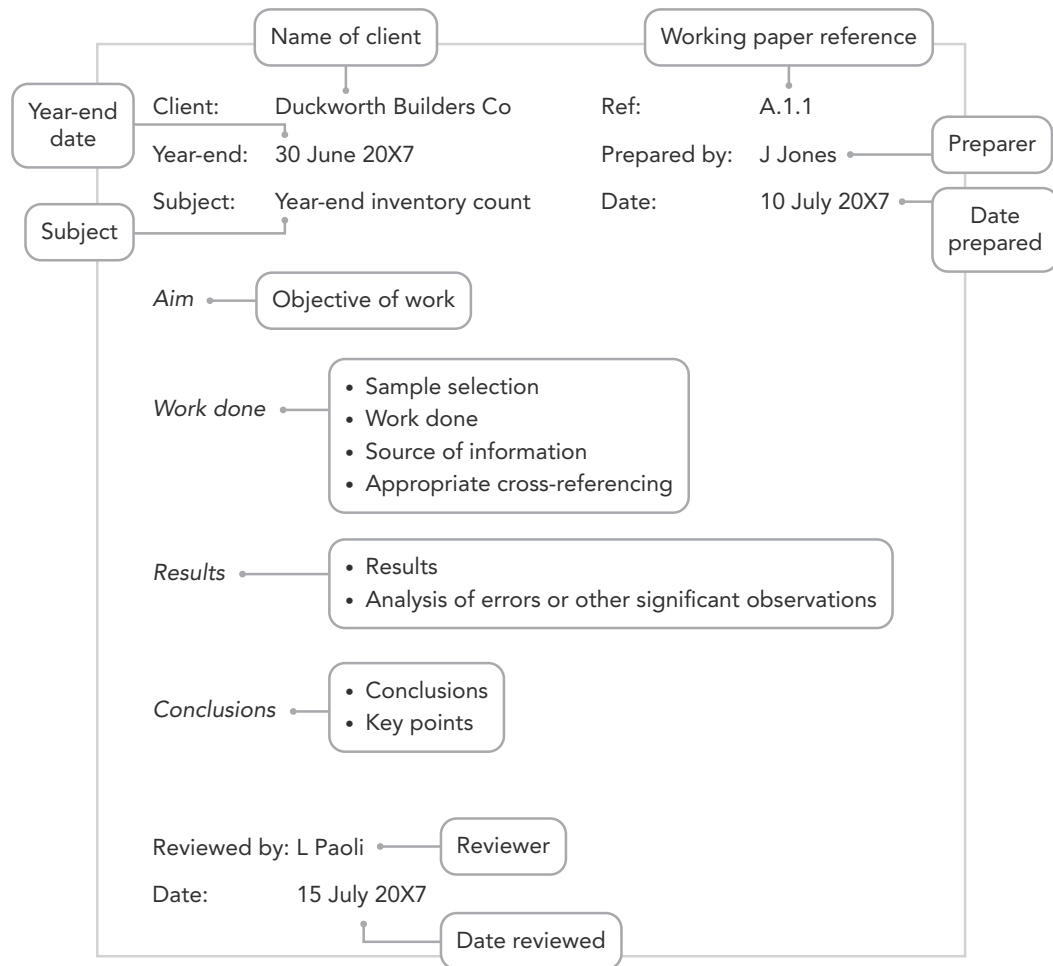
2.1 Examples:

Work is documented via working papers which can take many forms:

- (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 programmes 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 significant deficiencies in internal control
- (m) Written representations received from management of 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 achieved the audit objective

2.2 Example working paper

The following is an illustration of a typical audit working paper.



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.

A large teal arc curves from the top left towards the center. To its left, a series of small teal dots are arranged in a grid-like pattern, with some dots missing, creating a sparse, abstract design.

8

Introduction to audit evidence

Essential reading

1 Audit procedures to obtain audit evidence

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

- (a) 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**) (Chapter 6).
- (b) Test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level (**tests of controls**) (Chapters 9 and 10).
- (c) Detect material misstatements at the assertion level (**substantive procedures**) (Chapters 12 to 18).

The auditor must **always** perform **risk assessment procedures** to provide a satisfactory assessment of risks.

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 (ISA 500: para. A14–A25):

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 documentation 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	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.
Enquiry	This involves seeking information from client staff or external sources. Strength of evidence depends on the knowledge and integrity of source of information. Enquiry 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.

Procedures	
Confirmation	This is the process of obtaining a representation of information or of an existing condition directly from a third party, eg confirmation bank balances from the bank.
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



9

Internal control

Essential reading

1 Components of an internal control system

It could be said that the 2019 revision of ISA 315 brought with it a greater emphasis on principles and auditor judgment. It is a constant refrain of the standard that processes should be ‘**appropriate to the nature and complexity of the entity**’, and that the requirements of the standard must be ‘scaled’ for entities of different sizes. This revision removed some of the detailed lists of requirements that featured in previous versions of the standard, requiring auditors instead to make judgments about the controls that would be appropriate to the actual entity they are auditing. This is intended to make the auditor’s risk assessment more effective, with the aim of improving audit quality.



Assessment focus point

The approach advocated by ISA 315 links in with risk assessment questions in your exam: you should be focusing on the risks that are present in the actual scenario, rather than on risks that you have learned in advance but which may not be present.

1.1 Control environment



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. (ISA 315: Appendix 3, para. 4)

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. Conversely, a deficient control environment can undermine the effectiveness of controls.

The ISA (ISA 315: para. 21), states that auditors shall obtain an understanding of the control environment. As part of this understanding, the auditor shall:

- (a) Understand the set of controls, processes and structures that address:
 - (i) How management’s oversight responsibilities are carried out, such as the **entity’s culture and management’s commitment to integrity and ethical values**;
 - (ii) When those charged with governance are separate from management, the independence of, and oversight over the entity’s system of internal control by, those charged with governance;
 - (iii) The entity’s assignment of authority and responsibility;
 - (iv) How the entity attracts, develops, and retains competent individuals; and
 - (v) How the entity holds individuals accountable for their responsibilities in the pursuit of the objectives of the system of internal control;
- (b) Evaluate whether:
 - (i) Management, with the oversight of those charged with governance, has created and maintained a **culture of honesty and ethical behaviour**;
 - (ii) The control environment provides an appropriate foundation for the other components of the entity’s system of internal control considering the nature and complexity of the entity; and
 - (iii) Control deficiencies identified in the control environment undermine the other components of the entity’s system of internal control.

The auditor should obtain this understanding of the control environment because it “provides an overall foundation” of the system of internal control (ISA 315: para. A97). Any deficiencies that the auditor picks up in the control environment can then feed into the assessment of audit risks.

Once the control environment has been understood, the auditor then **evaluates it**. This will involve consideration of the nature and complexity of the entity in question, and may be complex since some factors can be offer both advantages and disadvantages – for instance, the domination of

an entity by a single individual may be key to it meeting its corporate objectives (eg for growth), but may also lead to a risk of management override of internal controls (ISA 315: para. A105).

1.2 Entity's process to monitor internal control

ISA 315 (para. 24), says the auditor shall:

- (a) Understand the entity's process to address:
 - (i) Ongoing and separate evaluations for **monitoring the effectiveness of controls**, and the identification and remediation of **control deficiencies** identified; and
 - (ii) The entity's internal audit function, if any, including its nature, responsibilities and activities;
- (b) **Understanding the sources of the information used** in the entity's process to monitor the system of internal control, and the basis upon which management considers the information to be sufficiently reliable for the purpose;
- (c) Evaluating whether the entity's process for monitoring the system of internal control is **appropriate to the entity's circumstances** considering the nature and complexity of the entity

1.3 Entity's risk assessment process

ISA 315 (para. 22), says the auditor shall:

- (a) Understand the entity's process for:
 - (i) **Identifying business risks** relevant to financial reporting objectives;
 - (ii) Assessing the significance of those risks, including the likelihood of their occurrence;
 - (iii) Addressing those risks;
- (b) Evaluate whether the entity's risk assessment process is **appropriate to the entity's circumstances** considering the **nature and complexity** of the entity

If the auditor identifies a risk that management was not aware of, then they should obtain an understanding of why management missed the risk. This may in turn feed into the auditor's assessment of the robustness of management's risk assessment process (ISA 315: para. 23).

1.4 Information system and communication

Obtain an understanding of the information system and communication, by:

- Understanding information processing activities that define:
 - How information flows - **how transactions are initiated and reported**, and **how information about events and conditions is captured**
 - The accounting records
 - The financial reporting process for preparing the financial statements
 - The entity's resources - including **IT environment**
- Understanding how the entity communicates relevant matters:
 - Within the entity
 - With those charged with governance
 - With external parties (eg regulators)
- Evaluating whether the information system and communication system are appropriate

(ISA 315: para. 25)

1.5 Control activities



Controls : Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance. In this context:

- Policies are statements of what should, or should not, be done within the entity to effect control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions.

- Procedures are actions to implement policies.
(ISA 315: para. 12c)

The ISA states that the auditor shall obtain an understanding of control activities by (ISA 315: para. 26):

- Identifying controls that address the identified risks of material misstatement:
 - Controls for **significant risks**
 - Controls over **journals** and non-standard entries
 - **Controls that the auditor plans to test**
 - Other controls
- Identifying the **IT applications** involved in control activities
- **Risks from IT** and the entity's **general IT controls** to address these
- For controls and general IT controls:
 - **Evaluating whether the control is designed effectively**
 - **Determining whether the control has been implemented**

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 (ISA 315: para. A96).

Examples of control activities		
Example	Explanation	Category
Approval and control of documents	Transactions should be approved by an appropriate person. For example, overtime should be approved by departmental managers.	Authorisation
Controls over computerised applications	We shall look at computer controls later in this chapter.	Information processing
Checking the arithmetical accuracy of records	For example, checking to see if individual invoices have been added up correctly	Information processing
Maintaining and reviewing control accounts and trial balances	Control accounts bring together transactions in individual ledgers. Trial balances bring together transactions for the organisation as a whole. Preparing these can highlight unusual transactions or accounts.	Performance review
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 (eg resulting from timing differences).	Information processing

Examples of control activities		
Example	Explanation	Category
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.	Performance review
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	Performance review
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.	Physical control
Segregation of duties	Assigning different people the responsibility of authorising transactions, recording transactions and maintaining custody of assets	Segregation of duties

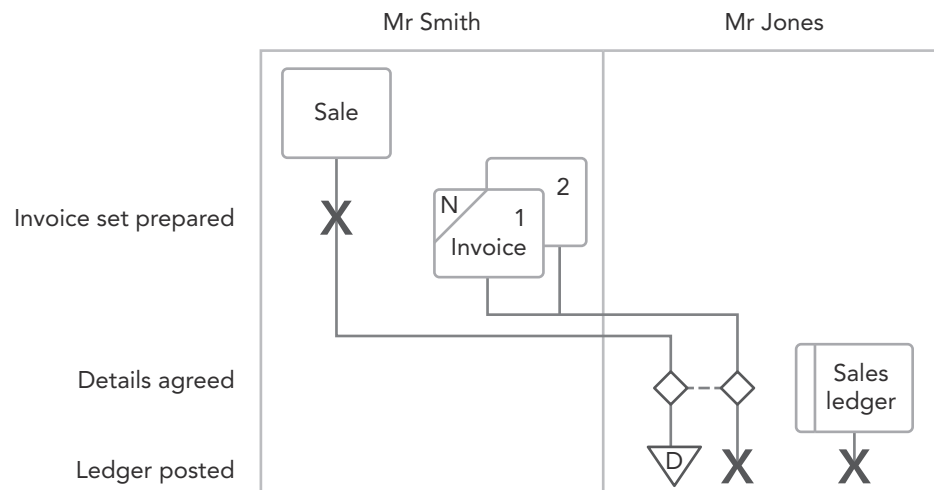
Segregation implies a **number of people** being involved in the accounting process. This makes it more difficult for fraudulent transactions to be processed (since a number of people would have to collude in the fraud), and it is also more difficult for accidental errors to be processed (since the more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

- 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.
- 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.
- 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.

2 Recording accounting and control systems

2.1 Flowcharts

The following diagram provides an example of a flowchart:



2.2 Internal control questionnaires (ICQs)

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

Goods inward

- Are supplies examined on arrival as to quantity and quality?
- Is such an examination evidenced in some way?
- Is the receipt of supplies recorded, perhaps by means of goods inward notes?
- Are receipt records prepared by a person independent of those responsible for:
 - Ordering functions?
 - The processing and recording of invoices?
- Are goods inward 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)?
- Are goods inward records regularly reviewed for items for which no invoices have been received?
 - Are any such items investigated?
- Are these records reviewed by a person independent of those responsible for the receipt and control of goods?

2.3 Internal control evaluation questionnaires (ICEQs)

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:

- Goods or services could not be received without a liability being recorded?
- Receipt of goods or services is required in order to establish a liability?
- A liability will be recorded:
 - 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 control question is supported by detailed control points to be considered.

For example, the detailed control points to be considered in relation to 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:

- (a) Is segregation of duties satisfactory?
- (b) Are controls over relevant master files satisfactory?
- (c) Is there a record that all goods received have been checked for:
 - (i) Weight or number?
 - (ii) Quality and damage?
- (d) Are all goods received taken on charge in the detailed inventory ledgers:
 - (i) By means of the goods received note (GRN)?
 - (ii) Or by means of purchase invoices?
 - (iii) Are there, in a computerised system, sensible control totals (hash totals, monetary values and so on) to reconcile the inventory system input with the payables system?
- (e) Are all invoices initialled to show that:
 - (i) Receipt of goods has been checked against the goods received records?
 - (ii) Receipt of services has been verified by the person using it?
 - (iii) Quality of goods has been checked against the inspection?
- (f) In a computerised invoice approval system are there printouts (examined by a responsible person) of:
 - (i) Cases where order, GRN and invoice are present but they are not equal ('equal' within predetermined tolerances of minor discrepancies)?
 - (ii) Cases where invoices have been input but there is no corresponding GRN?
- (g) Is there adequate control over direct purchases?
- (h) 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 direct 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.

A large teal arc curves from the top left towards the center. To its left, a series of small teal dots are arranged in a grid-like pattern, with some dots missing, creating a sparse, abstract design.

10

Tests of controls

Essential reading

1 Internal auditor's reports

In Chapter 4, we saw that the role of the internal audit function is wide and varied. In most cases once the internal audit function has completed an assignment, it would be usual for them to prepare a report which summarises their findings.

Internal auditor's reports are therefore flexible and can take different formats depending on the nature of the assignment.

The format of the report would be agreed with management **before** the assignment is undertaken.

More complicated assignments are likely to summarise the main findings and include a number of appendices containing detailed information.

The following is a brief example of a systems review report which has been produced following an assignment carried out by the internal audit function.

REPORT

To: Board of Directors of Robinson Co

From: Internal audit department

Subject: Review of sales system

Period of fieldwork: March 20XX

Terms of Reference

The scope of the assignment was to carry out a thorough review of the sales system. This involved performing tests of controls on the existing sales system to determine whether the controls were operating effectively.

In addition, we considered the key risks surrounding the sales function and identified any risks for which we found no related controls.

We have been able to make recommendations regarding existing controls as well as suggest new controls where we believe they are needed.

Executive Summary

The main findings from our review are:

- The sales system, on the whole, comprises adequate controls
- Some specific control deficiencies were identified and recommendations are given in the Appendix to the report

Follow-up

Responsibilities have been allocated for introducing/improving control procedures which we found to be deficient.

We propose a follow-up review in six months' time.

Dated.....

Signed.....

Head Internal Auditor

APPENDIX

Detailed identification of deficiencies, risks and recommendations

Deficiency	Risk	Recommendation	Responsibility	Timescale
There is no credit check of new customers prior to accepting an order from them.	These new customers could represent an increased risk of irrecoverable debts.	All new customers should be subject to a credit check and the computer system should generate a request for authorisation of the new customer before a sales order can be	To be implemented by the head of the credit control department.	June 20XX

Deficiency	Risk	Recommendation	Responsibility	Timescale
		accepted.		
There is no follow-up of sales orders unmatched to GDNs.	Any dissatisfaction from customers not receiving their goods as ordered decreases the likelihood of repeat purchases.	There should be a monthly reconciliation between the month's sales orders and the related GDNs. Any unmatched orders should be followed up with queries being directed to head of sales.	To be implemented and managed by the head of the sales department.	May 20XX
Customers are not asked to sign a proof of delivery.	This could lead to disputes as to whether goods have actually been delivered, loss of customer goodwill and increased irrecoverable debts.	The proof of delivery should be a multi-part document. All copies must be signed by the customer. One copy should be left with the customer and the other copy retained within the sales department along with the order and invoice.	To be implemented by head of the sales department.	June 20XX

A large teal arc curves from the top left towards the center. To its left, a series of small teal dots are arranged in a grid-like pattern, with some dots missing, creating a sparse, abstract design.

11

Audit sampling and automated tools and techniques

Essential reading

1 Audit Sampling and Automated Tools and Techniques

1.1 Design of the sample



Non-sampling risk: is “the risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk”; for example, the use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognise a misstatement or deviation (ISA 530: paras. 5(d) and A1).

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 (ISA 530: paras. 5(f) and A2).

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)” (ISA 530: para. 5(h)).

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 (ISA 530: para. 6).

When considering the characteristics of the population, the auditor might determine that stratification or **value-weighted selection** is appropriate (ISA 530: para. A8).

The auditor must design a sample size sufficient to reduce sampling risk to an **acceptably low level** (ISA 530: para 7). Sampling risk can lead to two types of erroneous conclusions: for tests of controls, that they are more effective than 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 (ISA 530: paras. A10, A11). Sample size can be determined using a statistically-based formula or through the use of judgement (ISA 530: para. A4).

ISA 530 (para. 8) 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 (ISA 530: para. A12). 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.

1.2 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) (ISA 530: paras. 9, 10, 11).

1.3 Deviations and misstatements

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 (ISA 530: para. 13).

1.4 Evaluating the results

ISA 530 (para. 15) 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 (ISA 530: para. A21).

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.

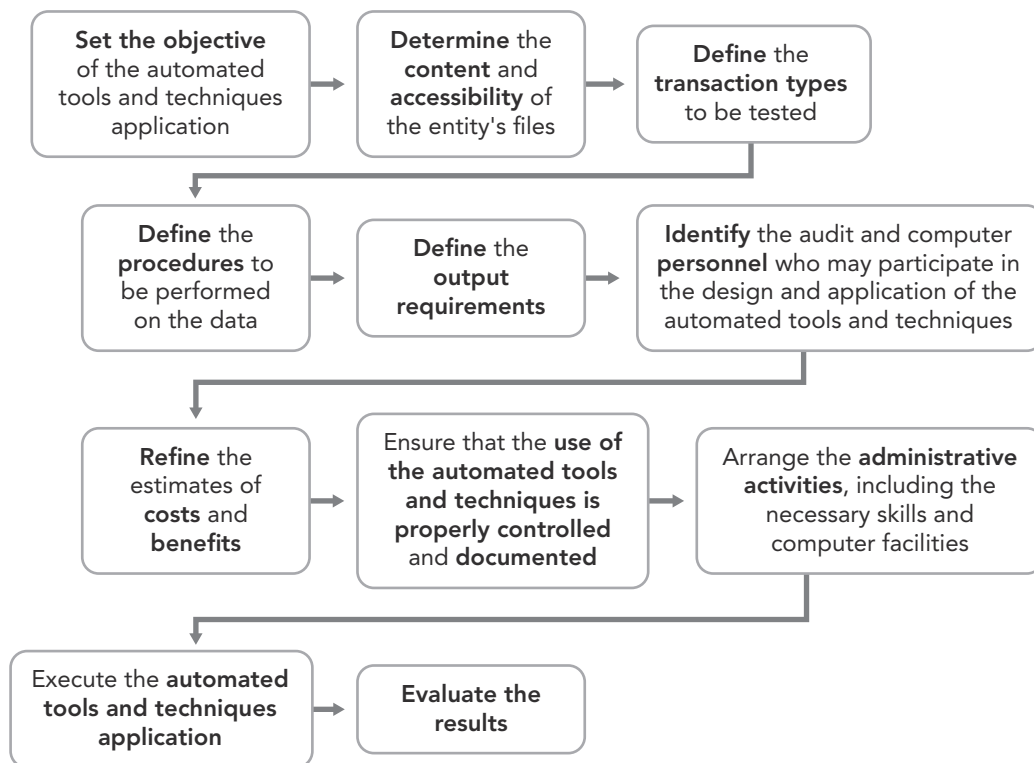
The risk may be reduced if additional audit evidence is obtained (ISA 530: para. A22).

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 (ISA 530: para. A23).

2 Automated tools and techniques

2.1 Using automated tools and techniques

The major steps to be undertaken by the auditors in the application of automated tools and techniques are as follows:



2.2 Audit software

The benefits and potential difficulties of using audit software are as follows:

Benefits	Difficulties
Audit software can perform calculations and comparisons more quickly than those done	The costs of designing tests using audit software can be substantial, as a great deal

Benefits	Difficulties
manually.	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.
Audit software makes it possible to test more transactions than when simply manually scanning printouts. 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	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.
Audit software may allow the actual computer files (the source files) to be tested from the originating program, rather than printouts from spool or previewed files which are dependent on other software (and therefore could contain errors or could have been tampered with following export).	If errors are made in the design of the audit software, audit time, and therefore 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.
Using audit software is likely to be cost-effective in the long term if the client does not change its systems	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.

2.3 Test data

The benefits and potential difficulties of using test data are as follows:

Benefits	Difficulties
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.	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.
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.	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.
	Initial computer time and costs can be high and the client may change its programs in subsequent years.

3 Audit data analytics

In the context of the financial statement audit, **data analytics** is ‘the science and art of **discovering and analysing patterns, deviations and inconsistencies, and extracting other useful information in the data underlying or related to the subject matter of an audit through analysis, modelling and visualisation for the purpose of planning or performing the audit**’ (IAASB Data Analytics Working Group Request for Input: Exploring the Growing Use of Technology in the Audit, with a Focus on Data Analytics, September 2016).

3.1 Applying ADA

There are clear benefits to the use of ADA which may also help the auditor to obtain an understanding of the entity and its environment, which in turn can help improve professional scepticism (another hot topic) (IAASB, 2016e: para. 7).

However, there are also limitations to its use, such as:

- Auditors need to have a clear understanding of the data they are analysing. There is a risk that the data analysed is not actually relevant to the audit.
- It should not be thought that if, in the future, auditors are able to test 100% of a population, the auditor’s opinion could provide more than just reasonable assurance. It cannot, because professional judgement is always involved.
- Both accounting estimates and qualitative disclosures require professional judgement. ADA can be a useful aid to this, but judgement and scepticism will always be needed.
- Although technology can help obtain evidence, auditors and stakeholders should not become overconfident in technology.

(IAASB, 2016e: para. 8)

Current ISAs neither encourage nor stimulate the use of ADA. However, they were created before ADA came into being. Some auditors have said that they find it hard to fit ADA into the current model of ISA 500 *Audit evidence*. In relation to analysing 100% of a population, some key issues include:

How this affects the identification of risks of material misstatement – can ADA help with this?

- Whether ADA can also be used to provide substantive audit evidence – are these tests of controls, tests of detail or substantive analytical procedures?
- Whether ADA has an effect on the evidence required from other audit procedures.

(IAASB, 2016e: para.11)

Challenges to the increased use of ADA include:

- Data acquisition – the auditor needs to acquire and store large amounts of the entity’s data. This can pose technical difficulties.
- Conceptual challenges – the auditor will need to think about how to use data in ways that are different from how the entity has used it in the past.
- Legal and regulatory challenges – eg concerning data security.
- Resource availability. If ADA involves the use of centralised highly-skilled data scientists, then there may not be enough of this resource to support audit teams.
- How regulators can maintain oversight. Regulators may not have experience of ADA, so they may find it hard to inspect audits.
- Re-training/re-skilling auditors. This will require significant time and investment in training.

(IAASB, 2016e: para.18)

The IAASB does not intend to make wholesale changes to ISAs in the near future, as these may have unintended consequences – particularly given that studies that seek to understand the use of ADA are currently still underway.



12

Non-current assets

Essential reading

1 Assertions

Existence, completeness, rights and obligations, accuracy, valuation and allocation, classification and presentation are the key assertions relating to the audit of non-current assets.

Assertion	Audit objective
Existence	• Additions represent assets acquired in the year and disposal represents 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, valuation and allocation	• Non-current assets are correctly stated at cost less accumulated depreciation. • Additions and disposals are correctly recorded.
Classification	• Tangible assets have been recorded in the correct accounts, and expenses which are not of a capital nature are taken to profit or loss.
Presentation	• Disclosures relating to cost, additions and disposals, depreciation policies and useful lives are adequate and in accordance with accounting standards.

2 Using the work of others

Whilst auditors are highly trained individuals, it is possible that when conducting an audit they encounter issues which are outside the scope of their expertise, for example, valuation of buildings.

Additionally, it is increasingly common for companies to outsource specific functions, for example payroll, to service organisations that have more expertise than the entity.

As such, the auditor must consider the availability and reliability of the evidence provided by such experts and by the work of service organisations.

Also, in some cases, external auditors may want to rely on work done by internal audit.

When the auditors plan to use the work of others, whether experts, service organisations or internal audit, they must consider the following:

- S** Scope of work – the work of others must be evaluated to determine if it is sufficient and appropriate
- O** Organisational status – (relevant to internal audit only). The external auditor must evaluate the status of the internal audit department within the entity. How seriously are its reports taken? Are its recommendations for improvements implemented?
- D** Due skill and care – the auditor must determine that the work of others is completed with due skill and care, ie that it is planned, directed, supervised and adequately reviewed
- I** Independence – the auditor must determine that the expert, service organisation or internal audit department is independent of the client to ensure no bias is reflected in their work
- T** Technical competence – the work of others must be of appropriate quality to be relied upon by the auditor and hence the expert, service organisation or internal auditor must have the technical ability and/or qualifications to provide such work

3 Use of a management's expert

3.1 Evaluating the competence, capabilities and objectivity of the expert.

Competence	Does the management's expert have the required level of expertise?
Capability	Are there any practical matters impacting the ability of the expert to perform their work? For example, do they have time available? Do they have enough staff?
Objectivity	Is there any bias, conflict of interest or influence from others that could affect the expert's judgement?

To evaluate these, the auditor will need to enquire about the following matters:

- Does the expert have previous experience in the area where their expertise is being sought?
- Does the expert have professional qualifications?
- Is the expert a member of a professional body?
- Does the expert hold a licence to practice if this is required?
- Has the expert published any books or papers?
- Is the work of the expert subject to any professional standards?
- Does the expert have any financial interests in the audit client?
- Does the expert have any business or personal relationships with the audit client?

3.2 Obtaining an understanding of the work done

ISA 500 *Audit evidence* requires the auditor to understand the work done by the expert. The auditor will need to enquire about the following:

- Are there any professional, legal or regulatory standards that apply to the expert's work?
- What assumptions has the expert made?
- What method has the expert used?
- What is the source of the data used by the expert?

3.3 Evaluating the appropriateness of the work done as audit evidence

The auditor will need to consider the following:

- Are the expert's findings consistent with other audit evidence?
- Are the expert's methods relevant and reasonable?
- Is the basis of the assumptions made by the expert reasonable? Are these similar to assumptions made for similar work for the audit client in the past?
- Is the source data used by the entity accurate and complete?

4 Auditing accounting estimates

4.1 Introduction

ISA 540 (Revised) *Auditing Accounting Estimates and Related Disclosures* provides guidance on the audit of accounting estimates contained in financial statements.



Accounting estimate: “a monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty” (ISA 540 (Revised): para. 12(a)).

Estimation uncertainty: “susceptibility to an inherent lack of precision in measurement” (ISA 540 (Revised): para. 12(c)).

Management's point estimate: “the amount selected by management for recognition or disclosure in the financial statements as an accounting estimate” (ISA 540 (Revised): para. 12(e)).

Auditor's point estimate or auditor's range: “an amount, or range of amounts, respectively, developed by the auditor in evaluating management's point estimate” (ISA 540 (Revised): para. 12(b)).

Some financial statement items cannot be measured precisely, only estimated. 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 their 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 if the auditor can formulate a reasonable estimate, it will be difficult for auditors to challenge management's estimate on the basis that the auditor's point estimate is different. Management will often argue that they are better placed to make estimates due to their ongoing involvement with the business and its environment.

4.2 Risk assessment procedures

ISA 540 (Revised) (para. 13) states that the auditor shall obtain an understanding of the following matters related to the entity's accounting estimates:

The entity and its environment	• Transactions, events and conditions that may give rise to the need for accounting estimates • The requirements of the applicable financial reporting framework with regards to accounting estimates • Any regulations affecting accounting estimates

	• Nature of accounting estimates
The entity's internal control	• The nature and extent of governance or oversight over accounting estimates made by management • How management assesses whether any specialist skills are required for making accounting estimates • How the entity identifies and addresses any risks relating to accounting estimates • The entity's information system relating to accounting estimates, in particular how management makes the accounting estimates and an understanding of the data on which they are based including: - Method - Assumptions - Sources of data - Relevant controls - Whether change from prior period in method used - Whether management has assessed the effect of estimation uncertainty • The entity's controls over managements' s process for making accounting estimates • Whether management reviews the outcome of previous accounting estimations and whether this influences future estimates

ISA 540 (Revised) (para. 14) also states that the auditor shall review the outcome of previous accounting estimates.

4.3 Risk identification and assessment

When assessing the risk of material misstatement relating to an accounting estimate, the auditor shall separately assess inherent risk and control risk.



Inherent risk factors: characteristics of conditions and events that may affect the susceptibility of an assertion to misstatement, before consideration of controls. (ISA 540 (Revised): para. A8)

The inherent risk factors the auditor may take into account are:

Estimation uncertainty

The susceptibility to an inherent lack of precision in the measurement of an accounting estimate

Complexity

The complexity inherent in making an accounting estimate, such as when multiple data sets or assumptions are required

Subjectivity

The inherent limitations in the knowledge or data reasonably available about valuation attributes

Other inherent risk factors

Includes susceptibility to misstatement due management bias or fraud

The degree to which inherent risk factors affect the likelihood or magnitude of misstatement varies on a scale known as the **spectrum of inherent risk**. (ISA 540 (Revised): para. 4)

The auditors must determine whether a **significant inherent risk** exists in relation to accounting estimates. If the auditor determines a significant inherent risk exists, the auditor shall obtain an understanding of the entity's controls, relevant to that risk.

4.4 Responding to the assessed risks

The ISA requires the auditor's further audit procedures to be responsive to the assessed risks of material misstatement at the assertion level. The further audit procedures shall include one or more of the following approaches:

Obtaining audit evidence from events occurring up to the date of the auditor's report

Testing how management made the accounting estimate

Developing an auditor's point estimate or a range

The higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be. (ISA 540 (Revised): para. 18)

4.4.1 Testing how management made the accounting estimate

The auditor's further audit procedures shall include procedures designed and performed to obtain sufficient and appropriate audit evidence regarding the risks of material misstatement to:

- (a) The selection and application of the **methods, significant assumptions and the data** used by management in making the accounting estimate; and
- (b) How management selected the point estimate and developed related disclosure about estimation uncertainty.

(ISA 540 (Revised): para. 22)

4.5 Disclosures

The auditor shall design and perform further audit procedure to obtain sufficient, appropriate audit evidence regarding the assessed risks of material misstatement at the assertion level for disclosures related to an accounting estimate. (ISA 540 (Revised): para. 31)

4.6 Management bias

The auditor is required to evaluate whether judgements and decisions made by management in making accounting estimates indicate possible management bias. If this occurs, the auditors must evaluate the implications for the audit. ISA 540 (Revised) (para.32) states that if there is an intention to mislead, management bias is fraudulent in nature.

4.7 Overall evaluation

ISA 540 (Revised) (paras. 33-35) includes a requirement to '**stand back**' and, based on the procedures performed, and audit evidence obtained with regards to accounting estimates, evaluate whether:

The original assessment risk of material misstatement with regards to accounting estimates remains appropriate

Managements decisions relating to the recognition, presentation, measurement and disclosure of the accounting estimates are in line with the applicable accounting framework

Sufficient appropriate audit evidence has been obtained

The auditor must evaluate whether accounting estimates (and their related disclosures) are **reasonable** or **misstated** based on the audit procedures performed and the audit evidence obtained.



13

Inventory

Essential reading

1 Assertions

The following table demonstrates the audit objectives for inventory and the related financial statement assertions:

Assertions	Audit objectives
Existence and occurrence	- Recorded purchases and sales represent inventories bought and sold. - Inventory on the statement of financial position physically exists.
Completeness	- All purchases and sales are recorded. - All inventory at year end is included on the statement of financial position.
Rights and obligations	The entity has rights to inventory recorded in the period and at the year-end.
Accuracy, valuation and allocation	- Costs are accurately determined in accordance with accounting standards. - Inventory is recorded at year end at the lower of cost and net realisable value (NRV) (IAS 2: para. 9).
Classification	Inventory is recorded in the proper accounts.
Cut-off	All purchases and sales of inventories are recorded in the correct period.
Presentation	- Inventory is properly classified in the accounts. - Disclosures relating to classification and valuation are adequate and in accordance with accounting standards.

2 The physical inventory count

Considerations of the auditor when evaluating management's instructions and planning to attend the inventory count are as follows:

2.1 Planning the inventory count

Gain Knowledge

- **Review** previous year's **arrangements**
- **Discuss with management** the inventory count arrangements and significant changes

Assess key factors

- The **nature** and **volume** of the **inventory**
- **Risks** relating to inventory
- **Identification** of **high value items**
- **Method of accounting** for inventory
- **Location** of inventory and how it affects inventory control and recording
- **Internal control** and **accounting systems** to identify potential areas of difficulty

Plan procedures

- **Ensure** a **representative selection of locations, inventory and procedures** are covered
- Ensure sufficient attention is given to **high value items**
- **Arrange** to **obtain** from any **third parties confirmation** of inventory they hold
- Consider the need for **expert help**

2.2 Reviewing inventory count instructions

Organisation of count

- **Supervision** by senior staff including senior staff not normally involved with inventory
- **Tidying** and **marking** inventory to help counting
- **Restriction** and **control** of the production process and inventory movements during the count
- **Identification** of **damaged, obsolete, slow-moving, third-party** and **returnable** inventory

Counting

- **Systematic counting** to ensure all inventory is counted
- Teams of **two counters**, with one counting and the other checking or **two independent counts**

Recording

- **Serial numbering, control** and **return** of all inventory sheets
- Inventory sheets being **completed** in **ink** and **signed**
- **Information** to be recorded on the **count records** (location and identity, count units, quantity counted, conditions of items, stage reached in production process)
- Recording of **quantity, conditions** and **stage of production** of **work-in-progress**
- Recording of last numbers of **goods inwards** and **outwards** records and of internal transfer records
- **Reconciliation** with **inventory records** and **investigation** and correction of any **differences**

2.3 Inventory held by third parties

The other appropriate audit procedures for obtaining sufficient and appropriate evidence of inventory held by third parties 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

(ISA 501: para. A16)

2.4 Cut-off testing

2.4.1 The importance of cut-off testing

While cut-off is a transaction assertion, it is important to note that it has a direct impact on the related statement of financial position balances. For example, a cut-off error in the recording of sales will result in misstatements in the inventory and receivables balances. A cut-off error in the recording of purchases of raw materials will have an equal knock-on effect on inventory and payables. Therefore, cut-off testing is often used to confirm the completeness of inventory, as well as the existence of receivables and payables.

2.4.2 Management's cut-off procedures

The auditors should consider whether management at the audit client have implemented adequate cut-off procedures. These are the procedures implemented by management 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.

Revenue cut-off is generally more straightforward to achieve correctly than purchases cut-off. Invoices for goods despatched after the count should not appear in the statement of profit or loss 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 despatches of goods are in place, and also a system for documenting materials requisitions. GRNs and GDNs should be sequentially prenumbered.
- (b) Final GRN and GDN and materials requisition numbers are noted. These numbers can then be used to subsequently check that purchases and revenue 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 is satisfactory.

There should ideally be no movement of inventory during the count. Preferably, receipts and despatches 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.

2.5 Continuous (perpetual) inventory counting

If **continuous** inventory counting is used at an audit client, auditors will verify that management:

- (a) Ensures that all inventory lines are counted at least once a year
- (b) Maintains **adequate inventory records** that are kept up to date. Auditors may compare sales and purchase transactions with inventory movements and carry out other tests on the inventory records, for example, checking casts and classification of inventory.

- (c) Has **satisfactory procedures** for **inventory counts** and **test-counting**. Auditors should confirm the inventory count arrangements and instructions are as rigorous as those for a year-end inventory count by reviewing instructions and observing counts. **Auditors** will be particularly concerned with cut-off, that there are no inventory movements while the count is taking place and inventory records are updated up until the time of the inventory count.
- (d) **Investigates** and **corrects** all **material differences**. Reasons for differences should be recorded and any necessary corrective action taken. All corrections to inventory movements should be authorised by a manager who has not been involved in the detailed work. These procedures are necessary to guard against the possibility that inventory records may be adjusted to conceal shortages. Auditors should check that the procedures are being operated.

Audit tests performed will be as follows.

Attend one of the inventory counts	To observe procedures and confirm that instructions are being adhered to
Perform test counts in both directions	To gain evidence of existence and completeness of inventory
Follow up the inventory counts attended	To compare quantities counted by the auditors with the inventory records, obtaining and verifying explanations for any differences, and checking that the client has reconciled count records with book inventory records
Review the year's inventory counts	To confirm the extent of counting, the treatment of discrepancies and the overall accuracy of records (if matters are not satisfactory, auditors will only be able to gain sufficient assurance by a full count at the year-end)
Assuming a full count is not necessary at the year end, compare the listing of inventory with the detailed inventory records , and carry out other procedures (cut-off, analytical review)	To gain further comfort

3 Valuation of inventory

3.1 Assessment of cost

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

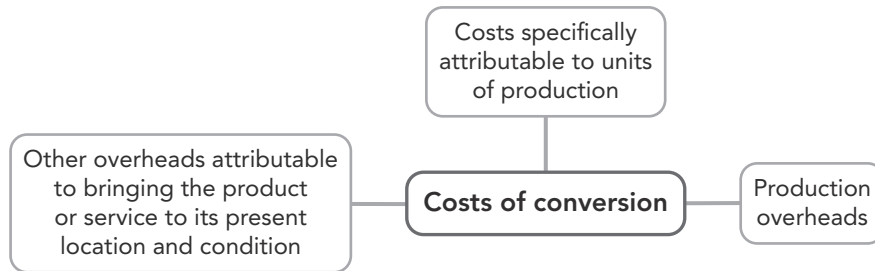
3.1.1 Valuation of raw materials and bought-in components

The auditors should perform work to test whether the correct prices have been used to value raw materials and bought-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' invoices 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.

3.1.2 Valuation of work-in-progress and finished goods

'Cost' comprises the cost of purchase plus the costs of conversion (IAS 2: paras. 10 and 12).



IAS 2 allows entities to use **standard costing**. This means that instead of working out exactly how much of each input – cost, labour, materials – relates to each individual item of inventory, the entity can just assign a 'standard cost' for that **type of inventory** and use this as its cost. IAS 2 permits standard costing to be used, provided that it approximates actual cost (IAS 2: paras. 21, 22).

3.2 Auditing cost and the allocation of overheads

The audit procedures will depend on the methods used by the client to value WIP 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.

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

(IAS 2: paras. 12–13)

Thus, overheads arising from **reduced levels of activity, idle time or inefficient production** should be written-off to the statement of profit or loss, 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.

3.3 Auditing cost vs NRV

Per IAS 2, inventory must be valued at the lower of cost and net realisable value (NRV). NRV 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

Tests to determine whether NRV is lower than cost include:

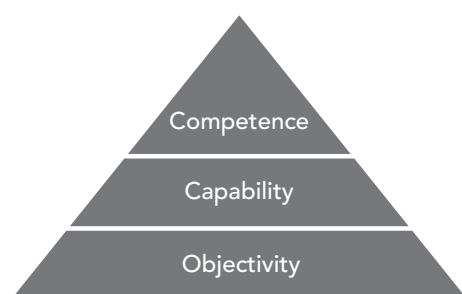
- Compare the selling prices of goods sold after the year end per sales invoices with their purchase price per supplier statements for each item of inventory. Where this is impracticable, the comparison may be done by group or category. For WIP, the ultimate selling price should be compared with the carrying value at the year-end plus costs to be incurred after the year end to bring WIP to a finished state.
- Review the order book to determine at what price the goods are ordered
- Look at write downs from last year. Are these items still in inventory?
- Analytical review of gross profit margin post year-end; if decreases may indicate that some inventory is being sold for less than cost

3.4 Using the work of an auditor's expert

ISA 620 (para. A4) states that an auditor's expert could be employed by the auditor to assist in:

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

ISA 620 (para. 9) requires the auditor to evaluate whether the auditor's expert has the necessary:



Where the auditor's expert is external, the evaluation of objectivity will include enquiry 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 management policies and procedures

(ISA 620: para. A15)

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 (ISA 620: para. 10).

When using an auditor's expert, the auditor shall agree in writing the following matters:

The nature and objectives of that expert's work
The respective roles and responsibilities of the auditor and that expert
The nature, timing and any report to be provided by that expert
The need for the auditor's expert to observe confidentiality requirements

(ISA 620: para. 11)

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.

3.4.1 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

(ISA 620: para. 12)

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 (ISA 620: para. 13).

3.4.2 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 (ISA 620: paras. 14–15).

4 Using the work of internal audit

The objectives of the auditor 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
- If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work

(ISA 610 (Revised): para. 13)

4.1 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

4.2 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.

4.2.1 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** (ISA 610 (Revised): para. 15).

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 (ISA 610 (Revised): paras. A5–A7).
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 (ISA 610 (Revised): para. A8).
Whether the internal audit function applies a systematic and disciplined approach (including quality management)	Consider whether internal audit activities include a systematic and disciplined approach to planning, supervising, reviewing and documenting assignments, whether the function has appropriate quality management procedures , the existence of audit manuals, work programmes and internal audit documentation (ISA 610 (Revised): para. A11).

If the internal audit function is found to be lacking in **any** of the preceding areas, the standard ISA 610 (Revised) (para. 16) states that the auditor shall **not** use the work of the internal auditor.

4.2.2 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

(ISA 610 (Revised): para. 17)

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 judgments being made. These will be areas where:

- (a) More judgment is needed in planning/performing procedures and evaluating evidence
- (b) The risk of material misstatement is high, including where risks are assessed as significant
- (c) The internal audit function's organisational status and relevant policies/procedures are not as robust in supporting the internal audit function's objectivity
- (d) The internal audit function is less competent

(ISA 610 (Revised): para. 18)

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 that the external auditor is solely responsible for the audit opinion.

4.3 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 that the auditor has made the above assessment before this communication takes place (ISA 610 (Revised): para. 20).

The auditor must also discuss the planned use of the work with the internal audit function so both parties' activities can be co-ordinated (ISA 610 (Revised): para. 21).

4.4 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 in terms of both 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.

4.4.1 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 (ISA 610 (Revised): para. 26).

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**

(ISA 610 (Revised): para. 28)

If either of these are lacking, then the external auditor must **not** use direct assistance.

4.4.2 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:

The amount of **judgement** involved in **planning** and **performing** the relevant audit procedures, and in **evaluating** the audit evidence gathered

The assessed **risk** of material misstatement

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): para. 29)

As we have already seen, ISA 610 ((Revised) (para. 32) 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.

4.4.3 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 (ISA 610 (Revised): para. 31).

4.4.4 Using internal auditors to provide direct assistance

As stated in ISA 610 ((Revised) (para. 33), before using internal auditors to provide direct assistance, **written agreement must be obtained**:

- (a) 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)
- (b) 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): para. A40).

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 (ISA 610 (Revised): para. 34).

Throughout the process, the external auditor must consider the degree of judgment 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 (ISA 610 (Revised): para. 35).

4.5 Documentation

Where **the work of the internal audit function has been used**, ISA 610 ((Revised): para. 36) requires the external auditors to document:

- (a) 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
- (b) The **basis for the decision** regarding the **nature and extent** of the work performed by the internal auditors

- (c) **The member of the external audit team who reviewed** the work performed and the **date** and **extent** of that review

Where the **external auditors have used direct assistance from the internal auditors**, ISA 610 ((Revised): para. 37) requires the following to be documented:

- (a) 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
- (b) The **basis for the decision** regarding the **nature and extent** of the work performed by the internal auditors
- (c) **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 should also be included in the audit documentation. The working papers prepared by the internal auditors who provided direct assistance should be filed.



14

Receivables

Essential reading

1 Assertions

The following table sets out the assertions that apply to revenue and receivables. The audit procedures described throughout Chapter 14 are used to provide evidence for these assertions.

Assertions about classes of transactions and related disclosures

- 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)
- All disclosed events and transactions relating to receivables have occurred and pertain to the entity (occurrence)
- All disclosures required have been included (completeness)
- Financial information is appropriately presented and described and disclosures clearly expressed (presentation)
- Financial and other information is disclosed fairly and at appropriate amounts (presentation)

Assertions about account balances at the period end and related disclosures

- 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 (accuracy, valuation and allocation)
- All disclosures required have been included (presentation)
- Financial information is appropriately presented and described and disclosures clearly expressed (presentation)
- Financial and other information is disclosed fairly and at appropriate amounts (presentation)

1.1 Internal control considerations

The audit of receivables and revenue is closely linked to the objectives we looked at when we considered controls over the revenue system in Chapter 10.

Segregating responsibilities in this area is a very important control. One person should not be responsible for taking orders, raising 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 direct 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 revenue system is having numerically sequenced invoices which are matched to shipping documentation or goods despatched notes (GDNs).

One area in which the auditor may be able to make use of client controls is over the completeness of revenue, where the client performs a reconciliation between revenue records outside of the accounting system and the revenue 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 revenue by checking that 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 of completeness

2 External confirmations

2.1 Example of an external confirmation letter

A specimen 'positive' confirmation letter is shown below:

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

306

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.

2.2 Management's refusal to allow the auditor to send a confirmation request

An external confirmation is essentially an act of the **client**, who alone can authorise third parties to divulge information to the auditors.

ISA 505 (para. 8) 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 enquire 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 (ISA 505: para. 9).

2.3 Unreliable responses to external confirmation requests

The ISA 505 (para. 10) 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**, they 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 (ISA 505: para. 11).

2.4 Exceptions

The following table outlines some reasons for exceptions occurring and the auditor's response:

Reasons for exceptions occurring	
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.
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, they then allocate 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.
(ISA 505: paras. A21-A22)	



15

Bank and cash

Essential reading

1 Assertions

The following table demonstrates the audit objectives for cash balances and how these are related to the relevant financial statement assertions. It also shows how the audit procedures described in the remainder of this chapter support these financial statement assertions.

Assertion	Objective	Procedure
Existence	Recorded cash balances exist at the period end	Bank confirmation letter
Completeness	Recorded cash balances include the effects of all transactions that have occurred	Bank confirmation letter Petty cash count Bank reconciliations Review of cash book for unusual items
Rights and obligations	The entity has legal title to all cash balances shown at the period end	Bank confirmation letter
Accuracy, valuation and allocation	Recorded cash balances are realisable at the amounts stated	Bank confirmation letter Petty cash count Bank reconciliations
Presentation	Disclosures relating to cash are adequate and in accordance with accounting standards and legislation	Review disclosures in the financial statements

2 Bank confirmation letter

2.1 Standard request for information

The bank confirmation request should specify:

- The names of all entities covered by the request
- Whether the auditor is requesting 'standard information'; and, where appropriate, the nature of supplementary information required
- The date for which the auditor is requesting confirmation (the audit confirmation date, ie the client's year-end)
- A statement that the bank's response will not create a contractual relationship between the bank and the auditor
- A statement requesting the bank to advise the auditor if the authority is insufficient to allow the bank to provide full disclosure of the information requested

Local practices will vary in the way bank confirmations are requested and carried out. An example is shown below which demonstrates what used to be UK practice, and covers all the major areas where confirmation would be required.

2.2 Example bank confirmation letter – for information purposes only

Check & Co Accountants 29 High Street Anytown AB1 2CD	
The Manager	
Clearing Bank Ltd City Branch	
Dear Sir/Madam,	
.....(Name of customer)	
STANDARD REQUEST FOR BANK REPORT	
FOR AUDIT PURPOSES FOR THE YEAR ENDED	
In accordance with your above-named customer's instruction given	
(1) hereon	
(2) in the attached authority	Delete as appropriate
(3) in the authority date already held by you	
please send to us, as auditors of your customer for the purpose of our business, without entering into any contractual relationship with us, the following information relating to their affairs at your branch as at the close of business on and, in the case of items 2, 4 and 10 during the period since For each item, please state any factors which may limit the completeness of your reply; if there is nothing to report, state 'none'.	
We enclose an additional copy of this letter, and it would be particularly helpful if your reply could be given on the copy letter in the space provided (supported by an additional schedule stamped and signed by the bank where space is insufficient). If you find it necessary to provide the information in another form, please return the copy letter with your reply.	
It is understood that any replies given are in strict confidence.	
<i>Information requested</i>	<i>Reply</i>
Bank accounts	
(1) Please give full titles of all accounts whether in sterling or in any other currency together with the account numbers and balances thereon, including nil balances:	
(a) Where your customer's name is the sole name in the title	
(b) Where your customer's name is joined with that of other parties	
(c) Where the account is in a trade name	
Notes	

1	Where the account is subject to any restriction (eg a garnishee order or arrestment), this information should be stated.	
2	Where the authority upon which you are providing this information does not cover any accounts held jointly with other parties, please refer to your customer in order to obtain the requisite authority of the other parties. If this authority is not forthcoming please indicate.	
(2)	Full titles and dates of closure of all accounts closed during the period.	
(3)	The separate amounts accrued but not charged or credited at the above date, of:	
(a)	Provisional charges (including commitment fees); and	
(b)	Interest.	
(4)	The amount of interest charged during the period if not specified separately in the bank statement.	
(5)	Particulars (ie date, type of document and accounts covered) of any written acknowledgement of set-off, either by specific letter of set-off, or incorporated in some other document or security.	
(6)	Details of:	
(a)	Overdrafts and loans repayable on demand, specifying dates of review and agreed facilities	
(b)	Other loans specifying dates of review and repayment	
(c)	Other facilities	
Customer's assets held as security		
(7)	Please give details of any such assets whether or not formally charged to the bank.	
	If formally charged, give details of the security including the dates and type of charge. If a security is limited in amount or to a specific borrowing, or if there is to your knowledge a prior, equal or subordinate charge, please indicate.	
	If informally charged, indicate nature of security interest therein claimed by the bank.	
	Whether or not a formal charge has been taken, give particulars of any undertaking given to the bank relating to any assets.	

Customer's other assets held	
(8) Please give full details of the customer's other assets held, including share certificates, documents of title, deed boxes and any other items in your Registers maintained for the purpose of recording assets held.	
Contingent liabilities	
(9) All contingent liabilities:	
(a) Total of bills discounted for your customer, with recourse	
(b) Date, name of beneficiary, amount and brief description of any guarantees, bonds or indemnities given to you by the customer for the benefit of third parties	
(c) Date, name of beneficiary, amount and brief description of any guarantees, bonds or indemnities given by you, on your customer's behalf, stating where there is recourse to your customer and/or to its parent or any other company within the group	
(d) Total of acceptances	
(e) Total sterling equivalent of outstanding forward foreign exchange contracts	
(f) Total of outstanding liabilities under documentary credits	
(g) Others – please give details	
Other information	
(10) A list of other banks, or branches of your bank, or associated companies where you are aware that a relationship has been established during the period.	
Yours faithfully,	
	
	(Official stamp of bank)
	
	(Authorised signatory)
	
	(Position)

3 Cash counts

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 Performing a cash count

- **Count cash balances** held and agree to petty cash book or other record
- 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 and in the presence of the individuals responsible**.
- **Obtain certificates** of cash-in-hand from responsible officials.
- Enquire into any IOUs or cashed cheques outstanding for a long period of 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, imprest petty cash float).
- **Confirm** that bank and cash **balances** as reconciled above are **correctly stated** in the financial statements.

3.3 Follow up procedures

- 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

A large teal arc curves from the top left towards the center. To its left, a series of small teal dots are arranged in a grid-like pattern, with some dots missing, creating a dotted effect.

16

Payables and accruals

Essential reading

1 Assertions

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 and related disclosures	• 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). • All disclosed events and transactions relating to liabilities have occurred and relate to the entity (presentation). • All disclosures required have been included (presentation). • Financial information is appropriately presented and described and disclosures clearly expressed (presentation). • Financial information is disclosed fairly and at appropriate amounts (presentation).
Assertions about period-end account balances and related disclosures	• 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 amount (accuracy, valuation and allocation). • All disclosures required have been included (presentation). • Financial information is appropriately presented and described and disclosures clearly expressed (presentation). • Financial information is disclosed fairly and at appropriate amounts (presentation).

2 Supplier 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.

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.

2.1 Reasons for differences

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.

Goods-in-transit

- **Ascertain** whether the **goods** were **received** before the year end by reference to the GRN
- Check whether the goods are included in year-end inventory and purchase accruals

Cash-in-transit

- Differences arise where the payment to the supplier was made by cheque before the year end but was not received by them 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.
- 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.

Other reasons

- Differences which do not arise from in-transit items need to be investigated and **appropriate adjustments** made where necessary.
- 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 they do 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.

If significant unexplained differences are discovered it may be necessary to **extend testing**.

There may also be a problem if sufficient suppliers' statements are not available. Alternative procedures, eg a circularisation may then be required.

3 Audit considerations relating to an entity using a service organisation

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 (Revised). 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

(ISA 402: para. 9)

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 (ISA 402: para. 10).

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 (ISA 402: para. 11).

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 (ISA 402: para. 12)

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 (ISA 402: para. 13).

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:

Determine **whether sufficient appropriate audit evidence** concerning the relevant financial statement assertions is available from records held at the user entity

and if not

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

3.3 Reporting by the user auditor

The user auditor is always **solely responsible** for the auditor's opinion. They must be assured that they have gained sufficient appropriate audit evidence to form an opinion on the financial statements, and they must then express the audit 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 (ISA 402: paras. 20–22).

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Non-current liabilities, capital and directors' emoluments

Essential reading

1 Non-current liabilities

Initially the auditors will obtain or prepare a **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. The schedule will be cast for accuracy and balances agreed to the audit client's general ledger.

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. If the company does not comply with these conditions the loan may be recalled which could impact the going concern of the company.

Procedures for auditing these conditions include the following

- Review restrictive covenants and provisions relating to default:
 - Agree the covenants to the loan agreement.
 - 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.
- Verify that borrowing **limits** imposed by agreements are **not exceeded**.

2 Provisions and contingencies

2.1 Accounting for provisions and contingencies

Under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (paras. 27 and 31), 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 (IAS 37: para. 30). 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 (IAS 37: paras. 33 and 34).

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

2.2 Audit procedures for provisions and contingencies

- Obtain a detailed analysis of all provisions showing opening balances, movements and the closing balance. Also obtain details of all contingencies which have been disclosed.
- Consider the nature of the client's business. Would you expect to see provisions, eg warranties?
- For all material provisions and contingencies obtain a written representation.
- Check that appropriate disclosures have been made in accordance with IAS 37.
- For each material provision:

Determine whether the company has a present obligation as a result of a past event at the year-end date by:

- Review of correspondence and other documentation relating to the item.
- Discussion with the directors. Have they created a valid expectation in other parties that they will discharge the obligation, ie established a constructive obligation? Review evidence of past practices, published policies and statements made.

Determine whether it is probable that an outflow of resources 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.
- 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 their views (where relevant).
- Discussing the position with similar past provisions with the directors. Were these provisions eventually settled?

Determine whether provisions represent the best estimate of liability by:

- Recalculating all provisions made.
- Comparing the amount provided with any post year end payments and with any amount paid in the past for similar items and considering opinions given by independent experts.
- In the event that it is not possible to estimate the amount of the provision, check that this contingent liability is disclosed in the accounts.

2.3 Specific procedures for litigation and claims

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 (ISA 501: para. 9). Such procedures would include the following:

Make appropriate enquiries 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 (ISA 501: para. 10). 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.

Letter of general enquiry	Letter of specific enquiry
Requests the entity's external legal advisers to inform the auditor of any litigation and claims that they are aware of, together with an	Used where it is unlikely that the entity's external legal advisers will respond appropriately to a letter of general inquiry.

Letter of general enquiry	Letter of specific enquiry
assessment of the outcome of the litigation and claims, and an estimate of the financial implications, including costs involved (ISA 501: para. A22).	Includes: (a) A list of litigation and claims (b) 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 (c) 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 (ISA 501: para. A23)

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 (ISA 501: para. A24).

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* (ISA 501: para. 11).

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 (ISA 501: para. 12).

3 Director's emoluments

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 auditor's opinion), the auditor is required by UK law to highlight this in their auditor's report (Companies Act 2006: s.498).

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 (para. 17) 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:

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
Post-employment benefits, such as pensions, other retirement benefits, post-employment life insurance and post-employment medical care
Other long-term employee benefits, including long-service benefits and deferred compensation
Termination benefits
Share-based payments

Auditors must therefore ensure that they are comfortable with the requirements of IAS **and** any local legislation. Then procedures adopted must ensure that related disclosure is accurate, complete and covers all areas required by local legislation.

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Not-for-profit organisations

Essential reading

1 Introduction

1.1 Accounting for not-for profit organisations

We noted in Chapter 1 that many not-for-profit organisations are legislated for and the acts which relate to them may specify how they are to report their results.

Many not-for-profit organisations are companies (often companies limited by guarantee) and so are required to prepare financial statements and have them audited under companies' legislation. For example, some public sector bodies are established as private companies limited by guarantee (eg industry regulators).

Private sector not-for-profit organisations

- Co-operatives
- Clubs
- Associations
- Industrial societies
- Trade unions
- Charities

Public sector not-for-profit organisations

- Government departments
- Schools
- Hospitals
- Local councils
- Housing associations

In the UK, some entities have Statements of Recommended Practice (SORP). SORPs are recommendations on accounting practices for specialised industries or sectors (please note that SORPs are not examinable within AA). They supplement accounting standards and other legal and regulatory requirements. Similar local guidance exists in other countries.

In the UK, two new SORPs for charities have been introduced by the Charity Commission for England and Wales: Charities SORP (FRS 102) and Charities SORP (FRSSE), ie one for charities which are able to apply the accounting rules for small entities and one for charities to whom these provisions do not apply. In broad terms the SORPs require the following:

- (a) A statement of financial activities (SOFA) that shows all resources made available to the charity and all expenditure incurred, and reconciles all changes in its funds
- (b) Where the charity is required to prepare accounts in accordance with the Companies Act, or similar legislation, or where the governing instrument so requires, a statement of comprehensive income (in addition to the SOFA) in certain circumstances
- (c) A balance sheet (the equivalent of a statement of financial position) that shows the assets, liabilities and funds of the charity
- (d) A cash flow statement may be required in some instances (eg for larger charities applying FRS102 SORP)
- (e) Notes

(Charity Commission for England and Wales, 2014)

1.2 Audit of not-for-profit organisations

Where a statutory audit is required, the auditors will be required to produce the statutory audit opinion concerning the truth and fairness of financial statements.

Where a statutory audit is not required, it is possible that the organisation might have one anyway for the benefit of interested stakeholders, such as the public if the entity is funded by taxpayers (eg transport services and hospitals in some countries) and, if the not-for-profit entity is a charity, people who donate to the charity.

It is also possible that such entities will have special, additional requirements of an audit. These may be required by a regulator, or by the constitution of the organisation. For example, a charity's constitution may require an audit of whether the charity is operating in accordance with its charitable purpose. The Charity Commission for England and Wales was established by law as the regulator and registrar for charities in England and Wales and requires that certain charities are subject to an annual statutory audit.

If the not-for-profit organisation receives government funding (for example a school or an academy) then the Government may ask for the auditor to provide assurance on additional

specific areas in addition to the statutory audit (although the Government may well carry out its own procedures instead to ensure that funds are being used as they should be).

2 Planning the audit

2.1 Auditing not-for-profit organisations

When planning the audit of a not-for-profit organisation, the auditors should particularly consider the following:

- The scope of the audit
- Recent recommendations of the regulatory bodies
- The acceptability of accounting policies adopted
- Changes in circumstances in the sector in which the organisation operates
- Past experience of the effectiveness of the organisation's accounting system
- Key audit areas
- The amount of detail included in the financial statements on which the auditors are required to report

The scope of the audit is twofold: the auditors have to report on the truth and fairness of the financial statements for the benefit of the trustees and also on whether the not-for-profit organisation is meeting its objectives. The auditors should therefore establish what the objectives are and consider how they can identify whether the objectives are being met. In order to identify the key audit areas, the auditors will have to consider audit risk.

2.2 Audit risk

The auditors should consider the following:

Inherent risk

- The complexity and extent of regulation (particularly in relation to public sector not-for-profit organisations)
- The significance of donations and cash receipts
- Difficulties of the organisation in establishing ownership and timing of voluntary income where funds are raised by non-controlled bodies
- Lack of predictable income or precisely identifiable relationship between expenditure and income
- Uncertainty of future income
- For charities in particular:
 - Restrictions imposed by the objectives and powers given by charities' governing documents
 - The importance of restricted funds
 - The extent and nature of trading activities must be compatible with the entity's charitable status
 - The complexity of tax rules (whether income, capital, sales or local rates) relating to charities
 - The sensitivity of certain key statistics, such as the proportion of resources used in administration
- The need to maintain adequate resources for future expenditure while avoiding the build-up of reserves which could appear excessive

Control risk

- The amount of time committed by directors/trustees to the organisation's affairs
- The skills and qualifications of individual directors/trustees
- The frequency and regularity of board/trustee meetings
- The form and content of board/trustee meetings
- The independence of trustees from each other
- The division of duties between management/trustees
- The degree of involvement in, or supervision of, the organisation's transactions on the part of individual directors/trustees

Control environment

- A recognised plan of the organisation's structure clearly showing the areas of responsibility and lines of authority and reporting
- Segregation of duties
- Supervision by management/trustees of the activities of staff where segregation of duties is not practical
- Competence, training and qualification of paid staff and any volunteers appropriate to the tasks they have to perform
- Involvement of the board/trustees in the recruitment, appointment and supervision of senior executives
- Access of trustees to independent professional advice where necessary
- Budgetary controls in the form of estimates of income and expenditure for each financial year and comparison of actual results with the estimates on a regular basis
- Communication of results of such reviews to the board/trustees on a regular basis



Example - Internal controls

Using **charities as an example**, the following types of internal control might be typical. The examples of controls over some areas, such as fundraising activities and central and local government grants, can be applied to other not-for-profit organisations and not just charities.

	Source	Example of controls
Cash donations	Collection boxes & tins	- Numerical control over boxes and tins - Satisfactory sealing of boxes and tins so that any opening prior to recording cash is apparent - Regular collection and recording of proceeds from collecting boxes - Dual control over counting and recording of proceeds
	Postal receipts	- Unopened mail kept securely - Dual control over mail opening - Immediate recording of donations on opening of mail or receipt - Agreement of bank paying-in slips to record of receipts by an independent person
	Deeds of covenant	- Regular checks and follow-up procedures to ensure due amounts are received - Regular checks to ensure all tax repayments have been obtained
	Legacies	- Comprehensive correspondence files maintained in respect of each legacy - Regular reports and follow-up procedures undertaken in respect of outstanding legacies
	Donations in kind	In case of charity shops, separation of recording, storage and sale of inventory
Other income	Fundraising activities	- Records maintained for each fundraising event - Other appropriate controls maintained over receipts - Controls maintained over expenses as for administrative expenses
	Central and local government grants and loans	- Regular checks that all sources of income or funds are fully utilised and appropriate claims made - Ensuring income or funds are correctly applied by adequate monitoring

	Resource	Example of controls
Use of resources	Restricted funds	- Separate records maintained of relevant income, expenditure and assets - Terms controlling application of funds - Oversight of application of fund monies by independent personnel or trustees
	Grants to beneficiaries	Records maintained, as appropriate, of requests for material grants received and their treatment

	Resource	Example of controls
		• Appropriate checks made on applications and applicants for grants, and that amounts paid are in accordance with legislation • Records maintained of all grant decisions, checking that proper authority exists, that adequate documentation is presented to decision-making meetings, and that any conflicts of interest are recorded • Controls to ensure grants made are properly spent by the recipient for the specified purpose

2.3 Auditing not-for-profit organisations in the public sector

As we pointed out at the start of the Chapter, some not-for-profit organisations are public sector organisations. These can include hospitals, schools and local government.

Because these organisations are government funded and receive taxpayers' money, they are obliged to deliver **value for money**. We looked at the concept of value for money in Chapter 5 when we considered internal audit assignments in the context of a not-for-profit entity. However, to recap, not-for-profit organisations in the public sector will rely on measures that estimate the performance of the organisation in relation to the three Es, **economy, efficiency and effectiveness**. As a result, many of the internal controls in such entities will be focused on providing the best service possible at the lowest price. For example, a government-funded hospital may implement the following controls:

- Requirements to compare prices of two or more suppliers before raising a purchase order; this helps with economy of the process, attaining resources at the lowest cost
- Capital expenditure committees put in place to authorise significant capital expenditure items
- Time card clocking in to ensure employees are only paid for those hours worked
- Strict controls over the authorisation of overtime to ensure it is only worked where really needed

Although they are aimed at providing value-for-money, they also serve to provide control over the financial statement areas over which the auditor needs to gain evidence and the auditor may be able to test and rely on some of these controls.

Auditors of not-for-profit public sector entities will need to take into account the specific requirements of any **other relevant regulations** which affect the audit mandate and any special auditing requirements. These special requirements will often relate to verifying that government funding is used for its intended purpose.

Often the audit mandate will be more specific than those in the private sector and encompass a wider range of objectives and a broader scope than is ordinarily applicable for the audit of private sector financial statements.

However, it is important to note that the ISAs are applicable to public sector entities and additional considerations specific to public sector entities are included within the ISAs.

2.3.1 Risk assessment and materiality

When carrying out risk assessment and obtaining an understanding of the entity's objectives and strategies that may result in material misstatement the auditor must take into account that 'management objectives' for public sector entities may be influenced by concerns regarding **public accountability** and may include objectives which have their source in law, regulation or other authority.

Due to the **high degree of regulation** in the public sector there are increased risks of **non-compliance** with laws and regulations and the auditor must formulate procedures to respond to those risks.

When considering assertions about the financial statements of public sector not-for-profit entities, in addition to the assertions we looked at in earlier chapters, management may often assert that transactions and events have been carried out in accordance with law, regulation or other authority. These assertions may fall within the scope of the financial statement audit.

It is also important to note that materiality levels for not-for-profit entities in the public sector are likely to be influenced by law, the needs of legislators and the public. Due to the focus on obtaining value for money and keeping costs down, percentages applied to benchmarks linked to costs (rather than profit) may be used to set materiality

3 Audit evidence

3.1 Designing procedures for not-for-profit entities

When designing substantive procedures for not-for-profit entities there are key considerations auditors should give special attention to:

Key considerations
Understatement or incompleteness of the recording of all income, including gifts in kind, cash donations and legacies
Incorrect accounting treatment of lifetime subscriptions
Overstatement (ie existence) of cash grants or expenses
Misanalysis or misuse in the application of funds, including the misuse of taxpayers' funds if the entity is government funded
Misstatement or omission of assets, including donated properties and investments
Misallocation of expenses to disguise excessive administration expenditure
The existence of restricted or uncontrollable funds in foreign or independent branches

Completeness of income can be a particularly problematic area. Areas auditors may check include:

- Loss of income through fraud
- Recognition of government funding
- Recognition of income from professional fundraisers
- Recognition of income from branches, associates or subsidiaries
- Income from informal fundraising groups
- Income from grants

3.2 Overall review of financial statements

The auditors must consider carefully whether the accounting policies adopted are **appropriate** to the activities, constitution and objectives of the not-for-profit entity, and are **consistently applied**, and whether the financial statements **adequately disclose** these policies and **present fairly** the state of affairs and the results for the accounting period.

In particular, the auditors should consider the basis of disclosing income from fundraising activities (for example, net or gross), accounting for income and expenses (accruals or cash), the capitalising of expenditure on non-current assets, apportioning administrative expenditure and recognising income from donations and legacies.

Charities without significant endowments or accumulated funds will often be dependent on future income from voluntary sources. In these circumstances, auditors may question whether a going concern basis of accounting is appropriate.

4 Assumed knowledge from *Financial Accounting*

The accounting knowledge that is assumed for *Audit and Assurance* is the same as the accounting standards examined in *Financial Accounting*. The purpose of this section is to provide you with a recap of the accounting standards covered in the Financial Accounting syllabus which could feature in Audit and Assurance questions.

4.1 Proforma financial statements

The financial statements of a limited liability company are subject to regulation and must follow a prescribed format in terms of the way they are presented.

Much of the prescribed format is determined by IAS 1 *Presentation of Financial Statements*. This accounting standard states what should be included in a set of financial statements and how they should be presented.

A complete set of financial statements in accordance with IAS 1 comprises:

- (a) A statement of financial position as at the end of the period
- (b) A statement of profit or loss and other comprehensive income for the period
- (c) A statement of changes in equity for the period
- (d) A statement of cash flows for the period
- (e) Notes, comprising a summary of significant accounting policies and other explanatory notes

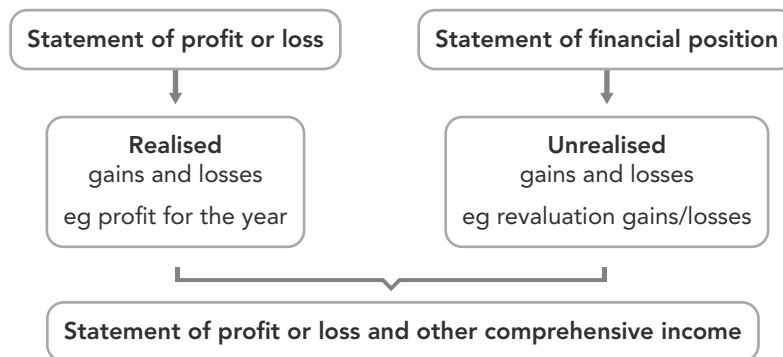
4.1.1 STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20X7

	\$'000
ASSETS	
Non-current assets	
Property, plant and equipment	X
Other intangible assets	X
	X
	—
Current assets	
Inventories	X
Trade receivables	X
Other current assets	X
Cash and cash equivalents	X
	X
	—
Total assets	X
	—
EQUITY AND LIABILITIES	
Equity	
Share capital	X
Share premium account	X
Revaluation reserve	X
Retained earnings	X
	X
	—
Non-current liabilities	

Long-term borrowings	X
Long-term provisions	X
	<u>X</u>
<i>Current liabilities</i>	
Trade payables	X
Short-term borrowings	X
Current tax payable	X
Short-term provisions	<u>X</u>
	<u>X</u>
<i>Total equity and liabilities</i>	<u>X</u>

4.1.2 Statement of profit or loss and other comprehensive income

This statement shows all of the **realised** gains and losses from the statement of profit or loss and the **unrealised** gains and losses from the statement of financial position in **one statement of performance**.



The statement can be presented in one of two ways:

- As one single statement (proforma 1)
- As two separate statements (proforma 2)

Proforma 1 – one single statement

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 MARCH 20X7

	20X7	20X6
	\$'000	\$'000
Revenue	X	X
Cost of sales	<u>(X)</u>	<u>(X)</u>
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Finance costs	(X)	(X)
Investment income	<u>X</u>	<u>X</u>
Profit before tax	X	X

Income tax expense	<u>(X)</u>	<u>(X)</u>
Profit for the year	X	X
Other comprehensive income:		
Gains on property revaluation	<u>X</u>	<u>X</u>
Total comprehensive income for the year	<u>X</u>	<u>X</u>

Proforma 2 – two separate statements

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 MARCH 20X7

	20X7	20X6
	\$'000	\$'000
Revenue	X	X
Cost of sales	<u>(X)</u>	<u>(X)</u>
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Finance costs	(X)	(X)
Investment income	<u>X</u>	<u>X</u>
Profit before tax	X	X
Income tax expense	<u>(X)</u>	<u>(X)</u>
Profit for the year	<u>X</u>	<u>X</u>

STATEMENT OF OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 MARCH 20X7

	20X7	20X6
	\$'000	\$'000
Profit for the year	X	X
Other comprehensive income:		
Gains on property revaluation	<u>X</u>	<u>X</u>
Total comprehensive income for the year	<u>X</u>	<u>X</u>

4.1.3 STATEMENT OF CHANGES IN EQUITY

	Share capital	Share premium account	Revaluation reserve	Retained earnings	Total equity
	\$'000	\$'000	\$'000	\$'000	\$'000
Balance at 31 March 20X6	X	X	X	X	X
Changes in accounting policy	–	–	–	X	X
Restated balance	X	X	X	X	X
Issue of share capital	X	X			X
Dividends				(X)	(X)
Total comprehensive income	–	–	X	X	X
Balance at 31 March 20X7	X	X	X	X	X

4.1.4 STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 MARCH 20X7

	\$'000	\$'000
<i>Cash flows from operating activities</i>		
Profit before taxation	X	
Adjustment for:		
Depreciation	X	
Investment income	(X)	
Interest expense	X	
	XX	
Increase in trade and other receivables	(X)	
Decrease in inventories	X	
Decrease in trade payables	(X)	
Cash generated from operations	XX	
Interest paid	(X)	
Income taxes paid	(X)	
<i>Net cash from operating activities</i>		XXX
<i>Cash flows from investing activities</i>		
Purchase of property, plant and equipment	(X)	
Proceeds from sale of equipment	X	
Interest received	X	
Dividends received	X	
<i>Net cash used in investing activities</i>		(XXX)

Cash flows from financing activities

Proceeds from issue of share capital	X
Proceeds from long-term borrowings	X
Dividends paid*	<u>(X)</u>

Net cash used in financing activities (XXX)

Net increase in cash and cash equivalents XXX

Cash and cash equivalents at beginning of period XXXXXX

Cash and cash equivalents at end of period XXX

*This could also be shown as an **operating** cash flow.

4.2 Notes to the accounts

Notes are included in a set of financial statements to give users extra information. You should be aware of the following notes:

4.2.1 PROPERTY, PLANT AND EQUIPMENT

	Land and buildings	Machinery	Office equipment	Total
	\$	\$	\$	\$
Carrying amount at 1 April 20X6	X	X	X	X
Additions	X	X	X	X
Revaluation surplus	X	–	–	X
Depreciation charge	(X)	(X)	(X)	(X)
Disposals	<u>(X)</u>	<u>(X)</u>	<u>(X)</u>	<u>(X)</u>
Carrying amount at 31 March 20X7	<u>X</u>	<u>X</u>	<u>X</u>	<u>X</u>
At 31 March 20X7				
Cost or valuation	X	X	X	X
Accumulated depreciation	<u>(X)</u>	<u>(X)</u>	<u>(X)</u>	<u>(X)</u>
Carrying amount	<u>X</u>	<u>X</u>	<u>X</u>	<u>X</u>
At 31 March 20X6				
Cost or valuation	X	X	X	X
Accumulated depreciation	<u>(X)</u>	<u>(X)</u>	<u>(X)</u>	<u>(X)</u>
Carrying amount	<u>X</u>	<u>X</u>	<u>X</u>	<u>X</u>

4.2.2 INTANGIBLE NON-CURRENT ASSETS

	Development expenditure
	\$
Carrying amount at 1 April 20X6	X

Additions	X
Amortisation charge	(X)
Disposals	<u>(X)</u>
Carrying amount at 31 March 20X7	<u>X</u>
At 31 March 20X7	
Cost	X
Accumulated amortisation	<u>(X)</u>
Carrying amount	<u>X</u>
At 31 March 20X6	
Cost	X
Accumulated amortisation	<u>(X)</u>
Carrying amount	<u>X</u>

4.2.3 Provisions

	\$
At 1 April 20X6	X
Increase in period	X
Released in period	<u>(X)</u>
At 31 March 20X7	<u>X</u>

4.2.4 Contingent liabilities

Unless remote, disclose for each contingent liability:

- A brief description of its nature; and where practicable
- An estimate of the financial effect;
- An indication of the uncertainties relating to the amount or timing of any outflow; and
- The possibility of any reimbursement.

4.2.5 Contingent assets

Where an inflow of economic benefits is **probable**, an entity should disclose:

- A brief description of its nature; and where practicable
- An estimate of the financial effect.

4.2.6 Events after the reporting period

In respect of non-adjusting events after the reporting period disclose:

- The nature of the event; and
- An estimate of its financial effect (or a statement that an estimate cannot be made).

4.3 IAS 2 Inventories

The inventories figure in the financial statements comprises two elements:

Quantity × Valuation

4.3.1 Quantity

The quantity of inventories a business has at the year-end is normally ascertained by completing an inventory count at the end of the accounting period or by continuous inventory records.

4.3.2 Valuation

The valuation of inventories is much more subjective and so guidance is provided in IAS 2 *Inventories*.

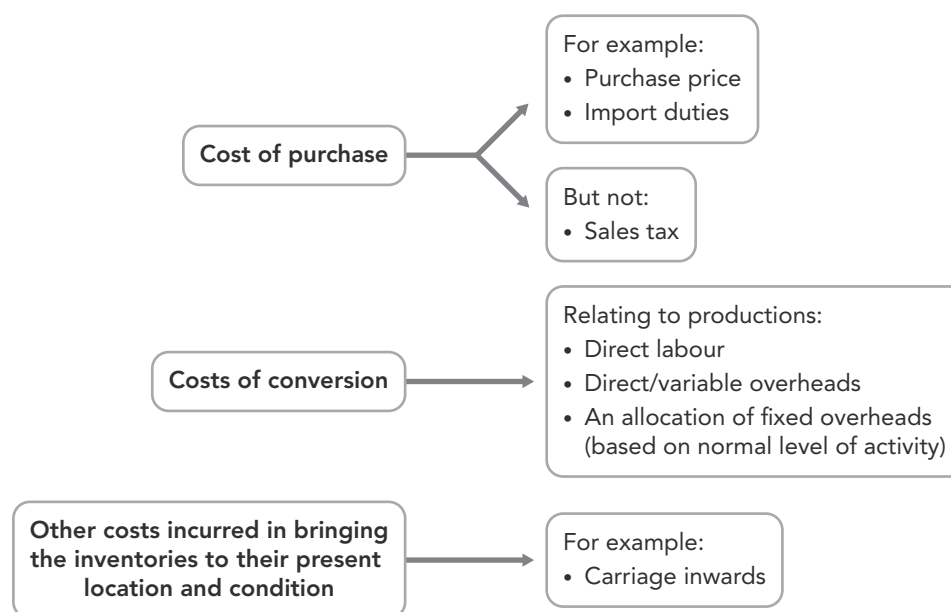
The basic rule per IAS 2 is:

“Inventories should be measured at the **lower of cost and net realisable value**” (IAS 2: para. 9).

This is another example of prudence in presenting financial information.

4.3.3 Cost

The cost of an item of inventory includes:



4.3.4 Net realisable value (NRV)

The net realisable value (NRV) of an item is essentially its net selling proceeds after all costs have been deducted.

It is calculated as:

	\$
Estimated selling price	X
Less estimated costs of completion	(X)
Less estimated selling and distribution costs	(X)
	<u>X</u>

4.3.5 No netting off

The IAS 2 rule “**lower of cost and net realisable value**” (IAS 2: para. 9) should be applied as far as possible on an item by item (or line by line) basis.

4.4 IAS 16 Property, plant and equipment

4.4.1 Definition

Property, plant and equipment comprises assets which:

- (a) Are held for use in the production or supply of goods or services or for administrative purposes; and
- (b) Are expected to be used during more than one period.

4.4.2 Cost

Property, plant and equipment should initially be recorded at **cost**.

Cost includes:

- **Purchase price**, excluding sales tax and trade discounts but including import duties
- **Directly attributable** costs to bring the asset to its intended location and ready to use.

These include:

- Initial delivery and handling costs
- Installation and assembly costs
- Costs of testing whether the asset is working properly
- Professional fees

The following costs may not be included:

- The cost of maintenance contracts
- Administration and general overhead costs
- Staff training costs

The asset can then be kept at cost and depreciated or the entity may choose to revalue its tangible non-current assets.

4.4.3 Depreciation

Assets will eventually be worn out (used up) and so there is a cost of generating income. This cost should be shown in the income statement to 'match' against the income.

This is called **depreciation**.

Depreciation results in the property, plant and equipment being systematically charged to the income statement over several accounting periods in recognition of the fact that the asset will contribute to the income-generating activities of each of these periods.

A formal definition is given by the accounting standard, IAS 16 *Property, Plant and Equipment*: '...the systematic allocation of the **depreciable amount** of an asset over its useful life.' (IAS 16: para. 6)

'Depreciable amount' = cost/revalued amount – residual value

'Residual value' = the amount the asset is expected to be sold for at the end of its useful life (scrap value)

Land normally has an unlimited useful life and is therefore **not depreciated**. Buildings have a limited life and, therefore, are depreciable assets.

There are two main methods for calculating depreciation: the straight-line method and the reducing balance method.

4.4.4 Straight line method

Here, the depreciation charge is the **same every year** and it is calculated using the following formula:

$$\text{Depreciation} = \frac{\text{cost} - \text{residual value}}{\text{Useful life (years)}} \text{ or } (\text{cost} - \text{residual value}) \times \%$$

where:

Residual value = expected proceeds/scrap value at the end of the asset's useful life.

Useful life = the number of years the business expects to make use of the asset.

This method is suitable for assets which are used up evenly over their useful life.

4.4.5 Reducing balance depreciation

This method is suitable for those assets which generate more revenue in earlier years than in later years; for example, a machine which may become progressively less efficient as it gets older.

Under this method the depreciation charge will be **higher in the earlier years** and reduce over time.

It is calculated using the following formula:

$$\text{Depreciation} = \text{Depreciation rate (\%)} \times \text{Carrying amount (CA)}$$

where: CA = cost – accumulated depreciation to date

4.4.6 Disposal of property, plant and equipment

When a non-current asset is disposed of, its CA needs to be removed from the statement of financial position.

The sales proceeds received are unlikely to be exactly the same as the asset's CA and so a profit or loss on disposal will arise.

If:

$$\begin{aligned} \text{Sales proceeds} &> \text{CA} \Rightarrow \text{profit on disposal} \\ \text{Sales proceeds} &< \text{CA} \Rightarrow \text{loss on disposal} \end{aligned}$$

This is not a 'true' profit or loss, but rather a book adjustment to reflect the fact that the depreciation charged over the asset's life wasn't completely accurate.

4.4.7 Revaluations

If an entity owns a property it may notice that its value increases over time.

IAS 16 requires property, plant and equipment to initially be recorded at cost. The entity can then either keep the asset at cost (and depreciate it) or choose to revalue it (depreciation is still required).

This is a choice of accounting policy.

If an entity chooses a policy of revaluation then all items in the same class of assets must be revalued.

Examples of classes of assets are:

- Land and buildings
- Plant and machinery
- Motor vehicles

Revaluations must be carried out sufficiently often so that the asset's carrying value is not materially different from its market value.

4.4.8 Steps and accounting treatment

- (a) Adjust cost account to revalued amount.
- (b) Remove accumulated depreciation charged on the asset to date.
- (c) Put the balance to the revaluation surplus.

The required journal is:

- Dr Non-current asset cost
- Dr Accumulated depreciation
- Cr Revaluation surplus

Depreciation should now be based on the revalued amount.

4.5 IAS 38 Intangible Assets

4.5.1 Definitions

- (a) **Research** is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.
- (b) **Development** is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

4.5.2 Accounting treatment

Research

- No certainty that the expenditure will generate future profit
- Show as an expense in income statement
- Dr Research expense (SPL)
Cr Bank/payables

Development

- Future profits are expected
- **Must** capitalise as an intangible non current asset if **all** of the relevant criteria (PIRATE – see below) are satisfied
- Dr Intangible non-current assets (SOFP)
Cr Bank/payables
- P**robable future economic benefits
- I**ntention to complete and use/sell asset
- R**esources adequate and available to complete and use/sell asset
- A**bility to use/sell the asset
- T**echnical feasibility of completing asset for use/sale
- E**xpenditure can be measured reliably
- Amortise asset over its useful life once asset is ready for use

4.5.3 Amortisation of capitalised development expenditure

Property, plant and equipment, for example a machine, is capitalised and then depreciated over its useful life. This is to allocate its cost over the accounting periods which benefit from its use.

In the same way development expenditure which is incurred now will generate future economic benefit.

The cost of the development expenditure should be matched against the future economic benefit it produces. This is called **amortisation**.

The 'depreciable amount' (cost less residual value) should be amortised over the useful life of the intangible asset and shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

Amortisation should begin when the asset is **ready for use**.

It is an expense in the statement of profit or loss and is accounted for using the following entry:

- Dr Amortisation expense (SPL)
- Cr Accumulated amortisation (SOFP)

4.6 Provisions, contingent liabilities and contingent assets

4.6.1 Provisions

Definition

A **provision** is a liability of uncertain timing or amount.

Recognition

A provision should only be recognised (ie included in the financial statements) when:

- (a) An entity has a **present obligation** (legal or constructive) as a result of a past event;
- (b) It is **probable** that an outflow of economic resources will be required to settle the obligation; and
- (c) A **reliable estimate** can be made of the amount of the obligation.

Unless **all three** conditions are met, no provision can be recognised.

Legal obligation

A legal obligation usually arises out of a **contract**.



Example

Grass Co sells lawnmowers and offers a one-year warranty on all models.

Once Grass Co sells a lawnmower (the past event) it has a legal obligation to repair any defects according to the warranty agreement.

It should therefore make an estimate of the probable costs of repair and make a provision for this amount in its financial statements.

Constructive obligation

A constructive obligation arises through past behaviour and actions where the entity has raised a **valid expectation** that it will carry out a particular action.



Example

Seed Co also sells lawnmowers. It does not offer a warranty on its products; however, it has a reputation for making free reasonable repairs to lawnmowers bought from the business. Customers buying from Seed Co all expect to receive this benefit.

Here no warranty is offered and so Seed Co does not have a legal obligation. However, its past actions have created a constructive obligation. It should also therefore make a provision for the probable costs of repairs.

Accounting treatment

The provision represents both a cost to the business and a potential liability:

Dr Expense (SPL)

Cr Provision (SOFP)

The required provision will be reviewed at each year-end and **increased or decreased** as necessary.

4.6.2 Contingent liabilities

A contingent liability is an uncertain liability that does not meet the three criteria for recognising a provision.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* defines a contingent liability as the following:

- (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 economic resources will be required to settle the obligation; or
 - (ii) The amount of the obligation **cannot be measured** with sufficient reliability.

Contingent liabilities should be **disclosed** in the notes unless probability of an outflow of resources embodying economic benefits is remote.

(IAS 37: para. 28)



Example

Company A has entered into an agreement to act as guarantor on a bank loan taken out by Mr Smith. Mr Smith is a financially secure individual, and the directors are of the opinion that the chances of him defaulting on the loan are slim.

How should Company A account for this guarantee?

Company A has a present obligation (it is legally obliged to honour the guarantee). However, as the likelihood of Company A having to pay out under the guarantee is not probable then no provision for the liability should be made. Instead, the guarantee should be disclosed in the notes as a contingent liability (unless considered remote, in which case it should be ignored altogether).

4.6.3 Contingent assets

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.

Contingent assets should be **disclosed** in the notes where an inflow of economic benefits is **probable**, otherwise they should be ignored.

If the probability of an inflow of economic benefits is **virtually certain** then the asset is not a contingent asset and should be **recognised** in the financial statements.

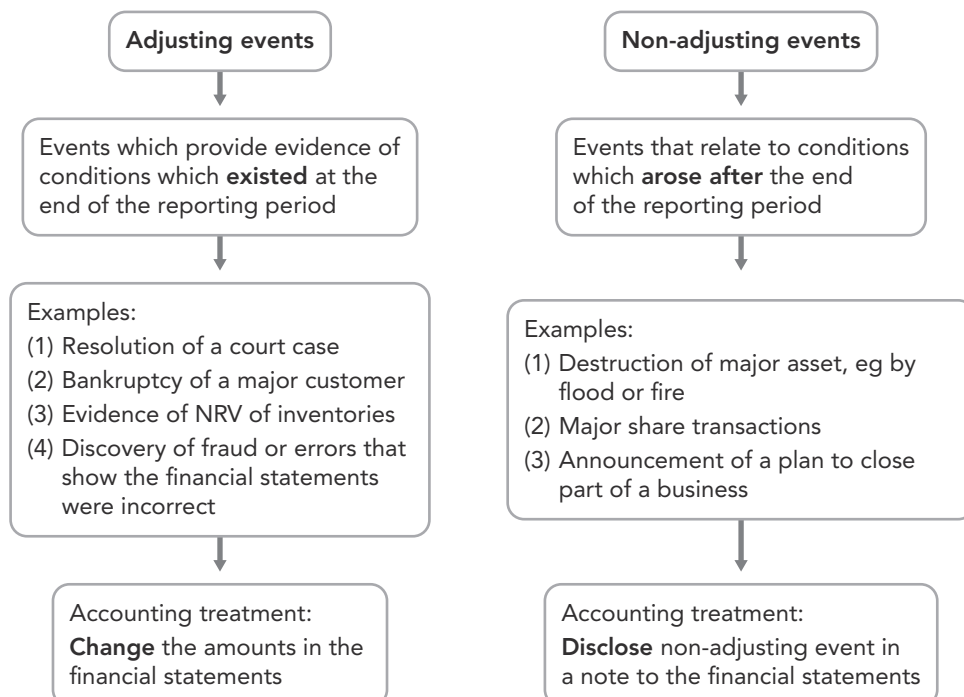
4.7 IAS 10 Events after the reporting period

4.7.1 Definition

Events after the reporting period: events, both favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are **authorised for issue**.

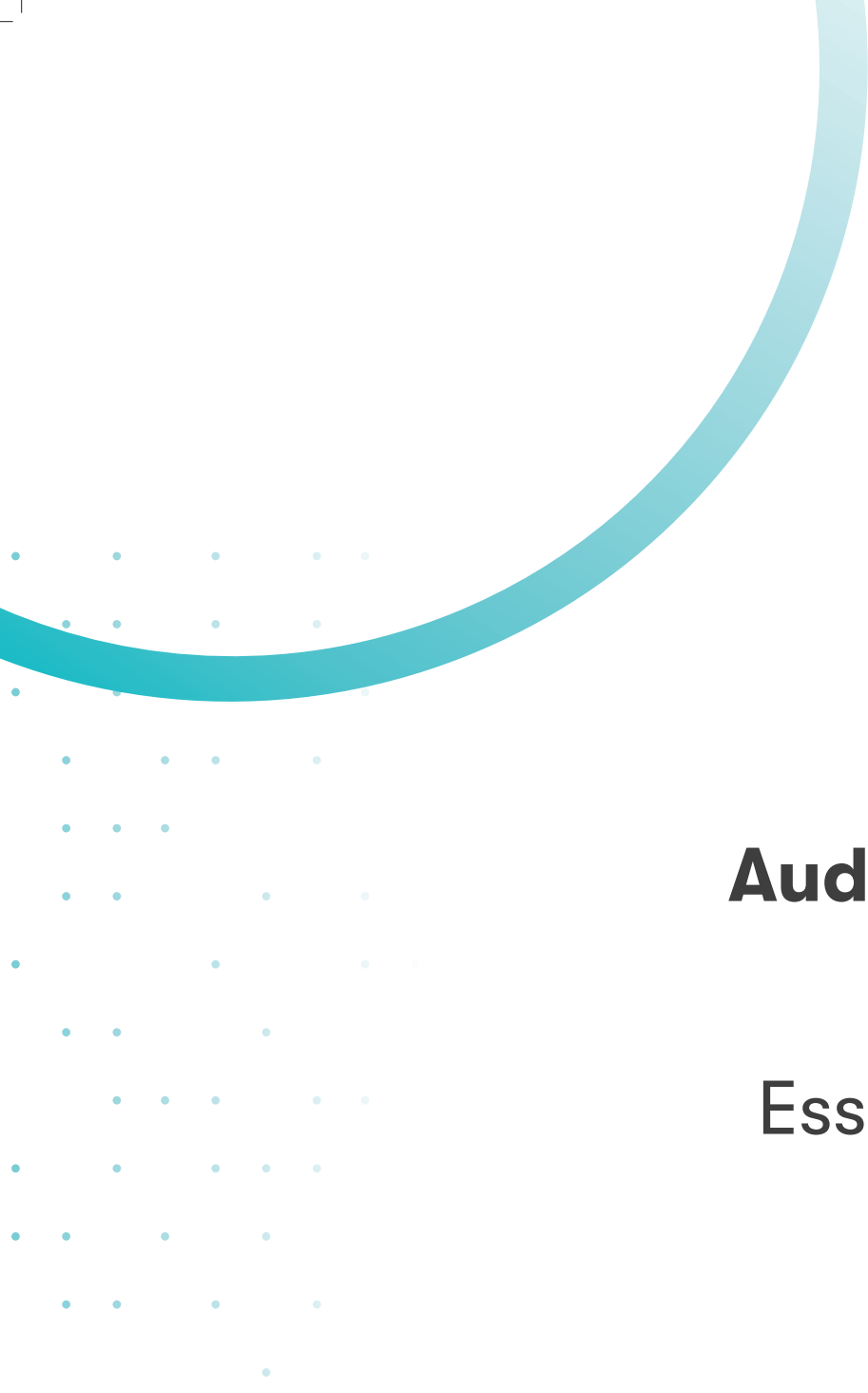
There are two types of event after the reporting period:

4.7.2 Adjusting and non-adjusting events



Dividends proposed or declared after the end of the reporting period but before the financial statements are approved should be disclosed in a note to the financial statements.

A non-adjusting event that affects going concern becomes an adjusting event.

A large teal arc curves from the top left towards the center. To its left, a series of small teal dots are arranged in a grid-like pattern, with some dots missing, creating a sparse, abstract design.

19

Audit review and finalisation

Essential reading

1 Subsequent events

Subsequent events represent a danger to auditors – in the terminology of ISAs, there is a risk of material misstatement in relation to them. Picture the auditor who works hard to ensure that there is evidence for every assertion in the financial statements, but who overlooks one simple point: that things might have happened outside the period covered by the financial statements, but which nevertheless have an impact on them. What if the entity discovers errors after the year-end, which showed that the financial statements were incorrect? Overlooking the risk that there were subsequent events, which should have been adjusted for but which were not, could leave the auditor in a tricky situation; the financial statements could be materially misstated. The issue is muddled by the fact that different kinds of events have different consequences for the financial statements. Furthermore, the auditor's duty is different at each point in the process.

ISA 560 (para. 4) 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

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 (ISA 560: para. 6).

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: para. A6).

ISA 560 (paras. 7, 9 and A9–10) 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 auditor's report. These include enquiring of management as to the following.

- 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

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 auditor's report and the date the financial statements are issued. The auditor does not have any obligation to perform procedures, or make enquiries regarding the financial statements, after the date of the report (although the auditors may need to consider requirements with respect to other information in accordance with ISA 720 (Revised) *The Auditor's Responsibilities Relating to Other Information*, which is covered in Chapter 20).

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, **enquire** how management intends to address the matter in the financial statements.

(ISA 560: para. 10)

Management make amendment to financial statements

- 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.

(ISA 560: para. 11)

Management does not amend 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.

(ISA 560: para. 13)

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, **enquire** how management intends to address the matter in the financial statements

(ISA 560: para. 14)

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** (ISA 560: para. 15).

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 20) that refers to a note in the financial statements that discusses the reason for the amendment (ISA 560: para. 16). 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 (ISA 560: para. 17).

2 Going concern

2.1 Going concern basis of accounting

It is vital that the going concern basis 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 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 basis of accounting has not been used and explain why (IAS 1: para. 25).

2.2 Management's responsibilities for going concern

Because general purpose financial statements are prepared on a going concern basis, the going concern basis of accounting 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 (ISA 570 (Revised): para. 4).

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 become aware of material uncertainties related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, then those **uncertainties must be disclosed** in the financial statements (IAS 1: para. 25).

As discussed earlier in the chapter, if management conclude the going concern basis of accounting 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 basis of accounting 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.

2.3 Management's preliminary 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 basis of accounting (ISA 570 (Revised): para. 10).

3 Written representations

ISA 580 *Written Representations* (para. 6) 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

3.1 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:

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 its 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

(ISA 580: para. A10)

3.2 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.

When looking at the objectives of the auditor regarding written representations, the second objective is to support other audit evidence (ISA 580: para. 6). This is because, although written representations are necessary, they cannot provide sufficient appropriate audit evidence when they stand alone.

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.

3.3 Obtaining written representations

The written representations are usually obtained in the form of a letter addressed to the auditor (ISA 580: para. 15).

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 written representation 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 written representation in Appendix 2. The date of the written representation 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 (ISA 580: para. 14).

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 (ISA 580: paras. 9 and A2).

3.4 Example of a written representation letter from management

This letter includes written representations that are required for audits of financial statements for periods beginning on or after 15 December 2009. It is not intended to be a standard letter. Representations by management will vary from one entity to another and from one period to the next.

(Entity Letterhead)	
(To Auditor)	(Date)
This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended 31 December 20XX for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, (or give a true and fair view) in accordance with International Financial Reporting Standards. We confirm that (to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves): <i>Financial Statements</i> • We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [insert date], for the preparation of the financial statements in accordance with International Financial Reporting Standards; in particular the financial statements are fairly presented (or give a true and fair view) in accordance therewith.	

- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable (ISA 540).
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of International Financial Reporting Standards (ISA 550).
- All events subsequent to the date of the financial statements and for which International Financial Reporting Standards require adjustment or disclosure have been adjusted or disclosed. (ISA 560)
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter (ISA 450).
- [Any other matters that the auditor may consider appropriate (see paragraph A10 of this ISA).]

Information Provided

- We have provided you with:
 - Access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
 - Additional information that you have requested from us for the purpose of the audit; and
 - Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.
- All transactions have been recorded in the accounting records and are reflected in the financial statements.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud (ISA 240).
- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:
 - Management;
 - Employees who have significant roles in internal control; or
 - Others where the fraud could have a material effect on the financial statements (ISA 240).
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others (ISA 240).
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements (ISA 250).
- We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware (ISA 550).
- Any other matters that the auditor may consider necessary.

Management

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 (ISA 580: para. 17).

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 (ISA 580: para. 18).

4 Overall review of financial statements

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.

When compliance with local/national statutory requirements and accounting standards is considered, the auditors may find it useful to use a **checklist**.

4.1 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* (para. 6), 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:

Principal considerations
Whether the financial statements adequately reflect the information and explanations previously obtained and conclusions previously reached during the course of the audit
Whether it reveals any new factors which may affect the presentation of, or disclosure in, the financial statements
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
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
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

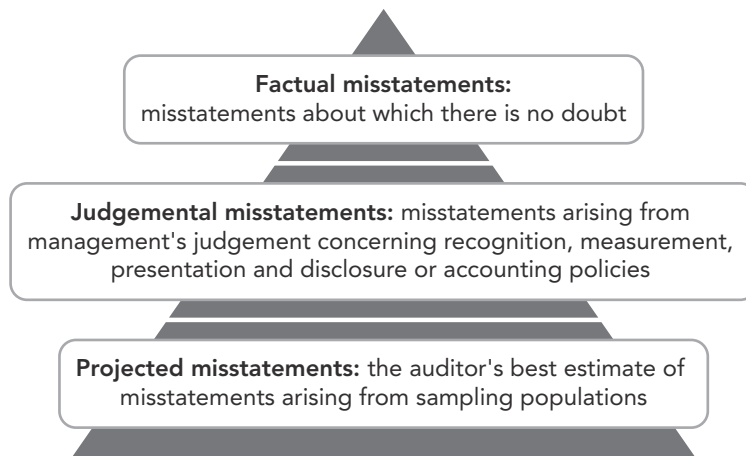
As at other stages of the audit process, significant fluctuations and unexpected relationships must be investigated by **enquiries** of management and **obtaining appropriate audit evidence** relevant to management's responses, and by performing **other audit procedures** considered necessary.

4.2 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.

4.3 Treatment of misstatements

ISA 450 *Evaluation of Misstatements Identified During the Audit* (para. 5) requires the auditor to accumulate misstatements identified during the audit, other than those that are **clearly trivial**. The ISA identifies three types of misstatement:



(ISA 450: para. A3)

ISA 450 (paras. 8–9) 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 (ISA 450: paras. 10–11).

If uncorrected misstatements are material, it will be necessary to **express a modified auditor's opinion**. The auditor must decide how seriously the financial statements are misstated. Less serious material misstatements would give rise to a qualified opinion. More serious issues, that are both 'material and pervasive', give rise to an adverse opinion. This could be the case where there are multiple misstatements that are individually materially, for example. The process of forming and reporting an opinion is described more fully in Chapter 19.

4.3.1 Communication of uncorrected misstatements

ISA 450 (paras. 12–13) 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 (ISA 450: para. 14).

For insurance or banking companies, inaccurate or incomplete descriptions of information about the objectives, policies and processes for managing capital

The incorrect description of an accounting policy relating to a significant item in the statement of financial position, the statement of comprehensive income, the statement of changes in equity or the statement of cash flows

The omission of information about the events which have led to an impairment loss (for example, in a mining company, this may be a significant long-term decline in the demand for a metal)

For an entity trading internationally, the inadequate description of the sensitivity of an exchange rate

Depending on the circumstances, misstatements in disclosures could also indicate **fraud** – for example, where they result from management bias, or where the disclosures are intended to obscure a proper understanding of the financial statements. **Professional scepticism** is therefore required in considering misstatements in disclosures (ISA 450: para. A17).



20

Reports

Essential reading

1 ISA 700 (Revised) Forming an Opinion and Reporting on Financial Statements

In order to form the opinion, the auditor needs to conclude whether reasonable assurance has been obtained that the financial statements are free from material misstatement. Additional considerations are as follows:

Qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements – this includes considering whether the accounting policies disclosed are relevant to the entity, and whether they have been presented in an understandable manner
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

(ISA 700 (Revised): para. 11–15)

1.1 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:

Basic elements of auditor's 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.
Opinion paragraph	The opinion paragraph must 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

Basic elements of auditor's report	Explanation
	explanatory notes, and specify the date or period covered by each statement comprising the financial statements. 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].
Basis for opinion	The basis for opinion paragraph must state that the audit was conducted in accordance with the ISAs, and refer to the 'Auditor's responsibilities for the audit of the financial statements' section which describes the auditor's responsibilities under the ISAs. The auditor must also state that they are independent of the audited entity, in accordance with the relevant ethical requirements relating to the audit. Finally, the auditor must state that they believe the audit evidence obtained is sufficient and appropriate to provide a basis for the audit opinion.
Going concern	Where the auditor considers a material uncertainty related to going concern exists, this should be described in a separate section headed 'Material uncertainty related to going concern'.
Key audit matters	For the audit of listed entities, or where required by law or regulation, the auditor should include a 'Key audit matters' section. This section describes the matters that, in the auditor's professional judgement, are most significant to the audit.
Other information	For the audit of listed entities or any other entity where the auditor has obtained other information, an 'Other information' section should be included in the auditor's report. This section should include: • A statement that management is responsible for the other information • An identification of the other information obtained before the date of the auditor's report (for listed entities, also the other information expected to be obtained after the date of the auditor's report) • A statement that the auditor's opinion does not cover the other information • A description of the auditor's responsibilities for reading, considering and reporting on other information, and • Where other information has been obtained, either a statement that the auditor has nothing to report, or a description of any uncorrected material misstatement
Responsibilities for the financial statements	This part of the report describes the responsibilities of those who are responsible for the preparation of the financial statements. This section should describe management's responsibility including the following: • The preparation of the financial statements in accordance with the applicable financial reporting framework; • The implementation of such internal control as are necessary to enable the preparation of financial statements that are free from

Basic elements of auditor's report	Explanation
	material misstatement, whether due to error or fraud. The assessment of the entity's ability to continue as a going concern, the appropriateness of the going concern basis of accounting and adequacy of related disclosures; 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.
Auditor's responsibilities for the audit of the financial statements	The report must state that: - The auditor's objectives are to obtain reasonable assurance whether the financial statements as a whole are free from material misstatement, and to issue an auditor's report that includes the auditor's opinion; and - Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with the ISAs will always detect a material misstatement when it exists. The report must also: - Explain that misstatements can arise from fraud or error - Describe the meaning of materiality - Explain that the auditor exercises professional judgment and maintains professional scepticism throughout the audit. - Describe the auditor's responsibilities in an audit. The description of the auditor's responsibilities must either be set out in the body of the auditor's report, in an appendix to the auditor's report or by including a specific reference in the body of the auditor's report to such a description on the website of an appropriate authority, where this is permitted by law and regulation.
Other reporting responsibilities	If the auditor is required by law to report on any other matters, this must be done in an additional paragraph titled 'Report on other legal and regulatory requirements' or otherwise as appropriate.
Name of the engagement partner	The name of the engagement partner should be identified, unless such a disclosure is reasonably expected to lead to a significant personal security threat.
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.
Auditor's address	The location where the auditor practises must be included.
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.

(ISA 700 (Revised):

paras. 21–49)

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.



Example - Unmodified auditor's report with unmodified opinion (listed entity)

The following is a copy of an auditor's report on the financial statements of a listed entity taken from Appendix 1 of with ISA 700 (Revised). You will not need to reproduce this in full in an exam but must learn the positioning of each of the various sections along with an understanding of their content.

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements

Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying 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 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants* (IESBA Code) together with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with ISA 701.]

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[Reporting in accordance with the reporting requirements in ISA 720 (Revised).]

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on Other Legal and Regulatory Requirements

[The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law, regulation, or national auditing standards. The matters addressed by other law, regulation or national auditing standards (referred to as 'other reporting responsibilities') shall be addressed within this section unless the other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the ISAs as part of the Report on the Audit of the Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the ISAs may be combined (ie, included in the Report on the Audit of the

Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the ISAs where such a difference exists.]

The engagement partner on the audit resulting in this independent auditor's report is [name].

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

2 ISA 701: Communicating Key Audit Matters (KAMs) in the Independent Auditor's Report

Reporting on KAMs aims to improve **transparency** by helping users to understand the most significant issues the auditor faced. This should enhance the **communicative value** of the auditor's report.

KAMs are part of every listed company auditor's report, and can be included by other auditors if needed (ISA 701: para. 5). **KAMs do not constitute a modification of the report** or of the opinion. They are a part of the standard report which must be tailored to each company's circumstances. KAMs are not a substitute for disclosures, for Emphasis of Matter/Other Matter paragraphs, nor for modified opinions.

The key part of the definition of KAMs above is that these are the most **significant matters**. Identifying the most significant matters involves using the auditor's **professional judgement**.

Other factors to consider when determining KAMs include:

The importance of the matter to intended users' understanding, including materiality
The nature of the underlying accounting policy relating to the matter or the complexity or subjectivity involved
Any misstatements related to the matter
The nature and extent of audit effort needed to address the matter
The nature and severity of difficulties in applying audit procedures, obtaining evidence or forming conclusions, including more subjective judgements
The severity of any control deficiencies
Whether several separate issues interacted, eg if a long-term contract had repercussions in several areas (revenue recognition, litigation or contingencies)

(ISA 701: para. A29)

Here is an example of how KAMs could appear, taken from the IAASB's guidance publication Auditor Reporting – Illustrative Key Audit Matters:



Example - Key audit matters disclosure

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Goodwill

Under IFRSs, the Group is required to annually test the amount of goodwill for impairment. This annual impairment test was significant to our audit because the balance of \$X as of 31 December 20X1 is material to the financial statements. In addition, management's assessment process is complex and highly judgmental and is based on assumptions, specifically [describe certain assumptions], which are affected by expected future market or economic conditions, particularly those in [name of country or geographic area].

Our audit procedures included, among others, using a valuation expert to assist us in evaluating the assumptions and methodologies used by the Group, in particular those relating to the forecasted revenue growth and profit margins for [name of business line]. We also focused on the adequacy of the Group's disclosures about those assumptions to which the outcome of the impairment test is most sensitive, that is, those that have the most significant effect on the determination of the recoverable amount of goodwill.

The Company's disclosures about goodwill are included in Note 3, which specifically explains that small changes in the key assumptions used could give rise to an impairment of the goodwill balance in the future.

2.1 Relationship with the auditor's opinion

The KAMs are the key matters for the audit of the whole financial statements. They are **not** separate auditor's opinions for each part of the financial statements, but merely further information on the process that led up to the opinion on the financial statements as a whole. Likewise, the auditor's opinion refers to the financial statements as a whole: as a whole they might give a true and fair view, or as a whole they might be true and fair 'except for' one area (and so on).

If a **modified opinion** is expressed, the matter that gives rise to the modified opinion will be described in the 'basis for modified opinion' paragraph, so it **must not be included as a KAM** (although the KAM section will include a reference to the 'basis for modified opinion paragraph') (ISA 701: para. 15). ISA 701 (para. 12) emphasises this:

The auditor shall not communicate a matter in the Key Audit Matters section of the auditor's report when the auditor would be required to modify the opinion in accordance with ISA 705 (Revised) as a result of the matter.

Note that where the auditor **disclaims an opinion** on the financial statements, a Key Audit Matters section must not be included in the auditor's report (ISA 705: para. 29).

ISA 701 (para. 15) also makes special mention of **going concern** problems, which we have covered in Chapter 19. Where there is a material uncertainty in relation to going concern, this is described in the 'Material uncertainty related to going concern' section. **Going concern issues should not be included as a KAM** (although the KAM section will include a reference to the 'Material uncertainty related to going concern' section).

2.2 Relationship with Emphasis of Matter (EoM) and Other Matter (OM) paragraphs

There is potentially some degree of overlap between matters which could be disclosed as KAMs or in an EoM paragraph. Where ISA 701 applies, ISA 706 (Revised) (para. A1) states that the use of an EoM is not a substitute for a description of individual key audit matters. In other words, if the matter meets the definition of a KAM it should be disclosed as such. Where a KAM is also judged to be fundamental to the users' understanding of the financial statements the auditor may wish to highlight its relative importance. This could be done, for example, by presenting the matter as the first matter in the KAM section (ISA 706 (Revised): para. A2). If a matter is not determined to be a KAM but is fundamental to the users' understanding and the auditor wishes to draw attention to the matter, it should be disclosed in the EoM paragraph (ISA 706 (Revised): para. A3).

A similar principle applies to the potential overlap between matters that may be included as 'Other Matters'. ISA 706 (Revised) (para. 10) states that the matter must be included in an 'Other Matter' paragraph provided, where ISA 701 applies, the matter has not been determined to be a KAM.

3 ISA 705 (Revised): Modifications to the Opinion in the Independent Auditor's Report

We saw in Chapter 19 that the auditor collects together any uncorrected misstatements that have been discovered by the audit process, in line with ISA 450. Where the aggregate of these misstatements is material, the opinion must be modified, but there are different types of modification depending on the type and the severity of the problem. Moreover, the auditor must also consider the possible effect of any areas where they has not been able to obtain 'sufficient appropriate audit evidence', as this will also give rise to a modified opinion where the problem is sufficiently severe.

ISA 705 (Revised) *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 modification: a **qualified** opinion, an **adverse** opinion and **disclaimer** of opinion

3.1 Qualified opinions

A qualified opinion must be expressed in the auditor's report in the following two situations:

The auditor concludes that misstatements are material, but not pervasive, to the financial statements (ISA 705 (Revised): para. 7(a)).

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

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 (ISA 705 (Revised): para. 7(b)).

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)

3.2 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 (ISA 705 (Revised): para. 8).

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.

Reason deemed pervasive	Example
Misstatements are not confined to specific elements, accounts or items in the financial statements (ISA 705 (Revised): para. 5(a)(i)).	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 statement of financial position (SOFPI).
Misstatements are confined to specific elements, accounts or	A house building company has included all the houses it has constructed in the year as noncurrent assets rather

Reason deemed pervasive	Example
items in the financial statements and represent a substantial portion of the financial statements (ISA 705 (Revised): para. 5(a)(ii)).	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 (ISA 705 (Revised): para. 5(a)(iii)).	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.

3.3 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** (ISA 705 (Revised): para. 10).

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 (ISA 705 (Revised): para. 11).

One example of when a disclaimer of opinion is used was given in Chapter 20 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.

3.4 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 after 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 (ISA 705 (Revised): para. 20).

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 (ISA 705 (Revised): para. 16).

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 (ISA 705 (Revised): para. 25).

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 (ISA 705 (Revised): para. 28): '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.'

3.5 Communication with those charged with governance

ISA 705 (Revised) (para. 30) 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 (ISA 705 (Revised): para. A27).

4 ISA 706 (Revised): Emphasis of matter paragraphs and other matter paragraphs

4.1 Emphasis of matter paragraphs

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**.

4.2 Other matter paragraphs

The other matter paragraph can be used whenever the auditor judges the matter to be relevant to users' understanding of the audit. Examples include:

- The auditor is unable to withdraw from the engagement and yet is unable to obtain sufficient appropriate audit evidence
- The auditor has been requested to report on other matters or to provide more clarifications in line with the legal jurisdiction of the country

Again, the auditor must exercise judgement in deciding where to place the other matter paragraph. ISA 706 (Revised): para. A16 states:

- (a) When an 'Other Matter' paragraph is included to draw users' attention to a matter relating to 'Other Reporting Responsibilities' addressed in the auditor's report, the paragraph may be included in the Report on 'Other Legal and Regulatory Requirements' section.
- (b) When relevant to all the auditor's responsibilities or users' understanding of the auditor's report, the 'Other Matter' paragraph may be included as a separate section following the Report on the Audit of the Financial Statements and the Report on Other Legal and Regulatory Requirements.

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.

4.3 Communication with those charged with governance

ISA 706 (Revised) (para. 12) 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.

5 The auditor's report as a means of communication

5.1 Implied information

Auditor's reports with unmodified opinions may not appear to give a great deal of information. However, the report says much by implication. Remember that the auditor's 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 auditor's 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.

5.2 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 therefore 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 unmodified auditor's 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 countries, leading to further rules which are nevertheless voluntary, not mandatory, as we discussed in Chapter 3.



Further question practice

Section A

1 ABC Co

Each question is worth 2 marks. The following scenario relates to the next five questions.

ABC Co is an engineering company which supplies parts to the automotive industry. The business has expanded rapidly in the last 12 months requiring new and revised systems to be implemented. This has also resulted in additional time-pressure for department heads who have struggled to keep up with their workload.

ABC Co is a listed company and must comply with corporate governance requirements. The company does not currently have an internal audit department but following its annual review the audit committee has concluded that an internal audit function FAO PE needs to be changed to level 2 numbered list is required.

Required

- (a) Which of the following factors would have been taken into account by ABC Co's audit committee when assessing the need for an internal audit function?

- (1) It provides a means of satisfying corporate governance requirements for risk management
- (2) The set-up and running costs versus the benefits
- (3) The increased scale and complexity of ABC's operations
- (4) The additional workload which department heads have been experiencing

- ☐ (a) and (b) only
- ☐ (b), (c) and (d) only
- ☐ (a), (c) and (d)
- ☐ (a), (b), (c) and (d)

(2 marks)

- (b) The members of the audit committee are preparing to put forward their recommendation to the board.

Required

Which **two** of the following statements correctly describes the role that the internal audit function may play in ABC Co if best practice is followed?

- ☐ Assessing and monitoring internal control procedures
- ☐ Managing the accounting and finance department
- ☐ Evaluating the overall risk management policies of the company
- ☐ Implementing changes to systems

(2 marks)

- (c) Following the audit committee's presentation to the board, the sales director complains that he doesn't understand the need for internal auditors when the company already employs a firm of external auditors.

Required

Which **two** of the following statements could be used by members of the audit committee in their explanation of the differences between internal and external auditors?

- ☐ The role of the external auditor is set down in law whilst the role of the internal auditor will depend on the requirements of the company.
- ☐ The internal auditor can be an employee of the company whilst the external auditor must be independent.
- ☐ The external auditor's report must be addressed to the board of directors whilst internal auditor's reports must be addressed to shareholders.

- ☐ External auditors must be members of a professional body whilst internal auditors must satisfy training and experience criteria set down in law. **(2 marks)**

- (d) The ABC Co board has agreed with the audit committee's recommendation that an internal audit function is required. However, the board is concerned about the cost of establishing an internal audit department and is considering the option of outsourcing this function.

Required

Indicate whether the following are advantages of outsourcing or establishing an internal audit department in-house.

	Advantage of outsourcing	Advantage of in-house
Provides flexibility with regards to level of staffing and resources		
Develops expertise of ABC Co staff		
Results in lower staff training costs		
Provides access to specialist skills		

- (e) After careful consideration, the board has decided to establish an in-house internal audit department.

Required

Applying the principles of corporate governance best practice, to whom should the internal audit department report?

- ☐ The board of directors
☐ The external auditors
☐ The audit committee
☐ The finance director

(2 marks)

(Total = 10 marks)

2 Balotelli Beach Hotel Co

The following scenario relates to the next five questions (Specimen exam)

Balotelli Beach Hotel Co (Balotelli) operates a number of hotels providing accommodation, leisure facilities and restaurants. You are an audit senior of Mario & Co and are currently conducting the audit of Balotelli for the year ended 31 December 20X4. During the course of the audit a number of events and issues have been brought to your attention:

Non-current assets and depreciation

Balotelli incurred significant capital expenditure during the year updating the leisure facilities at several of the company's hotels. Depreciation is charged monthly on all assets on a straight-line basis (SL) and it is company policy to charge a full month's depreciation in the month of acquisition and none in the month of disposal.

Food poisoning

Balotelli's directors received correspondence in November 20X4 from a group of customers who attended a wedding at one of the company's hotels. They have alleged that they suffered severe food poisoning from food eaten at the hotel and are claiming substantial damages. Management has stated that based on discussions with their lawyers, the claim is unlikely to be successful.

Trade receivables

Balotelli's trade receivables have historically been low as most customers are required to pay in advance or at the time of visiting the hotel. However, during the year a number of companies opened corporate accounts which are payable monthly in arrears. As such, the trade receivables balance has risen significantly and is now a material balance.

- (a) During the audit of non-current assets, the audit team has obtained the following extract of the non-current assets register detailing some of the new leisure equipment acquired during the year.

Extract from Balotelli's non-current assets register:

Date	Description	Original cost	Depreciation policy	Accumulated depreciation	Charge for the year	Carrying value
		\$		\$	\$	\$
1 May 20X4	15 treadmills	18,000	36 months SL	0	4,000	14,000
15 May 20X4	20 exercise bikes	17,000	3 years SL	0	5,667	11,333
17 August 20X4	15 rowing machines	9,750	36 months SL	0	2,167	7,583
19 August 20X4	10 cross trainers	<u>11,000</u>	36 months SL	<u>0</u>	<u>1,528</u>	<u>9,472</u>
		<u>55,750</u>		<u>0</u>	<u>13,362</u>	<u>42,388</u>

In order to verify the depreciation expense for the year, you have been asked to perform a proof in total. This will involve developing an expectation of the depreciation expense for the year and comparing this to the actual expense to assess if the client has calculated the depreciation charge for the year correctly.

Required

What is the expected depreciation expense for the above assets for the year ended 31 December 20X4 and the resultant impact on non-current assets?

- ☐ Depreciation should be \$10,660, assets are understated
- ☐ Depreciation should be \$18,583, assets are understated
- ☐ Depreciation should be \$9,111, assets are overstated
- ☐ Depreciation should be \$12,549, assets are overstated

(2 marks)

- (b) The audit assistant who has been assigned to help you with the audit work on non-current assets has expressed some uncertainty over why certain audit procedures are carried out and specifically is unsure what procedures relate to the valuation and allocation assertion.

Required

Which FOUR of the following audit procedures are appropriate to test the VALUATION assertion for non-current assets?

- ☐ Review board minutes for evidence of disposals during the year and verify that these are appropriately reflected in the non-current assets register
- ☐ Agree a sample of additions included in the non-current asset register to purchase invoice and cash book
- ☐ Review the repairs and maintenance expense accounts for evidence of items of a capital nature
- ☐ Recalculate the depreciation charge for a sample of assets ensuring that it is being applied consistently and in accordance with IAS 16 Property, Plant and Equipment
- ☐ Review physical condition of non-current assets for any signs of damage
- ☐ Ensure disposals are correctly accounted for and recalculate gain/loss on disposal

(2 marks)

- (c) In relation to the claim regarding the alleged food poisoning, which of the following audit procedures would provide the auditor with the MOST reliable audit evidence regarding the likely outcome of the litigation?
- ☐ Request a written representation from management supporting their assertion that the claim will not be successful
 - ☐ Send an enquiry letter to the lawyers of Balotelli to obtain their view as to the probability of the claim being successful
 - ☐ Review the correspondence from the customers claiming food poisoning to assess whether Balotelli has a present obligation as a result of a past event
 - ☐ Review board minutes to understand why the directors believe that the claim will not be successful
- (2 marks)**
- (d) As trade receivables is a material balance, the audit partner has asked that the audit team carry out a trade receivables circularisation.

Required

Which TWO of the following are benefits of carrying out a trade receivables circularisation?

- ☐ It provides evidence from an independent external source
 - ☐ It provides sufficient appropriate audit evidence over all relevant balance assertions
 - ☐ It improves audit efficiency as all customers are required to respond
 - ☐ It improves the reliability of audit evidence as the process is under the control of the auditor
- (2 marks)**

- (e) The results of the trade receivables circularisation carried out by the audit team on balances as at 31 December 20X4 are detailed below. You have been asked to consider the results and determine if additional audit procedures are required.

Customer	Balance per sales ledger	Balance per customer confirmation	Comment
	\$	\$	
Willow Co	42,500	42,500	
Cedar Co	35,000	25,000	Invoice raised 28 December
Maple Co	60,000	45,000	Payment made 30 December
Laurel Co	55,000	55,000	A balance of \$20,000 is currently being disputed by Laurel Co

The auditor has been asked to assess the replies and consider whether any additional audit work is required.

Required

Based on the results of the circularisation, match each customer to the appropriate audit procedure.

Customer	Audit procedure
	No further audit procedures required
	Agree to pre year end invoice

	Agree to post-year end cash book and bank statement
	Discuss with management and consider whether amount should be included in allowance for receivables

(Total = 10 marks)

3 X Co

The following scenario relates to the next five questions.

X Co has a year end of 31 December 20X6. The detailed audit work has been concluded and you have been asked to complete the review stage of the audit. The auditor's report is due to be signed by the audit partner on 15 March 20X7. The annual report, which includes the financial statements and other information, will be issued on 31 March 20X7. The audit file includes details of an ongoing legal claim against X Co. You are satisfied with its treatment as a contingent liability and that the details have been fully disclosed in the financial statements.

- (a) You have requested written representations from the directors of X Co but have not yet received them.

Required

By which date must the written representations letter be dated and signed by the directors of X Co?

- ☐ 31 December 20X6
- ☐ 15 March 20X7
- ☐ 31 March 20X7
- ☐ Any date between 16–31 March 20X7

(2 marks)

- (b) The following subsequent events took place relating to X Co:

- (1) On 1 February a fraud was identified which had resulted in the financial statements being materially misstated.
- (2) On 20 March 20X7 inventory which was held at the year end was sold at a material amount below its carrying amount as stated in the financial statements at 31 December 20X6.

Required

For which of these events would you be required to obtain sufficient appropriate evidence to enable you to determine whether they have been properly reflected in the financial statements at 31 December 20X6?

- ☐ (a) only
- ☐ (b) only
- ☐ (a) and (b)
- ☐ Neither (a) nor (b)

- (c) Your review of the audit file shows that a number of misstatements have been identified during the course of the detailed audit work.

Required

Which of the following statements correctly describes the auditor's responsibility to communicate these to X Co?

- ☐ All misstatements, both corrected and uncorrected must be communicated to those charged with governance.

- ☐ Only corrected misstatements must be communicated to those charged with governance.
- ☐ All misstatements other than those which are clearly trivial must be communicated to the appropriate level of management.
- ☐ Only material uncorrected misstatements are communicated to the appropriate level of management. **(2 marks)**

- (d) The annual report of X Co includes a summary of key financial results. You have reviewed this other information and have concluded that it is inconsistent with the financial statements. Your investigations have shown that it is the other information, not the financial statements, which is materially misstated. The directors of X Co have refused to correct the summary.

Required

How should this be addressed in the auditor's report?

- ☐ An Other Matter paragraph would be included outlining the material misstatement
- ☐ The Other Information section will state that the auditors have concluded that a misstatement of the other information exists
- ☐ The auditor's opinion will be qualified on the basis of a material misstatement
- ☐ This matter would not be addressed in the auditor's report as the material misstatement is not in the financial statements **(2 marks)**

- (e) The audit partner has concluded that the going concern basis of accounting is appropriate but a material uncertainty exists due to the ongoing legal claim against X Co.

Required

What form of audit opinion will be issued and how will the material uncertainty be disclosed in the auditor's report?

Audit opinion	Disclosure
Modified	Emphasis of Matter paragraph
Unmodified	Material Uncertainty Related to Going Concern
Modified	Material Uncertainty Related to Going Concern
Unmodified	Emphasis of Matter paragraph

- ☐ Modified - Emphasis of Matter paragraph
- ☐ Unmodified - Material Uncertainty Related to Going Concern
- ☐ Modified - Material Uncertainty Related to Going Concern
- ☐ Unmodified - Emphasis of Matter paragraph **(2 marks)**

(Total = 8 marks)

- 4 Which of the following statements is correct in relation to external statutory audits?
- ☐ External audits give absolute assurance that the financial statements are free from all misstatement.
 - ☐ External audits give limited assurance that the financial statements are free from material misstatement.
 - ☐ External audits give reasonable assurance that the financial statements are free from material misstatement.
 - ☐ External audits can only give limited assurance because of the inherent limitations of an audit. **(2 marks)**

- 5 Consider the following statements regarding stewardship and agency.
- (1) Directors are stewards of the investment made by shareholders in a company.
 - (2) Auditors act as an agent for the shareholders in a company.

Required

Which of these statements is/are true?

- ☐ (a) only
- ☐ (b) only
- ☐ (a) and (b)
- ☐ Neither (a) nor (b)

(2 marks)

- 6 The International Standards on Auditing are issued by which of the following bodies?

- ☐ IAESB
- ☐ IAASB
- ☐ IASB
- ☐ FRC

(2 marks)

- 7 Which **two** of the following statements are correct with regards to the International Standards on Auditing (ISA)?

- ☐ The ISAs aim to ensure that audits performed on different companies, in different jurisdictions, adhere to common standards.
- ☐ Where it is not possible to comply with one or several of the ISAs in an audit, the auditor should explain the reason for the non-compliance in the auditor's report.
- ☐ The ISAs apply to the audit of smaller entities.
- ☐ An auditor is legally required to follow ISAs when auditing a public interest entity.

(2 marks)

- 8 To ensure transparency, the internal audit team should report to:

- ☐ The company's directors
- ☐ The audit committee
- ☐ Both the directors and the audit committee
- ☐ The shareholders

(2 marks)

- 9 Consider the following statements:

- (1) In an effective system of corporate governance the directors take responsibility for risk management strategies within the business.
- (2) In an effective system of corporate governance a business is likely to have an internal audit department.

Required

Which of these statements is/are true?

- ☐ (a) only
- ☐ (b) only
- ☐ (a) and (b)
- ☐ Neither (a) nor (b)

(2 marks)

- 10 AB & Co audits DEF Co. In accordance with ACCA *Code of Ethics and Conduct* which TWO of the following circumstances would constitute a threat to objectivity?

- ☐ An employee of AB & Co owns shares in DEF Co but is not part of the audit team
- ☐ The best friend of the engagement partner owns a significant indirect financial interest in DEF Co
- ☐ The audit manager of DEF Co owns a small number of shares in DEF Co
- ☐ The husband of the audit partner owns shares in DEF Co

(2 marks)

11 AAB & Co is the statutory auditor of Y Co, a public interest entity.

Required

Which of the following services is AAB & Co prohibited from providing to Y Co under any circumstances?

- ☐ Provision of bookkeeping services
- ☐ Assistance in the resolution of tax disputes
- ☐ Internal audit services
- ☐ Valuation services

(2 marks)

12 Which of the following internal audit assignments is described below?

The examination of the economy, efficiency and effectiveness of activities and processes.

- ☐ Regulatory compliance audit
- ☐ Value for money audit
- ☐ Financial audit
- ☐ IT audit

(2 marks)

13 What are the two elements of the risk of material misstatement at the assertion level?

- ☐ Inherent risk and detection risk
- ☐ Audit risk and detection risk
- ☐ Inherent risk and control risk
- ☐ Detection risk and control risk

(2 marks)

14 Consider the following statements:

- (1) The audit engagement partner must review all audit documentation before the date of the auditor's report, in order to ensure that sufficient and appropriate audit evidence has been obtained to support the audit opinion.
- (2) All audit work should be directed, supervised and review by a more senior member of the audit team.

Required

Which of these statements is/are true?

- ☐ (a) only
- ☐ (b) only
- ☐ (a) and (b)
- ☐ Neither (a) nor (b)

(2 marks)

15 F Co is an oil and gas company mining for crude oil reserves in sub-Saharan Africa. In the external audit of F Co, to which of the following might specific performance materiality levels apply?

- (1) Directors' remuneration

- (2) Exploration and development costs
 - (3) The financial statements as a whole – to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole
 - (4) The financial statements as a whole – to determine whether misstatements identified during the audit should be accumulated and communicated to management
- ☐ (a), (b) and (c)
 - ☐ (a), (b) and (d)
 - ☐ (a) and (b)
 - ☐ (b) and (d)
- (2 marks)**

- 16 Which of the following matters would the overall audit strategy include?
- ☐ The applicable financial reporting framework
 - ☐ The nature, timing and extent of audit procedures at the assertion level
 - ☐ The timetable of planned audit work
 - ☐ The level for performance materiality
- (2 marks)**

- 17 Consider the following statements:
- (1) Existence is an assertion about account balances at the period end.
 - (2) Cut-off is an assertion about classes of transactions and events and related disclosures.

Required

Which of these statements is/are true?

- ☐ (a) only
 - ☐ (b) only
 - ☐ (a) and (b)
 - ☐ Neither (a) nor (b)
- (2 marks)**

- 18 The auditor of A Co wishes to reduce audit risk. Which of the following actions could the auditor take to achieve this?
- (1) Increase sample sizes
 - (2) Reduce control risk
 - (3) Assign more experienced staff to the engagement team
- ☐ (a) only
 - ☐ (b) only
 - ☐ (a) and (c)
 - ☐ (b) and (c)
- (2 marks)**

- 19 When gaining an understanding of the specific business operations of an audit client which of the following matters would an auditor need to consider?
- ☐ Accounting principles and industry specific practices relevant to the client's business
 - ☐ Acquisitions or disposals of the client's business activities
 - ☐ Leasing of property, plant or equipment for use in the client's business
 - ☐ Products or services and markets of the client's business
- (2 marks)**

- 20 How long is the minimum period that the ACCA recommends that working papers should be retained for?
- ☐ 2 years
 - ☐ 3 years
 - ☐ 5 years
 - ☐ 7 years
- (2 marks)**

- 21 The audit team of which you are a member is in the process of documenting the audit client's system of internal controls. You wish to assess what specific errors or frauds may occur, in order to identify the direct controls that the team will then need to test during control testing.

Required

Which of the following methods for recording control systems should you use?

- ☐ ICQ
 - ☐ ICEQ
 - ☐ Narrative notes
 - ☐ Flowcharts
- (2 marks)**

- 22 Information processing controls relate to procedures used to initiate, record, process and report transactions and other financial data.

Required

Which **two** of the following are information processing controls?

- ☐ Records of program changes
 - ☐ Virus checks
 - ☐ Batch reconciliations
 - ☐ Document counts
- (2 marks)**

- 23 One of the control objectives of the sales system of B Co is to ensure that goods and services are sold to credit-worthy customers.

Required

Which of the following control activities would assist B Co in achieving this objective?

- ☐ All sales orders are based on authorised price lists.
 - ☐ Credit limits are checked before sales orders are accepted.
 - ☐ Overdue debts are chased each month by the credit controller.
 - ☐ The aged-debt listing is reviewed by the finance director on a monthly basis.
- (2 marks)**

- 24 The auditor of Q Co has identified that Q Co does not match dispatch notes to sales invoices as part of the controls in the sales system.

Required

What is the potential consequence of this deficiency?

- ☐ Customer orders may not be fulfilled accurately.
 - ☐ Sales and trade receivables may be overstated.
 - ☐ Sales and trade receivables may be understated.
 - ☐ Sales invoices may be posted inaccurately in the receivables control account.
- (2 marks)**

- 25 The external auditor has identified a deficiency in the internal controls of S Co.

Which **TWO** of the following factors would indicate that the deficiency is a significant deficiency in accordance with *ISA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*?

- ☐ The likelihood of the deficiency leading to material misstatement is low
- ☐ There is a risk of fraud
- ☐ The number of transactions affected by the deficiency is low
- ☐ The deficiency interacts with other deficiencies identified

(2 marks)

- 26 The sales invoices of Z Co are matched to dispatch notes with any mismatched items investigated before they are recorded in the sales day book.

Required

Which of the following control objectives does this help to achieve?

- ☐ It ensures that sales and receivables are valid and accurate.
- ☐ It ensures that all goods dispatched are recognised as sales and receivables.
- ☐ It ensures that all goods ordered by customers are dispatched.
- ☐ It ensures that customers do not exceed their credit limits.

(2 marks)

- 27 To ensure that the recorded sales transactions represent goods that have actually been despatched, D Co's sales system only records sales if there is matching despatch documentation.

Required

Which of the following would be an appropriate test of control to confirm that the control is operating effectively?

- ☐ For a sample of sales invoices, verify that there are matching goods despatched notes.
- ☐ For a sample of goods despatched notes, verify that there are matching sales invoices.
- ☐ Verify that the numerical sequence of sales invoices is complete.
- ☐ Inspect the open-order file for unfulfilled orders.

(2 marks)

- 28 As the external auditor of G Co, you have performed analytical procedures which have highlighted a 40% increase in revenue compared to the previous period.

Required

Which further audit procedures would you perform in response to this?

- ☐ For a sample of sales invoices around the period end, inspect the dates and compare with the dates of goods despatch and the dates recorded in the sales and receivables ledger to confirm the application of correct cut-off.
- ☐ Trace a sample of shipping documentation to sales invoices and into the sales and receivables ledger.
- ☐ For a sample of sales transactions recorded in the ledger, vouch the sales invoice back to customer orders and shipping documentation.
- ☐ For a sample of sales invoices, examine for proper classification into revenue accounts.

(2 marks)

- 29 The draft financial statements of T Co show the following information:

	\$'000
Revenue	420
Cost of sales	270

	\$'000
Gross profit	150
Trade receivables	160
Trade payables	130

Required

What is the receivables collection period?

- ☐ 139 days
- ☐ 175 days
- ☐ 758 days
- ☐ 958 days

(2 marks)

30 Consider the following statements:

- (1) 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.
- (2) Auditors usually conduct audit sampling but there may be occasions when all items within a population are tested.

Required

Which of these statements is/are true?

- ☐ (a) only
- ☐ (b) only
- ☐ (a) and (b)
- ☐ Neither (a) nor (b)

(2 marks)

31 The auditor of P Co is planning the audit work on trade receivables.

Required

Which of the following procedures could **not** be performed by using computer-assisted audit techniques?

- ☐ Selection of a sample of receivables for confirmation
- ☐ Calculation of receivables collection period
- ☐ Production of receivables' confirmation letters
- ☐ Evaluation of the adequacy of the allowance for receivables

(2 marks)

32 X Co has an internal audit function. The external auditor has concluded that the internal audit function does not apply a systematic and disciplined approach to its work.

Required

How does this affect the extent to which the external auditor can rely on the work of the internal audit function?

- ☐ The external auditor must not use the work of the internal audit function.
- ☐ The external auditor can use the work of the internal audit function provided the individuals have been assessed as competent.
- ☐ The external auditor can use the work of the internal audit function provided the organisational status of the function supports its objectivity.
- ☐ The external auditor can use work performed by the internal audit function which relates to low risk areas of the external audit only.

(2 marks)

- 33 The auditor of G Co is performing audit procedures to confirm the company's ownership of motor vehicles.

Required

Which of the following would provide the most persuasive evidence of this?

- ☐ Physical inspection of the motor vehicles
- ☐ Inspection of vehicle registration documents
- ☐ Checking that the motor vehicles are recorded in the non-current asset register
- ☐ Review of vehicle insurance documentation

(2 marks)

- 34 The auditor of Q Co has performed purchases cut-off procedures and has identified that in two material instances goods received prior to the inventory count have not been included on the schedule of 'goods received not invoiced'. At the period end purchase invoices have not been received. What is the auditor's conclusion based on this evidence?

- ☐ Inventory is overstated and liabilities are understated.
- ☐ Inventory is understated and liabilities are understated.
- ☐ Inventory is overstated and liabilities are overstated.
- ☐ Inventory is understated and liabilities are overstated.

(2 marks)

- 35 Consider the following statements:

- (1) Auditors have no obligations to perform procedures or make enquiries regarding the financial statements after they have been issued.
- (2) Auditors must investigate a material subsequent event notified to them after the financial statements have been issued but before the entity's AGM.

Required

Which of these statements is/are true?

- ☐ (a) only
- ☐ (b) only
- ☐ (a) and (b)
- ☐ Neither (a) nor (b)

(2 marks)

- 36 M Co has a year end of 31 December 20X4. The auditor has identified that management's assessment of M Co's ability to continue as a going concern covers the period to 30 June 20X5.

Required

What action should the auditor take?

- ☐ Request that management extends the assessment period to 30 September 20X5
- ☐ Request that management extends the assessment period to 31 December 20X5
- ☐ Request that management extends the assessment period to 31 December 20X6
- ☐ No action is required provided the auditor is satisfied with management's assessment to 30 June 20X5

(2 marks)

- 37 Consider the following statements:

- (1) Written representations by management regarding specific assertions in the financial statements provide sufficient appropriate audit evidence in their own right.
- (2) Written representations should be prepared by the auditor on their own letterhead and given to management to sign and return.

Required

Which of these statements is/are true?

- ☐ (a) only
- ☐ (b) only
- ☐ (a) and (b)
- ☐ Neither (a) nor (b)

(2 marks)

- 38 Misstatements can arise from error or fraud.

Which of the following statements is correct regarding the auditor's accumulation of identified misstatements?

- ☐ The auditor must accumulate all misstatements identified during the audit.
- ☐ The auditor must only accumulate individually material misstatements identified during the audit.
- ☐ The auditor must accumulate misstatements identified during the audit, other than those that are clearly trivial.
- ☐ The auditor must accumulate all misstatements identified during the audit so that they can form part of the audit planning for the following year.

(2 marks)

- 39 ISA 700 *Forming an Opinion and Reporting on Financial Statements* sets out the basic elements of an auditor's report.

Required

Which of the following is **not** included in an unmodified auditor's report?

- ☐ Management's responsibility for the financial statements
- ☐ Auditors' responsibilities
- ☐ Audit opinion
- ☐ Deficiencies of internal controls

(2 marks)

- 40 The statement of financial position of R Co includes a material amount of \$200,000 in respect of costs capitalised in the year as development expenditure. The auditor has concluded that these costs are research expenditure.

Required

If the auditor is to issue an unmodified opinion which financial statements will require adjustment?

- ☐ Statement of financial position only
- ☐ Statement of profit or loss only
- ☐ Statement of financial position and statement of profit or loss
- ☐ Neither the statement of financial position nor the statement of profit or loss

(2 marks)

- 41 Due to disruptions caused by the recent transition to a new accounting system, one month of H Co's inventory records have been lost. The auditors performing the statutory audit for the twelve-month period have determined that the possible effects of undetected misstatements could be material, but not pervasive.

Required

What form of audit opinion would the auditor give?

- ☐ Unmodified opinion with an emphasis of matter paragraph
- ☐ Qualified opinion
- ☐ Adverse opinion

☐ Disclaimer of opinion

(2 marks)

- 42 C Co has a substantial bank loan which is due to mature in 20X7, and the company plans to negotiate for a new loan in March 20X7. The auditors concluded that the company's use of the going concern assumption in the financial statements for the year ended 31 December 20X6 is appropriate. However, they believe there is a material uncertainty related to going concern, which has been appropriately disclosed in the financial statements.

Required

What action should the auditor take with regards to going concern in the auditor's report?

- ☐ Express an unmodified opinion and describe the material uncertainty in the other matter paragraph
- ☐ Express an unmodified opinion and describe the material uncertainty in the material uncertainty related to going concern paragraph
- ☐ Express a modified opinion and describe the material uncertainty in the emphasis of matter paragraph
- ☐ Express a qualified opinion and describe the material uncertainty in the basis for qualified opinion paragraph

(2 marks)

- 43 Consider the following statements:

- (1) Where the auditor disclaims an opinion on the financial statements, the auditor's report must not include a key audit matters section.
- (2) Where there is insufficient evidence on a pervasive matter, the auditor should give an adverse opinion.

Required

Which of these statements is/are true?

- ☐ (a) only
- ☐ (b) only
- ☐ (a) and (b)
- ☐ Neither (a) nor (b)

(2 marks)

- 44 Which of the following is likely to be carried out as part of an engagement quality review for a listed entity?

- (1) Review of audit working paper files to ensure that the audit has been performed in accordance with professional standards and regulatory and legal requirements
- (2) Review of selected audit documentation relating to significant audit judgements
- (3) Review of the engagement team's evaluation of the firm's independence towards the audit
- (4) Consideration of whether appropriate consultations have taken place on differences of opinion/contentious matters
- ☐ (a) and (c)
- ☐ (b) and (d)
- ☐ (a), (b) and (d)
- ☐ (b), (c) and (d)

(2 marks)

Section B

Constructed response questions

Preparation Questions are not in the current exam format but are intended as useful practice. The Practice & Revision Kit provides a large number of exam format questions.

45 Objectives, characteristics and responsibilities (Preparation Question)

Your client, Mr Neville, has written to you saying he has been considering setting up an internal audit department but has heard from his brother that he would be better off abandoning this idea and getting the external auditor to do some assurance work instead. His brother also claimed that if the external auditor does some work for the company, there would be no need to have an external audit.

Required

Write a letter to Mr Neville explaining the objectives, characteristics and responsibilities of internal audit, external audit and assurance.

46 Audit and assurance engagements (Preparation Question) (18 mins)

- (a) Explain the difference between negative and positive assurance in the context of the external audit and review engagements. State some of the limitations of the external audit. **(4 marks)**
- (b) The audit opinion sets out explicit opinions which must be stated in the auditor's report. State what these are and outline the possible implied opinions, which are only reported on by exception. **(3 marks)**
- (c) Auditors have certain rights to allow them to carry out their duties. State and explain what these rights are, using the UK as an example. **(3 marks)**

(Total = 10 marks)

47 Standards (Preparation Question)

Discuss the advantages and disadvantages of auditing standards to auditors and the consequences of them being enforceable by statute.

48 Corporate governance (Preparation Question)

The objective of a system of corporate governance is to secure the effective, sound and efficient operation of companies. This objective transcends any legislation or voluntary code. Good corporate governance embraces not only making the company prosper but also doing business in a legal and ethical manner. A key element of corporate governance is the audit committee. The audit committee is a committee of the board of directors and is of a voluntary nature regulated by voluntary codes.

Required

- (a) Explain how an audit committee could improve the effectiveness of the external auditor's work.
- (b) Discuss the problems of ensuring the 'independence' of the members of the audit committee.
- (c) Discuss the view that the role of the audit committee should not be left to voluntary codes of practice but should be regulated by statute.

49 Independence (Preparation Question)

It has been suggested that the most important matter affecting the credibility of the auditor is that of 'independence'.

Required

- (a) Discuss, giving examples, matters other than independence, which might be relevant in relation to the credibility of the auditor and steps that the accounting profession has taken or might take in relation to them.
- (b) Discuss the following situations in the context of the independence of the auditor, showing clearly the principles involved:
 - (1) The audit manager in charge of the audit assignment of Andrew Co holds 1,000 \$1 ordinary shares in the company (total shares in issue – 100,000). The audit partner holds no shares.
 - (2) The recurring audit fee receivable from Janet Co, a private company, is \$100,000. The total fee income of the audit firm is \$700,000.
 - (3) The audit senior in charge of the audit of Margot Bank Co has a personal loan from the bank of \$2,000 on which she is currently paying 12% interest.
 - (4) The audit partner is responsible for two audit assignments, Harry Co and Jean Co. Harry Co has recently tendered for a contract with Jean Co for the supply of material quantities of goods over a number of years. Jean Co has asked the audit partner to advise on the matter.

50 Confidentiality and independence

(36 mins)

- (a) Explain the situations where an auditor may disclose confidential information about a client.
(8 marks)
- (b) You are an audit manager in McKay & Co, a firm of Chartered Certified Accountants. You are preparing the engagement letter for the audit of Ancients, a public limited liability company, for the year ending 30 June 20X6.

Ancients has grown rapidly over the past few years, and is now one of your firm's most important clients. Ancients has been an audit client for eight years and McKay & Co has provided audit, taxation and management consultancy advice during this time. The client has been satisfied with the services provided, although the taxation fee for the period to 31 December 20X5 remains unpaid.

Audit personnel available for this year's audit are most of the staff from last year, including Mr Grace, an audit partner, and Mr Jones, an audit senior. Mr Grace has been the audit partner since Ancients became an audit client. You are aware that Allyson Grace, the daughter of Mr Grace, has recently been appointed the financial director at Ancients.

To celebrate her new appointment, Allyson has suggested taking all the audit staff out to an expensive restaurant prior to the start of the audit work for this year.

Required

Identify and explain the risks to independence arising in carrying out your audit of Ancients for the year ending 30 June 20X6, and suggest ways of mitigating each of the risks you identify.
(12 marks)

(Total = 20 marks)

51 ZX

(36 mins)

You are a recently qualified Chartered Certified Accountant in charge of the internal audit department of ZX, a rapidly expanding company. Revenue has increased by about 20% p.a. for

the last five years, to the current level of \$50m. Net profits are also high, with an acceptable return being provided for the four shareholders.

The internal audit department was established last year to assist the board of directors in their control of the company and to prepare for a possible listing on the stock exchange. The Managing Director is keen to follow the principles of good corporate governance with respect to internal audit. However, he is also aware that the other board members do not have complete knowledge of corporate governance or detailed knowledge of International Auditing Standards.

Required

Write a memo to the board of ZX that:

- (a) Explains how the internal audit department can assist the board of directors in fulfilling their obligations under the principles of good corporate governance. **(10 marks)**
- (b) Explains the advantages and disadvantages to ZX of an audit committee. **(10 marks)**

(Total = 20 marks)

52 Glo

(36 mins)

Glo-Warm Co, a limited liability company, manufactures various heating products which it sells to both high street and catalogue retailers.

The statement of financial position for the years ended 20X7 and 20X6 are set out below. Last year, materiality for the financial statements as a whole was set at \$10,000.

		20X7		20X6
	\$'000	\$'000	\$'000	\$'000
Non-current assets				
Tangible non-current assets		20		21
Investments		2		2
Current assets				
Inventory	52		179	
Receivables	78		136	
Cash at bank	12		34	
Cash in hand	<u>1</u>		<u>1</u>	
	143		350	
Total assets		<u>165</u>		<u>373</u>
Current liabilities				
Trade payables	121		133	
Bank loan	<u>5</u>		<u>5</u>	
	126		138	
Long-term liabilities				
Bank loan		20		25
Provision*		20		
Capital and reserves				
Share capital		2		2

	20X7	20X6
	\$'000	\$'000
Reserves	(3)	208
Total liabilities	<u>165</u>	<u>373</u>

* The provision of \$20,000 consists entirely of a warranty provision.

Required

- Discuss whether the materiality level for the financial statements as a whole used in 20X6 will be appropriate for this year's audit, giving reasons for your answer. **(3 marks)**
- Explain audit risk. **(3 marks)**
- Review the statement of financial position given above and state the areas in which audit work should be concentrated, giving reasons in each case. **(14 marks)**

(Total = 20 marks)

53 Stone Holidays

(36 mins)

Fraud and error present risks to an entity. Both internal and external auditors are required to deal with risks to the entity. However, the responsibilities of internal and external auditors in relation to the risk of fraud and error differ.

Required

- Explain how the internal audit function helps an entity deal with the risk of fraud and error. **(5 marks)**
- Explain the responsibilities of external auditors in respect of the risk of fraud and error in an audit of financial statements. **(9 marks)**
- Stone Holidays is an independent travel agency. It does not operate holidays itself. It takes commission on holidays sold to customers through its chain of high street shops. Staff are partly paid on a commission basis. Well-established tour operators run the holidays that Stone Holidays sells. The networked reservations system through which holidays are booked and the computerised accounting system are both well-established systems used by many independent travel agencies.

Payments by customers, including deposits, are accepted in cash and by debit and credit card. Stone Holidays is legally required to pay an amount of money (based on its total sales for the year) into a central fund maintained to compensate customers if the agency should cease operations.

Required

Describe the nature of the risks to which Stone Holidays is subject arising from fraud and error. **(6 marks)**

(Total = 20 marks)

54 Parker

(36 mins)

- Explain the term 'audit risk' and describe the components of audit risk. **(4 marks)**
- You are the audit manager for Parker, a limited liability company which sells books, CDs, DVDs and similar items via two divisions: mail order and online ordering on the internet. Parker is a new audit client. You are commencing the planning of the audit for the year ended 31 May 20X7. An initial meeting with the directors has provided the information below.

The company's revenue is in excess of \$85m with net profits of \$4m. All profits are currently earned in the mail order division, although the Internet division is expected to return a small net profit next year. Revenue is growing at the rate of 20% p.a. Net profit has remained almost the same for the last four years.

In the next year, the directors plan to expand the range of goods sold through the Internet division to include toys, garden furniture and fashion clothes. The directors believe that when one product has been sold on the internet, then any other product can be as well.

The accounting system to record sales by the mail order division is relatively old. It relies on extensive manual input to transfer orders received in the post onto Parker's computer systems. Recently errors have been known to occur, in the input of orders and in the invoicing of goods following despatch. The directors maintain that the accounting system produces materially correct figures and they cannot waste time in identifying relatively minor errors. The company accountant, who is not qualified and was appointed because he is a personal friend of the directors, agrees with this view.

The directors estimate that their expansion plans will require a bank loan of approximately \$30m, partly to finance the enhanced website but also to provide working capital to increase inventory levels. A meeting with the bank has been scheduled for three months after the year end. The directors expect an auditor's report with an unmodified audit opinion to be signed prior to this time.

Required

Identify and describe the matters that give rise to audit risks associated with Parker.
(10 marks)

- (c) Explain the enquiries you will make, and the audit procedures you will perform to assist you in making a decision regarding the going concern status of Parker in reaching your audit opinion on the financial statements. **(6 marks)**

(Total = 20 marks)

55 Heels

(54 mins)

ISA 315 *Identifying and Assessing the Risks of Material Misstatement* requires the auditor to identify and assess the risks of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances and disclosures. As part of the risk assessment, the auditor shall determine whether any of the risks are 'significant risks'.

Required

- (a) Explain the steps the auditor must take when identifying and assessing the risks of material misstatement. **(4 marks)**
- (b) Define a 'significant risk' and list five factors that should be used to evaluate a risk's significance. **(4 marks)**
- (c) Heels Co, a limited liability company, has traditionally specialised in the manufacture and wholesaling of ladies' shoes to retailers. The shoes are manufactured for ladies' fashion retailers, who generally also sell luxury ladies' clothes and accessories. You have been assigned as audit senior for the year ended 31 December 20X1 and have established the following at a recent planning visit.

In January 20X1, the company expanded into retailing and opened a shop selling shoes to the general public. The store was an instant success and the company rushed through the purchase of three additional stores before the end of May 20X1. These opened in June 20X1 and have also been well received. Customers can pay by cash, debit card or credit card in all stores.

In order to accommodate the retailing activities, Heels recently upgraded its computerised accounting system. The new system uses a central computer at the company's head office

which is linked to computers at its warehouses and retail outlets. The software includes a bespoke inventory control system.

The new retail operations are expected to account for 15% of revenue for the year to 31 December 20X1 despite only being open for part of the year. However, as a result of the expansion, the company took out a significant loan secured against two of the stores and funded the remainder of the expansion out of working capital and by extending its overdraft facility.

Due to the increased volume of business and additional interest payments, the company is now trading at its overdraft limit. The board are seeking to increase the overdraft facility further.

Required

- (i) Describe SIX audit risks arising at the planning stage of the Heels Co audit. **(6 marks)**
- (ii) For the risks identified above, describe possible audit work that could be performed in response to those risks. **(6 marks)**
- (d) On a later visit to Heels, you discover that the retail stores have been offering a three-month return period on all shoes. Customers are entitled to a refund or can exchange the shoes. Management at Heels have said they will estimate the figure for the returns relating to 20X1 sales expected between 1 January 20X2 and 31 March 20X2 (inclusive). They will then make a provision for it in the financial statements for the year ended 31 December 20X1. The provision is likely to be material.

There is expected to be considerable time pressure on the audit this year because the board want to get it 'out of the way' by the middle of February 20X2 so they can focus on operational issues.

Required

Define an 'auditor's point estimate' and explain how the auditors of Heels could formulate and use a point estimate to gain evidence over the provision for shoe returns. **(5 marks)**

- (e) Describe FIVE other possible audit procedures you could carry out in respect of the provision. **(5 marks)**

(Total = 30 marks)

56 Turbo

(54 mins)

ISA 320 *Materiality in Planning and Performing an Audit* deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. Materiality has both qualitative and quantitative aspects.

Required

- (a) Explain what is meant by 'performance materiality' and contrast it with materiality for the financial statements as a whole. Give two examples of qualitative factors which may cause misstatements of quantitatively small amounts to be material. **(6 marks)**
- (b) State what the auditor must document in relation to materiality. **(2 marks)**
- (c) You are the audit senior for Purnell & Co and Turbo Co is a longstanding audit client of your firm. You have started the planning for the audit of Turbo Co for the year ended 31 May 20X1. You have obtained the following information from the previous year's file and from preliminary discussions with management.

Background and revenue sources

Turbo is a magazine publisher. It publishes a number of titles, all of which are weekly or monthly car and motorcycle magazines. The magazines are sold to supermarkets and newsagents who then sell them to the general public. Turbo generates its income in two ways;

from the sale of the magazines themselves and from selling advertising space in the magazines to companies who want to promote their cars or motorcycles. The revenue split has typically been around 50% in total for each sale type.

The key advertisers are large household names in the car and motorcycle industry. Turbo has to negotiate contracts with these advertisers for the provision of advertising space. These contracts can vary in length and can range from between one month and six months. The contract will set out all details of the arrangement, including the price of the adverts, the number or size of the adverts and how often the advertisements will appear.

An invoice is raised on the date of the first advertisement and the advertisers pay within ten days of this for shorter contracts. For six-month contracts the advertising fees are paid for by Turbo's customers in two instalments (half of the fee on the first date of advertising and the rest after three months). If recurring contracts have not been re-signed by the date advertising is meant to start Turbo raises an invoice based on the last contract and the paperwork is sorted out later. A few of the larger contracts run up to 31 May 20X1.

In respect of the magazine sales Turbo offers the supermarkets and newsagents up to 45 days' credit but many of the newsagents are struggling financially and tend to take longer than this to pay their invoices.

Trading conditions

In the last ten years the market for the magazines has become more and more competitive, resulting in Turbo needing to discount magazine prices. There is also increasing pressure from online competition and Turbo's revenue has been gradually decreasing over the last few years. This year has been a particularly bad year because difficult economic conditions have resulted in reductions in advertising revenue, as many of the car and motorcycle manufacturers that advertise in the magazines have seen their marketing budgets slashed and have renegotiated their contract terms.

Other relevant information

Turbo does not employ journalists or photographers for its magazines. Instead, it uses the best self-employed journalists, commentators and photographers in the industry. However, due to their numerous commitments these freelancers often get behind on their paperwork and don't get around to sending in their invoices to Turbo until a month or more after they have written their article or provided the photos requested.

Turbo prints its own magazines and as a result has a significant amount of plant and equipment. Turbo has been around for a number of years now and the equipment had become quite old and inefficient compared to that used by newly formed competitors. As a result, in December 20X0 extensive refurbishment of the printing equipment took place and this expenditure will be material to the financial statements. The heavy investment in refurbishment and declining revenues has seen Turbo operate close to its overdraft limit during the last six months. Although there is likely to be a small profit for the year, the management accounts for last six months show an operating loss.

The company would like to apply for a bank loan to ease cash flow concerns and has discussed this with its bank. However, the initial response from the bank was not overwhelmingly positive due to the competitive market Turbo operates in. As a result, Turbo needs to produce a cash flow forecast for the bank showing where the cash will be generated to pay back any loan. The bank also wants to see audited financial statements for the year to 31 May 20X1 before the end of June 20X1.

The forecasts currently being put together will include Turbo's plan to make popular titles available to the public online in exchange for a subscription fee. Online advertising fees will also be included in the forecast. However, the website will need to be quite complex and the investment in it will be significant.

Required

Using the information provided, describe nine audit risks and explain the auditor's response to each risk in planning the audit of Turbo Co. **(18 marks)**

- (d) Turbo's bank has said it would like a report from the external auditors to confirm the accuracy of the forecast. Following this request, Turbo has asked if you will examine the cash flow forecast when it has been prepared and then provide a report for the bank.

Required

Explain the type of assurance you could give in the context of the request by the bank and contrast this with the level of assurance given in the statutory audit of the financial statements.

(4 marks)

(Total = 30 marks)

57 Audit planning and documentation (Preparation Question) (18 mins)

- (a) Explain the difference between the overall audit strategy and the audit plan and state the key contents of the overall audit strategy document. **(4 marks)**
- (b) Briefly explain the reasons for auditors documenting their work. **(3 marks)**
- (c) Many audit firms use standardised working papers. List the advantages and disadvantages of audit firms using standardised working papers to document their audit work. **(3 marks)**

(Total = 10 marks)

58 Audit evidence considerations (Preparation Question) (18 mins)

- (a) Discuss how analytical procedures can be used as substantive audit procedures to provide audit evidence. Illustrate your answer with an example. **(5 marks)**
- (b) ISA 500 *Audit Evidence* requires auditors to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base their audit opinion. Discuss the different sources of evidence available to auditors and assess their relative appropriateness. **(5 marks)**

(Total = 10 marks)

59 Internal control (Preparation Question) (18 mins)

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

Required

- (a) Explain the limitations of internal control systems. **(4 marks)**
- (b) One method of recording an audit client's accounting and internal control system is using narrative notes.

Required

Describe two advantages and two disadvantages of using narrative notes to document accounting and control systems. **(4 marks)**

- (c) Briefly describe two alternative methods of documenting accounting and control systems. **(2 marks)**

(Total = 10 marks)

60 Fenton Distributors (Preparation Question)

(47 mins)

Fenton Distributors Co is a small company which maintains its sales, purchase and nominal (general) ledgers on a small PC, using a standard computerised accounting package. The company buys products from large manufacturers and sells them to shops which either sell or hire them to the general public. The products include drain clearing machines, portable generators, garden cultivators and wallpaper strippers.

You have been asked to carry out an audit of the nominal ledger system to verify that items are accurately recorded in the year. At the end of the year, the nominal ledger produces a trial balance, which is used to prepare the annual accounts.

The company employs a bookkeeper, who is responsible for posting the sales and purchase ledgers and maintaining the nominal ledger. Data is posted to the nominal ledger as follows:

- (1) At the start of the financial year, all the balances on the nominal ledger accounts are set to zero (using the standard year-end procedure of the computer package).
- (2) The following procedures relate to purchase transactions:
 - (i) When invoices are posted to the purchase ledger, the purchase analysis code (for the nominal ledger), the purchases value and the sales tax value are entered. The total invoice value is posted to the purchase ledger.
 - (ii) At the end of the month, the computer posts the following items to the nominal ledger:
 - The total of each category of invoice expense and sales tax for purchase invoices and credit notes posted in the month (at the same time the computer prints details of the individual invoices making up the total of each invoice expense and sales tax for the month).
 - The total of purchase ledger cash payments, discount received and adjustments posted to the purchase ledger in the month (the computer prints details of the individual items comprising the total cash discount and adjustments for the month).
 - Where there is no account in the nominal ledger relating to the items being posted, the computer posts the items to a payables suspense account. Also, all adjustments are posted to the suspense account.
- (3) Sales ledger data is posted to the nominal ledger in a similar way to purchase ledger data.
- (4) Journals are posted manually to the nominal ledger for:
 - (i) The opening balances at the start of the year
 - (ii) Other cash book items (other than sales and purchase ledger cash)
 - (iii) Petty cash payments
 - (iv) Wages analysis (details are obtained from the computerised payroll system)
 - (v) Adjustments, which include:
 - Correction of errors
 - Dealing with items in the sale and purchase ledger suspense accounts (adjustments posted to the ledger, and items where there is no account in the nominal ledger)

All these journals are written manually in an accounts journal book, and they must be authorised by the managing director before posting. The opening balances are posted to the nominal ledger when the previous year's accounts have been approved by the auditors. Although the employee wages are calculated using another computer package, the total wages expense is posted to the nominal ledger manually. The wages expense is calculated from the payroll's monthly summary, using a spreadsheet package, and the wages expense is analysed into directors, sales, warehouse and office wages (or salaries).

Required

- (a) List three control objectives of a sales system and three control objectives of a purchases system. **(6 marks)**
- (b) List and describe the audit work you would perform on the computerised nominal ledger system, and in particular:

- (i) The audit procedures you would perform to verify the accuracy of purchases transactions which are posted to the nominal ledger. **(5 marks)**
- (ii) The audit procedures you would perform to verify the validity and accuracy of journals posted to the nominal ledger. Also, you should briefly describe any other tests you would perform to verify the accuracy of the year-end balances on the nominal ledger. **(15 marks)**

Note. You should assume that sales transactions are accurately recorded and correctly posted to the nominal ledger.

(Total = 26 marks)

61 Cheque payments and petty cash (Preparation Question)

(18 mins)

Mr A Black has recently acquired the controlling interest in Quicksand Co, which is an importer of sportswear. In his review of the organisational structure of the company Mr Black became aware of weaknesses in the procedures for the signing of cheques and the operation of the petty cash system. Mr Black engages you as the company's auditor and requests that you review the controls over cheque payments and petty cash. He does not wish to be a cheque signatory himself because he feels that such a procedure is an inefficient use of his time. In addition to Mr Black, who is the managing director, the company employs 20 personnel including four other directors, and approximately 300 cheques are drawn each month. The petty cash account normally has a working balance of about \$300, and \$600 is expended from the fund each month. Mr Black has again indicated that he is unwilling to participate in any internal control procedures which would ensure the efficient operation of the petty cash fund.

Required

- (a) Prepare a letter to Mr Black containing your recommendations for good internal control procedures for:
 - (1) Cheque payments
 - (2) Petty cash**(8 marks)**
- (b) Discuss the audit implications, if any, of the unwillingness of Mr Black to participate in the cheque signing procedures and petty cash function. **(2 marks)**

(Total = 10 marks)

62 Using the work of others (Preparation Question)

(18 mins)

ISA 402 *Audit Considerations Relating to an Entity Using a Service Organisation* provides guidance to auditors whose clients use service organisations.

Required

- (a) In the context of an audit, explain what a service organisation is and explain what the auditor's responsibilities are in relation to gaining an understanding of a service organisation used by an audit client. **(4 marks)**
- (b) ISA 620 *Using the Work of an Auditor's Expert* provides guidance to auditors on relying on work carried out by an auditor's expert.

Required

List four examples of audit evidence that might be obtained from the use of an auditor's expert. **(2 marks)**

- (c) Describe the factors that should be considered by the auditor when evaluating the work carried out by the expert. **(2 marks)**
- (d) Explain the actions the auditor should take if they conclude that the results of the expert's work do not provide sufficient appropriate audit evidence or if the results are inconsistent with other audit evidence. **(2 marks)**

(Total = 10 marks)

63 Elsams

(36 mins)

You are the auditor of Elsams Co which operates a chain of retail shops throughout the country selling

a wide range of electrical goods. Each branch has computerised cash registers linked into the central computerised sales, receivables and inventory records. At the point of sale, the information keyed in includes the following: branch reference, product number, inventory location, unit selling price and date of sale.

The file of inventory records is updated daily for sales and receipts. It contains both cost (on a FIFO basis) and selling price information. The only regular printed output is sales summaries analysed by value, product and branch.

Required

- (a) Explain the ways in which you, as the auditor of Elsams Co, could use computer programs to assist in the verification of inventory at the year end, and explain their limitations. **(8 marks)**
- (b) Without particular reference to Elsams Co, describe the objectives and principles of using test data and comment on the areas where it can be of most use in an audit, and on the difficulties of this technique. **(5 marks)**
- (c) Describe the following different methods of sample selection:
 - (1) Random selection
 - (2) Systematic selection
 - (3) Haphazard selection
 - (4) Block selection

(7 marks)

(Total = 20 marks)

64 ZPM

(36 mins)

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 in order to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor.

Required

- (a) Explain the factors the external auditor will consider when:
 - (i) Determining whether the work of the internal audit function can be used for the audit
 - (ii) Determining the nature and extent of work of the internal audit function that can be used **(5 marks)**
- (b) ZPM is a listed limited liability company with a year end of 30 June. ZPM's main activity is selling home improvement or 'Do-It-Yourself' (DIY) products to the public. Products sold range from nails, paint and tools to doors and showers; some stores also sell garden tools and furniture. Products are purchased from approximately 200 different suppliers. ZPM has 103 stores in eight different countries.

ZPM has a well-staffed internal audit department, which reports on a regular basis to the audit committee. Areas where the internal and external auditors may carry out work include:

- (1) Attending the year-end inventory count in 30 stores annually. All stores are visited rotationally.
- (2) Checking the internal controls over the procurement systems (eg ensuring a liability is only recorded when the inventory has been received).

Required

For each of the above two areas, discuss:

- (i) The objectives of the internal auditor (4 marks)
 - (ii) The objectives of the external auditor (4 marks)
 - (iii) Whether the external auditor will rely on the internal auditor and, if reliance is required, the extent of that reliance (4 marks)
- (c) Although an internal audit function may undertake a number of assignments and provide useful information for the organisation, it does have limitations.

Required

Explain **three** limitations of the internal audit function.

(3 marks)

(Total = 20 marks)

65 Boston Manufacturing

(36 mins)

You are the audit assistant assigned to the audit of Boston Manufacturing. The audit senior has asked you to plan the audit of non-current assets. He has provisionally assessed materiality at \$72,000.

Boston Manufacturing maintains a register of non-current assets. The management accountant reconciles a sample of entries to physical assets and vice versa on a three-monthly basis. Authorisation is required for all capital purchases. Items valued at less than \$10,000 can be authorised by the production manager; items costing more than \$10,000 must be authorised by the Managing Director. The purchasing department will not place an order for capital goods unless it has been duly signed.

The company has invested in a large amount of new plant this year in connection with an eight-year project for a government department.

The management accountant has provided you with the following schedule of non-current assets:

	Land and buildings	Plant and equipment	Computers	Motor vehicles	Total
	\$	\$	\$	\$	\$
Cost					
At 31 March 20X6	500,000*	75,034	30,207	54,723	659,964
Additions		<u>250,729</u>	<u>1,154</u>		<u>251,883</u>
At 31 March 20X7	<u>500,000</u>	<u>325,763</u>	<u>31,361</u>	<u>54,723</u>	<u>911,847</u>
Accumulated depreciation					
At 31 March 20X6	128,000	45,354	21,893	25,937	221,184
Charge for the year	<u>8,000</u>	<u>28,340</u>	<u>2,367</u>	<u>13,081</u>	<u>51,788</u>
At 31 March 20X7	<u>136,000</u>	<u>73,694</u>	<u>24,260</u>	<u>39,018</u>	<u>272,972</u>

Carrying amount

At 31 March 20X7	<u>364,000</u>	<u>252,069</u>	<u>7,101</u>	<u>15,705</u>	<u>638,875</u>
At 31 March 20X6	<u>372,000</u>	<u>29,680</u>	<u>8,314</u>	<u>28,786</u>	<u>438,780</u>

*Of which \$100,000 relates to land.

Required

- (a) Without undertaking any calculations, assess the risk of the tangible non-current assets audit, drawing reasoned conclusions. **(6 marks)**
- (b) State the audit procedures you would undertake on non-current assets in respect of the following assertions:
- (i) Existence **(3 marks)**
 - (ii) Valuation (excluding depreciation) **(4 marks)**
 - (iii) Completeness **(3 marks)**
- (c) Describe how you would assess the appropriateness of the depreciation rates. **(4 marks)**
- (Total = 20 marks)**

66 Wandsworth Wholesalers

(36 mins)

Your firm is the auditor of Wandsworth Wholesalers Co, and you have been asked to carry out audit checks on cut-off and verifying inventory quantities at the year end.

The company maintains details of inventory quantities on its computer. These inventory quantities are updated from goods received notes and sales invoices. The company carries out inventory counts each month, when all the fast-moving and high value inventory is counted, and a third of the remaining inventory is counted in rotation so that all items are counted at least four times a year.

You attend the inventory count on Sunday 13 October, and a further inventory count was carried out on Sunday 10 November. The company's year end was Thursday 31 October 20X1, and the inventory quantities at that date, as shown by the computer, have been used in the valuation of the inventory. No inventory was counted at the year end.

List and describe:

Required

- (a) The principal matters you should have checked and the matters you should have recorded when you attended the company's inventory count on Sunday 13 October. **(8 marks)**
- (b) The tests you will perform in ensuring that sales and purchases cut-off has been correctly carried out:
- (i) At the date of inventory count on 13 October 20X1
 - (ii) At the year end **(4 marks)**
- (c) The work you will carry out to test whether the book inventory records have been correctly updated from the counts at the inventory count. **(4 marks)**
- (d) The work you will carry out to satisfy yourself that the inventory quantities used in the valuation of the inventory at the year end are correct. **(4 marks)**

Note. You should assume that the price per unit of inventory is correct.

(Total = 20 marks)

67 Snu

(54 mins)

Some organisations conduct inventory counts once a year and external auditors attend those counts. Other organisations have perpetual systems (continuous inventory counting) and do not conduct a year-end count.

Snu is a family-owned company which retails beds, mattresses and other bedroom furniture items. The company's year end is 31 December 20X3. The only full inventory count takes place at the year end. The company maintains up-to-date computerised inventory records.

Where the company delivers goods to customers, a deposit is taken from the customer and customers are invoiced for the balance after the delivery. Some goods that are in inventory at the year end have already been paid for in full – customers who collect goods themselves pay by cash or credit card.

Staff at the company's warehouse and shop will conduct the year-end count. The shop and warehouse are open seven days a week except for two important public holidays during the year, one of which is 1 January. The company is very busy in the week prior to the inventory count but the shops will close at 15.00 hours on 31 December and staff will work until 17.00 hours to prepare the inventory for counting. The company has a high turnover of staff. The following inventory counting instructions have been provided to staff at Snu.

- (1) The inventory count will take place on 1 January 20X4 commencing at 09.00 hours. No movement of inventory will take place on that day.
- (2) The count will be supervised by Mr Sneg, the inventory controller. All staff will be provided with pre-printed, pre-numbered inventory counting sheets that are produced by the computerised system. Mr Sneg will ensure that all sheets are issued, and that all are collected at the end of the count.
- (3) Counters will work on their own, because there are insufficient staff for them to work in pairs, but they will be supervised by Mr Sneg and Mrs Zapad, an experienced shop manager who will make checks on the work performed by counters. Staff will count inventory with which they are most familiar in order to ensure that the count is completed as quickly and efficiently as possible.
- (4) Any inventory that is known to be old, slow-moving or already sold will be highlighted on the sheets. Staff are required to highlight any inventory that appears to be soiled or damaged.
- (5) All inventory items counted will have a piece of paper attached to them that will show that they have been counted.
- (6) All inventory that has been delivered to customers but that has not yet been paid for in full will be added back to the inventory quantities by Mr Sneg.

Required

- (a) Explain why year-end inventory counting is important to the auditors of organisations that do not have perpetual inventory systems. (5 marks)
- (b) Describe audit procedures you would perform in order to rely on a perpetual inventory system in a large, dispersed organisation. (6 marks)
- (c) Briefly describe the principal risks associated with the financial statements' assertions relating to inventory. (4 marks)
- (d) Describe the deficiencies in Snu's inventory counting instructions and explain why these deficiencies are difficult to overcome. (15 marks)

(Total = 30 marks)

68 Sitting Pretty

(36 mins)

Sitting Pretty Co is a small, family-run company that makes plastic chairs in a variety of shapes and colours for children and 'fun at heart' adults. It buys in sheets of plastic which can be cut and bent into the correct shape and a plastic leg that is custom made by another company to Sitting

Pretty's requirements. All off-cut plastic is sent back to the supplier who melts it down and reuses it, for which Sitting Pretty receives a 10% discount off its purchase price.

For the inventory count, the factory manager ensures that no work in progress is outstanding and closes down production for the day. The factory workers come in early on the day of the inventory count to count the inventory, and they are entitled to go home as soon as inventory is counted. Good controls have always been maintained over the inventory count in previous years. There are no perpetual inventory records. Raw materials are all kept in the stores and are only taken out when they are required for production. Finished goods are kept at the end of the factory, near the delivery exit.

You are the audit assistant assigned to attend the inventory count. You have just rung the factory manager and he has mentioned that on the day of the inventory count a large consignment of plastic is going to be delivered. It is the only day that his supplier can make the delivery, and he needs the material to continue with production on the day after the count.

The audit engagement partner has told you that he is aware that Sitting Pretty changed the specification of their customised leg recently, after a series of complaints over the stability of their chairs. Last year's inventory was valued at \$200,000 in the statement of financial position, of which \$30,000 related to raw material inventory.

Finished goods are all carried at the same valuation as each other, as there is very little difference between the inventory ranges. Planning materiality for this year has been set at \$5,000 on the grounds, at this stage, that the figures are expected to be similar to last year.

Required

- (a) Explain the importance of the inventory count in this situation. **(3 marks)**
- (b) Prepare notes for your audit supervisor detailing the procedures you propose to undertake in relation to your inventory count attendance. **(7 marks)**
- (c) State the procedures which should be taken in relation to cut-off at the final audit. **(5 marks)**
- (d) Describe the audit procedures you would carry out on the valuation of inventory at the final audit. **(5 marks)**

(Total = 20 marks)

69 Bright Sparks

(36 mins)

Bright Sparks, a limited liability company, distributes domestic electrical equipment from one warehouse. Customers are mainly installers of such equipment, but there is a 'cash and carry' counter in the warehouse for retail customers. The warehousemen are responsible for raising invoices and credit notes relating to credit sales, as well as handling cash sales.

You have carried out your interim audit in respect of the year ending 31 December 20X0 which included a circularisation of 80 trade accounts receivable as at 30 September 20X0 selected from a total credit customer list of 1,000. Replies were received from all customers circularised. The interim audit work disclosed the following:

- (1) Of the 80 customers' accounts circularised, 8 disagreed but could be reconciled by bringing into account payments stated by the customers concerned to have been made before 30 September 20X0 but which in each case were recorded in Bright Sparks's books between 14 and 18 days after the dates stated by the customers as the date of payment.
- (2) Your tests suggested that some 25% of credit customers were allowed settlement discounts of 2.5% although payments were consistently received after the latest date eligible for discount.
- (3) A large number of credit notes were raised representing approximately 12% of the total number of invoices raised. A review of the copy credit notes indicated that they usually arose from arithmetical and pricing errors on invoices raised.

Required

Explain the conclusions you would draw as a result of the interim audit and, based on those conclusions, describe the work you would plan to carry out at the final audit on trade receivables at 31 December 20X0. (20 marks)

70 Audit of cash and bank (Preparation Question) (18 mins)

- (a) State the characteristics of a bank confirmation letter. (2 marks)
- (b) List six examples of items requested in the bank confirmation letter. (6 marks)
- (c) Explain the purpose and importance of the bank reconciliation. (2 marks)

(Total = 10 marks)

71 Understatement (54 mins)

Research into the distribution of errors in accounts has shown that for most items on the statement of financial position the errors are normally distributed. However, with payables the distribution is skewed, and there is a greater risk that payables will be understated than overstated. Understatement of payables will lead to overstatement of profit, so auditors must design their tests to ensure that payables are not understated.

You have been asked by the manager in charge of the audit of Heanor Wholesale Co to verify trade payables and accruals at the company's year end of 30 April 20X2. The company maintains its purchase ledger on a microcomputer, using a standard purchase ledger accounting package. Purchase invoices are posted to the purchase ledger after they have been checked to the delivery note and the purchase order and have been authorised by either the financial director or the managing director.

The purchase ledger can show for each purchase ledger account:

- (1) The unpaid invoices and credit notes
- (2) An ageing of the balance into current month, one month, two months and three or more months
- (3) The total balance on the account

Also, the system is able to provide the total of the balances of all the accounts on the purchase ledger.

Your audit of the purchases system has revealed that the system for recording receipt of goods is relatively weak. The company does not use goods received notes, but the supplier's delivery note should be dated by the goods received department when the goods are received. Your audit tests have revealed that some delivery notes are not dated by the goods received department. The delivery note is filed with the purchase invoice in alphabetical order (by supplier).

A full inventory count was carried out at the company's year end and you are satisfied that it was counted accurately.

In the company's draft financial statements the value of trade payables and accruals at 30 April 20X2 are as follows:

	\$
Trade payables	509,200
Purchase accruals	<u>27,050</u>
	536,250
Sundry payables and accruals	<u>59,480</u>
Current liabilities	<u><u>595,730</u></u>

Heanor's annual revenue figure is about \$3.5m and its profit before tax is \$190,000. The age of payables at 30 April 20X2 is 3.4 months, which is similar to the previous year. Sundry payables and accruals comprise mainly wages accruals (including income tax and other deductions) and a sales tax liability of \$20,000.

Required

- (a) Consider and discuss the reasons why: **(6 marks)**
- (i) It is more likely that payables will be understated than overstated. **(marks)**
 - (ii) It is difficult for auditors to ensure that payables are not understated. **(6 marks)**
- (b) Describe the audit work you will perform to verify trade payables and purchase accruals. Your answer should include consideration of:
- (i) Tests using suppliers' statements
 - (ii) Why most auditors do not carry out a payables circularisation, and the circumstances when a payables circularisation should be carried out
 - (iii) Audit tests which are designed to detect understatement of payables **(14 marks)**
- (c) Describe the audit procedures you will perform to verify sundry payables and accruals, including the sales tax liability. **(10 marks)**

(Total = 36 marks)

72 'Tap!'

(36 mins)

You are an audit assistant in the firm Rogers and Smith. You have been asked to plan the audit of 'Tap!' for the year ended 30 June 20X4. It is the first time your audit firm has audited the charity, which has not been audited previously. The trustees have expressed interest in receiving a 'value added' audit and are particularly interested in business advice, especially in the area of systems controls.

'Tap!' is a registered charity that raises money for projects building wells in Africa through musical entertainment. The group consists of volunteers who travel around the country, putting on variety shows of music and dance, the proceeds of which are put towards building the wells. The main show is a tap dance production, acting out the difficulties many people face when they are not near a clean water supply.

The administrative offices of 'Tap!' are located in a large provincial town. It owns a house, donated by legacy in the past, where the administration is carried out and where the volunteers stay during off periods.

A large proportion of 'Tap!'s income comes from box office receipts which are taken by the theatre at which they are performing. The theatres usually waive their standard terms for use of the premises and merely take a 10% commission on ticket receipts to cover light and heat and other such expenses. Income usually comes in after every booking in the form of a lump sum cheque from the theatre, together with a breakdown of takings and commission.

'Tap!' also receives donations towards the work. These come from a variety of sources:

- Cash donations from buckets passed around at the interval of each performance
- Cash donations on the (rare) occasion that the team does street performances
- Cash donations made over the phone or by post by interested donors

The troupe consists largely of volunteers so they are only paid expenses for their work. The cost of housing the group while they are on the road is borne by the charity. The charity employs an administrator who organises bookings, handles publicity and co-ordinates all the finances.

Required

- (a) Discuss the risks arising for the audit of the year ending 30 June 20X4. **(8 marks)**

(b) State the audit procedures you would undertake in respect of cash income in the financial statements. **(6 marks)**

(c) List some controls over cash which the charity should implement. **(6 marks)**

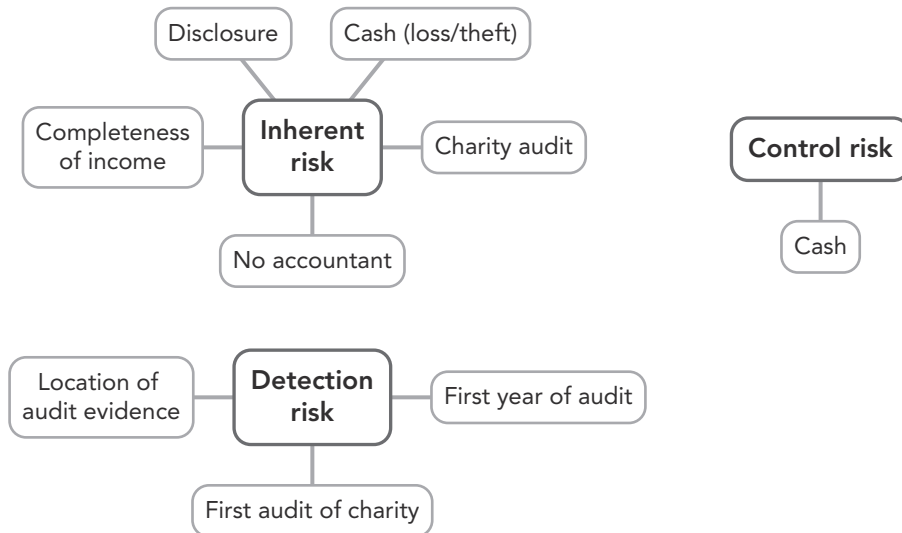
(Total = 20 marks)

Approaching the answer - 'Tap!'

You should read through the requirement before working through and annotating the question as we have so that you are aware of what things you are looking for.

Answer plan

(a) Audit risk



(b) Audit procedures

- Income from box office
- Income from buckets
- Income from other donations

(c) Controls

- Schedule of seats
- Two people to collect
- Pre-numbered forms

Security of cash during collection and between banking?

Other income

Use pre-numbered forms

Periodic reviews of work by trustees

73 Namul (Preparation Question)

(27 mins)

Namul Co is a retailer of mid- to low-range children's clothing. It operates in many countries around the world and has expanded steadily from its base in Asia. Its main market is aimed at 4- to 14-year-olds. The company's year-end was 31 March 20X0.

In the past, the company has bulk ordered its stock of children's clothing twice a year. However, if their goods failed to meet the key fashion trends then this resulted in significant inventory write-downs. As a result of this, the company has recently introduced a Just-in-Time ordering system. The fashion buyers make an assessment nine months in advance as to what the key trends are likely to be; these goods are sourced from their suppliers but only limited numbers are initially ordered.

Ordering process

Each country has a purchasing manager who decides on the initial inventory levels for each store. This is not done in conjunction with store or sales managers. These quantities are communicated to the central buying department at the head office in Asia. An ordering clerk amalgamates all country orders by specified regions of countries, such as South East Asia, Central Europe and North America, and passes them to the purchasing director to review and authorise.

As the goods are sold, it is the store manager's responsibility to reorder the goods through the purchasing manager; they are prompted weekly to review inventory levels as, although the goods are just in time, it can still take up to four weeks for goods to be received in store.

It is not possible to order goods from other branches of stores, as all ordering must be undertaken through the purchasing manager. If a customer requests an item of clothing which is unavailable in a particular store, then the customer is provided with other branch telephone numbers or recommended to try the company website.

Goods received and invoicing

To speed up the ordering to receipt of goods cycle, the goods are delivered directly from the suppliers to the individual stores. On receipt of goods the quantities received are checked by a sales assistant against the supplier's delivery note, and then the assistant produces a goods received note (GRN). This is done at quiet times of the day so as to maximise sales. The checked GRNs are sent to head office for matching with purchase invoices.

As purchase invoices are received they are manually matched to GRNs from the stores. This can be a very time-consuming process, as some suppliers may have delivered to over 500 stores. Once the invoice has been agreed then it is sent to the purchasing director for authorisation. It is at this stage that the invoice is entered onto the purchase ledger.

Required

As the external auditors of Namul Co:

- (1) Identify and explain FIVE deficiencies in the company's purchasing system.
- (2) Explain the possible implication of each deficiency.
- (3) Provide a recommendation to address each deficiency.

(15 marks)

74 Ajio

(36 mins)

Ajio is a charity whose constitution requires that it raises funds for educational projects. These projects seek to educate children and support teachers in certain countries. Charities in the country from which Ajio operates have recently become subject to new audit and accounting regulations. Charity income consists of cash collections at fundraising events, telephone appeals and bequests (money left to the charity by deceased persons). The charity is small and the trustees do not consider the charity able to afford to employ a qualified accountant. The charity employs a part-time bookkeeper and relies on volunteers for fundraising. Your firm has been appointed as accountants and auditors to this charity because of the new regulations. Accounts have been prepared (but not audited) in the past by a volunteer who is a recently retired Chartered Certified Accountant.

Required

- (a) Describe the risks associated with the audit of Ajio under the headings inherent risk, control risk and detection risk and explain the implications of these risks for overall audit risk.

(10 marks)

- (b) Identify and explain the audit tests to be performed on income and expenditure from fundraising events.

(10 marks)

Note. In part (a) you may deal with inherent risk and control risk together. You are not required to deal with the detail of accounting for charities in either part of the question.

(Total = 20 marks)

75 Going concern

(36 mins)

Carrington Joinery, a private company, owned by its directors, manufactures wooden window frames, doors and staircases for domestic houses. It has prepared draft accounts for the year ended 30 September 20X6 and you are concerned that they indicate serious going concern

problems. The statements of profit or loss and statements of financial position for the last five years (each ended 30 September) are given below.

STATEMENT OF PROFIT OR LOSS

	20X2	20X3	20X4	20X5	20X6
	\$'000	\$'000	\$'000	\$'000	\$'000
Sales	625	787	1,121	1,661	1,881
Cost of sales	<u>(478)</u>	<u>(701)</u>	<u>(962)</u>	<u>(1,326)</u>	<u>(1,510)</u>
Gross profit	147	86	159	335	371
Other expenses	(88)	(86)	(161)	(240)	(288)
Interest	<u>(6)</u>	<u>(9)</u>	<u>(58)</u>	<u>(90)</u>	<u>(117)</u>
Net profit/(loss)	<u>53</u>	<u>(9)</u>	<u>(60)</u>	<u>5</u>	<u>(34)</u>

STATEMENT OF FINANCIAL POSITION

	20X2	20X3	20X4	20X5	20X6
	\$'000	\$'000	\$'000	\$'000	\$'000
Assets					
Current assets					
Inventory	67	133	181	307	449
Trade accounts receivable	<u>91</u>	<u>240</u>	<u>303</u>	<u>313</u>	<u>364</u>
	158	373	484	620	813
Net current assets	<u>89</u>	<u>161</u>	<u>544</u>	<u>600</u>	<u>587</u>
Total assets	<u>247</u>	<u>534</u>	<u>1,028</u>	<u>1,220</u>	<u>1,400</u>
Liabilities and shareholders' funds					
Current liabilities					
Trade accounts payable	90	317	355	490	641
Bank overdraft	10	65	211	269	365
Lease creditor	<u>14</u>	<u>28</u>	<u>98</u>	<u>92</u>	<u>59</u>
	114	410	664	851	1,065
Non-current loan			<u>300</u>	<u>300</u>	<u>300</u>
	<u>114</u>	<u>410</u>	<u>964</u>	<u>1,151</u>	<u>1,365</u>
Shareholders' funds					
Share capital	17	17	17	17	17
Reserves	<u>116</u>	<u>107</u>	<u>47</u>	<u>52</u>	<u>18</u>
	<u>133</u>	<u>124</u>	<u>64</u>	<u>69</u>	<u>35</u>
Total liabilities and shareholders' funds	<u>247</u>	<u>534</u>	<u>1,028</u>	<u>1,220</u>	<u>1,400</u>

The company has been in business for about fifteen years. In January 20X3 it decided to build a new factory on a site leased from the local authority which would allow a major increase in sales.

This new factory with new equipment was completed a year later. The factory was financed by a non-current loan of \$300,000 from a merchant bank and an increase in the bank overdraft.

The loan from the merchant bank is secured by a fixed charge on the leasehold factory and the bank overdraft is secured by a second charge on the leasehold factory, a fixed charge on the other non-current assets and a floating charge on the current assets.

The company purchases its main raw material, wood, from timber wholesalers. It sells around 75% of its production to about 12 local and national builders of new domestic houses. The remaining sales are mainly to smaller builders with very few sales to local builders merchants.

Required

- (a) In relation to the financial statements above, list and briefly describe the factors which indicate that the company may not be a going concern. You should also highlight certain figures and calculate relevant ratios in the accounts.

You will only be given credit for going concern problems which can be determined from the accounts above. **(13 marks)**

- (b) Describe the investigations and tests you would carry out, in addition to those described in part (a) above, to determine whether the company is a going concern. **(7 marks)**

(Total = 20 marks)

76 Audit review and finalisation (Preparation Question) **(18 mins)**

- (a) ISA 560 Subsequent Events provides guidance on the responsibilities of auditors regarding subsequent events. Briefly explain the responsibilities of auditors for facts discovered up to the date of the auditor's report, facts discovered after the date of the auditor's report but before the accounts are issued and for facts discovered after the financial statements have been issued. **(4 marks)**
- (b) ISA 580 Written Representations explains the purpose and use of written representations as audit evidence. State six items that could be included in a written representation **(3 marks)**
- (c) Briefly discuss the use of analytical procedures at the review stage of the audit. **(3 marks)**

(Total = 10 marks)

77 Wiseguys National Bakeries (Preparation Question) **(18 mins)**

Your firm acts as auditor of Wiseguys National Bakeries Co. The finance director has prepared financial statements of the company for the year to 31 December 20X9 which show a pre-tax profit of \$450,000. You have been advised that the board of directors has approved the financial statements and decided that no amendments should be made thereto.

As partner responsible for the audit you have noted the following matters during your review of the financial statements and the audit working papers:

- (1) The freehold property which was included at cost in previous years' statement of financial position has now been restated at a professional valuation of \$1,250,000 carried out during the year. You are satisfied with the valuation and that the relevant figures have been correctly adjusted and the necessary information disclosed in the notes to the financial statements.
- (2) An amount of \$45,000 due from a customer in respect of sales during the year is included in receivables but, from information made available to you, you conclude that no part of this debt will be recovered. No allowance has been made against this amount.
- (3) The financial statements do not disclose the existence of a loan of \$36,000 made by the company to a director, which remains outstanding from 1 February 20X9.

Required

Explain how each of the above will impact on the auditor's report.

(10 marks)

78 Homes'r'Us

(36 mins)

Homes'r'Us is a large listed construction company based in the north of the country, whose activities encompass house building and development. Its annual revenue is \$550m and profit before tax is \$70m.

You are the audit senior involved with the audit of Homes'r'Us for the year ended 31 December 20X7. The following matters have come to your attention during the review stage of the audit in April 20X8:

- (1) Customer going into liquidation

One of Homes'r'Us's major commercial customers has gone into liquidation shortly after the year end. As at the year end, the customer owed the company \$7.5m.

(7 marks)

- (2) Claim for unfair dismissal

One of the company's construction workers, Basil Evans, was dismissed in November 20X7 after turning up to work under the influence of alcohol. In December 20X7, Mr Evans began a case against the company for unfair dismissal. Lawyers for the company have advised that it will be highly unlikely that he will be successful in his claim.

(7 marks)

- (3) In March 20X8 a fire was started by vandals at one of the company's ten storage depots, destroying \$1m worth of building materials.

(6 marks)

Required

For each of the three events at Homes'r'Us mentioned above:

- (a) Describe the additional audit procedures you will carry out.
- (b) State whether the financial statements will need to be amended and explain your reasoning.
- (c) Discuss the potential impact on the auditor's report, fully explaining your answers.

Note. The mark allocation is shown against each of the three events

79 Builders Merchants

(36 mins)

You are the auditor of Builders Merchants, a listed company which distributes materials to the construction industry from eight depots in the south of the country, and you are currently finalising the audit for the year ended 31 March 20X1. Your audit procedures have proved satisfactory with the exception of the following four matters.

- (1) The physical inventory count sheets for one of the depots were lost before they were made available to you, and you have not been able to confirm the inventory quantities and values for this depot by alternative methods. The directors have valued this part of the inventory at \$75,000 and this figure is included in the overall inventory valuation of \$640,000.
- (2) Included in trade receivables, which total \$580,000, is a debt amounting to \$45,000 from a customer which went into liquidation on 15 June 20X1. You have ascertained from the liquidator that your client is unlikely to receive a distribution. The statement of comprehensive income for the year shows a pre-tax profit of \$100,000 but the directors are not prepared to provide for this debt.
- (3) The financial statements of Builders Merchants do not contain a statement of cash flows.
- (4) A substantial claim has been lodged against the company by a major customer. The matter is fully explained in the notes to the financial statements, but no provision has been made for

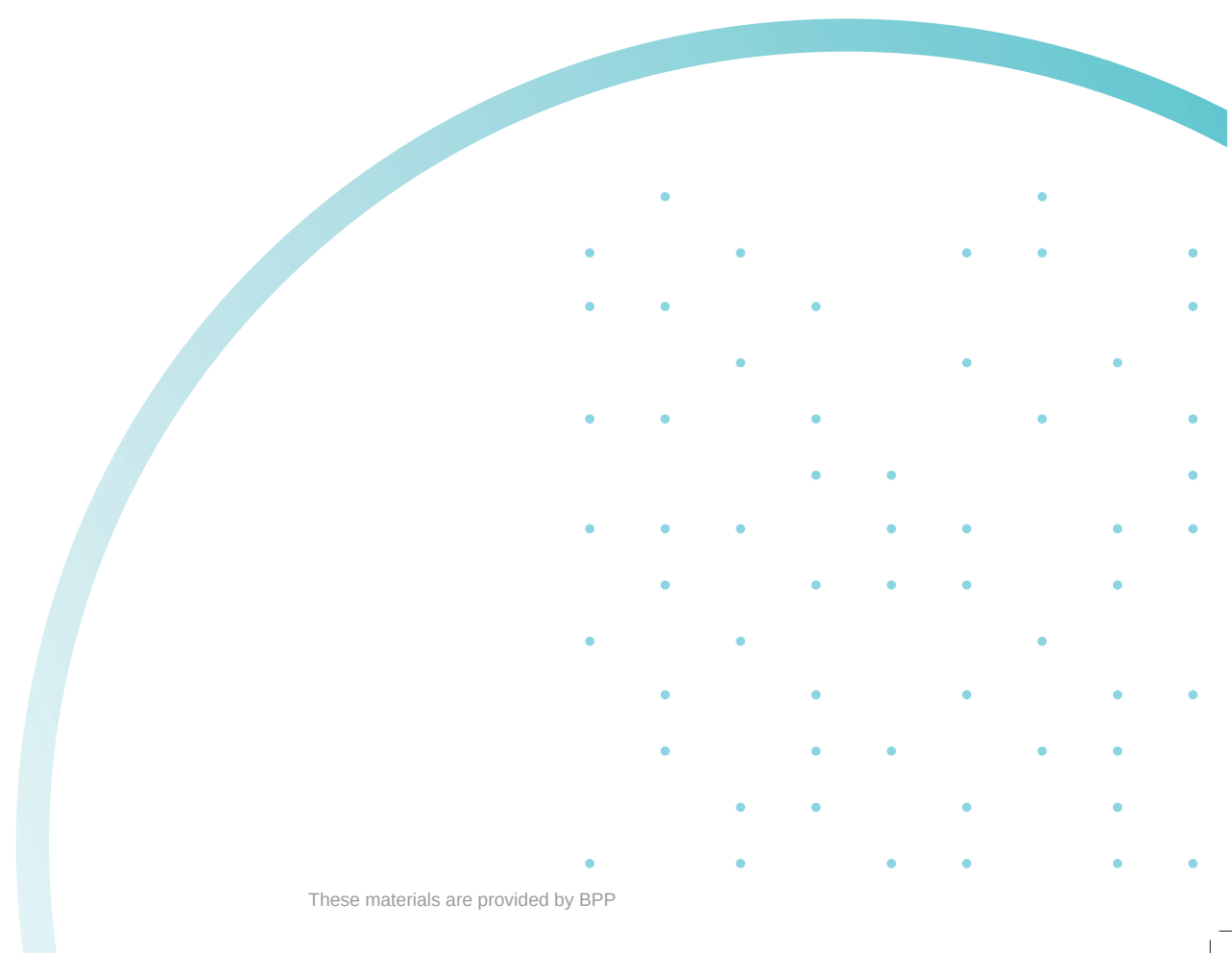
legal costs or compensation payable, as it is not possible to determine with reasonable accuracy the amounts, if any, which may become payable. The directors have received legal advice which appears to be reliable in indicating that the claim can be successfully defended.

Required

Explain the individual and cumulative impact of the above issues on the auditor's report.
(20 marks)



Further question solutions



Section A

1 ABC Co

(a) The correct answer is: (a), (b), (c) and (d)

(b) The correct answers are:

- Assessing and monitoring internal control procedures
- Evaluating the overall risk management policies of the company

Internal auditors must retain objectivity towards the systems which it monitors. This would be impaired if it managed the accounting and finance department or implemented changes to systems.

(c) The correct answers are:

- The role of the external auditor is set down in law whilst the role of the internal auditor will depend on the requirements of the company.
- The internal auditor can be an employee of the company whilst the external auditor must be independent.

The external auditor's report is addressed to the shareholders, not the board of directors. Internal auditors' reports would normally be addressed to the board or the audit committee.

(d)

	Advantage of outsourcing	Advantage of in-house
Provides flexibility with regards to level of staffing and resources	TRUE	-
Develops expertise of ABC Co staff	-	FALSE
Results in lower staff training costs	TRUE	-
Provides access to specialist skills	TRUE	-

(e) The correct answer is: The audit committee

It would be acceptable for the internal auditors to report to the board but greater independence is achieved by reporting to the audit committee. The effectiveness of the internal audit function would be reduced if it reported to the finance director as the finance director is likely to be responsible for many of the systems being monitored by the internal audit department. It would not be appropriate for the internal audit department to report to the external auditors as internal auditors are employed by the company for its own purposes.

2 Balotelli Beach Hotel Co

(a) The correct answer is: Depreciation should be \$10,660, assets are understated

Depreciation should be calculated as:

Treadmills/exercise bikes = $(18,000 + 17,000)/36 \times 8$ months =	7,778
Rowing machines/cross trainers = $(9,750 + 11,000)/36 \times 5$ months =	2,882
Total	<u>10,660</u>

Therefore, the correct answer is \$10,660 and assets are currently understated as too much depreciation has currently been charged.

The second option is based on depreciation being applied for a full year instead of for the relevant months.

The third option is based on depreciation not being charged in the month of acquisition (ie seven and four months).

The fourth option is based on depreciation for the exercise bikes being divided by the three years instead of allocated on a monthly basis.

(b) The correct answers are:

- Agree a sample of additions included in the non-current asset register to purchase invoice and cash book
- Recalculate the depreciation charge for a sample of assets ensuring that it is being applied consistently and in accordance with IAS 16 Property, Plant and Equipment
- Review physical condition of non-current assets for any signs of damage
- Ensure disposals are correctly accounted for and recalculate gain/loss on disposal

Reviewing board minutes for evidence of disposals is a test for existence and reviewing the repairs and maintenance account is a test for completeness. All other tests are relevant for valuation.

(c) The correct answer is: Send an enquiry letter to the lawyers of Balotelli to obtain their view as to the probability of the claim being successful

While all procedures would be valid in the circumstances, only the written confirmation from the company's lawyers would allow the auditor to obtain an expert, third party confirmation on the likelihood of the case being successful. This would provide the auditor with the most reliable evidence in the circumstances.

(d) The correct answers are:

- It provides evidence from an independent external source
- It improves the reliability of audit evidence as the process is under the control of the auditor

The evidence obtained from the trade receivables circularisation should be reliable as it is from an external source and the risk of management bias and influence is restricted due to the process being under the control of the auditor.

Customers are not obliged to answer and often circularisations have a very low response rate. A circularisation will not provide evidence over the valuation assertion for receivables and therefore the second and third options are drawbacks of a circularisation.

(e)

Customer	Audit procedure
Willow Co	No further audit procedures required
Cedar Co	Agree to pre year end invoice
Maple Co	Agree to post-year end cash book and bank statement
Laurel Co	Discuss with management and consider whether amount should be included in allowance for receivables

Willow Co – The external confirmation has confirmed the balance and no further work is required.

Cedar Co – The difference represents an invoice in transit and therefore should be confirmed to a pre year end invoice to verify that it is a legitimate timing difference.

Maple Co – The difference represents a payment in transit and should be agreed to post year end payment to confirm that it is a legitimate timing difference.

Laurel Co – The customer is disputing the balance and therefore the need for an allowance against the balance should be assessed.

3 X Co

- (a) The correct answer is: 15 March 20X7

In accordance with ISA 580 (para. 14) written representations must be dated as near as is practicable, but not after, the date of the auditor's report.

The third and fourth options are after the date of the auditor's report therefore would not be relevant audit evidence in forming the audit opinion.

The first option is possible as it is before 15 March but does not answer the question which is asking for the latest date on which they can be signed.

- (b) The correct answer is: (a) only

ISA 560 (para. 6) requires auditors to obtain sufficient appropriate evidence of events occurring between the date of the financial statements (31 December 20X6) and the date of the auditor's report (15 March 20X7).

Event 2 takes place after 15 March 20X7 and so the auditor does not therefore have a responsibility in respect of this.

- (c) The correct answer is: All misstatements other than those which are clearly trivial must be communicated to the appropriate level of management.

All misstatements accumulated during the audit must be communicated to the appropriate level of management (ISA 450: para. 8). Accumulated misstatements are all misstatements except those which are clearly trivial.

The fourth option is incorrect as it only refers to material uncorrected misstatements being communicated.

Uncorrected misstatements only are communicated to those charged with governance (ISA 450: para. 12) therefore, the first and second options are incorrect.

- (d) The correct answer is: The Other Information section will state that the auditors have concluded that a misstatement of the other information exists

ISA 720 (para. 21) requires the inclusion of an Other Information section in the auditor's report.

The first and fourth options are incorrect as the matter is addressed in the auditor's report but not in an Emphasis of Matter paragraph.

Option three is incorrect as the audit opinion is on the financial statements, not the other information.

- (e) The correct answer is: Unmodified - Material Uncertainty Related to Going Concern

Unmodified audit opinion, Material Uncertainty Related to Going Concern section disclosure

The audit opinion is not modified as the auditor agrees with the treatment of the claim and the disclosure is adequate. There is a material uncertainty re going concern and in accordance with ISA 570 (para. 22) this is addressed in the Material Uncertainty Related to Going Concern section of the auditor's report.

The first and third options are incorrect as the audit opinion would not be modified as the financial statements are not misstated and sufficient audit evidence has been obtained.

The fourth option is incorrect as an Emphasis of Matter paragraph is not used to disclose a material uncertainty related to going concern.

Multiple choice questions

The remaining questions in this section of the Practice Question Bank are not in the current exam format, but are intended as useful practice for the material in the chapters. The Practice & Revision Kit provides a large number of exam format questions.

- 4 The correct answer is: External audits give reasonable assurance that the financial statements are free from material misstatement.

Statutory audits give reasonable assurance. It is not possible to give absolute assurance, given the inherent limitations of audit. Limited assurance is given in review engagements, where the audit opinion is expressed in a negative form.

- 5 The correct answer is: (a) and (b)

Both statements are true. The directors are stewards of the shareholders' investment and the auditors act as an agent for the shareholders because they assess whether or not the financial statements prepared by the directors are free from material misstatement.

- 6 The correct answer is: IAASB

The ISAs are issued by the International Auditing and Assurance Standards Board (IAASB), a technical standing committee of the IFAC. The International Accounting Education Standards Board (IAESB), also part of the IFAC, publishes the International Education Standards aiming to increase the competence of the global accountancy profession. The International Accounting Standards Board (IASB) issues the International Financial Reporting Standards. The Financial Reporting Council (FRC) issues ISAs (UK), not the international standards.

- 7 The correct answers are:

- The ISAs aim to ensure that audits performed on different companies, in different jurisdictions, adhere to common standards.
- The ISAs apply to the audit of smaller entities.

All of the ISAs must be complied with in an audit of historical financial information. A 'comply or explain' approach is not possible here. The ISAs also apply to smaller entities, although specific guidance is given on how certain requirements may be met in this case. There is no legal requirement to comply with ISAs, rather this is a professional requirement.

- 8 The correct answer is: Both the directors and the audit committee

Best practice indicates that the internal audit function should have a dual reporting relationship, reporting both to management and the audit committee. If the internal audit function does not report to the audit committee, management may be able to unduly influence the internal audit plan and scope, thus compromising the effectiveness of internal audit. The external auditors, not the internal auditors, report to the shareholders.

- 9 The correct answer is: (a) and (b)

Risk management is a key feature of effective corporate governance. Similarly, whilst not obligatory, the existence of an internal audit function improves corporate governance as it enhances internal control.

- 10 The correct answers are:

- The audit manager of DEF Co owns a small number of shares in DEF Co
- The husband of the audit partner owns shares in DEF Co

The ACCA Code of Ethics and Conduct (s. 510.2) does not allow the following to have a direct or indirect material financial interest in a client: the audit firm, a member of the audit team and an immediate family member of a member of the audit team.

- 11 The correct answer is: Provision of bookkeeping services

Valuation for an immaterial matter can be undertaken for a public interest entity provided safeguards exist, such as second partner review and the use of separate personnel for the valuation and the audit. Assistance can be given in tax disputes provided the firm is not acting as an advocate of the client and the effect of the matter is material to the financial statements. Internal audit services can be provided except where this would result in the audit firm's personnel assuming management responsibility.

- 12 The correct answer is: Value for money audit

Economy, efficiency and effectiveness are sometimes referred to as the '3E's' of VFM audits.

- 13 The correct answer is: Inherent risk and control risk

The risk of material misstatement at the assertion level is made up of inherent risk and control risk. Detection risk is the risk that the auditor's procedures will not detect a misstatement that exists in an assertion that could be material. Audit risk is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is made up of inherent risk, control risk and detection risk ($AR = IR \times CR \times DR$)

- 14 The correct answer is: (b) only

The audit engagement partner is not required to review all audit documentation. However, ISA 220 (para. 17) requires reviews to be performed to ensure that any significant issues are addressed on a timely basis and sufficient and appropriate audit evidence is obtained to support the audit opinion. All audit work should be directed, supervised and reviewed by a more senior member of the audit team in order to identify any errors, inconsistencies and areas where further audit work is required.

- 15 The correct answer is: (a), (b) and (c)

Performance materiality may be set for particular classes of transactions, account balances or disclosures. Directors' remuneration is an account where law and regulation affect users' expectations regarding disclosure. A lower level of performance materiality therefore should be applied. Exploration and development costs are material due to the industry in which the company operates, and therefore merits a lower performance materiality level.

ISA 320 (para. 11) requires performance materiality to be set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. All uncorrected misstatements should be cumulated and communicated to management, unless they are clearly trivial.

- 16 The correct answer is: The applicable financial reporting framework

The applicable financial reporting framework would be expected to be covered in an overall audit strategy document. The nature, timing and extent of audit procedures at the assertion level should be included in the more detailed audit plan, as should the timetable for audit work and the level of performance materiality.

- 17 The correct answer is: (a) and (b)

Both statements are true. Existence asserts that asset, liabilities and equity interests exist and cut-off asserts that transactions and events have been recorded in the correct accounting period.

- 18 The correct answer is: (a) and (c)

The auditor cannot affect control risk or inherent risk. The auditor can reduce audit risk by manipulating detection risk. Increasing sample sizes and assigning more experienced staff to the audit will both reduce detection risk and therefore audit risk.

- 19 The correct answer is: Products or services and markets of the client's business

The matters mentioned in the fourth option relate specifically to business operations. The matters mentioned in the other options relate specifically to financial reporting, investments and financing respectively.

- 20 The correct answer is: 7 years

ACCA recommends a minimum retention period of seven years (ACCA, 2016).

- 21 The correct answer is: ICEQ

ICEQs would be best suited to help auditors identify the direct controls for controls testing. ICQs focus on whether the desirable controls are present, and so would not identify the areas at risk of specific errors or frauds. Narrative notes describe and explain the system, but their detailed nature makes it difficult to identify control exceptions at a glance. Flowcharts also describe the system but do not highlight exceptions.

- 22 The correct answers are:

- Batch reconciliations
- Document counts

Records of program changes and virus checks are general IT controls.

- 23 The correct answer is: Credit limits are checked before sales orders are accepted.

This means that customers are not able to exceed their credit limits and are therefore more likely to be able to pay. The first option helps to ensure that goods are sold at the right price. The third and fourth options are effective controls regarding the recovery of debts but do not prevent sales being made to customers who are unlikely to pay as the sale has already been made by this stage.

- 24 The correct answer is: Sales and trade receivables may be understated.

The matching of dispatch notes to an invoice ensures that for all goods dispatched an invoice has been raised. If this is not the case sales and trade receivables may be understated. For option 2 an appropriate control would be to match dispatch notes to invoices. Matching dispatch notes and invoices would not prevent orders being dispatched incorrectly (option 1) or prevent invoices being input incorrectly (option 4).

- 25 The correct answers are:

- There is a risk of fraud
- The deficiency interacts with other deficiencies identified

This is in accordance with guidance given in ISA 265 (para. A6).

If the likelihood of material misstatement and the number of transactions affected by the deficiency is low, the deficiency is unlikely to be judged to be significant.

- 26 The correct answer is: It ensures that sales and receivables are valid and accurate.

The control helps to ensure sales are valid as sales are only recognised for goods which have been dispatched.

- 27 The correct answer is: For a sample of sales invoices, verify that there are matching goods despatched notes.

The direction of the test is important here. The sample is taken from sales invoices, as this tests whether each sales order has been fulfilled (the assertion of occurrence). If the sample is taken from goods despatched notes, this would instead confirm whether the goods sold had been correctly invoiced (the assertion of completeness). The third and fourth options both test for completeness.

28 The correct answers are:

- For a sample of sales invoices around the period end, inspect the dates and compare with the dates of goods despatch and the dates recorded in the sales and receivables ledger to confirm the application of correct cut-off.
- For a sample of sales transactions recorded in the ledger, vouch the sales invoice back to customer orders and shipping documentation.

The risk here is the overstatement of sales revenue. The first option is an audit procedure which tests for cut-off, where potential errors may cause revenue to be overstated. The third option is a test of occurrence, also focusing on the overstatement of revenue. The second option tests for completeness, so therefore identifies the understatement of revenue instead. The fourth option relates to classification – this assertion has no impact on the overall revenue balance.

29 The correct answer is: 139 days

$$(160/420) \times 365$$

30 The correct answer is: (a) and (b)

The first sentence provides the definition of audit sampling as set out in ISA 530 Audit Sampling (para. 5).

The second sentence is also true, the situation may arise where a population consists of a small number of high value items and the level of audit risk is deemed to be high. In this case the auditor may well test all items within the population to reduce audit risk to an acceptable level.

31 The correct answer is: Evaluation of the adequacy of the allowance for receivables

Computer-assisted audit techniques cannot replace the skill of judgement used by the auditor.

32 The correct answer is: The external auditor must not use the work of the internal audit function.

In accordance with ISA 610 Using the Work of Internal Auditors the external auditor is prohibited from using the work of internal audit in this situation as the risks to the quality of the evidence provided are too great.

33 The correct answer is: Inspection of vehicle registration documents

The vehicle registration document records the details of the legal registered owner of the vehicle.

34 The correct answer is: Inventory is understated and liabilities are understated.

As the goods have been received, the goods must be recognised as an asset and the liability for the goods must be recognised at the period end. As a purchase invoice has not been received and the invoice amount has not been accrued for, liabilities are understated. This implies that the corresponding asset (inventory) is also understated.

35 The correct answer is: (a) and (b)

Both statements are true. However, if the auditor does become aware of a fact that, had it been known 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 determine whether the financial statements need amendment.

- 36 The correct answer is: Request that management extends the assessment period to 31 December 20X5

Where the period used by management to determine whether the entity is a going concern is less than 12 months from the period end, the auditor should request that management extends the assessment period to at least 12 months from the period end (ISA 570: para. 13).

- 37 The correct answer is: Neither (a) nor (b)

In accordance with ISA 580 Written Representations (para. 4), written representations support other evidence relevant to financial statements, ie they are not sufficient appropriate evidence on their own. Written representations should be prepared on the entity's letterhead as they are a formal communication from the entity's management to the auditor.

- 38 The correct answer is: The auditor must accumulate misstatements identified during the audit, other than those that are clearly trivial.

This is in accordance with ISA 450 Evaluation of Misstatements (para. 5) identified during the audit.

- 39 The correct answer is: Deficiencies of internal controls

The basic elements of the auditor's report are title, addressee, opinion paragraph, basis for opinion paragraph, going concern paragraph, key audit matters paragraph, other information paragraph, management's responsibility for financial statements, auditor's responsibility, other reporting responsibilities, name of engagement partner, auditor's signature, auditor's address and date of the report.

- 40 The correct answer is: Statement of financial position and statement of profit or loss

Both statements are materially misstated as the asset must be written off reducing the profit for the year. An unmodified opinion can only be issued if both statements are adjusted.

- 41 The correct answer is: Qualified opinion

A qualified opinion is appropriate, because the matter is considered to be material, but not pervasive. An unmodified opinion with an emphasis of matter paragraph is not relevant: it serves to draw the attention of users to a matter appropriately presented or disclosed in the financial statements, which is fundamental to the users' understanding of the financial statements.

- 42 The correct answer is: Express an unmodified opinion and describe the material uncertainty in the material uncertainty related to going concern paragraph

The matter should be described in a material uncertainty related to going concern paragraph, in accordance with ISA 570 ((Revised): para. 19) Going concern. The other matter paragraph is used to refer to a matter that is not presented or disclosed in the financial statements: the material uncertainty is disclosed in this case, so that would not be appropriate. The emphasis of matter paragraph does not modify the audit opinion. As the going concern assumption is appropriate and there is adequate disclosure, the audit opinion should not be modified.

- 43 The correct answer is: (a) only

ISA 705 (para. 29) states that the auditor must not include a key audit matters section in the auditor's report where a disclaimer of opinion is expressed.

If there is insufficient evidence in relation to a pervasive matter, a disclaimer of opinion should be issued.

- 44 The correct answer is: (b), (c) and (d)

The review of audit working paper files to ensure that the audit has been performed in accordance with professional standards and regulatory and legal requirements is carried out by the audit engagement partner.

Section B

Constructed response questions

Preparation Questions are not in the current exam format but are intended as useful practice. The Practice & Revision Kit provides a large number of exam format questions.

45 Objectives, characteristics and responsibilities (Preparation Question)

Bird & Co
1 Old Street
New Town
M1 3WQ

1 January 20X1

Mr G Neville

1 Any Street

New Town

M2 5LM

Dear Mr Neville

In response to your queries I have produced some information on the difference between statutory audit, assurance work and internal audit. I have included this information in an appendix.

However, it is important to note that the external audit is a legal requirement for many companies and cannot be avoided by employing the auditor to do other work.

If you require any further details please do not hesitate to contact me.

Yours sincerely

A N Accountant

Enclosure: Appendix

External audit	Assurance work	Internal audit
Characteristics and objectives		
The external audit is a legal requirement for limited liability companies above a certain size. Partnerships and sole traders do not normally need to have any audit, though some may opt to do so to give independent credibility to their financial statements.	Assurance work is voluntary for companies. Management can employ the external auditor to report on any specific areas. Directors may employ the external auditor when they feel a specific investigation or some specific work needs to be done, eg in support of an insurance claim or loan application.	Internal audit departments are not a legal requirement, though the <i>UK Corporate Governance Code</i> recommends them as best practice for listed companies in the UK and other countries are following this model.
In an external audit the auditor gives an independent opinion on whether the financial statements are presented fairly, in all material respects (or give a true and fair view), in	The scope of assurance work is determined by management.	Internal auditors are employees of the company. They report on the internal controls, identifying problems and suggesting improvements. They may also report on the effectiveness of

External audit	Assurance work	Internal audit
accordance with the applicable financial reporting framework. Implied opinions may also be given on such issues as whether the financial statements agree with the underlying records and all information and explanations which are relevant to the audit have been received.		efficiency of operations.
External audits are performed annually, and the auditor is paid based on hours worked. The audit fee is normally disclosed in a set of financial statements.	Assurance work is a one-off specific assignment; fees are normally agreed with management and based on hours worked.	Internal auditors are full-time employees, and as such there are ongoing costs involved with setting up an internal audit department.
The auditor's report is a formal report with standard wording, prepared for shareholders. An auditor's report with an unmodified audit opinion indicates that the auditor believes the financial statements are presented fairly, in all material respects (or give a true and fair view).	Reports are tailored to the scope of work, and addressed to management.	Reports are prepared for management. There is no guidance governing the wording of reports, though companies may have their own internal guidelines.
Responsibilities		
Work and procedures are governed by International Standards on Auditing, produced by the International Auditing and Assurance Standards Board of IFAC. Compliance with these standards is a good defence should the auditor end up in court.	The <i>International Framework for Assurance Engagements</i> provides guidance on the nature of assurance engagements. ISAE 3000 (Revised) <i>Assurance Engagements Other than Audits or Reviews of Historical Financial Information</i> provides standards for assurance engagements other than audits or reviews of historical financial information. Auditors are expected to comply with this standard for both reasonable and limited assurance engagements.	There are no ISAs to govern internal audit work.

46 Audit and assurance engagements (Preparation Question)

- (a) Assurance engagements are engagements in which a professional accountant expresses a conclusion which provides the intended user with a level of assurance about a particular

subject matter. External audits and review engagements are examples of assurance engagements.

An external audit provides only reasonable assurance because of the inherent limitations of the audit, such as the fact that not all the transactions in the accounts can be tested and that judgement is required in the audit of provisions.

Review engagements only provide limited assurance which would usually be expressed in a negative form of words. This means that nothing has come to the attention of the auditor which indicates that the accounts have not been prepared according to the applicable framework.

Limitations of the external audit:

- (1) Not all items in the financial statements are tested.
 - (2) Judgement is required.
 - (3) There are limitations in the accounting and control systems.
 - (4) The auditor's report is often issued a while after the statement of financial position date.
- (b) The explicit opinions stated in the auditor's report:
- (1) The state of the company's affairs at the end of the financial year in the statement of financial position
 - (2) The company's profit or loss for the financial year in the statement of profit or loss and other comprehensive income
 - (3) Implied opinions are reported on in the auditor's report only by exception and could include the following:
 - (4) Adequate accounting records have been kept.
 - (5) Returns adequate for the audit have been received from branches not visited.
 - (6) The accounts are in agreement with the accounting records and returns.
 - (7) All information and explanations have been received by the auditors and they have had access at all times to the company's books, accounts and records.
 - (8) Details of directors' emoluments and other benefits have been correctly disclosed in the accounts.
 - (9) Particulars of loans and other transactions in favour of directors and others have been correctly disclosed in the accounts.
- (c) Using the UK as an example, auditors have the following rights (Companies Act 2006: s. 499 & 502):
- (1) Access to records: Auditors have a right to access at all times, the books, accounts and vouchers of the company.
 - (2) Information and explanations: Auditors have a right to require from the company's officers any information and explanations that they consider necessary for the performance of their duties.
 - (3) Attendance at and notices of general meetings: Auditors have a right to attend any general meetings of the company and to receive all notices of and communications relating to such meetings which any member of the company is entitled to receive.
 - (4) Right to speak at general meetings: Auditors have a right to be heard at general meetings which they attend on any part of the business that concerns them as auditors.
 - (5) Rights in relation to written resolutions: Auditors have a right to receive a copy of any written resolution proposed.
 - (6) Right to require laying of accounts: Auditors have a right to give notice in writing that a general meeting is held for the purpose of the laying of accounts and reports before the company.

47 Standards (Preparation Question)

The major advantages and disadvantages of auditing standards can be summarised as follows:

Advantages
They give a framework for all audits around which a particular audit can be developed.
They help to standardise the approach of all auditors to the common objective of producing an opinion.
They assist the court in interpretation of the concept of 'due professional care' and may assist auditors when defending their work.
They increase public awareness of what an audit comprises and the work behind the production of an auditor's report.
They provide support for auditors in potential disputes with clients regarding the audit work necessary.

Disadvantages
It may appear that they impinge on, rather than assist, professional judgement.
They are considered by some to stifle initiative and development of new auditing methods.
They may create additional and unnecessary work and thus raise fees, particularly in the audit of small companies.

If auditing standards were to be enforceable by statute it would mean that there would be government intervention in areas currently controlled solely by the profession itself. This might ultimately lead to a diminished role of self-regulation. To be enforceable by statute the standards would have to be applicable to all circumstances and thus need to be very general and broad in their instructions. This might reduce their usefulness to the auditors. Auditors might spend unnecessary time ensuring that they have complied with the law rather than considering the quality of service to their clients.

Finally, it should be considered whether full statutory backing for standards would force auditors into narrow views and approaches which might gradually impair the quality of accounting and auditing practices.

48 Corporate governance (Preparation Question)

(a) Improving the effectiveness of audit

- (1) Increasing assurance from stronger corporate governance and internal controls
- (2) Providing an opportunity to discuss the terms and scope of external audit in an impartial way
- (3) Strengthening the ability of the external auditor to request changes in control systems
- (4) Ensuring that there is minimal duplication of work where internal auditors are involved, by discussing the audit plan with the external auditors via the audit committee
- (5) Ensuring that directors' statements on internal control are reviewed by the audit committee
- (6) Reviewing going concern issues and ensuring that appropriate disclosures are made
- (7) Acting as a forum for resolving problems between the directors and the external auditors
- (8) Resolving difficulties over the availability of information and key client personnel
- (9) Reviewing draft financial statements before presentation to the auditors and the executive board

(b) **Independence of audit committees**

- (1) The members should be independent and declare any interests in the company.
- (2) Non-executive directors often sit on several boards, so conflicts of interest can easily arise.
- (3) Salaries are paid by the company so financial independence can be compromised.
- (4) Members of the audit committee tend to have other roles at the client, eg personnel. They act in several capacities and independence may be impaired.
- (5) Members may have had previous involvement in executive positions and could have share options or pension schemes, again compromising independence.

(c) **Statutory regulation**

Statutory regulation could impose additional costs and regulatory burdens, which might not justify the end in all cases and could sometimes be detrimental to shareholders.

However, an argument in favour of statutory regulation is that **voluntary codes of practice** may not be applied consistently by companies. Another is that the non-executive audit committee may not feel able to criticise management unless they have **statutory backing**.

Shareholders do not readily understand the role of the audit committee. If it was appointed by statute and governed this role might be better understood, but this is not necessarily the case. There is no evidence that shareholders understand legal regulations any better than voluntary ones in many cases. It is difficult to arrive at a '**model**' **audit committee** suitable for all entities, as would be required if statutory regulation were introduced. Companies are unique and have unique requirements.

A **statutory monitoring report** on the audit committee would be required. This would further increase costs for the company. It would be very difficult to set **standards for non-executive directors** on audit committees.

49 Independence (Preparation Question)

- (a) If auditors are to have credibility, then it is vital that they should be seen to be independent of any concern on which they are required to report. However, independence is but one of a number of qualities which the modern auditor must possess if they are to be accepted as suitable for their role.

Outside of independence, perhaps the two most important qualities required of an auditor are:

(1) **Integrity**

Auditors must be seen as honest. Having formed their opinion, based on the audit evidence they have collected, they will not allow others to sway their judgement to suit their own ends. It is the auditor's integrity which will allow interested parties to place reliance on their reports.

IFAC (through the IESBA) and national supervisory bodies do a great deal to try to ensure that the integrity of the profession as a whole, as well as that of individual members, is maintained. This is done by laying down ethical guidelines which all members are required to follow (disciplinary proceedings are taken against any member known to have breached such guidelines). The accounting bodies also assist in this area by providing a broad framework for the training and examination of prospective new members, such as the ACCA's *Code of Ethics and Conduct*.

(2) **Professional competence**

Clearly the auditor must be in possession of certain technical skills. This fact is clearly recognised so far as statutory audits are concerned, as only suitable qualified accountants are recognised as being competent to hold office as auditor. Examples of some of the skills required of modern auditors are that they must be:

- Aware of and understand audit objectives
- Able to interpret systems

- Able to communicate well with others
- Conversant with required techniques such as sampling
- Able to cope with the impact of modern technology on accounting and internal control systems

The accounting profession is only too well aware of the need to maintain and improve standards of professional competence and for this reason has issued and recently revised a number of International Standards on Auditing. In addition, the accounting bodies are heavily involved in running courses to assist members in maintaining and improving their technical skills.

- (b) Independence on the part of the auditor as a reporting accountant is seen by many to be a fundamental concept of auditing. It has been said that it would never be sufficient for auditors to claim that they were independent. In fact, they must always be clearly seen to be independent in practice. Given this situation, it would be almost impossible to draw up a set of rules to cover every conceivable situation where an auditor's independence might be called into question.

While not able to provide an exhaustive list of recommendations, the main principles which should be applied when considering the question of independence may be found in the relevant section of the ACCA's Code of Ethics and Conduct. With this in mind, the following comments could be made in relation to the situations specified in the question.

- (1) The audit partner has no shareholdings in the client company and so, all other things being equal, they could be seen as giving an objective audit opinion. However, the audit manager does have a shareholding in the client company which, while not material to the company (at 1% of issued share capital), could be material to the audit manager and certainly might be seen to influence their ability to give an impartial opinion in relation to the company's affairs. In fact, the ACCA Code of Ethics and Conduct does not permit a member of the audit team to have a direct financial interest in an audit client. As the partner will inevitably have to rely on the work completed and controlled by the audit manager, it is clearly undesirable for the manager to have such a financial involvement in the client's affairs. The audit manager should either be excluded from the audit team or requested to dispose of their shares.
- (2) The Code of Ethics and Conduct states that when a firm receives a high proportion of its fee income from just one audit client, a self-interest or intimidation threat. The reason for this is that the fear of losing a major client, and thus a substantial proportion of fee income, could prejudice the auditor's objectivity and make them more likely to bow to pressures from the client.

The Code of Ethics and Conduct does not set out specific guidelines in relation to percentages of total fees except for in relation to public interest clients, where the Code requires communication of the situation to those charged with governance and an independent review if total fees from a client are more than 15% of the firm's total fees for two consecutive years. Auditors of private companies could adopt the same approach as best practice.

The audit fee from Janet Co contributes some 14.3% of the total fees income of the practice, which is a significant proportion. It would be necessary to consider whether any other fee income was received from this client, as this could result in a proportion well in excess of 15%. Depending on the other fees the firm would need to assess the threats to independence taking into account the operating structure of the firm and the significance of the client to the firm both qualitatively and quantitatively. The firm should consider what safeguards are necessary; these may include reducing the dependency on the client, arranging independent quality reviews or consulting a third party on key judgements. The firm would need to keep this situation under constant review.

- (3) As another instance of where financial involvement in a client's affairs could be seen to impair an auditor's objectivity, the code recommends that between an auditor and a client there should be no loans or guarantees in respect of loans either way. Any such financial involvement could be seen to impair the auditor's judgement either because of a

client putting pressure on the auditor or because of the auditor's own fear of suffering some financial loss.

However, the ACCA Code of Ethics and Conduct does allow for one exception in making the above recommendation and that is where the loan is in the normal course of business and on normal commercial terms. It is part of a bank's normal business to make personal loans, and, if the rate of interest being paid by the audit senior appears to be a commercial rate of interest, this transaction is unlikely to be seen as impairing the auditor's independence.

- (4) The Code also considers the problems that can be created when conflicts of interest arise between different clients and between clients and the auditor's own business interests. It concludes that every effort should be made to avoid conflicts of interest arising and that it would be unethical for accountants to act in a situation where they knew that a conflict of interest existed (ACCA Code of Ethics and Conduct: s. 220).

The situation described in the question is a good example of the type of conflict of interest with which the code is concerned. The audit partner should not advise Jean Co with regard to the contract tender received from Harry Co. The auditor should explain the professional reasons why he is unable to act on this occasion and suggest that Jean Co seek advice from another firm of accountants.

50 Confidentiality and independence

(a) Situations where an auditor may disclose confidential information about a client

Auditors have a professional duty of confidentiality and this is an implied term of the agreement made between the auditor and the client.

However, there may be a legal right or duty to disclose confidential information or it may be in the public interest to disclose details of clients' affairs to third parties.

Also, the client may have given the auditor consent to disclose confidential information. These are general principles only and there is more specific guidance, which is discussed below

Obligatory disclosure

If the auditor knows or suspects that their client has committed money-laundering, treason, drug-trafficking or terrorist offences then they are obliged to disclose all the information they have to a competent authority (ACCA Code of Ethics and Conduct: s. 114.1 A1B1).

Under ISA 250 (Revised) *Consideration of Laws and Regulations in an Audit of Financial Statements* auditors must also consider whether non-compliance with laws and regulations (NOCLAR) may affect the accounts. They might have to include in the auditor's report a statement that non-compliance with laws and regulations has led to significant uncertainties (in an emphasis of matter paragraph), or may consider modifying the audit opinion if there is a disagreement over the way specific items have been treated in the accounts.

Under both the ACCA Code of Ethics and ISA 250 (Revised), the auditor is required to consider the most appropriate authority to whom any cases of NOCLAR should be reported, as this reporting may prejudice any investigation by a regulator or other third party (ACCA Code of Ethics and Conduct: s. 114.1 A1B1).

Voluntary disclosure

Voluntary disclosure may be applicable in the following situations:

- Disclosure is reasonably necessary to protect the auditor's interests, for example to enable them to sue for fees or defend an action for, say, negligence.
- Disclosure is authorised by statute.
- It is in the public interest to disclose, say, where an offence has been committed which is contrary to the public interest.
- Disclosure is to non-governmental bodies which have statutory powers to compel disclosure.

(ACCA Code of Ethics and Conduct: s. 114.1 A1B1)

If an auditor is requested to assist the police, the taxation or other authorities by providing information about a client's affairs in connection with enquiries being made, they should first enquire under what statutory authority the information is demanded.

Unless the auditor is satisfied that such statutory authority exists they should decline to give any information until they have obtained their client's authority (unless such a request is considered to prejudice any investigation). If the client's authority is still required but not forthcoming, and the demand for information is pressed, the auditor should not accede unless advised to do so by their legal adviser.

If an auditor knows or suspects that a client has committed a wrongful act they must give careful thought to their own position. The auditor must ensure that they have not prejudiced themselves by, for example, relying on information given by the client which subsequently proves to be incorrect or unreliable.

However, it would be a criminal offence for a member to act positively, without lawful authority or reasonable excuse, in such a manner as to impede with intent the arrest or prosecution of a client whom they know or believe to have committed an 'arrestable offence'.

(b) Risks to independence

Audit partner

Mr Grace has been the audit partner on the audit of Ancients for the last eight years. His independence and objectivity are likely to be impaired as a result of this close relationship with a key client and its senior management. The ACCA *Code of Ethics and Conduct* (s. R540.11-13) requires key audit partners to be rotated after seven years and Mr Grace's involvement for eight years already contravenes this rule.

This threat could (and should) be addressed by appointing another audit partner to the audit of Ancients and rotating partners at suitable intervals thereafter.

Tax fees outstanding

There are taxation fees outstanding from Ancients for work that was done six months previously. In effect, McKay & Co are providing an interest-free loan to Ancients. This can threaten independence and objectivity of the audit firm, as it may not want to modify the audit opinion in case the outstanding fees are not paid.

This can be addressed by discussing the issue with the directors of Ancients and finding out why the fees have not been paid. If the fee is still not paid the firm should consider delaying the start of the audit work or even the possibility of resigning.

Fee dependence

Ancients is one of McKay & Co's most important clients and the firm provides other services to this client as well as audit, including taxation services. Also, the company is growing rapidly. Objectivity and independence are considered to be threatened to the degree that an independent engagement review is needed by an external firm or regulator (and disclosure to those charged with governance) if the fees for audit and recurring work exceed 15% of the firm's total fees for a listed client such as Ancients (ACCA Code: s. R410.4).

This threat could be mitigated by reviewing the total of the audit and recurring fee income from Ancients as a percentage of McKay & Co's total fee income on a regular basis and possibly limiting the provision of the other services if deemed necessary to maintain independence.

Relationship to Financial Director of Ancients plc

Allyson Grace, the daughter of Mr Grace, has recently been appointed the Financial Director of Ancients. The independence of Mr Grace could be threatened because of their close family relationship. The extent of the threat depends on the position the immediate family member holds with the client and the role of the professional on the assurance team.

As Financial Director, Allyson has direct influence over the financial statements and as engagement partner, Mr Grace has ultimate responsibility for the audit opinion, so there is a clear threat to objectivity and independence.

This threat to independence could (and should) be mitigated by the appointment of another audit partner to this client.

Meal

The fact that Allyson Grace wants to take the audit team out for an expensive meal before the audit commences could be considered a threat to independence, as it might influence the audit team's decisions once they start the audit of the financial statements. The ACCA Code of Ethics and Conduct (s. 420.2) states that gifts or hospitality from the client should not be accepted unless the value is trivial and inconsequential.

This threat could be mitigated by declining the invitation.

51 ZX

(a)

To:	Board of ZX Co
From:	Chief Internal Auditor
Date:	Today
Subject:	Role of Internal Audit and Audit Committee

Areas where the internal audit department can assist the directors with the implementation of good corporate governance include:

(1) Internal controls

The directors are responsible for assessing the risks faced by the company, implementing appropriate controls and monitoring the effectiveness of those controls.

The internal audit department could assist the board in a number of ways:

- (i) They could review the directors' risk assessment and report on its adequacy.
- (ii) In certain areas (perhaps in respect of the accounting system) they could actually carry out the risk assessment.
- (iii) They could review and report on the adequacy of the controls that are to be implemented.
- (iv) They could carry out annual audits of the effectiveness of controls (performing tests of the controls), identifying weaknesses and making recommendations for improvements.

It would be inappropriate for them to be involved at every stage, ie assessing risks, designing controls and reviewing their effectiveness, as this would mean that they are checking their own work. This would undermine the credibility of their reports.

In a sense, the existence of an internal audit serves as a control procedure in its own right. An example would be that the existence of an internal audit department is likely to act as a deterrent against fraud, and so helps the directors meet their responsibilities to implement appropriate controls to prevent and detect fraud.

(2) Financial statements

Good corporate governance requires the directors to prepare financial statements that give a balanced and understandable view. As the internal audit department has experience in accounting and auditing and is led by a qualified Chartered Certified Accountant it can assist the directors in applying accounting standards and meeting the expectations of readers of the accounts (particularly as these expectations will greatly increase if ZX proceeds with the possible listing).

(3) Board reports

A principle of good corporate governance is that the board should be properly briefed. The internal audit department can review the reports that are presented to the board to

ensure that they are properly prepared and presented in a way that can be easily understood.

(4) Communication with external auditors

Although it is mainly the audit committee (if one has been established) that will act as a channel of communication between the external auditors and the board, it will often be the case that the external and internal auditors will work together on some areas. This could be the case if the external auditor found it appropriate to rely on internal auditors' reports on some areas (for example, on periodic inventory counting procedures) or where the external auditor wants to extend automated tools testing over the whole year under the supervision of the internal auditors. This could add value to information available to the board where areas have been considered by both groups of auditors.

(5) Knowledge of corporate governance and auditing standards

As qualified professionals the internal audit department will have up to date knowledge of corporate governance requirements and of developments in auditing standards. They will be able to help the board keep up to date with what is expected of them under the codes of corporate governance and with what will be expected of them from the external auditors.

(b) Advantages and disadvantages of an audit committee

(1) Advantages

Proposed listing

If ZX is listed it will in all probability have to follow tighter requirements, such as the UK Corporate Governance Code. The establishment of an audit committee is considered good practice under this code. If ZX did not establish one it would have to disclose the non-compliance with the code in that respect and this might affect shareholder confidence in respect of the accounting and auditing functions within the company.

'Critical friend' of the board

An effective audit committee will be made up of individuals with relevant knowledge and experience, who are independent of the day-to-day running of the company. This will give the shareholders confidence that there is some independent oversight of the board which should help ensure that the company is being run in the best interests of the shareholders. They should also be able to advise the executive directors on areas such as corporate governance where their own knowledge may be incomplete.

Communication

The existence of an audit committee gives an effective channel of communication for the external auditors. It means there is a quasi-independent body with whom the external auditor can discuss contentious audit issues, such as disagreements over accounting treatments, rather than going directly to the board who have made the decisions on those matters. This may increase stakeholders' confidence in the financial statements and the audit process.

Financial reporting

The non-executive directors are expected to have a good knowledge of financial reporting. In the case of ZX, this should prove a useful source of advice to the board. Also, externally, it should increase confidence in the financial reporting processes and reports of ZX.

Appointment of external auditors

The audit committee, rather than the board, would recommend which auditors should be appointed. They would also review annually any circumstances, such as provision of other services, which might threaten the perceived independence of the external auditor. This should again increase the confidence that readers of the financial statements have in the objectivity of the opinion given by the external auditors, and, therefore, the credibility of the financial statements.

(2) Disadvantages

Cost

Although the non-executive directors will not require full-time salaries, the level of fees that will be required to attract suitably experienced individuals may be significant but must be weighed against the benefits which will be derived, especially in view of the planned listing.

Knowledge and experience

The board may question whether individuals from outside ZX will have adequate experience of the business to make a useful contribution to the board. As explained above, it is their very independence that adds value to their role as well as their particular experience in respect of financial accounting and corporate governance issues.

Responsibilities

The current board may be concerned that the establishment of an audit committee of non-executive directors may diminish their powers in running the company. It could be seen as another tier of management. They should be assured that the audit committee would act in support of the board, not as an alternative to it.

52 Glo

(a) Materiality for the financial statements as a whole

It is **never appropriate** to apply the prior year's materiality figure to the current year figures. Materiality should be assessed in each year.

If the financial position has not changed much and the results are comparable with the prior year, it is possible that the materiality assessed year on year is very similar, but this does not mean that the auditors should not assess it for each audit. When assessing materiality, the auditor must consider **all known factors at the current date**. In this case, the position has changed considerably, increasing the risk of the audit, which may lower materiality itself.

As the **position** on the statement of financial position has **changed considerably**, when materiality is assessed, it is unlikely that it will be similar to the prior year. Using the information available, **materiality is likely to be assessed extremely low** in monetary terms, due to the overall decrease in assets and the loss that appears to have been made in the year. It is also possible that, given the current position, the figures on the statement of financial position will not be used to assess materiality in this year.

(b) Audit risk

Audit risk is the risk that the auditor will give an inappropriate opinion on financial statements. It is made up of three different elements of risk (ISA 200: para. 13):

- (1) **Inherent risk:** the risks arising naturally in the business and specific accounts/transactions
- (2) **Control risk:** the risk that the accounting system will fail to detect and prevent errors
- (3) **Detection risk:** the risk that the auditors will not detect material misstatements

Detection risk comprises **sampling risk** (the risk that the auditors' conclusion drawn from a sample is different to what it would have been, had the whole population been tested) and **non-sampling risk** (the risk that auditors may use inappropriate procedures or misinterpret evidence).

Inherent and control risk are assessed by the auditors. Detection risk is then set at a level which makes overall audit risk acceptable to them.

(c) Specific audit areas of risk

A review of this statement of financial position suggests that audit work should be directed to the following areas:

Going concern

Total assets have fallen from \$373,000 to \$165,000. Although the statement of profit or loss has not been reviewed, the statement of financial position shows a **retained loss** for the year of \$211,000.

Net assets show a **reduction in both inventory and receivables**, which **suggests a decrease in activity**, although trade payables do not seem to have fallen so considerably. However, this could be accounted for by Glo-Warm not paying its suppliers in a similar fashion to the previous year. It will be **necessary to review the statement of profit or loss** to substantiate whether activity has reduced.

The **cash position has also worsened**, with cash falling by \$22,000. The statement of cash flows should reveal more detail about this fall. However, the company has paid off \$5,000 of its bank loan, reducing overall net debt.

In summary, audit work should be directed at going concern, as **several indicators of going concern problems** exist on the statement of financial position. This will be further amplified when the statement of profit or loss is available.

Inventory

Inventory has been mentioned above in the context of going concern. Audit work should be directed at inventory specifically, as this **balance has fallen significantly** from the previous year, which seems **odd in a manufacturing company**. There is no suggestion on the statement of financial position for why this should be so (for example, receivables are not correspondingly high, suggesting high pre-year-end sales, and payables are not correspondingly low, suggesting low pre-year-end purchases). It may be that the inventory count did not include every item of inventory. Alternatively it could simply point to a fall in activity (discussed above).

Warranty provision

A provision of \$20,000 has been included in 20X6 for warranties. The reasons for this must be investigated and the auditors must check that it has been accounted for correctly.

It seems **odd that a warranty provision should suddenly appear on a statement of financial position**. It suggests a change in the terms of contracts given to customers, or a change in the customers themselves (with different terms then applying). Alternatively it suggests that **IAS 37** has been **wrongly applied in the current year, or should have been applied in the previous year**, and was not.

Other material items

As stated above, given the indications of loss and the reduction in total asset value, it is likely that materiality will be assessed low in monetary terms. In this case, most balances on the statement of financial position are likely to be material (excluding investments and cash-in-hand which appear to be very low risk).

However, as the bank loan is likely to be substantiated by good audit evidence, the most risky of the other balances are **trade receivables** and **trade payables**, for reasons discussed above in going concern. More detail is required to make a judgement about the risk of tangible non-current assets.

53 Stone Holidays

(a) Internal audit and the risk of fraud and error

The management of an entity have the primary responsibility of preventing and detecting fraud and error. An internal audit function may assist them in this responsibility. This is encouraged under the UK Corporate Governance Code. The role of the internal audit function in respect of fraud and error will be decided by the entity's management but is likely to include some of the following:

- (1) **Risk assessment** – The internal audit function may carry out risk assessments identifying the main risks of fraud and error or may review that process if it is carried out by management.
- (2) **Control recommendations** – Internal auditors' reports may recommend controls to address the risks of fraud and error identified by management.

- (3) **Control procedures** – The internal audit function may be involved in carrying out certain control functions, such as counting cash or inventories and comparing to book records. It may be management's objective to detect even low-value frauds and misappropriations.
 - (4) **Monitoring controls** – The internal audit function may perform procedures to monitor whether the control procedures implemented by management are operating effectively. This could involve inspecting documents for evidence of appropriate authorisation or using test data to check the operation of computerised controls.
 - (i) It would not be appropriate for the internal audit function to be involved in all of these areas in a particular entity, as they would effectively be checking their own work thus undermining their credibility.
 - (ii) The existence of an internal audit function within an entity is likely to act as a deterrent against fraud and error.
- (b) **External audit and the risk of fraud and error**
- (1) The ultimate responsibility of external auditors is to give an opinion on the **truth and fairness** of the financial statements. This means that the auditors give **reasonable assurance** that the financial statements are free from **material misstatement**.
 - (2) **Professional scepticism**. The auditor is responsible for maintaining professional scepticism throughout the audit, considering the possibility of management override of controls, and recognising that audit procedures effective for detecting errors may not be effective for detecting fraud.
 - (3) **Discussion**. The members of the audit team must also discuss the possibility of the entity's financial statements containing material misstatements resulting from fraud or error.
 - (4) **Risk assessment**. When obtaining an understanding of the entity, the external auditor will consider any indications of frauds that may lead to material misstatements. This would involve enquiries of management, internal audit (if applicable) and analytical procedures. Any risks of material misstatement due to fraud will be treated as significant risks.
 - (5) **Responses to assessed risk**. The auditor must determine **overall responses** to address the assessed risks of material misstatement due to fraud at the financial statement level. This will involve:
 - (i) **Assigning and supervising** staff responsible taking into account their knowledge, skill and ability
 - (ii) Evaluating whether the **accounting policies** may be indicative of fraudulent financial reporting
 - (iii) Incorporating **unpredictability** in the selection of the nature, timing and extent of audit procedures
 - (6) **Specific audit procedures**. Irrespective of the auditor's assessment of the risks of management override, audit procedures must be performed which test the appropriateness of journals and other adjustments. Accounting estimates must be reviewed for bias and, where significant transactions appear to be outside the normal course of business, the auditor must consider if they are concealing a fraud or are themselves fraudulent entries.
 - (7) **Written representations**. The external auditor must obtain written representations from management:
 - (i) Acknowledging their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud
 - (ii) That they have disclosed to the auditor management's assessment of the risk of fraud in the financial statements
 - (iii) That they have disclosed to the auditor their knowledge of fraud/suspected fraud involving management, employees with significant roles in internal control, and others where fraud could have a material effect on the financial statements

- (iv) They have disclosed to the auditor their knowledge of any allegations of fraud/suspected fraud
- (8) **Limitations.** It is not reasonable to expect external auditors to identify all instances of material misstatements where fraud is involved even when the audit is properly planned and performed in accordance with the ISAs. Where a fraud has been perpetrated, particularly if it is at management level, it is likely to be carefully concealed and collusion may be involved.
- (9) **Reporting.** Where the external auditor detects or suspects that a fraud has occurred, this should be reported to the appropriate level of management. In certain circumstances, for example in matters subject to legislation such as money laundering, the auditor may have to report to external bodies.
- (c) **Risks arising from fraud and error**
 - (1) Staff are paid on a **commission basis**. This may result in deliberate overstatement of sales figures as individuals try to inflate their own income.
 - (2) The use of the networked reservations system introduces the risk that information may be lost or corrupted in transmission.
 - (3) Errors may occur in the computerised accounting system if the controls within that system are not operating effectively. It may also be the case that certain employees have discovered how to circumvent the controls and are able to amend records perhaps to hide misappropriations of assets.
 - (4) Some payments are received in **cash**. This introduces the risk that cash may be misappropriated and the records falsified to conceal this.
 - (5) The amount that the entity is required to pay into the central compensation fund is based on the sales figure for the year. There may be management bias towards understating sales to reduce the amounts payable or delaying revenue recognition thus deferring the due date of the payment.
 - (6) Customers may attempt to defraud Stone Holidays by using stolen credit or debit cards.

54 Parker

- (a) The term 'audit risk' literally means the risk that the auditor will give an incorrect opinion. The concern for the auditor is that an unmodified opinion may be issued in circumstances where there are material misstatements in the financial statements.

It can be analysed into three separate components (*ISA 200: para. 13*).

- (1) **Inherent risk**

This arises from factors specific to the business or its operating environment and which make errors more likely to occur. It could result from complex transactions, such as leases, or from pressures on management to achieve particular targets.

- (2) **Control risk**

This is the risk that the audit client's internal control does not prevent errors occurring or detect them after the event so that they may be corrected. This could be due to failures in the control environment, such as management allowing a culture of carelessness towards control procedures to develop or to failures of specific control procedures; for example, a lack of proper reconciliation of payables ledger balances to supplier statements could allow misstatements in trade payables to go undetected.

- (3) **Detection risk**

This is the risk that the auditor's substantive procedures do not detect material errors that exist. One component of this is sampling risk. Many audit procedures are performed using samples so introducing the possibility that while the sample may have been free from errors, there could be material misstatements elsewhere in the population.

There are a variety of other reasons why the auditor may fail to detect errors. These include lack of experience and time pressure.

(b) **Audit risks**

Nature of goods

The company sells books, CDs, DVDs and similar items. These goods are subject to fashions and trends, and this is a very competitive business where undercutting of sales prices is common. As a result, inventory values could be overstated if some lines cannot be sold or have to be sold at substantially discounted prices.

New audit client

Parker is a new audit client and this increases the detection risk for the auditor, as the firm has no previous experience of the company. This makes it harder to establish which areas of Parker's accounting systems are most susceptible to errors and also means that less reliance can be placed on analytical procedures.

Controls over online ordering

Online ordering over the internet may increase the control risk, as the ordering and sales system is reliant on the security and procedures of not only Parker itself but also its counter-parties and service provider etc.

Expansion of product range

The directors plan to expand the range of goods to include toys, garden furniture and fashion clothes.

The directors are moving into areas of business where they have less experience. In particular, furniture is very different from the CDs and books – the furniture being bulky and likely to incur high delivery and storage costs. Also, the level of clothes sales will be susceptible to swift changes in taste.

There is a risk that new systems are not properly set up to deal with the new products and inventory may be overvalued if clothes go out of fashion. If the expansion is unsuccessful, the company's going concern status may be threatened.

Mail ordering accounting system

The high level of manual input into the mail ordering accounting system appears to introduce many errors into the records. This could lead to errors in sales and receivables in the financial statements. The related invoicing errors may destroy customer goodwill and in the longer term may add to the threats to the company's going concern status.

The directors appear to disregard the importance of internal control, meaning that no efforts are being made to detect and correct the errors mentioned above.

Unqualified company accountant

The accountant seems to have been appointed solely because he is a friend of the directors rather than for his skill and experience. Also, as he is not a member of a reputable professional body, he is under no ethical obligations if he does have any doubts about the integrity of management.

Over-trading

There must be doubts over whether a business, which is suffering so much pressure on its margins and is moving into new areas of activity, is going to be able to generate sufficient cash to repay loans required to fund the expansions. This will raise the question of whether the company can continue as a going concern.

Meeting with bank after the year end

The directors will want to present a healthy set of financial statements to the bank manager so there will be a risk that figures may have been manipulated. There will be an increased risk of error throughout the financial statements, particularly in areas that are at all subjective.

Additionally, the directors expect an auditor's report with an unmodified audit opinion to be signed before the meeting with the bank. This increases detection risk, as the auditor is under time pressure and also will lack evidence of events after the reporting period. If the new loan is essential to the company's going concern status it may be difficult for the auditor to reach an opinion before the completion of the loan negotiations.

(c) **Enquiries**

- (1) Enquire about management's views on the prospects for profitability of the planned new lines of business.
- (2) Enquire into any planned cost cutting to improve the company's profit margins.
- (3) Enquire into whether there have been any problems with the operation of the online ordering system.

Procedures

- (1) Obtain management's forecasts and projections and:
 - Assess reasonableness of assumptions (for example, compare projected margins with those achieved by similar businesses)
 - Review projections to verify that they have been based on these assumptions
 - Review projections to check that all the information is consistent; for example, as the directors are planning to increase the inventory levels, check that allowance has been made for related increases in inventory holding costs.
 - Calculate ratios, eg receivables collection period to check reasonableness
- (2) Review loan agreements for terms and conditions of existing borrowings and consider whether it appears likely that interest and capital payments can be met.
- (3) Review minutes of board and committee meetings to assess management's views of the proposed new lines of business.
- (4) Review correspondence with bank for any indications of the current relationship between Parker and its bankers and the likelihood of the bank providing more finance.
- (5) These reviews should all be continued in the period after the year-end date right up to the date of the auditor's report.
- (6) Obtain written representations from management acknowledging their responsibility for:
 - Assessing the going concern status of the company
 - Making reasonable assumptions in preparing forecasts and projections
 - Deciding on the appropriate basis of preparation of the financial statements

55 Heels

(a) **Steps to identify and assess risks of material misstatement**

The auditor must take the following steps to identify and assess risks of material misstatement:

- (1) Identify risks throughout the process of obtaining an understanding of the entity and its environment.
- (2) Assess the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole.
- (3) Relate the risks to what can go wrong at the assertion level.
- (4) Consider the likelihood of the risks causing a material misstatement.

(b) **Significant risks**

A significant risk is a risk at the higher end of the spectrum of inherent risk.

The following inherent risk factors should be considered:

- (1) Complexity;
- (2) Subjectivity;
- (3) Change;
- (4) (b) and (c) Uncertainty;

- (5) Susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk.

(ISA 315: para. A7)

(ii)

Audit risk	Responses to risks
The company sells fashion shoes. These are desirable items susceptible to theft. Also, they may not be saleable, as fashion tastes change. Therefore inventory may be overstated because it is stated at a value in excess of the net realisable value (NRV, or actual quantities are below those recorded.	At the physical inventory count particular attention needs to be paid to the instructions to identify slow-moving lines. Increased emphasis on reviewing the year-end aged inventory analysis for evidence of slow-moving inventory. Physical controls over shoes at stores and warehouses will need to be observed. Extension of the review of post year end sales values for items in inventory at 31 December 20X1 to assess their NRV.
The company has rushed through the purchase of new stores. These are significant purchases and there is a risk they have not been adequately recorded in non-current assets. In particular, some of the shop fittings and the new systems may not have been correctly allocated between capital and revenue expenditure.	Specific tests to be undertaken to inspect documentation relating to property purchases. Detailed review of repairs accounts to take place for any items which should be included in non-current assets. Review of asset register to ensure only capital items have been included.
The retail stores have resulted in cash income, increasing the risk of incomplete or unrecorded income due to fraud or theft.	Analytical procedures specified where monthly takings from each store are compared with those of other stores to identify anomalies. Reconcile a sample of till records to actual bankings.
The company's rapid expansion has meant significantly extending its borrowing as well as needing to operate close to its overdraft facility. There is a risk the bank could withdraw the facility and the company may not be able to pay its debts as they fall due (a going concern risk).	Correspondence with the bank will need to be reviewed for any evidence of withdrawal/extension of the facility. Post year end results and cash flow forecasts will need to be reviewed if prepared.
Although management are experienced in selling shoes, they are inexperienced in the retail market. Although the stores have been initially successful, in the long term the lack of experience may result in poor results and threaten the going concern of the company.	Review or discuss management's long-term plans and consider their viability.
Heels has opened new stores and implemented a new bespoke system. Staff might not be fully trained on the system and controls might not be suitably designed or may not be operating effectively. This increases the risk of	Store visits will be needed to assess the effectiveness of controls operating at the stores. Extra work will be needed to document and assess the controls over the new accounting system, performing tests of

Audit risk	Responses to risks
errors flowing through to the financial statements.	controls where necessary.

Tutorial note. There are other audit risks you could have identified and explained, such as the risk of the new loans not being properly accounted for and disclosed, but only six are needed for full marks.

There are a number of procedures listed in the 'Responses to risks' columns and you may have thought of other valid ones, but only six were needed for full marks.

(d) **Auditor's point estimate**

An auditor's point estimate is the amount derived from audit evidence for use in evaluating management's point estimate (ISA 540 (Revised): para. 12(b)).

Management at Heels have indicated that they will provide a point estimate. The auditors could formulate their own point estimate by establishing what proportion of, say, July, August and September 20X1 sales were returned in October, November and December 20X1.

This percentage could be applied to the sales made in the period from 1 October to 31 December 20X1 to arrive at an estimate of returns expected in the first three months of 20X2 which related to pre year end sales.

The auditor's point estimate could be adjusted for any known returns in January 20X2, as the auditor's report is not expected to be signed off until February.

This estimate could then be compared with management's estimate to assess whether management's estimate is reasonable.

(e) **Audit procedures**

Enquire of management how their point estimate is made and the data on which it is based.

Review the method of measurement used by management in respect of their estimate and assess the reasonableness of assumptions made.

Review the January 20X1 period to compare the level of returns actually made against the amounts provided.

Review board minutes to assess whether any changes are required to the level of the provision as a result of an increased or decreased level of returns by customers.

Request written representations from management on the level of the provision.

Test the operating effectiveness of the controls over how management made their point estimate.

Note. Only five audit procedures were required in relation to provisions

56 Turbo

(a) **Performance materiality**

Performance materiality is the amount or amounts set by the auditor at less than materiality for the financial statements as a whole (see below) to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole (ISA 320: para. 9).

It also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

Materiality for the financial statements as a whole

The materiality level for the financial statements as a whole is set for the purposes of evaluating the effect of misstatements on the financial statements and will generally exceed performance materiality levels used while carrying out audit procedures.

Misstatements are considered material to the financial statements as a whole if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of users. Therefore, a misstatement in isolation that exceeds performance materiality may not necessarily be considered material to the financial statements as a whole.

Determining materiality for the financial statements as a whole involves the exercise of professional judgement but generally a percentage is applied to a chosen benchmark as a starting point for determining materiality for the financial statements as a whole (eg 5% of profit before tax).

When setting all materiality levels and judging the materiality of misstatements, the auditor will consider both qualitative and quantitative effects.

Qualitative factors

Examples of qualitative factors which may cause misstatements of quantitatively small amounts to be material include:

- (1) Laws or regulations that affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, and the remuneration of management and those charged with governance).
- (2) Disclosures that are key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company).

(b) Documentation of materiality

The auditor must document the following in relation to materiality:

- (1) Materiality for the financial statements as a whole
- (2) Materiality level or levels for particular classes of transactions, account balances or disclosures if applicable
- (3) Performance materiality
- (4) Any revision of the above as the audit progresses

(ISA 320: para.14)

(c) (b) Risks and responses

Risk	Response(s) to risk
Contracts for adverts may span year end and the timing of invoicing does not necessarily reflect the timing of adverts. Invoicing for half or the whole contract coincides with the advert start date. Therefore there is a risk that sales are recognised early and not matched appropriately to costs, overstating revenue in the financial statements.	In relation to a sample of contracts in place at the year end or commencing near to the year end – it should be checked that revenue is recognised in the financial statements according to the timing of the adverts. Any deferred or accrued income should be recalculated and traced to the financial statements.
If recurring contracts have not been re-signed by the date advertising is meant to start an invoice is raised for the same amount as before but it is known that key customers are renegotiating contracts. Key contracts are to be renewed on 25 May and invoiced amounts for these may not reflect the revenue due if contracts are still being negotiated.	Procedures planned for the audit should include a review of renewal invoices close to the year end and these should be traced to contracts to ensure the correct amount and proportion of revenue has been included in respect of these.
Receivables may be overvalued, as newsagents are taking credit beyond the agreed 45 day limit. This could indicate	The auditors should undertake external confirmation of receivables balance to ensure they exist and extend cash-after-date testing

Risk	Response(s) to risk
poor credit control which could result in uncollectable receivable balances.	to test recoverability of receivables. Customer correspondence files should be reviewed for evidence of any disputes.
Journalist and photographer invoices are often received after their services have been provided. As a result, liabilities and related costs may be incomplete, understating the amounts included in the financial statements.	Review payments made to journalists or photographers after the year end to identify any payments which relate to pre-year-end articles/pictures.
There is a risk that Turbo may not be a going concern due to falling revenues, losses and poor cash flow.	Ask management for their assessment as to whether Turbo is a going concern and how they arrived at their conclusions and obtain written representation on their conclusion. Review any contracts that have recently been renegotiated and compare to previous contract to ascertain the extent to which revenues are falling.
There is increased competition from new entrants and online publications. Unless the bank provides additional finance the business may struggle to continue for the foreseeable future. Whether finance is obtained is dependent on the forecasts being prepared.	When available, review the forecasts prepared by management, paying particular attention to the appropriateness of the assumptions made and the sensitivity of forecasts to changes in variable factors. Review post-year-end management accounts to identify any significant changes in the performance of the business and compare with the forecast to assess the accuracy of them.
Turbo's bank intends to rely on the audited financial statements when making a decision to provide loan finance. As a result, management have an incentive to overstate profits by manipulating balances which are reliant on an element of judgement.	Particular attention should be directed to judgemental areas in the financial statements (eg any provisions reversed and revenue recognition policies). An independent partner review should be undertaken for judgemental areas of the financial statements.
Material refurbishment of printing equipment has taken place and there is a risk some repair costs have been included as non-current assets and vice versa. Non-current assets and repair costs could be misstated (either under- or over-statement).	An analysis of the refurbishment costs should be reviewed and traced to invoices. The invoice descriptions and supporting documents should be reviewed to assess the nature of the expenditure. Once established as either capital or revenue it should be traced to the general ledger and the financial statements to ensure it has been classified correctly as an asset or repairs.
The company plans to embark on a costly project in an area it has no experience of – online publishing for subscriptions. This may add to its going concern problems by putting additional strain on cash flows without generating adequate returns, given that Turbo seems to be later to market with this than competitors.	Discuss the project with management including their assumptions for growth and returns and compare with the forecasts when available. Review any formal planning documents and quotes from businesses bidding for the website construction to assess the level of

Risk	Response(s) to risk
	expenditure likely to be needed.

Tutorial note. There are other risks you could have identified and explained for (b) but only nine were asked for.

In the answer above there is often more than one response listed for each risk to demonstrate that there are different valid responses you could use. However, one well-explained response for each of the nine risks would have been sufficient.

Approaching the answer to part (b)

Question requirements which ask students to identify audit risks and suggest suitable responses to those risks are common in the AA exam. Therefore, we will take a look at how you should approach part (b) of the question above. The requirement is part of a 30-mark question so if you were in the exam you would want to use some time to familiarise yourself with the lengthy scenario.

(1) Read the requirement carefully!

First of all you should read the requirement carefully. Note that you are being asked to describe the **audit** risks and then come up with responses. A good way to structure your answer therefore may be to set up two columns with headings of 'Audit risk' and 'Response to Risk'.

(2) Identify your audit risks

Then, bearing this requirement in mind, you should actively read the scenario picking out the audit risks as you go. You should highlight sections of the question as you go and we look at this technique in more detail in our approach to question 28 later in this question bank.

(3) Describe your audit risks and make sure they are audit risks!

You may choose to plan your answer. Alternatively, you could enter the risks straight into your 'Audit risk' column of your answer as you progress through the scenario but be careful that bits of the scenario may need linking together to form a risk. It is very important to remember that for a risk to be an audit risk rather than just a general business risk it needs to have an impact on the financial statements being audited.

You should therefore include the relevant assertion or area of the financial statements affected. If you do this you can be sure you have come up with a valid audit risk. For example, you may have identified it is a problem that journalists and photographers send in their invoices late – but you need to follow this through to the impact on the financial statements. Your audit risk is that liabilities and expenses in the financial statements are incomplete (understated) because purchase invoices are received late and not recorded until after the year end.

(4) Use your risks to formulate responses

When you have listed your risks you can then set about coming up with a relevant response for each.

Make sure your responses to risks in a question like this are responses of the auditor, not of management. This is where the approach you took before in relating your risks to financial statement areas will help you come up with responses more quickly. You now know there is a risk of incomplete or unrecorded liabilities in respect of the freelance invoices, so your response will be an audit procedure that tests for understatement of liabilities, such as reviewing payments after the year end and ensuring they were recorded as liabilities at the year end where the invoices related to work pre year end.

(5) Keep to time

You were asked for nine risks and there are 18 marks available so you can work out that you also need nine valid responses to get to the full 18 marks. Don't provide more than needed and stick to your time allowance for each requirement and the question as a whole. 18 marks

for part (b) means 35 minutes – get into the habit now of not overrunning on your allotted question time.

(d) **Level of assurance over accuracy of forecasts**

Purnell & Co will be unable to confirm the accuracy of the forecast as requested by the bank. The forecast will be based on assumptions made by management at Turbo and it will not be possible to gain enough evidence to confirm that these are completely accurate.

Due to the uncertainties of the future cash flows included in the forecast, the bank should be informed that only a limited level of assurance can be provided in any report, expressed in the form of negative assurance. The report will set out the types of procedures undertaken and the assumptions made by management. If no irregularities were found during the work performed, the report will state that nothing had come to the attention of Purnell & Co that would cause them to believe that management's assumptions do not provide a reasonable basis for the cash forecast.

The negative assurance expressed is a lower level of assurance than the reasonable assurance provided in the statutory audit of financial statements. In the auditor's report on financial statements, a positive form of expression of the practitioner's conclusion is given rather than a negative one. The auditor expresses an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

57 Audit planning and documentation (Preparation Question)

- (a) The overall audit strategy is a document that outlines the general strategy of the audit. It sets the direction of the audit, describes the expected scope and conduct of the audit and provides guidance for the development of the audit plan.

The audit plan is a more detailed document than the overall audit strategy and includes instructions to the audit team that set out the audit procedures the auditors intend to adopt. The audit plan may also contain references to other matters, such as audit objectives, timing, sample sizes and the basis of selection for each account area. It also serves as a means to control and record the proper execution of the audit work.

Key contents of an overall audit strategy:

- (1) Section on understanding the company's environment
 - (2) Section on understanding the company's accounting and internal control system
 - (3) Risk and materiality considerations
 - (4) Nature, timing and extent of audit procedures
 - (5) Section on co-ordination, direction, supervision and review
 - (6) Any other matters
- (b) ISA 230 *Audit Documentation* (para. 3) requires auditors to document their audit work. Audit work needs to be documented for a number of reasons which are outlined below.

Audit documentation provides evidence of the auditor's basis for a conclusion about the achievement of the auditor's objectives and evidence that the audit was planned and performed in accordance with ISAs and other applicable legal and regulatory requirements.

It also assists the engagement team to plan and perform the audit; it assists team members responsible for supervision to direct and supervise the audit work; it enables the team to be accountable for its work; it allows a record of matters of continuing significance to be retained; and it allows for the conduct of quality reviews and inspections (both internal and external).

- (c) Standardised audit working papers

Advantages

- (1) May improve efficiency of audit work, through the use of checklists and specimen letters, for example

- (2) Automated working paper packages may make documenting audit work easier, because they include features such as automatic cross-referencing
- (3) Facilitate review
- (4) Can lead to time saving

Disadvantages

- (1) May lead to a mechanical approach without applying audit judgement
- (2) May not be applicable to all clients
- (3) New audit staff will require training to use the audit documentation system used by the audit firm

58 Audit evidence considerations (Preparation Question)

- (a) Analytical procedures can be used at the planning stage, as substantive procedures, and at the review stage of the audit. Analytical procedures consist of the analysis of significant ratios and trends including the resulting investigations of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predictable amounts. Analytical procedures include comparisons with similar information from prior periods, comparisons to budgets and forecasts, comparisons with predictions prepared by auditors, and comparisons with industry information.

When using analytical procedures as substantive tests, auditors need to consider the information available in terms of its availability, relevance and comparability. They also need to consider the plausibility and predictability of the relationships they are testing. Other factors to consider include materiality, other audit procedures, the accuracy with which the expected results can be predicted, the frequency with which a relationship is observed and the assessments of inherent and control risks.

An example of an analytical procedure that can be used as a substantive test is a proof in total test on depreciation and amortisation. In this test, the auditor predicts the expected charge for the year for depreciation and amortisation by using the client's accounting policy for depreciation and applying this to the brought forward figures for non-current assets from the prior year's audited financial statements, factoring in additions and disposals for the year. The figure obtained can be compared to the charge in the draft financial statements to assess its reasonableness and accuracy.

- (b) Audit evidence is available to auditors in a variety of forms. These include auditor-generated evidence (eg analytical procedures), external sources of evidence from third parties (eg solicitors' correspondence, valuation reports from surveyors for land and buildings), internal sources of evidence from within the entity being audited (eg minutes of meetings from the Board of Directors, reports generated from the accounting system), and oral or written evidence. Another factor to consider is whether the evidence, if written, is from an original document or a copy.

Audit evidence from external sources to the entity is more reliable than that obtained from the entity's records. Evidence from the entity's records is more reliable when the related internal control system is operating effectively. Auditor-generated evidence is more reliable than that obtained indirectly or by inference. Evidence in the form of documents or written representations is more reliable than oral representations. Where evidence is written, original documents are more reliable than photocopies, which can be altered by the client relatively easily.

59 Internal control (Preparation Question)

- (a) **Limitations of accounting and control systems**

Management can only obtain a certain level of assurance (reasonable assurance) that internal control objectives have been achieved because of certain inherent limitations of accounting and control systems. These limitations include the following:

- (1) Control systems still rely on human input and compliance. Therefore there is always a possibility of human error rendering the control ineffective.
 - (2) Employees can collude to bypass controls. For example, one employee may 'sign in' or 'clock in' another employee to bypass controls designed to monitor hours worked.
 - (3) Management can use their authority to override controls.
 - (4) Controls are usually designed to cope with routine transactions. When a non-routine or unusual transaction occurs, the system may not be adequately designed to ensure it is properly recorded.
 - (5) The costs of implementing controls should not outweigh the benefits. This means that controls are not always implemented where management has taken the view they would rather accept the risk of certain errors occurring than incur the cost of implementing a preventative control.
- (b) Narrative notes

Advantages

- (1) Narrative notes are relatively simple to record and can facilitate understanding by all audit team members.
- (2) They can be applied to any system and are therefore a flexible method of documenting systems.
- (3) Updating narrative notes in future years can be relatively easy if they are computerised notes.

Disadvantages

- (1) Narrative notes can be time consuming to prepare compared to alternative methods.
- (2) When using narrative notes it can be difficult to identify missing internal controls because notes record the detail of systems but may not identify control exceptions clearly.
- (3) They are difficult to update if prepared manually.

Only two advantages and two disadvantages were needed.

- (c) Alternative methods of documenting accounting and control systems include:

Flowcharts

Flowcharts 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.

Internal control questionnaires (ICQs)

ICQs comprise a list of questions designed to determine whether desirable controls are present. Often the questions are phrased to ask whether the desirable control is present, so the user can answer 'yes' or 'no'. A 'no' answer will then indicate a potential deficiency. There is usually a list of questions to cover each of the major transaction cycles.

Internal control evaluation questionnaires (ICEQs)

This is a questionnaire designed to assess (evaluate) 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). These questions concentrate on the significant errors or omissions that could occur at each phase of the appropriate cycle if controls are weak.

Checklists

Checklists may be used to document and evaluate the internal control system. They include statements (rather than questions) to 'mark off' and tick boxes are used to indicate where the statement holds true. Those statements not marked off will indicate potential deficiencies.

Only two alternative methods were needed.

60 Fenton Distributors (Preparation Question)

(a) Control objectives

Sales system

- Goods and services are only supplied to customers with good credit ratings.
- Customers are encouraged to pay promptly.
- Orders are recorded correctly.
- Orders are fulfilled.
- All despatches are recorded.
- All goods and services sold are correctly invoiced.
- All invoices raised relate to goods and services supplied by the business.
- Credit notes are only issued for valid reasons.
- All sales that have been invoiced are recorded in the accounting system.
- All entries in the sales ledger are made to the correct accounts.
- Potentially doubtful debts have been identified.

Purchases system

- All orders for goods and services are properly authorised and are for goods and services that are actually received and are for the company.
- Orders are only made to authorised suppliers and at competitive prices.
- Goods and services are only accepted if they have been ordered and the order has been authorised.
- All goods and services received are accurately recorded.
- Liabilities are recorded for all goods and services that have been received.
- All credit notes received are recorded in the nominal and purchase ledger.

Only three were required for each.

- (1) To verify the accuracy of the purchases transactions posted to the nominal ledger I would perform the following tests.
- (2) I would verify that the bookkeeper was up to date with the monthly posting of all purchases transactions to the nominal ledger.
- (3) Specific tests on purchase transactions will include the following.
 - Purchase transactions will be traced from the invoice to the nominal ledger and the analysis and analysis code will be checked.
 - The total invoice value will be traced to the nominal ledger.
 - The category of invoice expense and the expense amount will be examined to confirm that it appears correctly on the detailed computer list for the month concerned.
 - The total of the items on the detailed list will be matched to the nominal ledger.
 - Transactions will also be traced backwards from the entries in the nominal ledger making up the monthly total posted to the purchase ledger back to both the detailed analysis and the individual invoice.
 - The amount of the invoice expense will be agreed with the amount posted to the nominal ledger.

The tests above check accounting entries forwards and backwards within the system and any errors would be fully investigated as to their type, cause, materiality and pattern.

- (4) The tests on the detailed list and total postings of cash payments, discounts received and adjustments will follow the same procedure as for invoices and credit notes. The monthly cash book total will be agreed to the total posted from the purchase ledger to the nominal ledger.

- (5) An examination of the analysis and coding of purchase invoices will be carried out to establish the level of accuracy achieved. Particular care will be taken to see that the expense category 'purchases' is correctly identified and coded from invoices and is not confused with other categories, for example stationery, rates, gas and telephone. Incorrect analysis and/or coding may be indicated where the expense category is high or low in comparison with its budget to date.

Large variations between actual and budget on expense categories should be examined further to verify that they are not due to errors in analysis, coding or posting.

- (1) To verify the validity and accuracy of the journals posted to the nominal ledger I would carry out the following tests:
- (2) Firstly, I would check the opening balances at the start of the financial year from the opening trial balance back to the closing entries on the previous year's accounts. After this, each item would be agreed to the nominal ledger ensuring that both the value and analysis are correct. These opening postings should be the first entries in the new year, as all nominal ledger balances should have been set to zero, and this should be confirmed.
- (3) Other cash book items would be agreed to the nominal ledger to confirm that postings are correct as to value and expense category. Large items would require a larger sample size and large, unusual or suspicious items should all be checked and evidenced by supporting documentation or Board approval.
- (4) The year-end balances of cash and bank on the nominal ledger should be agreed with the year-end balances in the cash book. This would require the last month to be scrutinised, as the closing balances at all previous month ends will have been agreed already.
- (5) The tests on petty cash payments transactions would include the following:
- Check that transactions are supported by vouchers and correctly posted to the right nominal ledger account. This would include checking that transactions are valid and coded to the correct expense category.
 - Check that petty cash transactions are within any limits, regarding the type of expenditure or maximum value, established by management.
 - Agree that the petty cash balance in the nominal ledger at the end of each month and at the financial year end matches with the balance in the petty cash book.
- (6) The wages expense is posted manually to the nominal ledger from the monthly payroll summaries by means of a journal. To verify that the journals are correctly posted I would select several journals and check the following matters:
- The totals of the analysis columns on the monthly summary shown on the spreadsheet should be posted to the journal, and forwarded to the nominal ledger.
 - The breakdown of wages expense into directors and the several departmental categories will be checked. The correct identification of directors' pay is important, as this requires statutory disclosure. I would obtain the current list of directors. I would add up the totals in the analysis columns to confirm the summary total and consider its reasonableness.
 - Amounts owing at the year end for income tax, accrued pay and other deductions will be verified and any reconciliation drawn up by the bookkeeper agreed.
 - Any additions to, or amendments of, weekly wages records posted to the nominal ledger through the adjustments journal will be fully investigated and their validity established.
 - The analysis of wages expense for the year will be compared with the budget and an explanation will be sought for any significant variances.
- (7) Adjustment journals are potentially a high-risk area and any tests would include the following:
- Check that all the manually written adjustment journals were authorised by the managing director and supported by documentation and proper narratives.

- Check journals are posted in numerical order and that there are no missing numbers gaps in the postings.
- Examine all large adjustments and the reasons given for the errors. These will be traced to the nominal ledger to ensure that postings do correct the errors.
- Closely investigate recurring errors to establish their cause and whether these can be avoided in future by management action.
- Examine the purchase ledger suspense account (payables suspense) and trace all postings in and out.
- Where there was no account in the nominal ledger, agree back to the purchase invoice, establish the account number and verify that the item has been posted from the suspense account to the correct account.
- Where the adjustment is due to the wrong account number being used, agree that the journal correctly transfers the item to the right account.
- Where the bookkeeper has created contra entries between the purchase ledger and the sales ledger, check that the supplier/customer company concerned is posted with a purchase ledger and sales ledger contra of the same value.
- All other adjustments will be checked for validity and supporting documentation.

(8) Year-end balances on the nominal ledger would be further tested as follows:

- Any balances remaining on the purchase ledger and sales ledger suspense accounts should be itemised on a supporting schedule and the existence of each item justified.
- Nominal ledger balances for the cash book, petty cash book, sales ledger and purchase ledger should agree to, or be reconciled to, the cash book, petty cash book, total sales ledger and total purchase ledger balances at the year end. I will investigate further to confirm that any difference is reconciled and explained. It may be that further adjustments are required to reduce or eliminate a difference.
- All non-current asset movements should be checked, including purchases, sales, revaluations and depreciation.
- All outstanding liabilities should be verified and their size reviewed for reasonableness.
- The bank reconciliation should establish the correctness of balances on all types of bank account, ie loan, current, deposit and special transactions.
- A review of the financial statements would be carried out to ensure that material changes in assets, expenses, revenues, liabilities and share capital are justified and explained. Justification would be sought in both relative and absolute terms.

61 Cheque payments and petty cash (Preparation Question)

A Black
Managing Director
Quicksand Co
12 Kelvin Street
Anytown

MNO & Co
3 Green Street
Anytown

Date

Dear Mr Black

You recently requested that we should advise you on good internal controls over cheque payments and petty cash.

The main objectives of control over payments are to ensure that payments are made only in respect of valid transactions and that they are suitably authorised. The following control procedures will contribute towards attaining these objectives.

(1) Cheque payments

- (i) Cheques should be raised only on the basis of authorisation, for example a purchase invoice which has been suitably authorised.

- (ii) Cheques should be signed by people other than those who approve invoices.
- (iii) There should be two independent signatories for each cheque; for instance, two directors might act as signatories. Signatories should inspect the documents supporting the cheque to ensure that the details agree. They should also mark the document so that it cannot be reused.
- (iv) Cheques should be restrictively crossed.
- (v) Unused cheques should be kept in a secure place. Blank cheques should never be signed.
- (vi) Cheques should be under sequential control and all numbers should be accounted for. Spoilt cheques should therefore be retained.
- (vii) When cheques have been signed, they should be despatched immediately.

(2) Petty cash

- (i) Petty cash payments should be made only on the basis of suitably authorised vouchers, which should be under sequential control. Vouchers should be retained for subsequent references. Where independent evidence is also available, for example invoices and receipts, this should be retained.
- (ii) An imprest system should be used to control petty cash. This means that the petty cash float is maintained at a specific amount and is reimbursed at regular intervals on the basis of vouchers showing the payments which have been made. It is suggested that the float should be kept at a level of \$300 and be reimbursed on a weekly basis.
- (iii) The petty cash float should be subject to periodic surprise counts by a responsible person not involved with the petty cash system. The balance in-hand should be reconciled to the imprest account by reference to the vouchers not yet reimbursed.
- (iv) The size of individual payments out of petty cash should be subject to a maximum to be agreed by the directors.
- (v) Staff should not be allowed to cash personal cheques or borrow from petty cash.

I hope that the above information is useful to you in designing your systems of internal control. If you require any more information, please let me know.

Yours sincerely,

A Smith

- (b) Mr Black presumably feels that involvement in cash and cheque controls will be time-consuming, and that he is too busy to be involved in it. He may feel that he does not want to play a direct part in the petty cash function. Because of the small amounts involved, he may wish to delegate this function to another director. He should appreciate, however, that involvement at least in the authorisation of cheque payments would help to ensure that he is aware of major transactions in his business. He might consider the possibility of authorising cheques in excess of a given amount; this would minimise the demands on his time, while exercising control and keeping him informed of significant outgoings from the business.

Auditors may wish to consider whether Mr Black's lack of involvement may be symptomatic of insufficient attention being given to financial matters by the board.

62 Using the work of others (Preparation Question)

(a) Service organisations

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.

An auditor who audits and reports on the financial statements of a user entity is known as a 'user auditor' and a user auditor must obtain an understanding of the services provided by

the service organisation that are relevant to the audit. A relevant example is where the audit client outsources its payroll processes to an external organisation.

This understanding obtained by the user auditor must include the following:

- (1) The nature of services provided and the significance of these to the user entity, including effect on user entity's internal control
- (2) The nature and materiality of transactions processed or financial reporting processes affected
- (3) The degree of interaction
- (4) The nature of relationship including contractual terms

When obtaining an understanding of the internal control relevant to the audit, the user auditor must also evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organisation.

(b) Audit evidence that could be obtained from an expert

- (1) Valuations of assets, such as land and buildings, plant and machinery, works of art, precious stones
- (2) Determination of quantities or physical condition of assets
- (3) Determination of amounts using specialised techniques or methods, such as an actuarial valuation
- (4) Measurement of work completed and to be completed on contracts in progress
- (5) Legal opinions concerning interpretations of agreements, statutes and regulations

Only four were required.

(c) Factors to consider when evaluating the work carried out by an auditor's expert

When evaluating the expert's work the auditor should consider how relevant the work is, the standard of the work and its consistency with other audit evidence.

The auditor should also consider the relevance and reasonableness of any assumptions and methods used, along with the relevance, completeness and accuracy of any source data used.

(d) Actions to take if evidence is not sufficient or results are inconsistent

If the results of the expert's work do not provide sufficient appropriate audit evidence or are inconsistent with other audit evidence, the auditor needs to resolve the matter.

This could be done through discussions with the entity and the expert or applying additional audit procedures, including engaging another expert.

The auditor must consider the need to modify the auditor's opinion in the auditor's report (this is a last resort if the issues are still unresolved after all the other avenues have been explored).

63 Elsans

(a) Use of computer programs to verify inventory

If physical inventory counting takes place at the year end, it may be assumed that the results of the physical inventory count are entered into, and valued by, the computer. If so, then it is important to compare the results of the physical count with the book quantities. The client may have a computer program to make this comparison. It would be possible for the auditor to check this comparison by reperformance using their own specially written computer audit program or a computer audit package. The auditor's computer audit program or package, when run against the file of book inventory, might also be used to carry out the following tasks:

- (1) Select a monetary unit or random sample of book inventory items for the auditor to check the physical count quantities.

- (2) Select items with specific characteristics, eg no sale since a specific date, unit selling price over a specified figure for further testing (test counts or obsolescence enquiries).
- (3) Prepare an aged analysis of inventory items.
- (4) Re-perform calculation of the FIFO cost of each inventory item, compare with the book inventory figure and print details if there is a discrepancy.
- (5) Cast the file of book inventory and print the total.
- (6) Print details (product number, supplier, quantity, cost, date of supply) for a sample of recent inventory receipts contained in the file of book inventory for substantiation against suppliers' invoices.
- (7) Prepare summaries of inventory by branch, product number and location to assist in analytical procedures on the inventory figure, especially when comparing with previous years.
- (8) Compare the unit FIFO cost of each inventory item with the unit selling price and print details of all inventory items where unit selling price is the lower to assist in evaluating net realisable value.

Limitations

Computer audit programs specific to the client are expensive to write. Computer audit packages that are tailored to the client's computer and file structure are less expensive. However, packages are often only compatible with certain makes of computer. The audit software can work only with the information contained in the computer files. For example, an inventory ageing cannot be produced if the dates of inventory movements are not available. Clearly audit software cannot perform audit tests where an element of judgement is involved. For example, it can produce an inventory ageing analysis but the auditor must decide, on the basis of all available evidence, what level of obsolescence provision is reasonable. Audit software requires the auditor to have a detailed knowledge of the software and of the computer files to be used.

(b) Test data

Audit test data consists of data submitted by the auditor for processing by the enterprise's computer-based accounting system. It may be processed during a normal production run (live test data) or during a special run separate from the normal cycle (dead test data). The auditor predicts the results of processing the data and compares the prediction with the actual results. The primary objective of test data is to test programmed controls. For example, if the program contains a control which rejects overtime hours greater than 20 per week, then the test data might include the case of 21 hours' overtime to see if it is rejected. The basic principle of using test data is that if the program processes the test data correctly, then the logic of the program and the program coding works and will process the actual data correctly.

Difficulties

- (1) When live test data is used there is difficulty in ensuring that the dummy data does not become included in the actual data.
- (2) When dead test data is used it may be difficult to ensure that the program tested is identical with that used for the actual data.
- (3) The initial time spent designing the test data is excessive in relation to the benefit it brings – many auditors would rather devote that time to substantive audit work.

(c) Audit sampling

- (1) Random selection ensures that all items in the population have an equal chance of selection, eg by use of random number tables or computerised generator.
- (2) Systematic selection involves selecting items using a constant interval, the first interval having a random start. When using this method, the auditor must be sure that the population is not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

- (3) Haphazard selection is an alternative to random selection, as long as the auditor is satisfied that the sample is representative of the whole population. This method requires care to guard against making a selection that is biased. It should not be used if statistical sampling is being carried out.
- (4) Block selection can be used to check whether certain items have particular characteristics. However, it may produce samples that are not representative of the population as a whole, especially if errors only occurred during a certain part of the period and therefore the errors found cannot be projected onto the rest of the population.

64 ZPM

- (a) (i) **Factors to consider when determining whether the work of the internal audit function can be used (ISA 610 (Revised): para. 15).**

- (1) The extent to which its objectivity is supported by its organisational status, relevant policies and procedures
- (2) The level of competence of the function
- (3) Whether the internal audit function applies a systematic and disciplined approach (including quality management)

- (ii) **Factors to consider when determining the nature and extent of work of the internal audit function that can be used (ISA 610 (Revised): para. 17).**

- (1) The nature and scope of specific work performed or to be performed
- (2) The relevance of that work to the audit strategy and audit plan
- (3) The degree of judgement involved in evaluation of audit evidence gathered by the internal audit function

- (b) (i) Objectives of the internal auditor

Year-end inventory count

The objective of the year-end inventory count is to ensure that the figure for inventories in the financial statements is materially correct. The internal auditors will review the control system over inventory counting and ensure that all inventory is counted as well as performing test counts themselves to check the accuracy of the counting.

Procurement system

The objective of the internal auditor is to ensure that the procurement system is operating in accordance with company guidelines. For example, they will undertake work to ensure that all purchases are authorised, quantity discounts are received and goods received are documented and recorded appropriately.

- (ii) **Objectives of the external auditor**

Year-end inventory count

The objective of the external auditor is to determine whether inventory is materially correct in the year-end financial statements. Inventory should be valued appropriately at the lower of cost and net realisable value in accordance with accounting standards and legislation. In the case of ZPM, the main risk appears to be inaccurate counting of inventory, as some of it consists of lots of small items. The external auditor will attend the inventory count to check whether the quantities and condition of inventory are correctly recorded.

Procurement system

The objective of the external auditor is to determine whether payables and purchases in the financial statements are materially correct. If the testing allows the external auditor to conclude that the controls over procurement are operating effectively, this will form part of the evidence that purchases and payables are recorded completely and accurately, eg in the correct year of account.

(iii) **Extent of reliance**

Year-end inventory count

The company has over a hundred stores in various countries, making it impossible for the external auditors to attend the inventory count in every one of these. The external auditors can place reliance on the work of the internal auditors, in addition to their own attendance at a small sample of inventory counts. The external auditors will still have to review the work of internal audit to ensure that they can rely on the work undertaken. They should also compare their own results with those obtained by internal audit.

Procurement system

The external auditors may be able to rely on the work performed by internal audit on the controls over the procurement system, as these are relevant to financial statement assertions such as completeness of liabilities. The external auditors will still have to carry out their own work on the system, although it will be reduced if they can place reliance on any of the work done by the internal auditors.

(c) **Limitations of the internal audit function**

- (1) Internal auditors are employed by the organisation and this can impair their independence and objectivity. They may be reluctant to report fraud/error to senior management because of perceived threats to their continued employment within the company.
- (2) Internal auditors are not required to be professionally qualified and so there may be limitations in their knowledge and technical expertise.
- (3) If internal audit only reports to one level of management, management may be able to unduly influence the internal audit plan, scope, and whether issues are reported appropriately. This results in a serious conflict, limits the scope and compromises the effectiveness of the internal audit function.

65 Boston Manufacturing

(a) **Risk in the tangible non-current asset audit**

Control risk

The controls over non-current assets at Boston Manufacturing appear to be strong. The company maintains and reconciles a non-current asset register and there are authorisation procedures in operation. These controls should be tested and, if they prove effective, control risk could be assessed as low.

Inherent risk

The tangible non-current assets are material on the basis of the proposed materiality level. There has been a substantial movement on the plant and equipment account this year, but this appears to be supported by the information given by the management accountant. There appear to be no disposals in the year, which may indicate that they have been omitted, or that obsolete items are included in the register. It is also unclear whether land is being depreciated. It would be inappropriate if it was being depreciated. Overall, the inherent risk seems to be medium.

Detection risk

Given that inherent risk has been assessed as moderate and control risk has been assessed as low, detection risk will be assessed as higher. However, there is usually good evidence in relation to the existence and valuation of non-current assets and these are the key assertions which the auditors are interested in. There will also be scope to carry out good analytical procedures, such as proof in total of depreciation.

Conclusion

The audit of non-current assets appears to be medium to low risk.

(b) (i) **Existence**

In many cases it is self-evident that land and buildings exist. However, it is important for the auditors to verify all components of land and buildings contained within the statement of financial position if, for example, they are on a site different to the one which the auditors are primarily attending. Land and buildings should also be verified to **title deeds** to ensure **not only** that they **exist** but also that **they are owned** by the client.

The other classes of asset should be **inspected**. A sample of assets from the **register should be agreed to the physical asset**. There may be scope to rely on the work that the management accountant has undertaken here. The auditor should check a reconciliation which the accountant has performed. The auditors should make use of any identification marks on assets recorded in the register, for example security tags or bar codes which are kept on assets to distinguish them. The auditor should inspect the **condition** of the assets and ensure that they are **in use**.

The motor vehicles should be **reconciled in terms of number of vehicles existing at the opening and closing positions**. Again, to ensure not only that they exist, but also that they are owned by the company, the auditors should check the **registration documents** to ensure that the company is the registered owner.

For all the above assets, the external auditor should also review the insurance provision for the assets. This gives **third-party evidence** of the existence of assets, as the insurer would not insure an asset which did not exist.

(ii) **Valuation (excluding depreciation)**

Land and buildings appear to be stated at historical **cost**, as the schedule does not contain the words 'at valuation'. The auditors should **confirm** that this is the case with the management accountant. The cost can then be **agreed to brought forward figures**, as there have been no additions in the year. These figures will have been audited in the previous year. If the assets are held at valuation, the auditors must ensure that the requirements of IAS 16 in relation to revaluations are being complied with.

Similarly, as there have been no movements in the year, **motor vehicles** can be agreed to the **opening position**.

To audit the valuation of **plant and computers**, the auditors should **agree the opening position**. They should then **obtain a schedule of additions** to non-current assets, which can be **agreed to purchase invoices** to verify valuation.

Lastly, the auditors should investigate whether the cost figures include any **fully written down assets**. This is implied by the fact that the depreciation charge on plant, excluding additions, is low. If so, the auditor should find out whether these assets **are still in use** and, if not, consider whether they **should be excluded** from the cost and accumulated depreciation figures contained within the notes to the accounts. Excluding them would have a net effect on the reported figure of \$0.

(iii) **Completeness**

The schedule of non-current assets prepared should be reconciled to:

- (1) The opening position (that is, the previous statement of financial position)
- (2) The **closing position** (what is disclosed in the financial statements)
- (3) The **underlying records** (the nominal ledger)

If the non-current asset register contains details of the cost and accumulated depreciation of each asset, the **register should also be reconciled to the schedule**. Explanations should be sought for any differences.

The additions of the schedule should also be checked to ensure that the opening and closing positions reconcile within the schedule.

The auditors should also carry out a test on some of the **individual additions**, tracing the transaction through the system, from purchase orders to delivery notes and invoices and through the ledgers to the financial statements to ensure that additions have been included completely.

(c) **Depreciation**

(1) **Appropriateness**

The appropriateness of the rates should be considered and discussed with management.

Relevant factors to consider are matters such as:

- (i) The replacement policy for the asset
- (ii) The pattern of usage in the business
- (iii) The purpose of the asset being owned

(2) **Audit procedures**

Depreciation on buildings can be verified by agreeing the purchase date of the buildings to last year's file or historical invoices / purchase documents and the valuation applied to the building portion.

For the other classes of asset, depreciation should be agreed for individual assets, as it is not possible to agree them in total. The auditors should obtain a breakdown of the charges for the year. They should be able to recalculate the depreciation from details in the non-current asset register and compare the results.

66 Wandsworth Wholesalers

(a) I would have checked the following matters at the pre-year-end inventory count:

- (1) Counting staff, although not the usual custodians of the inventory, were competent. They were briefed before the count and given sufficiently detailed written instructions. They were assigned marked areas to count.
- (2) No inventory was moved during the count. If inventory had to be moved, then the count supervisor would make a detailed note of quantities, inventory numbers and goods despatched notes (GDNs).
- (3) The inventory was clearly identified and well laid out. The counters should work in an organised way, with one counting and one checking. Each inventory line or area should be marked or tagged when counted to avoid any double counting.
- (4) Count sheets should be pre-numbered if possible, to ensure that they are all returned. Numbers should be in ink, not pencil.
- (5) Management (or internal audit) should perform test counts throughout the inventory count. Any discrepancies should be investigated and resolved, usually by a recount.
- (6) Slow-moving, obsolete and damaged inventory should be marked as such on the inventory count sheets in as much detail as possible to highlight inventory which possibly should be valued at net realisable value.
- (7) The management present should initial all the inventory sheets after performing random tests to check that all items of inventory have been counted.

I should record the following matters during my attendance at the inventory count:

- (1) Perform test counts, selecting items from the floor to check to the sheets and vice versa. I would record all these tests (including inventory numbers and inventory sheets) and any discrepancies I find should be investigated by the count staff and management present at the time.
 - (2) Record all the inventory sheet numbers used in the count.
 - (3) Record the last goods received note (GRN) number received and the last GDN number issued prior to the inventory count.
 - (4) Complete an inventory count checklist.
 - (5) Record any problems or unresolved discrepancies. This would include obsolete, slow-moving or damaged inventory and any inventory movements during the inventory count.
- (b) (i) To test cut-off at the inventory count on 13 October I would perform the following procedures:

- (1) Sales cut-off. Select a few GDNs from immediately both before and after the inventory count. Check that they have been recorded in the book inventory records in the appropriate period as being despatched before or after the inventory count date.
 - (2) Purchases cut-off. Select a few GRNs from immediately both before and after the inventory count. Check that they have been recorded as received in the appropriate period, either before or after the inventory count date.
- (ii) At the year end it will be necessary to perform full cut-off tests, rather than just a check on the computerised book records as in (b)(i) above. After performing these tests for transactions about the year end, the following additional tests will be carried out.
- (1) Sales cut-off. Trace the goods from the GDNs to the relevant sales invoices and check that those invoices were posted to the sales ledger either before or after the year end, as appropriate.
 - (2) Purchases cut-off. Trace the goods from the GRNs to the relevant purchase invoices and check that the invoices have been recorded in the purchase ledger in the correct period, as appropriate. Invoices which relate to the period prior to the year end may not have been received in time to be posted in the ledger. In these cases, such invoices should be included in the purchase accruals at the year end.
- (c) The following procedures are relevant:
- (1) Trace the check counts I performed at the inventory count to the inventory sheets, and from there to the book records. Some small adjustments may have been made to the book inventory. These discrepancies, if not material, may be explained by small differences found at the inventory count.
 - (2) Investigate any material discrepancies between the inventory-sheet quantities counted at the inventory count and the book inventory records. Adjustments between the inventory count date and the year end should also be investigated.
- Large differences should be explained by the results of the inventory count. Evidence should be seen that further check counts were performed to ensure the inventory counts were correct. There should also be evidence that the management of the company have investigated large differences.
- (d) As well as the tests detailed above in relation to the inventory count and cut-off, I would perform the following procedures:
- (1) Vouch the quantities used in the year and valuation to the book inventory records. This test should also be performed in reverse.
 - (2) An overall check of complete book inventory against the amounts used in the valuation might be attempted using a computer program if the book inventory records are held on file. The program might produce all material discrepancies.
 - (3) Investigate all material adjustments to the book inventory records at the year end.
 - (4) Investigate the level of adjustments made to book inventory records throughout the year. Consider whether the adjustments are small enough to give comfort that the book inventory records are reasonably accurate.
 - (5) Review the inventory counts from throughout the year to ensure that all inventory lines have been counted at least once during the year.
 - (6) Review the book inventory records at the year end and check for any negative inventory quantities. Where such negative figures have occurred, there should be evidence that the managers of the company have investigated the reasons for them, and that the figures have been adjusted to the actual physical amount.

67 Snu

- (a) Importance of year end inventory counts

Auditors are required to obtain **sufficient appropriate** evidence to support the inventory figure stated in the accounts. This is particularly relevant where inventories are material to the financial statements. Where perpetual inventory systems are not maintained, the year-end count is the most reliable means by which the auditor can obtain the following audit evidence:

- (1) **Quantity and existence** of inventory
- (2) An indication of the **value** of inventory and the means by which management identify slow and obsolete items
- (3) **Cut-off** details
- (4) The overall **control environment** in which the inventory system operates
- (5) Evidence of **fraud or misappropriation**

(b) **Audit procedures**

The following procedures would be performed in order to rely on a perpetual inventory system:

- (1) **Check management procedures** to ensure that all inventory lines are counted at least once a year.
- (2) Confirm that **adequate inventory records** are maintained and that they are kept up-to-date. Tests would include a comparison of sales and purchase transactions with inventory movements. Inventory records would also be checked for correct casting and classification of inventory.
- (3) For a sample of counts at a number of locations the inventory count **instructions should be reviewed**.
- (4) **Attend and observe** the counts at a sample of locations. (As the organisation is dispersed, this may involve the use of staff from other offices.) Those visited should be chosen on the basis of the materiality of the inventory balance and whether the site is identified as high risk eg where controls have historically been weak. The remainder could then be visited on a rotational basis.
- (5) Assess the extent to which the results of **internal audit work** can be relied on. As the organisation is large, it is likely to have an internal audit function. Results of test counts performed by internal audit may reduce the extent of external audit test counts.
- (6) Check that procedures are in place to **correct book inventories** for discrepancies identified at the inventory counts. Changes should be **authorised** and made accurately and on a timely basis.

(c) **Principal risks associated with the financial statement assertions for inventory**

One of the risks associated with inventory is its appropriate valuation. Inventory should be valued at the lower of cost and net realisable value per IAS 2 *Inventories* (IAS 2: para. 9). Inventory can be a material figure in the financial statements of many entities, particularly manufacturing companies, and therefore appropriate valuation of inventory is very important, particularly for obsolete and slow-moving items. The valuation can also be a matter of judgement and this increases the risk associated with inventory.

Inventory in the statement of financial position must **exist** –this is another key assertion. Inventory can be subject to theft and misappropriation, and is often held at more than one location, and so controls to safeguard it are very important.

Cut-off is another key issue for inventory. All purchases, transfers and sales of inventory must be recorded in the correct accounting period, as again inventory can be a material figure for many companies. Incorrect cut-off can result in misstatements in the financial statements at the year end and this can be of particular concern where inventory is material. Auditors therefore need to consider whether the management of the entity being audited have implemented adequate cut-off procedures to ensure that movements into and out of inventory are properly identified and reflected in the accounting records and ultimately in the financial statements.

Deficiency	Explanation
Timing of the inventory count The count is due to take place on New Year's Day. This is unlikely to be popular with staff. Resentment and a desire to get the job done as quickly as possible may mean that the counts are not done thoroughly. There is also little time given to preparation before the count, a problem exacerbated by the fact that both the shops and warehouse are very busy in the period leading up to the count.	As the company operates seven days a week it would be difficult to find an alternative date for the inventory count. In addition, it is at this time of year to coincide with the company's December year end. It would be expensive and difficult to find alternative staff to perform the task and it is unlikely that the business will change its year end simply because the inventory count is inconvenient. It may be possible to perform the count a week before or a week after the year end and roll forward/back the inventory calculation. This would involve closing the business for an extra day and would also involve a degree of reliance on inventory records.
There is a lack of segregation of duties. Mr Sneg is the inventory controller as well as being the count supervisor and count checker. This means that he is responsible for the physical assets as well as maintaining the book records. It would therefore be possible for Mr Sneg to cover up theft of inventory or mistakes made by himself. This situation affects the control environment of the overall performance of the inventory count.	In some respects this situation could be resolved if an alternative senior member of staff were made the inventory supervisor. However, in family businesses it is common for a small number of loyal and trusted staff to bear the majority of the responsibility. There is likely to be strong resistance from Mr Sneg himself who would feel that his good character was being questioned. Other senior members of staff are also likely to be reluctant to take on a role for which they may feel they have little experience and understanding.
Counters will work on their own. Normally counts should be performed by pairs of counters, as this reduces the risk of error.	Where there is a limited number of staff it may be difficult to work in pairs and get the count completed in the available timescale. Due to the timing of the count it will not be easy to get staff from other areas of the business to volunteer to take part.
This is of particular concern in this case as the company has a high turnover of staff. Counters are likely to be inexperienced and may not be motivated to do a good job.	Where staff turnover is high it is difficult to resolve the problem of inexperience in the short term. Management could consider the factors which contribute to staff leaving eg poor pay to determine whether these can be addressed in the medium term. However, warehouse work is often unskilled and therefore an element of staff turnover is inevitable.
The treatment of inventory delivered to customers that has not yet been paid for is incorrect. The inventory should not be added back and the unpaid balances should be included as receivables.	There is no reason why this matter cannot be dealt with. The treatment of inventory not paid for should be corrected.

68 Sitting Pretty

(a) Importance of the inventory count

The inventory count provides important **audit evidence** as to the **existence** and **completeness** of inventory included in the financial statements.

In this case, the inventory count is particularly important because the **company does not maintain perpetual inventory records**. As no perpetual records are maintained, the only basis for the inventory entries in the financial statements is the result of this inventory count.

Inventory is **generally material** to the statement of financial position of a manufacturing company and is also one of the **higher risk areas** on the statement of financial position. The inventory count provides important audit evidence, reducing the risk of material misstatement in relation to inventory.

(b) Planning for attendance

Gain knowledge. I must review the notes of last year's inventory count and I must contact the factory manager to obtain details of this year. I must review this year's details to ensure that the inventory count appears to be planned efficiently and effectively.

Assess key factors. There are various key factors given in the scenario:

- (1) **Nature and volume of the inventory.** There should be no WIP, so I will count raw materials (approximately 10% of the inventory) and finished goods. However, raw material plastic should be low because a delivery is required to continue with production.
- (2) **Possible obsolescence.** I must make a note of the number of old chair legs maintained in raw materials, as these are now obsolete, a new specification having been agreed.
- (3) **Cut-off issues.** I need to ensure that the delivery on the day is isolated and that I obtain details of the delivery made during the inventory count. I need to determine whether this should be included as deliveries for the year, but most of all ensure that it does not get counted twice (as it arrives, and if it is put into stores). I should also obtain copies of the relevant documents, for example, the last invoices in the year and the last goods received and despatched notes.
- (4) **Off-cuts.** I need to consider whether any off-cuts are maintained on site and whether these are being included in the inventory count. As the company receives a discount relating to them, they are unlikely to be considered Sitting Pretty's legally and so should not be included.
- (5) **Staff issues.** It appears that the inventory count is undertaken by the people who work in the factory and handle the inventory on a daily basis. This is not best practice, although in practical terms it is difficult to avoid. However, I should discuss this with the factory manager to assess whether staff can be allocated to counting inventory they have not produced. Also, as the staff are allowed to go home as soon as the inventory count is completed, there is a risk that the inventory count will be rushed and mistakes will be made.

Plan procedures. I need to determine my sample sizes and whether there is a need for expert assistance at this inventory count.

- (1) **Procedures.** I will carry out test counts, checking from a sample of physical items to the count sheets and a sample of count sheet items to the physical items.
- (2) **Samples.** There are no higher value items that I should concentrate particularly on. Materiality for the year has been set at \$5,000 currently. Dividing last year's figures for inventory by this materiality level would give a sample size of six items for raw materials and 34 items for finished goods. I need to determine the batches in which inventory is valued to ensure that I count the correct items. I need to assess the levels of inventory when I arrive to ascertain whether this remains appropriate.

(c) Cut off at final audit

General procedures

The audit team should take a **sample of delivery notes** for sales and purchases on either side of the year end and **trace** these to **invoices** and **ledgers** and **inventory** records to ensure that **sales and purchases have been included in the correct period** and that **inventory is accounted for where appropriate** (that is, sales have not been counted twice and purchases have been included in inventory). As the factory has been shut down, there is a lower risk that sales cut-off is inappropriate than purchases cut-off.

Inventory count delivery

Once it is determined whether this delivery should count as this year's inventory (which it should if the inventory count was the year-end date), the delivery information should be traced to purchase invoices and ledgers to ensure that the purchase is recorded in the year and that the creditor is accounted for in the year. The inventory should then also be included.

Other matters

If inventory returns are material, the returns after the year end should be reviewed to ensure that items are not included as sales in the year and that the inventory is added to the inventory figure unless it is now obsolete, whereupon it should be written-off.

(d) Valuation of inventory

The auditors should obtain the client's working papers relating to the valuation of inventory. Items which the auditor sampled at the inventory count should already have been verified to the inventory count records as part of the verification of existence.

Cost

The auditors should then **trace a sample of items to purchase invoices** to ensure that **cost has been correctly applied**. Cost of purchase excludes trade discounts and rebates, so the auditors should ensure that the valuation **cost excludes the 10% discount** received for returning the off-cuts of plastic.

The auditors should then ensure that for a sample of finished goods items, **costs of conversion** (comprising costs of labour and overheads) have been included. This should be on a comparable basis to the previous year and therefore can be audited by analytical review.

Net realisable value

The auditors should ensure that **cost is lower than net realisable value** by tracing their sample to **after-date sales**. If no invoices are yet available, the auditors can make confirmations by reviewing sales orders and price lists.

Obsolete

Lastly, the auditors should ensure by review and by discussion with management that inventory which has been identified as **obsolete** at the inventory count has **not been attributed value** and has been **scrapped**.

Analytical procedures

The auditors will undertake general analytical procedures to ensure that the inventory figure stacks up. This could include calculating ratios such as inventory collection period and ensuring that they tally with the facts that have been presented to them in the course of the inventory audit.

69 Bright Sparks

(1) Conclusions to be drawn as a result of the interim audit

The following deficiencies exist in the company's systems:

- (i) In any system of internal control, one person should not be able to process a whole transaction from start to finish:
 - (a) Authorisation
 - (b) Execution
 - (c) Recording

The most serious deficiency in the company's system is that warehousemen can:

- (a) Sell goods
- (b) Receive cash from cash sales
- (c) Raise sales invoices for credit sales
- (d) Raise credit notes

Moreover, there appears to be no procedures in place for checking any of their work. Since the accounting records are written up on the evidence of these invoices and credit notes, any errors made by the warehousemen will be carried into the records. It may also be the case that the issue of credit notes is not authorised by a senior member of staff.

Possible consequences

- (a) Errors on invoices may not be detected except by customers
 - (b) Risk of unauthorised or fraudulent invoices or credit notes being raised without detection
 - (c) Risk of goods leaving the premises without being invoiced, whether through error or fraud (this is particularly dangerous in a business such as this, with a variety of high-value items)
 - (d) Time wasted by needless disagreements with customers about amounts owing
- (ii) There appears to be a weakness in the recording of cash received by the company. The dates recorded in the books are presumably the dates when the entries were written up. If so, there is clearly an excessive delay in recording cash received, and possibly also in banking it. There may also be no record of cash received made when incoming mail is opened.

Possible consequences

- (a) Errors and defalcations can arise where a cash received system is weak.
 - (b) The longer the gap between receipt and recording, the more likely it is that discrepancies can occur.
 - (c) **Specific possibilities:**
 - Falsification of records leading to misappropriation of cash (teeming and lading)
 - Mislaying of cheques if not banked promptly
 - Errors in the records, especially concerning dates
- (iii) Stricter control is needed over the granting of cash discounts (assuming that it is the actual receipt of cash which is later than the due date, not merely the late recording of same).

Possible consequence

Discounts given to a standard list of customers who may be friends of staff or regular customers, not necessarily prompt payers.

(2) Audit work on trade accounts receivable at the final audit

- (i) Second circularisation
 - (a) Consider circularising all trade receivables accounts, or at least a larger sample than before of accounts not circularised at 30 September.
 - (b) Circularise and investigate disagreeing replies. Discover if reasons are similar to those given at 30 September circularisation.
- (ii) To gain further evidence about the rights and obligations and existence of receivables:
 - (a) Check the sales invoices which make up the balances with backing documentation, for example purchase orders and despatch notes (if the latter exist).
 - (b) Ascertain extent of cash received from customers after the year end; reconcile the individual invoices to ensure that no discrepancies exist.

- (c) Obtain explanations for invoices remaining unpaid after subsequent invoices have been paid.

To gain evidence about the valuation of receivables, I would review the cash received after-date and would also carry out the following tests:

- (a) Check calculation of outstanding invoices.
- (b) Carry out further tests on settlement discounts and ascertain whether the position has improved or deteriorated since the time of the interim audit.
- (c) Confirm necessity/adequacy of provision against write-off of specific debts by review of correspondence, solicitors' debt collection, agencies' letters, liquidation statements.
- (d) Consider whether amounts owed may be not recovered where there have been round sum payments on account or invoices unpaid after subsequent invoices paid.
- (e) Review customer files/correspondence from solicitors and circularisation results for evidence of potential bad debts.
- (f) Confirm any general provisions for uncollectable (bad) debts, considering how well previous year's provisions predicted actual bad debts and whether the formula used is reasonable and consistent with previous years.

I would check the completeness of receivables by carrying out cut-off tests at 31 December to ensure that all goods leaving the premises by that date (and only those) have been included in sales. I would also check that all returns of goods after the year end relating to 20X0 sales have been correctly recorded.

Other general tests include:

- (a) Agree the opening balance on the sales ledger control account with the previous year's working papers to ensure all the necessary adjustments were put through last year.
- (b) Scrutinise sales ledger control for unusual entries.
- (c) Check list of trade account receivables balances to and from sales ledger, and reconcile with sales ledger control account.
- (d) Carry out analytical procedures, particularly reviewing changes in the receivables turnover period, and changes in the age profile of receivables.
- (e) Check that trade receivables have been separately disclosed in the notes to the accounts.

70 Audit of cash and bank (Preparation Question)

- (a) Characteristics of bank confirmation letter:
 - (1) The client must give its permission in writing to the bank for disclosure of information to the auditors.
 - (2) The bank letter must refer to the client's letter of authority and the date of that letter.
 - (3) The bank letter should reach the bank at least one month before the year-end date and should state the year-end date and the previous year-end date.
- (b) Items requested in the bank confirmation letter:
 - (1) Balances due to or from the client on current, deposit and loan accounts
 - (2) Nil balances on accounts
 - (3) Accounts closed during the year
 - (4) Maturity and interest terms on loans and overdrafts
 - (5) Confirmation of contingent liabilities on guarantees etc
 - (6) Confirmation of securities and other items in safe custody
 - (7) Any offset or other rights or encumbrances

(8) Collateral given or received

Only six were required.

- (c) The bank reconciliation is carried out because the balance on a company's general ledger cash account is unlikely to match the figure in the year-end bank statement because of timing differences for cheques and other payments and receipts clearing. The bank reconciliation is an exercise to compare the balance per the ledger and the balance per the bank statement and therefore to confirm the accuracy of the figure on the company's statement of financial position.

71 Understatement

- (a) (i) It is more likely that payables will be understated than overstated because of the nature of the evidence available to indicate that liabilities exist.

It is relatively simple to ensure whether a recorded liability has been correctly accrued at the year end. However, it is more difficult to identify liabilities which have been omitted from payables.

- (ii) The auditor's difficulty in ensuring that payables are not understated arises precisely because of the circumstances described above. The auditor can test accrued invoices to ensure that they are a valid liability of the company at the year-end date. However, identifying liabilities which have been omitted at the year end presents a more difficult problem. As there may be no direct evidence of the liability (say, an invoice) understatement may have to be identified using indirect evidence, such as unmatched pre-year-end goods received notes or post-year-end cash book entries.

- (b) (i) Audit work to verify trade payables and purchase accruals would be as follows:

Purchases cut-off: As goods received notes are not used, the normal procedures for auditing cut-off will need to be adapted.

- (1) Examine purchase invoices on either side of the year end to dated supplier's delivery note to ensure invoices have been correctly accrued. (Where the Goods Received department has not date-stamped the delivery date it will be necessary to use the supplier's despatch date.)
- (2) Enquire if the goods received department or bought ledger department are holding any unmatched delivery notes (those without an invoice) relating to the period before the year end.

- (ii) **Completeness, existence and ownership**

- (1) Select invoices from the trade payables listing and trace to supporting documentation to ensure that the purchase was for the purpose of the business.
- (2) Reconcile a sample of suppliers' statements with purchase ledger balances. This will highlight any purchases that have been omitted. Where there are major accruals for which statements are not available it may be necessary to carry out a payables circularisation. (A circularisation is not normally the primary procedure to be selected, as the supplier's statement provides more effective evidence and a reconciliation is simpler to carry out than a circularisation.)
- (3) Review balances for unusually low balances with major suppliers.
- (4) Compare the ratio of trade payables to purchases and inventory with the previous year's figures.
- (5) Match cash payments posted in purchase ledger accounts before and after the year end to cash records to ensure they were posted in the right period.

- (iii) **Trade payables listing**

- (1) Agree the total unpaid invoices and credit notes to balances on the aged payables listing.
- (2) Agree the total of balances on the aged payables listing to the purchase ledger control account.

- (3) Agree the list of balances to individual ledger accounts and vice versa.
 - (4) Review the listing for large payable balances and enquire into reasons for them and action being taken.
 - (5) Review the control account around the year end for unusual items.
- (c) Sundry payables and accruals is an area that lends itself to analytical review and reconciliation techniques, except for liabilities such as income tax and sales tax, which should be checked in detail.
- (1) From the sundry payables and accruals listing confirm that the calculation of accruals is reasonable and verify to subsequent payments. Income tax and related deductions liabilities should also be verified to payroll.
 - (2) Scrutinise post year end payments/invoices received to check for understatement of sundry payables and accruals.
 - (3) Ascertain whether any expenditure is likely to be invoiced a long time after the goods or services are received.
 - (4) Compare sundry payable and accruals with prior year balances and enquire into significant variations.
 - (5) Check that the sales tax accrual is disclosed at correct amount by vouching to returns and accounting records.
 - (6) Ensure that no non-deductible tax is reclaimed on the return by scrutinising it.
 - (7) Vouch payments or refunds of sales tax to cash book from sales tax returns.
 - (8) Obtain sales tax returns for the period and check that they have been properly prepared and filed promptly.
 - (9) Test sales tax totals from prime records to monthly/quarterly summaries and test cast summaries and scrutinise for unusual items.
 - (10) Review correspondence with taxation authority and results of any recent control visits.

72 'Tap!'

(a) Audit risks

There is a higher audit risk associated with a charity as, in the event of problems arising and litigation taking place, the audit firm could experience a significant amount of bad publicity.

Inherent risks

- (1) **Cash.** The charity operates with a high number of cash and cheque transactions. A substantial part of its **income** comes from cash donations. Put another way, it is likely that very little of its income comes from direct bank transfers. Also, it is likely that many of the **expenses** which 'Tap!' incurs are also cash expenses. Cash is **risky for audit purposes** because it is **susceptible to loss, miscounting or misappropriation**.
- (2) **Charity.** The theatre company is a charity, and is therefore subject to a high degree of **regulation**. This raises the risk for our audit.
- (3) **Accounting specialist.** The charity employs an administrator, but there is no mention of an accountant. It is unclear who is going to draft the charity accounts (which must comply with specialist requirements) but it does not appear that a specialist exists to undertake this job. This increases the risk of errors existing in the accounts.
- (4) **Completeness of income.** As the charity appears to have **no control** over the primary collection of income from box office receipts, there is a significant **risk that income is understated** and that the theatres have not accounted properly to the charity.
- (5) **Disclosure of income.** The disclosure of income must be considered. It is unlikely to be appropriate to show the 'net income from theatres' figure. Rather, the gross income less commission should probably be disclosed.

- (6) **Expenditure.** The charity expenses may be well-recorded, or they may be **difficult to substantiate** – this is not clear. It may also be difficult to substantiate payments made to build wells in Africa. We currently have no knowledge about how that aspect of the charity operates. It will be important to check that expenditure is made in accordance with the trust deed. Some essential administrative expense will not necessarily be conducive to the aims of the charity. We must ensure that it is all analysed correctly.

Control

There currently appear to be **no controls over cash** in the charity.

Detection

This is a **first-year audit**, so there is little knowledge of the business at present. It is also the **first ever audit** of the charity, so the comparatives are unaudited. We must make this clear in our report, and we will need to undertake more detailed work on the **opening balances**. As the charity is to a large degree **peripatetic**, we may find audit evidence difficult to obtain, if it has not been properly returned to the administrative offices.

Conclusion

This appears to be a high-risk first year audit. It is likely to result in a modified audit opinion.

(b) Audit procedures

Income from box office takings

Income from box office takings can be **verified to the statement from the theatre** and the **bank statements** to ensure that it is complete. The **commission** can be agreed by **recalculation**.

It might be necessary to **circularise** a number of the theatres and request **confirmation of the seats sold** for each performance to ensure that income is completely stated on the return from the theatre. (However, if theatres have been defrauding the charity, they are unlikely to confirm this to the auditors. This may have to be an area which is aided by stronger controls over income.)

Income from buckets (theatres and streets)

We must discover whether the charity fills out 'counting sheets' when the buckets of money are originally counted. If so, the **money in buckets can be verified from the original sheet to the banking documentation**.

However, in the **absence of strong controls** over the counting, it will be **impossible to conclude that this income is complete**.

Income from other donations

Donations made over the phone should have been noted on documents and then retained at the administrative offices. Donations made by post should have **original documents**. A sample of these should be **traced to banking documentation** and bank statements.

Again, in the **absence of originating documentation**, it will be **difficult to conclude that income is fairly stated**.

(c) Controls over cash

Income from box office takings

It would be a good control over completeness of income to request a **schedule of seats sold** from the theatres for every night a performance is given. This is likely to be information that theatres can print off their systems with no trouble. This will lead to the theatre company having more assurance as to the completeness of income.

Income from buckets

As this income is highly susceptible to loss or misappropriation, strong controls should be put in place.

- (1) **Number of people.** If possible, the charity should assign **two people** to each bucket during the collection phase and two people should count the money in the bucket at the end of the day. These people will act as a **check on each other** to ensure that cash is kept more secure.

- (2) **Security.** The security arrangements for buckets should be strong. The charity could invest in a **transportable safe** in which to store the money between collection and banking. It might also be wise to use **collecting tins** rather than buckets, as this simple measure would ensure that the cash was less open to the public. The cash should also be **banked frequently**. It should not be kept unbanked for longer than 24 hours after collection.
- (3) **Recording.** A record should be made of cash counts and it should be signed by both the people that undertook the count. This can provide an initial record of the cash takings.

Other income

The controls over other income will be restricted by the number of staff at the provincial office. It appears that only the administrator may work there regularly. If this is the case, it is going to be difficult to introduce supervision into the cash operations.

All phone donations should be recorded on pre-numbered documentation so as to give evidence of completeness.

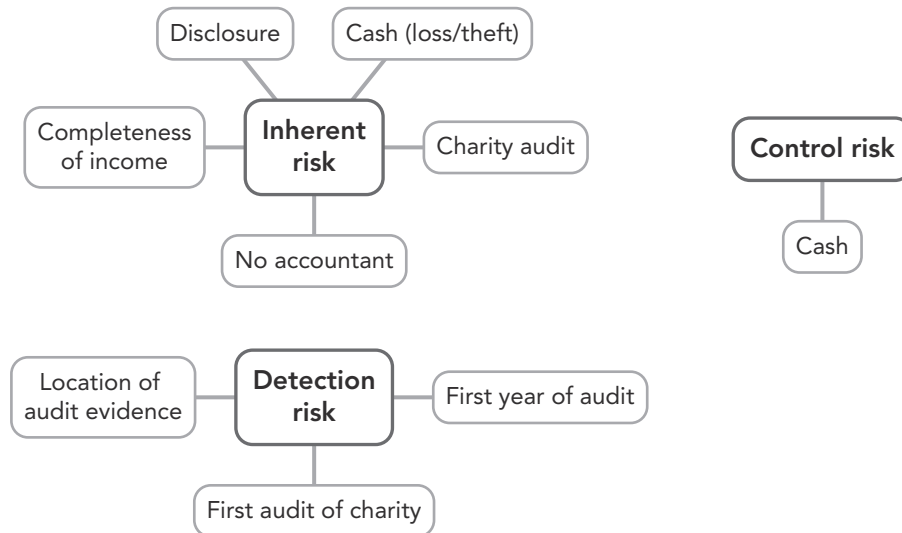
As the administrator largely works alone, it would be a good idea for the Board of Trustees to carry out a cyclical review of the work of the administrator. This would provide useful protection from problems for both the charity and the administrator.

Approaching the answer - 'Tap!'

You should read through the requirement before working through and annotating the question as we have so that you are aware of what things you are looking for.

Answer plan

(a) Audit risk



(b) Audit procedures

- Income from box office
- Income from buckets
- Income from other donations

(c) Controls

- Schedule of seats
- Two people to collect
- Pre-numbered forms

Security of cash during collection and between banking?

Other income

Use pre-numbered forms

Periodic reviews of work by trustees

73 Namul (Preparation Question)

Text reference. Chapters 5, 9, 10 and 19.

Tutorial note. As you looked through a scenario such as this, you should be searching for any clue you are given that there is a deficiency in a particular area. For example, there is a lot of potential for running out of inventory where you have a four-week wait for orders to arrive. In the absence of a robust control here, you should be able to pick up that the current ordering system is not up to the job and suggest viable improvements, such as setting minimum reorder levels.

Determination of inventory levels

(i) Deficiency

The purchasing manager determines store inventory levels without consulting those who are best placed to judge the local market; the store or sales managers.

(ii) Implication

Certain clothes and accessories may be initially over-ordered and may need to be sold at reduced prices. This may also result in overvalued inventory (if held at cost) in the management accounts and ultimately the financial statements. Also, some inventory may not be ordered in enough volume to meet demand and the reputation of Greystone may suffer.
(iii) Recommendation
The purchasing manager should consult (in a meeting or by conference call) the store managers and a joint decision should be made on the initial inventory levels to be ordered for clothes/accessories.
Reordering
(i) Deficiency
Store managers are responsible for reordering through the purchases manager and it can take four weeks for goods to be received.
(ii) Implication
The reliance is on store managers to be proactive and order four weeks before a potential stock-out. Without prompting they may order too late and inventory may run out for a period of up to four weeks, resulting in lost revenue.
(iii) Recommendation
Realistic reorder levels should be established in the inventory system. When inventory is down to the predetermined level, the purchasing manager should be prompted to raise a purchase order (for example, the system may generate an automatic reorder request which is emailed to the purchasing manager).
Internal ordering
(i) Deficiency
Stores can not transfer goods between each other to meet demand. Customers are directed to try other stores/the website when an item of clothing is sold out.
(ii) Implication
Revenue is lost because the system is inconvenient for the customer, who may not follow up at other stores, but may have purchased if the goods were transferred to their local store. Additionally, the perceived lack of customer service may damage the store's reputation.
(iii) Recommendation
An internal ordering system should be set up which allows for the transfer of goods between stores. In particular, stores with very low inventory levels should be able to obtain excess inventories from those with high levels to meet demand while goods are reordered.
Checking of goods received
(i) Deficiency
Goods received are not checked against purchase orders.
(ii) Implication
Goods which were not ordered in the first place could be received. Once received, it may be difficult to return these goods and they may need to be paid for. In any case, there is a potential unnecessary administrative cost. Additionally, some goods ordered may not be received, leading to insufficient inventory levels and potential lost revenue.
(iii) Recommendation

A copy of authorised orders should be kept at the relevant store and checked against GRNs. If all details are correct, the order should be marked completed and sent to head office. The purchasing clerk should review the purchase orders at regular intervals for incomplete items and investigate why these are not completed.

Review of purchase orders

(i) Deficiency

The purchase orders reviewed and authorised by the purchasing director are aggregated by region.

(ii) Implication

The lack of detail does not allow the purchasing director to make an informed assessment of the buying policies and they may be unsuitable for specific markets within regions.

(iii) Recommendation

A country by country review of orders should be carried out by the purchasing director. Where appropriate, discussions should take place between the purchasing director and local purchasing managers before authorisation of orders.

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

Tutorial note. The answer to (a) includes four well-explained deficiencies, implications and recommendations as four were needed to gain 12 marks. Together with the 2 marks available for presentation, this would be enough for the full 14 marks.

Please note, however, there were a number of alternative deficiencies/implications/recommendations you may have identified, including those shown in the table below.

(i) Deficiency	(ii) Implication	(iii) Recommendation
Quality of goods is not checked by sales assistants, only quantity.	Poor quality clothes are accepted and may not be saleable (also inventory may be temporarily overvalued).	Goods should be checked on arrival for quantity and quality prior to acceptance.
Purchase invoices and GRNs are manually matched, which is time consuming.	The manual process of such a high volume of documents is prone to human error. Invalid invoices may be processed as a result.	A purchasing system should be adopted which allows for logging of GRNs against original invoices, and then electronic/automatic matching of invoices against GRNs. A regular review by the purchasing clerk should then be focused on unmatched items.
A purchase invoice is not put on the system until it is	The purchase ledger will not have all invoices posted,	Invoices not matched should be filed separately, as

(i) Deficiency	(ii) Implication	(iii) Recommendation
ready for authorisation by the purchasing director.	understating liabilities. Also, payables may be paid late.	should those not posted. These should be reviewed at period ends and accrued for to ensure completeness of payables.

74 Ajio

(a) Risks

Inherent and control risks (risk of material misstatement)

The complexity and extent of regulations

There is a risk that the charity will **fail to comply** with new and existing regulations. It may also be involved in activities which are not compatible with its charitable status. This is particularly the case where small charities like Ajio are involved, as they may not be run by individuals with the required expertise. However, the fact that the accounts are prepared by a recently retired accountant should reduce the auditor's assessment of this risk.

Completeness of income

There is a risk that **income may be understated**. This risk is increased by the high levels of cash donations made, as these are not supported by any documentary evidence. Cash may be misappropriated or errors could be made in counting and recording. Completeness of income from bequests would also be difficult to confirm, as there is no predictable pattern in terms of their receipt. This risk is likely to be increased by the fact that Ajio is unlikely to have sophisticated controls in place.

Uncertainty of future income

Due to the **unpredictable nature of income** there is a risk that the charity will undertake projects which it subsequently finds it is unable to finance. This factor will also make it more difficult for the auditor to assess whether the charity is viable on an ongoing basis.

Skills and qualifications of trustees

Control risk is increased if the trustees do not have the skills required to manage the affairs of the charity. It will also be affected by the extent to which they are involved and the amount of time which they are able to devote to its affairs.

Use of volunteers

Control risk is increased by the use of volunteers. The charity is dependent on their integrity and commitment. Shortcomings may arise from a lack of training and from their attitude in that they may resent formal procedures. Bogus volunteers may commit fraud.

Quality of paid staff

Lack of resources may result in staff being employed who are not sufficiently qualified. In the case of Ajio, a part-time bookkeeper has been employed instead of a full-time accountant. If this individual is under constant time pressure the **risk of errors** in the accounts is increased.

Lack of formal procedures

There is a risk that the charity may be run in an informal manner which will result in a **poor control environment**. This problem is likely to be accentuated by a lack of segregation of duties due to the small number of staff involved.

Detection risk

Recent appointment

Detection risk is increased by the fact that the firm has only recently been appointed. The audit team will not be able to rely on their experience of this audit from previous years. In addition, the regulations are new. There is a risk that the auditors will fail to perform specific

procedures required by the regulations due to a lack of familiarity with them. Adequate planning will reduce this risk.

Reduced reliance on analytical procedures

Due to the unpredictable nature of income it may be more difficult to rely on the results of analytical procedures to assess the **completeness of income**. This increases detection risk, as analytical procedures are one of the key tests in this area. The results of alternative procedures will reduce this risk.

Implications for overall audit risk

The aim of the auditor is to reduce overall audit risk (the risk of issuing an inappropriate opinion) to a reasonable level. Audit risk is a function of the risk of material misstatement (inherent risk and control risk) and detection risk. As inherent risk and control risk in Ajo appear to be high/medium, **detection risk will need to be low**. This will be achieved by increasing audit work eg increasing sample sizes. Risk areas will also be targeted, in this case income and cash being key balances.

(b) Audit tests

Income

- (1) Attend a fundraising event and observe procedures to confirm that they are in accordance with the guidance set down by the charity eg use of sealed collection boxes.
- (2) Count cash at the end of the day and agree to returns submitted by volunteers.
- (3) Match returns submitted with amounts on the bank paying-in slips.
- (4) Trace entry of cash received to cash book and bank statements.
- (5) Review the preparation of monthly bank reconciliations.
- (6) Compare amounts received by cash collections with previous years' balances and forecasts. Discuss major fluctuations with trustees.
- (7) Obtain representations from the trustees regarding the completeness of income.

Expenditure

- (1) Obtain a breakdown of expenditure relating to fundraising events and check that the nature of the cost is reasonable.
- (2) For a sample of expenses trace the cost to a supporting invoice or other documentation.
- (3) Compare the overall level of expenditure with previous years and with budgets. Discuss any major fluctuations with management.
- (4) For a sample of major expenses confirm that the expenditure has been authorised by the trustees.

75 Going concern

Working

Accounting ratios

The following significant accounting ratios are based on the accounts provided in the question:

	20X2	20X3	20X4	20X5	20X6
Gross profit (%)	23.50	10.90	14.20	20.20	19.70
Other expenses: sales (%)	14.10	10.90	14.40	14.40	15.30
Interest: sales (%)	0.90	1.10	5.20	5.50	6.20
Net profit (%)	8.50	(1.10)	(5.40)	0.30	(1.80)
Current ratio	1.39	0.91	0.73	0.73	0.76

Liquidity ratio	0.80	0.59	0.46	0.37	0.34
Leverage (%)	84.71	57.14	9.52	9.45	4.83
Inventory (months)	1.68	2.28	2.26	2.77	3.57
Receivables (months)	1.75	3.66	3.24	2.26	2.32
Payables (months)	2.26	5.43	4.43	4.43	5.09

Notes

Inventory age =

Receivables' age =

Payables' age =

Leverage =

The various factors in the accounts which may be indicative of going concern problems are as follows:

- (1) Only losses or low profits are being made and the company is not generating sufficient funds to finance the expansion required.
 - (2) There has been a dramatic increase in the level of overdraft over the last year, and there seems to be little prospect of the borrowing being reduced and the security is threatened.
 - (3) There are signs of overtrading, as the expansion has been financed by borrowings and the increase in current assets is being financed by trade accounts payable.
 - (4) The leverage is low and decreasing, with very little security being available for the loans.
 - (5) There is a low current ratio and short-term funds are being used to finance long-term assets.
 - (6) The liquidity ratio is low and decreasing and the company's ability to meet its liabilities on demand must be very questionable.
 - (7) Inventory levels are increasing, suggesting that one or more of the following problems may exist: deteriorating sales, poor inventory control, obsolete or slow-moving inventories.
 - (8) The value and age of trade accounts payable are increasing: some suppliers are probably having to wait a considerable time before being paid and it can only be a matter of time before pressure is put on the company by one or more of its creditors.
 - (9) High and increasing interest charges make the company very vulnerable, especially in a period of recession and high interest rates.
 - (10) The fluctuating gross profit would suggest that the company's profit margins are under pressure. The present level of gross profit does not seem sufficient given the company's high level of expenses.
- (b) The other important steps to be taken by the auditors in determining whether or not the company may be properly regarded as a going concern at the year end would include:
- (1) Review carefully the cash and profit forecasts for the next year to see if they suggest any improvement in the company's position.
 - (2) Seek some evidence that the company's bank is prepared to continue supporting the company.
 - (3) Review the level of post year end trading to see if this supports the forecasts and shows any signs of improvement in the company's position.
 - (4) Examine correspondence files for any evidence that suppliers might be putting pressure on the company for repayment of monies owing.
 - (5) Consider how the company's position compares with similar companies in the same business.

- (6) Discuss generally the situation with management and review any recovery plans which they may have in mind.

76 Audit review and finalisation (Preparation Question)

- (a) The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of their report that may require adjustment or disclosure in the financial statements have been identified (ISA 560: para. 6). These procedures should take place as near as possible to the date of the auditor's report. They would include, for example, reading minutes of meetings with shareholders and audit committee meetings, reviewing the entity's latest interim accounts, and reviewing procedures that management have for identifying subsequent events. The auditor shall request that management and those charged with governance provide a written representation that all subsequent events requiring adjustment or disclosure have been adjusted or disclosed.

The auditor has no obligation to undertake audit procedures or make enquiries regarding the financial statements after the date of the auditor's report. Between this date and the date of issue of the financial statements, it is the management's responsibility to inform the auditors of any facts that might affect the financial statements. If such facts do arise which the auditor becomes aware of, they shall consider whether the financial statements need amending, discuss the matter with management and take appropriate action. If the financial statements are amended, a new auditor's report must be issued. If management refuses to make any amendments required, the auditor shall modify the audit opinion.

After the financial statements have been issued, the auditor has no obligation to make any enquiry regarding the financial statements. Where the auditor becomes aware of facts that may affect the financial statements after they have been issued, they shall consider whether they need to be revised and shall discuss with management and take appropriate action. If amendments are made to the financial statements, the auditor shall issue a new auditor's report which shall include an emphasis of matter paragraph referring to a note in the financial statements that discusses the reason for the revised financial statements in more detail.

- (b) Written representation:

- (1) Addressed to the auditor
- (2) Signed and dated, normally the date of the auditor's report
- (3) Acknowledgement from management for the design and implementation of internal control to prevent and detect error
- (4) A statement that management believes that the effects of uncorrected misstatements are immaterial, both individually and in aggregate; the letter should contain a summary of these items
- (5) A statement confirming the completeness of information provided regarding the identification of related parties
- (6) A statement that the financial statements are free from material misstatements, including omissions
- (7) A statement that the management have made available to the auditors all books of account and supporting documentation and all minutes of meetings of shareholders and the board of directors
- (8) A statement that the entity has satisfactory title to all assets and there are no liens or encumbrances on the entity's assets, except where disclosed in the notes to the accounts
- (9) A statement that all liabilities, both actual and contingent, have been disclosed in the accounts, as well as any guarantees to third parties
- (10) A statement that there have been no events subsequent to the year end which require adjustment or disclosure in the accounts, other than where specifically disclosed in the accounts

- (c) The auditors must perform and document an overall review of the financial statements before they can reach an opinion. This review gives the auditors a reasonable basis for their opinion on the financial statements. At the review stage, the auditors consider compliance with accounting regulations, consistency and reasonableness and application of accounting policies.

Analytical procedures are a very useful tool at this stage of the audit. They can be used to calculate important accounting ratios, changes in products or customers, price and mix changes, variances, trends in production and sales and variations caused by industry or economic factors. Any significant fluctuations and unexpected relationships must be investigated through enquiries with management and obtaining appropriate audit evidence relevant to **management's responses**, and **performing other audit procedures** considered necessary in the circumstances.

77 Wiseguys National Bakeries (Preparation Question)

(1) Freehold property

In past years this property has been shown in the statement at its original cost, whereas it is now restated at \$1,250,000 as professionally valued during the year. The auditor is satisfied as to the basis of the revaluation, adjustment to and disclosure made in the financial statements. As a result of the audit evidence obtained, no further reference to the property revaluation will be required in the auditor's report.

(2) Allowance for doubtful debts

No part of the debt of \$45,000 due from XYZ Co will be recovered by the company. Since the financial statements which the directors have approved include no allowance for this debt, a qualified opinion should be issued.

It will be necessary for the auditor's report to state that in the auditor's opinion, except for the failure to make such allowance, the financial statements present fairly, in all material respects (or give a true and fair view of), the state of the company's affairs and its results.

The Basis for Qualified Opinion paragraph should explain that no allowance has been made against an amount of \$45,000 owing by the customer, while the auditor believes such amount to be irrecoverable.

(3) Loan to a director

The outstanding loan of \$22,000 constitutes a related party transaction, and disclosure is required under IAS 24. Since no disclosures have been made in the financial statements, and the amount is material ($\$36k/\$450k = 8\%$ of profit before tax), the auditors should issue a qualified opinion.

The opinion paragraph in the auditor's report should state that in the auditor's opinion, except for the failure to make such a disclosure, the financial statements present fairly, in all material respects (or give a true and fair view of), the state of the company's affairs and its results.

The Basis for Qualified Opinion paragraph should describe the outstanding loan to the director, including:

- (1) The amount of the loan and any interest
- (2) The zero outstanding balance at the year end
- (3) Terms and conditions

78 Homes'r'Us

(a) Customer going into liquidation

Audit procedures

- Assess the likelihood of recovery of this amount by discussion with the directors of Homes'r'Us.

- Confirm the amount of the amount outstanding as at the year end by inspection of the receivables ledger and correspondence with the customer.
- Review any correspondence between the company and the customer to assess the likelihood of recovery of any amounts.
- Obtain a written representation point regarding the amount outstanding from the customer from the directors of Homes'r'Us.

Impact on financial statements

The financial statements will need to be amended, as this is an example of an adjusting event after the reporting period. It provides additional information concerning the recoverability of the debt at the reporting date.

Revenue, profit and net assets will all be overstated by \$7.5m if the accounts are not adjusted. The amount represents 10.7% of profit before tax and 1.4% of revenue so is clearly material.

An adjustment is required in the financial statements to reduce the receivables balance and profits.

Effect on auditor's report

The effect of the matter on the financial statements is clearly material. If the adjustments required are made, then there would be no effect on the auditor's report.

If the directors refused to make the adjustment required, the audit opinion would be modified on the basis that the accounts are not free from material misstatement and a qualified 'except for' opinion would be issued, as the matter is material but not pervasive.

(b) Claim for unfair dismissal

Audit procedures

- Discuss the case for unfair dismissal with the directors of Homes'r'Us to find out background of case, date when claim was lodged and assessment of success.
- Review lawyer's correspondence regarding this case, as it may have an impact for next year's audit.
- Review any press reports in the local or national papers about this claim against the company.
- Review minutes of board meetings regarding this case and any other claim cases against the company.
- Obtain written representations on this matter from the directors of Homes'r'Us.

Impact on financial statements

A provision for this claim is not required since the requirements for recognising a provision under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* are not met. Under IAS 37 (para. 14), a provision should be recognised when there is a present obligation as a result of a past event, it is probable that a transfer of economic benefits will be required to settle it and a reliable estimate can be made.

In this case, it appears unlikely that Mr Evans will be successful in his claim and so no provision should be recognised in the financial statements for the year ended 31 December 20X7.

Disclosure of a contingent liability is also unlikely to be required since the possibility of any transfer in settlement appears to be remote.

Effect on auditor's report

There would be no effect on the auditor's report as a result of this matter, as no amendment would be required to the financial statements. An unmodified report on the financial statements could therefore be issued.

(c) Fire

Audit procedures

- Discuss fire with management of Homes'r'Us to clarify facts of the situation.

- Read minutes of board meetings and any reports submitted by insurers.
- Review insurance documents to confirm that damage caused by the fire is covered.

Impact on financial statements

The fire at the storage depot is a non-adjusting event after the reporting period – it does not relate to conditions which existed at the year end. It is unlikely that the fire is significant enough to impact on the going concern of the company. Disclosure of the event surrounding the fire should be made, together with an estimate of the financial effect.

Effect on auditor's report

Provided that adequate disclosure has been made of the event and its financial impact, there would be no need to modify the audit opinion as a result of this incident. An emphasis of matter paragraph drawing attention to this issue is unlikely to be required, unless it is viewed as being fundamental to the users' understanding.

79 Builders Merchants

- (1) This represents a potential material limitation on scope because the 'missing' inventory represents 12% of the total value of the inventory. The auditor would expect all inventory counting sheets to be available. The auditor's opinion would be modified on the basis that the auditor is unable to obtain sufficient appropriate evidence (ISA 705: para. 7).

The opinion paragraph would state that 'except for' adjustments that may have been necessary in relation to this inventory, the financial statements present fairly, in all material respects (or give a true and fair view).

The auditor's report would include a basis for qualified opinion paragraph after the opinion paragraph, which would refer to the fact that the inventory counting sheets for this depot were lost. The same paragraph would explain, in relation to inventory quantities:

- (i) All information and explanations considered necessary were not obtained.
- (ii) The auditor was unable to determine whether proper accounting records were kept.
- (iii) This represents a material misstatement. The debt represents 8% of the total receivables balance and 45% of the profit for the year.

The auditor's opinion would be modified. A qualified opinion would be issued.

The qualified opinion paragraph would state that 'except for' the absence of this allowance the financial statements are presented fairly, in all material respects (or give a true and fair view), in accordance with the applicable financial reporting framework.

The basis for qualified opinion paragraph would refer to the fact that the customer is in liquidation and there is little prospect of payment. It would also state that net assets and profits are overstated by \$45,000.

- (2) As the client is listed, its financial statements should include a statement of cash flows.

The auditor's opinion should therefore be qualified, as the financial statements are materially misstated. This misstatement is not pervasive to the financial statements; it is limited to the statement of cash flows, so this would be a qualified opinion.

The Qualified Opinion paragraph will state that the financial statements give a true and fair view and have been prepared, in all material respects, in accordance with an applicable financial reporting framework except for the omission of a statement of cash flows.

The Basis for Qualified Opinion paragraph will refer to the fact that the financial statements do not contain a statement of cash flows and include the figures required.

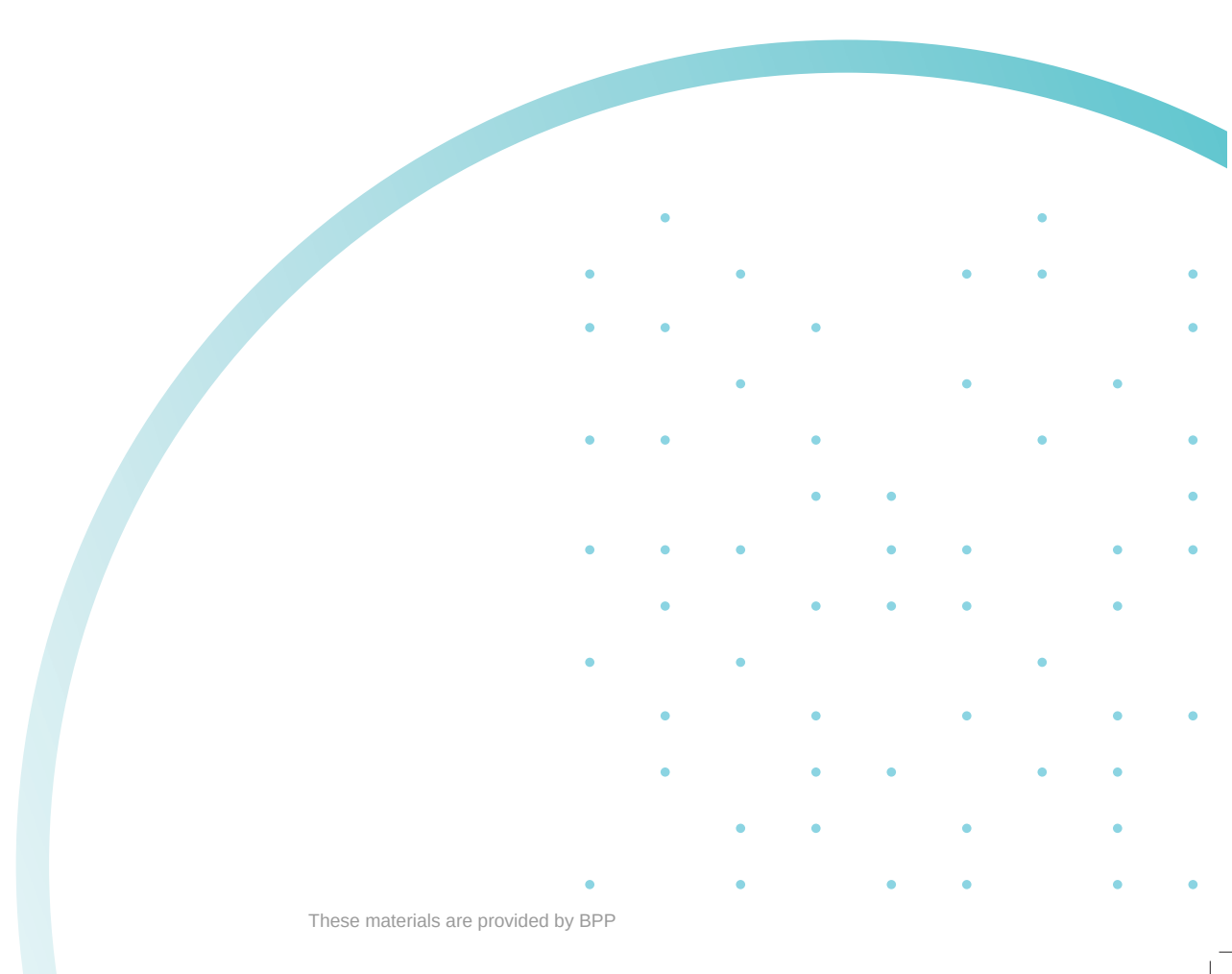
- (3) It appears that the disclosure in the financial statements is adequate and there appears to be no basis on which to make a provision in the financial statements. Assuming that the auditors agree with the assessment of the likely outcome the audit opinion would not be modified.

As the company is listed the auditors would need to consider whether the matter is one which has required significant auditor attention in performing the audit (ISA 701: para. 9). If this is the case it would be disclosed as a Key Audit Matter.

If the matter is not a key audit matter but it is assessed to be fundamental to users' understanding, the auditor's report should include an emphasis of matter paragraph beneath the basis of opinion paragraph describing this matter. It should also state that the auditor's opinion on the financial statements is not modified in relation to this matter.



Glossary



Chapter 1: The concept of audit and other assurance engagements

Accountability: the quality or state of being accountable; that is, being required or expected to justify actions and decisions. It suggests an obligation or willingness to accept responsibility for one's actions.

Agents: the people employed or used to provide a particular service. In the case of a company, the people being used to provide the service of managing the business also have the second role of trying to maximise their personal wealth in their own right.

The key reason for having an audit or review can be seen by working through the following case study.

Stewardship: the duties and obligations of a person who manages another person's property.

Assurance engagement: is one in which: a **practitioner** aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the **intended users** other than the **responsible party** about the outcome of the measurement or evaluation of an underlying **subject matter** against **criteria**. (IFAC, 2016(e))

Intended users: 'the individual(s) or organisation(s), or group(s) thereof that the practitioner expects will use the assurance report'. (ISAE 3000 (Revised): para. 12m)

Practitioner: 'the individual conducting the engagement (usually the engagement partner or other members of the engagement team, or as applicable, the firm'. (ISAE 3000 (Revised): para. 12r)

Responsible party: 'the party responsible for the underlying subject matter'. (ISAE 3000 (Revised): para. 12v)

Materiality: is an expression of the relative significance or importance of a particular matter in the context of the financial statements as a whole. A matter is **material** if its omission or misstatement would **reasonably be expected to influence the economic decisions** of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. (ISA 200: para. 6)

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 applicable financial reporting framework. (ISA 200: para. 3)

The objectives of an auditor: are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, in order to enable them to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. (ISA 200: para. 11)

Fair:

Information is free from discrimination and bias and in compliance with expected standards and rules. The accounts should reflect the commercial substance of the company's underlying transactions.

Present fairly: The financial statements show a true and fair view. They are factual and free from bias.

True: Information is factual and conforms with reality. In addition, the information conforms with required standards and law. The financial statements have been correctly extracted from the books and records.

Chapter 2: Statutory audit and regulation

Smaller entity: an entity which typically possesses qualitative characteristics, such as:

- (a) Concentration of ownership and management in a small number of individuals (often a single individual); and
- (b) One or more of the following:
 - (i) Straightforward or uncomplicated transactions

- (ii) Simple record-keeping
- (iii) Few lines of business and few products within business lines
- (iv) Few internal controls
- (v) Few levels of management with responsibility for a broad range of controls
- (vi) Few personnel, many having a wide range of duties

(IFAC, 2016(b))

Chapter 3: Corporate governance

Audit committee: a sub-committee of the board of directors, usually containing a number of independent non-executive directors.

Corporate governance: the internal systems or means by which companies are **directed** and **controlled**.

Chapter 4: Internal audit

Internal audit function: 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. (IFAC, 2016(b))

Chapter 5: Professional ethics and quality management procedures

Engagement letters: are the written terms of an engagement in the form of a letter.

Non-compliance with laws and regulations (NOCLAR): acts of omission or commission, intentional or unintentional, committed by the entity, or by those charged with governance, by management or by other individuals working for or under the direction of the entity, which are contrary to the prevailing laws or regulations. Non-compliance does not include personal misconduct unrelated to the business activities of the entity. (ISA 250 (Revised): para. 12)

Cold review/ Post-issuance review:

A peer review carried out **after** the auditor's report is signed.

Hot review/ Pre-issuance review: A peer review carried out **before** the auditor's report is signed. This is also known as an engagement quality review (EQR).

Peer review: A review of the audit file carried out by another partner in the assurance firm.

Chapter 6: Risk assessment

Audit risk: the risk that the auditor expresses an **inappropriate audit opinion** when the financial statements are materially misstated (ISA 200: para. 13(c)). **Audit risk** is the risk that the auditor expresses an **inappropriate audit opinion** when the financial statements are materially misstated (ISA 200: para. 13(c)).

Control risk: the **risk that a material misstatement** that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, individually or when aggregated with other misstatements, **will not be prevented or detected and corrected** on a timely basis by the entity's **internal control**. (ISA 200: para. 13 (nii))

Detection risk: the risk that the **procedures performed by the auditor** to reduce audit risk to an acceptably low level **will not detect a misstatement** that exists and that could be material, either individually or when aggregated with other misstatements (ISA 200: para. 13(e)).

Fraud: an "intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage" (ISA 240: para. 11(a)).

Fraud may be perpetrated by an individual, or colluded in, with people internal or external to the business.

Fraud risk factors are “events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud” (ISA 240: para. 11(b)).

Fraudulent financial reporting : Fraudulent financial reporting “involves intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users” (ISA 240: para. A2).

Inherent risk: the **susceptibility** of an assertion about a class of transaction, account balance or disclosure to a **misstatement** that could be material either individually or when aggregated with other misstatements, **before consideration of any related internal controls** (ISA 200: para. 13(nii)).

Material: Information is **material** if its omission or misstatement could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

Misappropriation of assets: Misappropriation of assets “involves the theft of an entity’s assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect” (ISA 240: para. A5).

Performance materiality: “the amount or amounts set by the auditor at **less than materiality for the financial statements as a whole** to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole”.

It also refers to “the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures” (ISA 320: para. 9).

Professional judgement: “application of relevant training, knowledge and experience in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement” (ISA 200: para. 13(m)).

Professional scepticism: “an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence” (ISA 200: para. 13(l)).

Significant risk: An identified risk of material misstatement:

- For which the assessment of inherent risk is close to the upper end of the **spectrum of inherent risk** due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur; or
- That is to be treated as a significant risk in accordance with the requirements of other ISAs.

(ISA 315: para. 12l)

Chapter 7: Audit planning and documentation

Audit documentation: is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as ‘working papers’ or ‘work papers’ are also sometimes used). (ISA 230: para. 6(a))

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.

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.

Chapter 8: Introduction to audit evidence

Assertions: Representations, explicit or otherwise, with respect to the recognition, measurement, presentation and disclosure of information in the financial statements which are inherent in management representing that the financial statements are prepared in accordance with the applicable financial reporting framework. Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing and responding to the risks of material misstatement (ISA 315: para. 12a).

Audit evidence: is all the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based **Audit evidence** (ISA 500: para. 5(c)).

Management's expert: 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.

Substantive procedures:

audit procedures designed to detect material misstatements at the assertion level. Substantive procedures comprise:

- (a) Tests of details (of classes of transactions, account balances, and disclosures); and
- (b) Substantive analytical procedures

(ISA 330: para. 4(a))

Tests of controls: audit procedures designed to **evaluate the operating effectiveness of controls** in preventing, or detecting and correcting, material misstatements at the assertion level (ISA 330: para. 4(b)).

Chapter 9: Internal control

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. (ISA 315: Appendix 3, para. 4)

Controls : Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance. In this context:

- Policies are statements of what should, or should not, be done within the entity to effect control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions.
- Procedures are actions to implement policies.

(ISA 315: para. 12c)

General IT controls: Controls over the entity's IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information processing controls and the integrity of information (ie, the completeness, accuracy and validity of information) in the entity's information system (ISA 315: para. 12(d)).

Information processing controls: Controls relating to the processing of information in IT applications or manual information processes in the entity's information system that directly address risks to the integrity of information (ie, the completeness, accuracy and validity of transactions and other information) (ISA 315: para. 12(e)).

System of internal control: The system designed, implemented and maintained by those charged with governance, management and other personnel, to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations (ISA 315: para. 12(m)).

Chapter 10: Tests of controls

Those charged with governance: are the person(s) or organisation(s) with responsibility for **overseeing the strategic direction** of the entity and obligations relating to the **accountability** of the entity (ISA 260 (Revised): para. 10a).

Chapter 11: Audit sampling and automated tools and techniques

Anomaly: “a misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population” (ISA 530: para. 5(e)).

Tolerable misstatement: “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” (ISA 530: para. 5(i)).

Tolerable rate of deviation: “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: para. 5(j)).

Audit sampling: means “the application of audit procedures to **less than 100%** of the items within a population of audit relevance such that all sampling units have **an equal chance of selection**, in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population” (ISA 530: para. 5(a)).

Population: is “the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions” (ISA 530: para. 5(b)).

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

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

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.

Automated tools and techniques: are “applications of auditing procedures using the computer as an audit tool”.

Big data: is a broad term for the larger, more complex datasets that can be held by modern computers. The term refers to a qualitative shift in the amount of data that is available in comparison with the past.

Data analytics: is the examination of data to try to identify patterns, trends or correlations. As the quantity of data has increased, it has become more and more necessary to evolve ways of processing and making sense of it.

Non-sampling risk: is “the risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk”; for example, the use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognise a misstatement or deviation (ISA 530: paras. 5(d) and A1).

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 (ISA 530: paras. 5(f) and A2).

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)” (ISA 530: para. 5(h)).

Sampling risk: is the risk that the auditor's conclusion, based on a sample, may be different from the conclusion if the entire population were subjected to the same audit procedure. (ISA 530: para. 5(c))

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.

Chapter 12: Non-current assets

Accounting estimate: "a monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty" (ISA 540 (Revised): para. 12(a)).

Auditor's point estimate or auditor's range: "an amount, or range of amounts, respectively, developed by the auditor in evaluating management's point estimate" (ISA 540 (Revised): para. 12(b)).

Estimation uncertainty: "susceptibility to an inherent lack of precision in measurement" (ISA 540 (Revised): para. 12(c)).

Management's point estimate: "the amount selected by management for recognition or disclosure in the financial statements as an accounting estimate" (ISA 540 (Revised): para. 12(e)).

Inherent risk factors: characteristics of conditions and events that may affect the susceptibility of an assertion to misstatement, before consideration of controls. (ISA 540 (Revised): para. A8)

Management's expert: an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements (ISA 500: para. 5(d)).

Development:

the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

Research: original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Chapter 13: Inventory

Auditor's expert: An Auditor's expert is "an individual or organisation possessing expertise in a field other than accounting or auditing, 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 either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm) or an auditor's external expert" (ISA 620: para. 6(a)).

Cost: Cost is defined by IAS 2 (para. 10) as comprising all costs of purchase and other costs incurred in bringing inventory to its present location and condition.

Net realisable value (NRV): Net realisable value (NRV) is the estimated selling price in the ordinary course of business, less the estimated cost of completion and the estimated costs necessary to make the sale (IAS 2: para. 6).

Direct assistance: Direct assistance refers to "the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor" (ISA 610 (Revised): para. 14(b)).

Internal audit function: Internal audit function is "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" (ISA 610 (Revised): para. 14(a)).

Chapter 14: Receivables

Exception: “A response that indicates a difference between information requested to be confirmed, or contained in the entity’s records, and information provided by the confirming party.” (ISA 505: para. 6(e))

Non-response: “A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.” (ISA 505: para. 6d))

External confirmations: Audit evidence obtained as a direct written response to the auditor from a third-party (the confirming party), in paper form, or by electronic or other medium.

Chapter 16: Payables and accruals

Service auditor:

“An auditor who, at the request of the service organisation, provides an assurance report on the controls of a service organisation.” (ISA 402: para. 8(d))

Service organisation: “A third-party organisation that provides services to user entities that are part of those entities’ information systems relevant to financial reporting.” (ISA 402: para. 8(e))

User auditor: “An auditor who audits and reports on the financial statements of a user entity.” (ISA 402: para. 8(h))

User entity: “An entity that uses a service organisation and whose financial statements are being audited.” (ISA 402: para. 8(i))

Chapter 17: Non-current liabilities, capital and directors’ emoluments

Constructive obligation:

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.
- (b) As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Contingent asset: 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 (IAS 37: para. 10).

Contingent liability:

- (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.

Legal obligation: an obligation that derives from:

- (a) A contract (through its explicit or implicit terms);
- (b) Legislation; or
- (c) Other operation of law.

Liability: 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.

Obligating event: an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

Provision: a liability of uncertain timing or amount.

Chapter 19: Audit review and finalisation

Going concern basis of accounting: Under the **going concern basis of accounting**, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. General purpose financial statements are prepared using the going concern basis of accounting, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. (ISA 570 (Revised): para 2)

Misstatement: 'A difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud' (ISA 450: para. 4(a)).

Subsequent events: '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' (ISA 560: para. 5(e)).

Written representations: 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.

Chapter 20: Reports

Emphasis of matter: 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 (ISA 706 (Revised): para. 7(a)).

Key audit matters: those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

(ISA 701: para. 8)

A misstatement of the other information:

exists when the other information is incorrectly stated or otherwise misleading (including because it omits or obscures information necessary for a proper understanding of a matter disclosed in the other information) (ISA 720 (Revised): para. 12(b)).

Annual report: a document, or combination of documents, prepared typically on an annual basis by management or those charged with governance in accordance with law, regulation or custom. Its purpose is to provide owners (or similar stakeholders) with information on the entity's operations and the entity's financial results and financial position as set out in the financial statements (ISA 720 (Revised): para. 12(a)).

Other information: financial or non-financial information (other than the financial statements and the auditor's report thereon) included in an entity's annual report (ISA 720 (Revised): para. 12(c)).

Other matter paragraph: 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 (ISA 706 (Revised): para. 7(b)).

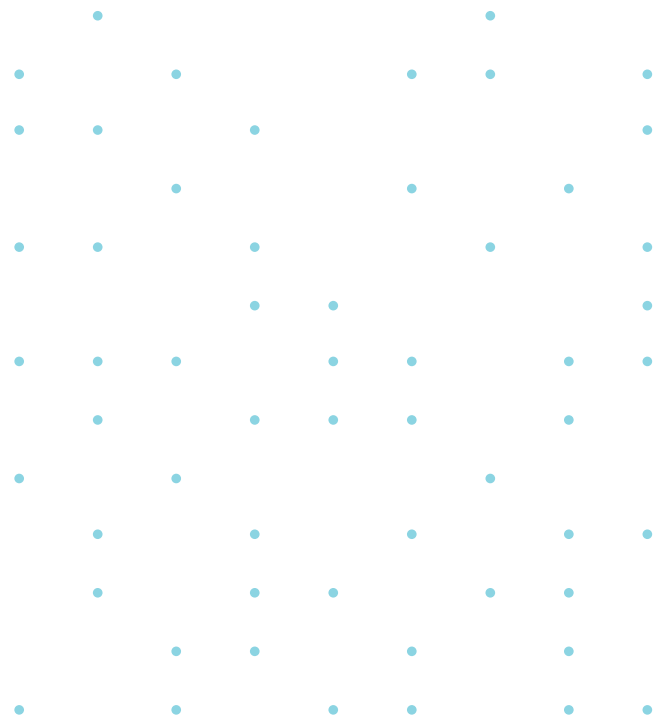
Pervasiveness: a term used to describe the effects or possible effects on the financial statements of misstatements or undetected misstatements (due to an inability to obtain sufficient appropriate audit evidence). There are three types of pervasive effect:

- (a) Those that are not confined to specific elements, accounts or items in the financial statements
- (b) 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
- (c) Those that relate to disclosures which are fundamental to users' understanding of the financial statements (ISA 705 (Revised): para. 5(a))

Unmodified opinion: 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: para. 16).



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