Audit and Assurance

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Syllabus objective and learning outcomes

CERTIFICATE IN ACCOUNTING AND FINANCE

AUDIT AND ASSURANCE

Objective
To acquire knowledge of theory, skills, techniques of auditing and to enable the students to understand International Standards on Auditing, Assurance and Ethics.

Learning Outcome	
On the successful completion of this paper candidates will be able to:	
1	demonstrate knowledge of general concepts governing an audit
2	demonstrate working knowledge in respect of performance of simple audit procedures and understand the audit report requirement under the companies act, 2017
3	understand the requirement and application guidelines relating to some of the specific areas of audit procedures including external confirmation, review of subsequent events etc.
4	comprehend nature of engagements of review of interim financial statements
5	demonstrate familiarity with computer programming and IT controls relevant to financial reporting
6	respond on audit matters in the light of fundamental principles given in the code of ethics.

Grid	Weighting
General concepts and principles of audit	15-20
Performance of audit and reporting	25-35
Specific areas	20-25
Computer programming and IT controls	10-15
Professional Ethics	10-15
Total	**100**

Syllabus Ref		Contents	Level	Learning Outcome
A		**General concepts and principles of audit**		
	1	Introduction to International Federation of Accountants	1	**LO1.1.1:** Briefly describe the organisational overview encompassing • History; • Vision and mission
	2	Introduction to international auditing and assurance standard setting body	1	**LO1.2.1:** Briefly describe the objectives and functions of IAASB.
	3	Objective and general principles governing an audit (ISA 200)	2	**LO1.3.1:** Describe the objectives of audit including concepts of accountability, stewardship, agency, independence and fair presentation **LO1.3.2:** Describe the overall objectives of the independent auditor. **LO1.3.3:** Describe the concepts of assurance and levels of assurance i.e. absolute, reasonable and limited assurance including elements of an assurance engagement, assurances provided by audit and review engagement **LO1.3.4:** Explain the requirements of an external audit, eligibility and ineligibility of auditor **LO1.3.5:** Describe the rights and duties of auditors **LO1.3.6:** Explain the nature and scope of an audit designed to enable the independent auditor to meet those objectives **LO1.3.7:** Outline the requirements establishing the general responsibilities of the independent auditor applicable in all audits including consideration of inherent limitations of an audit **LO1.3.8** Discuss the concept of professional skepticism. **LO1.3.9:** Discuss the concept of interim and final audit **LO1.3.10:** List the audit procedures that can be performed by the external auditor at the interim and final stage of an audit **LO1.3.11:** Discuss the concept of audit of Not-for-profit organisations.
	4	Responsibility for the financial statements	2	**LO1.4.1:** Understand the responsibility of management and those charged with governance for financial reporting and related internal control on financial reporting.
	5	Auditor's responsibility to consider fraud (ISA 240)	2	**LO1.5.1:** Distinguish between the terms 'error', 'fraud' and 'misstatement'

Syllabus Ref		Contents	Level	Learning Outcome
				LO1.5.2: Compare the respective responsibilities of management and auditors for fraud **LO1.5.3:** Describe the matters to be considered and procedures to be carried out to assist the auditor in identifying, assessing and detecting the risks of material misstatement due to fraud **LO1.5.4:** Identify the fraud risk factors in the simple scenario as given in the appendix 1 of ISA 240 **LO1.5.5:** Identify the circumstances that indicate the possibility of fraud in the simple scenario as given in the appendix 3 of ISA 240.
	6	Legal considerations relating to appointment and removal of auditors (sections 246 to 253 of the Companies Act, 2017)	2	**LO1.6.1:** Explain how the first and subsequent auditors are appointed **LO1.6.2:** Explain how the first and subsequent auditors are removed **LO1.6.3:** Describe qualification and disqualification of the auditor **LO1.6.4:** Describe the powers and duties of auditors **LO1.6.5:** Describe the concept of audit of cost accounts **LO1.6.6:** Discuss the additional matters to be included in the auditor's report.
	7	Terms of Audit engagements (ISA 210)	2	**LO1.7.1:** Describe the preconditions for an audit and upon which it is necessary for the auditor and the entity's management to agree **LO1.7.2:** Respond if preconditions are not present or limit is imposed on scope of audit in well explained simple situations **LO1.7.3:** State the contents of an audit engagement letter **LO1.7.4:** Discuss the requirement of issuance of engagement letter and factors that necessitate the issuance of engagement letter in case of recurring audit **LO1.7.5:** Discuss the circumstances of acceptances of changes in terms of engagement by the auditor.
B		**Performance of audit and reporting**		
	1	Planning an audit (ISA 300)	2	**LO2.1.1:** Discuss the need for planning an audit including contents of an audit plan and its relation with risk assessment **LO2.1.2:** Discuss the contents of overall audit strategy and audit plan **LO2.1.3:** State who should be involved in planning and what preliminary engagement activities are necessary

Syllabus Ref		Contents	Level	Learning Outcome
				LO2.1.4: Outline the additional considerations that should be identified while planning the initial audit.
	2	Assessment of audit risks (ISA 315 and 330)	2	**LO2.2.1:** Discuss the risk based approach to auditing including audit risk model **LO2.2.2:** Identify the inherent risk, control risk and detection risk in simple scenario **LO2.2.3:** Explain relationship between audit risk and its components i.e. inherent risk, control risk and detection risk **LO2.2.4:** Discuss the identification and assessment of the risks of material misstatement at both the financial statement level and assertion level, including understanding of entity, its environment, accounting and internal control systems **LO2.2.5:** Explain the elements of internal control **LO2.2.6:** Discuss the evaluation of controls and control environment and communication of deficiencies to the management **LO2.2.7:** Explain the categories of control activities (internal controls) by using simple examples including Application and General IT Controls **LO2.2.8:** Explain and identify the control weaknesses in the given scenario and suggest appropriate recommendations to remove these weaknesses **LO2.2.9:** Discuss and explain the limitations of internal control system **LO2.2.10:** Discuss and explain the risks in specialised IT systems **LO2.2.11:** Explain the different methods of recording internal control systems.
	3	Audit materiality (ISA 320)	2	**LO2.3.1:** Explain the concepts of materiality and performance materiality using simple examples. **LO2.3.2:** Explain materiality level or levels for particular classes of transactions, account balances or disclosures **LO2.3.3:** Explain the relationship between audit risk and level of materiality
	4	Audit evidence (ISA 500)	2	**LO2.4.1:** Explain, using examples, sufficient appropriate audit evidence **LO2.4.2:** Discuss the general principles assisting the auditor in assessing the relevance and reliability of audit evidence **LO2.4.3:** Discuss audit procedures to obtain audit evidence including types of audit procedures

Syllabus Ref		Contents	Level	Learning Outcome
				LO2.4.4: Discuss the course of action available to auditor in case sufficient appropriate audit evidence is not obtained **LO2.4.5:** Explain the financial statement assertions including Assertions about class of transactions, account balances and presentation and disclosure **LO2.4.6:** Explain the audit work related to Inventory
	5	Audit sampling (ISA 530)	2	**LO2.5.1:** Explain audit sampling, statistical sampling and sampling and non-sampling risk using simple examples **LO2.5.2:** Discuss the relationship between sampling and audit risk model **LO2.5.3:** Explain what matters are considered by auditors in respect of sample design, size and selection of items for testing using simple examples including sample selection method **LO2.5.4:** Discuss the concept of misstatement and rate of deviation including expected and tolerated **LO2.5.5:** State the audit procedures to be performed on selected sample **LO2.5.6:** Discuss the concept of projecting misstatement and evaluating the results of audit sampling.
	6	Substantive procedures (ISA 330)	2	**LO2.6.1:** Understand the financial statement assertions **LO2.6.2:** Briefly explain the advantages and dis-advantages of both test data and audit software. **LO2.6.3:** Discuss the use of computer software in substantive testing, auditing around the computer and directional testing **LO2.6.4:** Discuss the methods of obtaining audit evidence for substantive testing **LO2.6.5:** Explain the nature, extent and timing of substantive procedures for different items of financial statements.
	7	Tests of controls (ISA 330)	2	**LO2.7.1:** Explain the nature, extent and timing of test of controls using simple examples **LO2.7.2:** Explain the concept of Computer Assisted Audit Techniques **LO2.7.3:** Explain how auditors evaluate the operating effectiveness of controls using simple examples **LO2.7.4:** Explain the controls over major transaction cycles including related risks, weaknesses control objectives and designing appropriate tests of controls.

Syllabus Ref		Contents	Level	Learning Outcome
	8	Analytical procedures (ISA 520)	2	**LO2.8.1:** Explain the nature and purpose of substantive analytical procedures using simple examples **LO2.8.2:** State the purpose of analytical procedures performed near the end of the audit **LO2.8.3:** Applying analytical procedures through calculations of different ratios for different items of financial statements **LO2.8.4:** Factors to be considered when using analytical procedures as substantive procedures **LO2.8.5:** Course of action when results of analytical procedures identify fluctuations and inconsistencies.
	9	Documentation (ISA 230)	2	**LO2.9.1:** Explain the nature and purpose of audit documentation **LO2.9.2:** Describe the form, content and extent of audit documentation using simple examples **LO2.9.3:** Discuss the use of computer based audit working papers **LO2.9.4:** Explain the difference between permanent and current working papers with examples. **LO2.9.5:** List the contents of working paper file / audit documentation **LO2.9.6:** Discuss the ownership, custody and confidentiality of audit working papers **LO2.9.7:** Understand the nature of assembly of the final audit file. **LO2.9.8:** Explain the features of audit working papers.
	10	Audit opinion and form of audit report under International Standards on Auditing and under the Companies Act, 2017 and Going Concern (ISA-570 Revised)	2	**LO2.10.1:** Understand modified and unmodified audit opinion **LO2.10.2:** Explain qualified opinion, disclaimer of opinion and adverse opinion **LO2.10.3:** Explain emphasis of matter and other matter in the auditor's report **LO2.10.4:** List the circumstances under which an external auditor uses an emphasis of matter and other matter paragraph in the auditor's report **LO2.10.5:** Discuss the modification of audit opinion and audit report in different situations including when entity is not a going concern and related concepts. **LO2.10.6**: Drafting of opinion paragraph

Syllabus Ref		Contents	Level	Learning Outcome
				LO2.10.7: Key Audit matters and other related concepts as per ISA 701. **LO2.10.8:** Briefly state the contents of the auditor's report under International Standards on Auditing and under the Companies Act, 2017 **LO2.10.9:** Explain the differences between auditor's report under International Standards on Auditing and under the Companies Act, 2017 **LO2.10.10:** State the penalty for noncompliance with provisions related to the audit report.
C		**Specific areas**		
	1	External confirmations (ISA 505)	2	**LO3.1.1:** Define external confirmation and list various types of third party confirmations available to an external auditor. **LO3.1.2:** Describe the significance of using external confirmation procedures for obtaining relevant and reliable audit evidence **LO3.1.3:** Describe the steps involved in external confirmation procedures **LO3.1.4:** Differentiate between the positive confirmation request and negative confirmation request, including their appropriateness in different situations **LO3.1.5:** Discuss the conditions of sending negative confirmations **LO3.1.6:** Discuss the auditor's course of action if management refuses to allow auditor to send confirmation.
	2	Subsequent events (ISA 560)	2	**LO3.2.1:** Explain subsequent events and its relevance with the following critical dates • Date of the financial statements • Date of approval of the financial statements • Date of the auditor's report • Date the financial statements are issued **LO3.2.2:** Explain the subsequent events review procedure **LO3.2.3:** Discuss the classification of subsequent events into adjusting and non-adjusting events **LO3.2.4:** Describe the auditor's responsibility in respect of following situations • Events occurring between the date of the financial statements and the date of the auditor's report

Syllabus Ref		Contents	Level	Learning Outcome
				• Facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued • Facts which become known to the auditor after the financial statements have been issued **LO3.2.5:** Identify the subsequent events and explain the auditor's responses.
	3	Written representation (ISA 580)	2	**LO3.3.1:** Discuss the nature of written representations as audit evidence **LO3.3.2:** Discuss the circumstances where written representations are necessary and the matters on which representations are commonly obtained **LO3.3.3:** Discuss the form and content of written representations **LO3.3.4:** Explain the various types of written representation **LO3.3.5:** Discuss the auditor's course of action if management refuses to provide requested written representation. **LO3.3.6:** Discuss the auditor's course of action when there is doubt as to the reliability of written representation provided by the management.
	4	Consideration of related parties (ISA 550)	2	**LO3.4.1:** Describe the term related party using simple examples **LO3.4.2:** Discuss how related party transactions can give rise to the risk of material misstatement using simple examples **LO3.4.3:** describe the audit procedures including risk assessment procedures and related activities to obtain information relevant to identifying the related party relationships and transactions including responses to the assessed risk of material misstatement.
	5	Using the work of internal auditors and auditor's experts, (ISA 610 and ISA 620)	2	**LO3.5.1:** Explain the relationship between the external auditor with internal auditors and auditor's experts **LO3.5.2:** Explain the internal audit function including internal audit activities **LO3.5.3:** Discuss the factors determining the independence of internal auditors and weaknesses and limitations of internal audit **LO3.5.4:** Discuss how external auditors determine whether and to what extent they use the work of internal audit **LO3.5.5:** Discuss how the auditor assesses the work of an expert

Syllabus Ref		Contents	Level	Learning Outcome
				LO3.5.6: Discuss how the external auditor uses the work of an auditor's expert when that work is used to assist in obtaining sufficient appropriate audit evidence.
	6	Engagement to review financial statements 2400	2	**LO3.6.1:** Explain the objective of a review engagement of financial statements and how it differs from an audit **LO3.6.2:** State the terms of engagement which may be included in the engagement letter **LO3.6.3:** Explain assurance and non-assurance engagement with examples. **LO3.6.4:** Describe the procedures generally adopted by the practitioner to obtain evidence in review engagements **LO3.6.5:** Discuss and explain the report issued under engagement to review financial statements.
D		**Computer programming and IT controls**		
	1	Benefits and limitations of flowcharts	1	**LO4.1.1:** Describe the macro, mini and micro level details of flowcharts **LO4.1.2:** State the benefits and limitations of flowcharts using simple examples.
	2	Types of flowcharts	1	**LO4.2.1:** Classify and distinguish between types of flowcharts, namely, linear, deployment and opportunity flowcharts **LO4.2.2:** Draw different types of flowcharts for given situations
	3	General and application controls in IT systems/environment		**LO4.3.1**: Describe general controls and classify them into environment, development, maintenance and operational controls using simple examples **LO4.3.2:** Describe IT application controls using simple examples **LO4.3.3:** Discuss the evaluation of various IT controls including authorization, separation of duties/functions, adequacy of documentation, access controls, safeguard of IT assets, independent check on performance, verification of accounting records, comparison of accounting records with assets, computer-dependent controls (edit, validation, etc.), user controls (control balancing, manual follow-up, etc.), audit trails **LO4.3.4:** State controls over data transmission
	4	Preventative, detective and corrective controls	2	**LO4.4.1:** Describe preventative, detective and corrective controls using simple examples.

Syllabus Ref		Contents	Level	Learning Outcome
				LO4.4.2: Describe procedures and controls for identification/investigation /correction / tracking of errors in IT systems/environment
	5	Logical access controls	2	**LO4.5.1:** Describe logical access controls for a given situation/system. **LO4.5.2:** Describe the usefulness of system logs for analysing a system's performance.
E		**Professional Ethics**		
	1	Fundamental principles (sections 100 to 150 of the Code of Ethics for Chartered Accountants)	2	**LO5.1.1:** Describe with simple examples the fundamental principles of professional ethics of integrity, objectivity, professional competence and due care, confidentiality and professional behavior **LO5.1.2:** Apply the conceptual framework to identify, evaluate and address threats to compliance with fundamental principles **LO5.1.3:** Understand the threats and circumstances that cause threats of selfinterest, self-review, advocacy, familiarity, and intimidation **LO5.1.4:** Discuss the safeguards to offset the threats to compliance with the fundamental principles **LO5.1.5:** Discuss the concept of ethical conflict resolution.
	2	Client and engagement acceptance (section 210 of the Code of Ethics for Chartered Accountants)	2	**LO5.2.1:** Explain the advertisement and publicity guidelines of ICAP's Code of Ethics for obtaining the audit work **LO5.2.2:** Apply the conceptual framework to identify, evaluate and address threats in case of Fees, Referral Fees and Tendering for audit work. **LO5.2.3:** Explain using simple examples the matters to be considered and the procedures that an audit firm/ professional accountant should carry out in the following circumstances: • Client acceptance • Engagement acceptance • Changes in a professional appointment (including Additional work, Mid-Term Removal and Non reappointment)

CHAPTER 1

Concept and need for assurance

Contents

1 The meaning of audit
2 The meaning of assurance
3 Statutory audit - the regulatory framework
4 International Standards on Auditing (ISAs)
5 Advantages and limitations of statutory audits
6 Chapter review

INTRODUCTION

Contents and Learning outcomes

The overall objective of the syllabus is acquiring knowledge of theory, skill and techniques of auditing and to enable the students to understand International Standards on Auditing, Assurance and Ethics.

General concepts and principles of audit

1. Introduction to International Federation of Accountants

LO1.1.1: Briefly describe the organisational overview encompassing

- History;
- Vision and mission

2. Introduction to international auditing and assurance standard setting body

LO1.2.1: Briefly describe the objectives and functions of IAASB.

3. Objective and general principles governing an audit (ISA 200)

LO1.3.1: Describe the objectives of audit including concepts of accountability, stewardship, agency, independence and fair presentation

LO1.3.2: Describe the overall objectives of the independent auditor.

LO1.3.3: Describe the concepts of assurance and levels of assurance i.e. absolute, reasonable and limited assurance including elements of an assurance engagement, assurances provided by audit and review engagement

LO1.3.4: Explain the requirements of an external audit, eligibility and ineligibility of auditor

LO1.3.5: Describe the rights and duties of auditors

LO1.3.6: Explain the nature and scope of an audit designed to enable the independent auditor to meet those objectives

LO1.3.7: Outline the requirements establishing the general responsibilities of the independent auditor applicable in all audits including consideration of inherent limitations of an audit

LO1.3.8 Discuss the concept of professional skepticism.

LO1.3.9: Discuss the concept of interim and final audit

LO1.3.10: List the audit procedures that can be performed by the external auditor at the interim and final stage of an audit

1 THE MEANING OF AUDIT

Section overview

- Definition and objective of audit
- Concepts of accountability, stewardship and agency
- The audit report: independence, materiality and true and fair
- The statutory requirement for audit
- Responsibility of management and those charged with governance

1.1 Definition and objective of audit

An **audit** is an official examination of the accounts (or accounting systems) of an entity (by an auditor).

When an auditor examines the accounts of an entity, what is he looking for?

The main objective of an audit is to enable an auditor to convey an opinion as to whether or not the **financial statements** of an entity are prepared according to an **applicable financial reporting framework**.

Financial statements –A structured representation of historical financial information, including disclosures, intended to communicate an entity's economic resources or obligations at a point in time, or the changes therein for a period of time, in accordance with a financial reporting framework. Financial statements have the following components (as per IAS-1):

- Statement of Financial Position (Balance Sheet)
- Statement of Profit or Loss and other comprehensive income
- Statement of Changes in Equity
- Cash Flow Statement
- Notes to the Financial Statements
- Comparative information prescribed by the standard

Applicable financial reporting framework – The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

The applicable financial reporting framework is decided by:

- legislative or regulatory environment within each individual country, and
- accounting standards (for example, International Accounting Standards/ International Financial Reporting Standards).

The auditor seeks to express an opinion as the result of the audit work that he does. The type of work carried out by an auditor in order to reach his opinion is described in later chapters.

1.2 Concepts of accountability, stewardship and agency

An audit of a company's accounts is needed because in companies, the owners of the business are often not the same persons as the individuals who manage and control that business.

- The shareholders own the company.
- The company is managed and controlled by its directors.

The directors have a **stewardship** role. They look after the assets of the company and manage them on behalf of the shareholders. In small companies the shareholders may be the same people as the directors. However, in most large companies, the two groups are different.

The relationship between the shareholders of a company and the board of directors is also an application of the general legal principle of **agency**. The concept of agency applies whenever one person or group of individuals acts as an agent on behalf of someone else (the **principal**). The agent has a legal duty to act in the best interests of the principal, and should be accountable to the principal for everything that he does as agent.

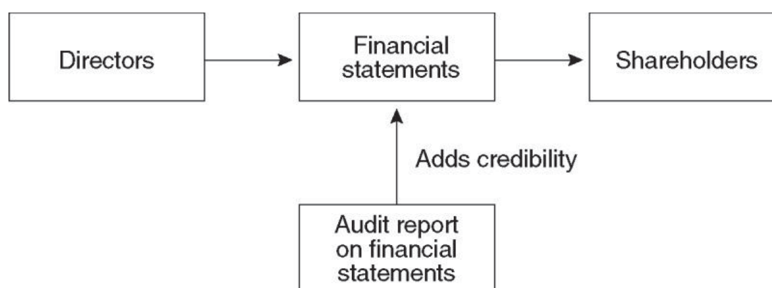
As agents for the shareholders, the board of directors should be accountable to the shareholders. In order for the directors to show their **accountability** to the shareholders, it is a general principle of company law that the directors are required to prepare annual **financial statements**, which are presented to the shareholders for their approval.

1.3 The audit report: independence, materiality and true and fair

Audit has a very long history. The concept of an audit goes back to the times of the Egyptian and Roman empires. In medieval times, independent auditors were employed by the feudal barons to ensure that the returns from their stewards and their tenants were accurate.

Over time, the annual audit was developed as a way of adding **credibility** to the financial statements produced by management. The **statutory audit** is now a key feature of company law throughout the world.

An auditor reports **to the shareholders** on the financial statements produced by a company's management.



The key features of the audit report are as follows:

- The auditors producing the report are **independent** from the directors producing the financial statements.
- The report gives an opinion on whether the financial statements "**give a true and fair view**", or "**present fairly**" the position and results of the entity.
- The report considers whether the financial statements give a true and fair view **in all material respects**. The concept of materiality is applied in reaching an audit opinion.

Independence of the auditor

The external auditor must be **independent** from the directors; otherwise his report will have little value. If he is not independent, his opinion is likely to be influenced by the directors.

In contrast to external auditors, internal auditors may not be fully independent from the directors, although they may be able to achieve a sufficient degree of independence.

The concept of 'internal auditors' shall be described in details in a later chapter.

True and fair view (fair presentation)

The auditor reports on whether (or not) the financial statements **give a true and fair view,** or **present fairly**, the position of the entity as at the end of the financial period and the performance of the entity during the period. **The auditor does not certify or guarantee that the financial statements are correct**.

Although the phrase 'true and fair view' has no legal definition, the term 'true' implies free from error, and 'fair' implies that there is no undue bias in the financial statements or the way in which they have been presented.

In preparing the financial statements, a large amount of judgement is exercised by the directors. Similarly, judgement is exercised by the auditor in reaching his opinion. The phrases ‘true and fair view’ and ‘present fairly’ indicate that a judgement is being given that the financial statements can be relied upon and have been properly prepared in accordance with an appropriate financial reporting framework.

Materiality concept

The auditor reports in accordance with the concept of **materiality**. He gives an opinion on whether the financial statements present fairly **in all material respects** the financial position and performance of the entity.

Information is material if, on the basis of the financial statements, it could influence the economic decisions of users should it be omitted or misstated.

For example, the shareholders of a company with assets of Rs.1 million will not be interested if petty cash was miscounted with the result that the amount of petty cash is overstated by Rs.100. This is immaterial. However, they will be interested if there are receivables in the statement of financial position of Rs.200,000 which are not in fact recoverable and which should therefore have been written off as a bad debt.

Applying the concept of materiality means that the auditor will not aim to examine every number in the financial statements. He will concentrate his efforts on the more significant items in the financial statements, either:

- because of their (high) value, or
- because there is a greater risk that they could be stated incorrectly.

1.4 The statutory requirement for audit

Most countries impose a statutory requirement for an annual (external) audit to be carried out on the financial statements of most companies.

However, in many countries, smaller companies are exempt from this requirement for an audit. Other entities, such as sole traders, partnerships, clubs and societies are usually not subject to a statutory audit requirement. Small companies and these other entities may decide to have a voluntary audit, even though this is not required by law.

1.5 Responsibility of management and those charged with governance

With respect to the audit and contrary to what many members of the public think, it is management and those charged with governance which are responsible for:

- Prevention and detection of fraud
- Preparation of the financial statements
- Design and implementation of effective internal controls – for example authorising payments above a certain amount, monthly bank reconciliation and a monthly trade payables control account reconciliation.

They are also responsible for:

- Providing the auditor with:
  - Access to information relevant to the preparation of the financial statements
  - Additional information relevant to the audit
  - Unrestricted access to persons whom the auditor needs access to in order to complete the audit
- Providing written representations to the auditor at the end of the audit (see later chapter for details)

2 THE MEANING OF ASSURANCE

Section overview

- Definition of assurance
- Levels of assurance
- Elements of an assurance engagement

2.1 Definition of assurance

'Assurance' means confidence. In an assurance engagement, an 'assurance firm' is engaged by one party to give an opinion on a piece of information that has been prepared by another party. The opinion is an expression of **assurance** about the information that has been reviewed. It gives assurance to the party that hired the assurance firm that the information can be relied on.

Assurance can be provided by:

- **audit**: this may be external audit, internal audit or a combination of the two
- review.

A statutory audit is one form of assurance. Without assurance from the auditors, the shareholders may not accept that the information provided by the financial statements is sufficiently accurate and reliable. The statutory audit provides assurance as to the quality of the information.

The provision of this assurance should add credibility to the information in the financial statements, making the information more reliable and therefore more useful to the user.

However, there are differing levels or degrees of assurance. Some assurances are more reliable than others.

2.2 Levels of assurance

The degree of assurance that can be provided about the reliability of the financial statements of a company will depend on:

- the amount of work performed in carrying out the assurance process, and
- the results of that work.

The resulting assurance falls into one of two categories:

- **Reasonable Assurance** – A **high (but not absolute)** level of assurance provided by the practitioner's conclusion expressed in a **positive form**. E.g. "*In our opinion the accounts are true and fair*". The objective of a statutory audit is to provide reasonable assurance.
- **Limited Assurance** – A **moderate** level of assurance provided by the practitioner's conclusion expressed in a **negative form**. E.g. "*Based on our review, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view*". The objective of a review engagement is often to provide limited assurance.

Assurance provided by audit

An **audit** provides a **high, but not absolute**, level of assurance that the audited information is free from any material misstatement. This is often referred to as **reasonable assurance**.

The reason why auditor is not expected to provide absolute assurance is that there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. The inherent limitations of an audit are discussed later in this chapter.

Assurance provided by review

A **review** is a 'voluntary' investigation. In contrast to 'reasonable' level of assurance provided by an audit, a **review** into an aspect of the financial statements would provide only a **moderate** level of assurance that the information under review is free of material misstatement. The resulting opinion is usually (although not always) expressed in the form of **negative assurance**.

Negative assurance is an opinion that nothing is obviously wrong: in other words, 'nothing has come to our attention to suggest that the information is misstated'.

A review does not provide the same amount of assurance as an audit. An external audit provides **positive assurance** that, in the opinion of the auditors, the financial statements **do** present fairly the financial position and performance of the company.

The higher level of assurance provided by an audit will enhance the credibility provided by the assurance process, but the audit work is likely to be:

- more time-consuming than a review, and so
- more costly than a review.

Negative assurance is necessary in situations where the accountant/auditor cannot obtain sufficient evidence to provide positive assurance. For example the management of a client entity may ask the audit firm to carry out a review of a cash flow **forecast**. A forecast relates to the future and is based on many assumptions, and an auditor therefore **cannot provide positive assurance** that the forecast is accurate. However he **may be able to provide negative assurance** that there is nothing he is aware of to suggest that the forecast contains material errors.

2.3 Elements of an assurance engagement

Definition: Assurance engagement

An engagement 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 subject matter information (that is, the outcome of the measurement or evaluation of an underlying subject matter against criteria).

Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Pronouncements, 2016–2017 Edition

An assurance engagement performed by a practitioner will consist of the following five elements:

- A three party relationship:
  - **Practitioner** – the individual providing professional services that will review the subject matter and provide the assurance. E.g. the audit firm in a statutory audit
  - **Responsible party** – the person(s) responsible for the subject matter. E.g. the Directors are responsible for preparing the financial statements to be audited
  - **Intended users** – the person(s) or class of persons for whom the practitioner prepares the assurance report. E.g. the shareholders in a statutory audit
- **Subject matter**: This is the data such as the financial statements that have been prepared by the responsible party for the practitioner to evaluate. Another example might be a cash flow forecast to be reviewed by the practitioner.
- **Suitable criteria**: This can be thought of as 'the rules' against which the subject matter is evaluated in order to reach an opinion. In a statutory audit this would be the applicable reporting framework (e.g. IFRS and company law).
- **Evidence**: Information used by the practitioner in arriving at the conclusion on which their opinion is based. This must be sufficient (enough) and appropriate (relevant).
- **Assurance Report**: The report (normally written) containing the practitioner's opinion. This is issued to the intended user following the collection of evidence.

3 STATUTORY AUDIT - THE REGULATORY FRAMEWORK

Section overview

- Appointment, removal and remuneration of auditors (s246 CA17)
- Resolutions relating to the appointment or removal of auditors – s246 CA17
- Removal of auditors
- Qualification and disqualification of auditors (s247 CA17)
- Rights and duties of auditors (s248 CA17)
- Audit of cost accounts (s250 CA17)

3.1 Appointment, removal and remuneration of auditors (section 246 CA17)

First auditor

The first auditor or auditors of a company shall be appointed by the board within ninety days of the date of incorporation of the company; and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting.

Subsequent auditors

Every company shall at each annual general meeting appoint an auditor or auditors on the recommendation of the board after obtaining consent of the auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.

The Commission may appoint a person to fill the vacancy in the cases if the company fails to appoint:

- the first auditors within a period of 90 days of the date of incorporation of the company; or
- the auditors at an annual general meeting; or
- an auditor in the office to fill up a casual vacancy within thirty days after the occurrence of the vacancy; and
- appointed auditors are unwilling to act as auditors of the company.

Casual vacancy

The board will fill any casual vacancy in the office of an auditor within thirty days but, while any such vacancy continues, the surviving or continuing auditor or auditors, if any, may act.

Moreover, any auditor appointed to fill in any casual vacancy shall hold office until the conclusion of the next annual general meeting.

However, where the auditors are removed during their tenure, the board shall appoint the auditors with prior approval of the Commission.

Remuneration of the auditors

The remuneration of the auditors of a company shall be fixed:

- by the company in the general meeting
- in the case of an auditor appointed by the board or by the Commission, by the board or by the Commission, as the case may be.

3.2 Resolutions relating to the appointment or removal of auditors – s246 CA17

Whilst the Companies Act does not give specific guidance as to the resignation of auditors it does address the mechanics of resolutions relating to the appointment and removal of auditors.

The Act states:

- A notice shall be required for a resolution at a company's annual general meeting appointing as auditor a person other than a retiring auditor.
- A member or members having not less than 10% shareholding of the company will be entitled to propose any auditor for appointment whose consent has been obtained by him. A notice in this regard will be given to the company not less than seven days before the date of the annual general meeting. The company shall forthwith send a copy of such notice to the retiring auditor and will also post it on its website.
- Where an auditor, other than the retiring auditor is proposed to be appointed, the retiring auditor will have a right to make a representation in writing to the company at least two days before the date of general meeting. Such representation will be read out at the meeting before taking up the agenda for appointment of the auditor:

  However, where such representation is made, it will be mandatory for the auditor or a person authorized by him in writing to attend the general meeting in person.
- Every company shall, within fourteen days from the date of any appointment of an auditor, send to the registrar intimation thereof, together with the consent in writing of the auditor concerned.

3.3 Removal of auditors

The auditor or auditors appointed by the board or the members in an annual general meeting may be removed through a special resolution.

3.4 Qualification and disqualification of auditors (Section 247 CA17)

A person shall not be qualified for appointment as an auditor—

(a) in the case of a public company or a private company which is subsidiary of a public company or a private company having paid up capital of three million rupees or more unless such person is a chartered accountant having valid certificate of practice from the Institute of Chartered Accountants of Pakistan or a firm of chartered accountants; and

(b) in the case of a company other than that specified above, unless such person, is a chartered accountant or cost and management accountant having valid certificate of practice from the respective institute or a firm of chartered accountants or cost and management accountants, having such criteria as may be specified:

It should be noted that for the purposes of (a) and (b) above, a firm where majority of practicing partners are qualified for appointment shall be appointed by its firm name to be auditors of the company.

Where a partnership firm is appointed as auditor of a company, only the partners who meet the qualification requirements as given above will be authorized to act and sign on behalf of the firm.

None of the following persons will be appointed as auditor of a company:

*(a) a person who is, or at any time during the preceding three years was, a director, other officer or employee of the company;

*(b) a person who is a partner of, or in the employment of, a director, officer or employee of the company;

(c) the spouse of a director of the company;

(d) a person who is indebted to the company other than in the ordinary course of business of such entities. The following persons will not be deemed to be indebted to the company:

- a person who owes a sum of money not exceeding one million rupees to a credit card issuer; or
- a person who owes a sum to a utility company in the form of unpaid dues for a period not exceeding ninety days shall not be deemed to be indebted to the company.

(e) a person who has given a guarantee or provided any security in connection with the indebtedness of any third person to the company other than in the ordinary course of business of such entities;

(f) a person or a firm who, whether directly or indirectly, has business relationship with the company other than in the ordinary course of business of such entities;

(g) a person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction;

(h) a body corporate;

(i) a person who is not eligible to act as auditor under the code of ethics as adopted by the Institute of Chartered Accountants of Pakistan and the Institute of Cost and Management Accountants of Pakistan; and

(j) a person or his spouse or minor children, or in case of a firm, all partners of such firm who hold any shares of an audit client or any of its associated companies:

Provided that if such a person holds shares prior to his appointment as auditor, whether as an individual or a partner in a firm, the fact shall be disclosed on his appointment as auditor and such person shall disinvest such shares within ninety days of such appointment.

A person will not be qualified for appointment as auditor of a company if he is due to the above mentioned disqualifications is disqualified for appointment as auditor of any other company which is that company‘s subsidiary or holding company or a subsidiary of that holding company.

If, after his appointment, an auditor becomes subject to any of the disqualifications due to any reason mentioned above, he will be deemed to have vacated his office as auditor with effect from the date of disqualification.

A person who is not qualified to be an auditor of a company, acts as auditor of a company shall be liable to a penalty of level 2 on the standard scale.

The appointment as auditor of a company of an unqualified person, or of a person who is subject to any disqualifications to act as such, shall be void, and, where such an appointment is made by a company, the Commission may appoint a qualified person in place of the auditor appointed by the company.

* A reference to officer or employee will not be interpreted as reference to auditor.

3.5 Rights and duties of auditors (Section 248 & 249 of CA17)

An auditor of a company has a right:

- of access at all times to the company‘s books, accounts and vouchers (in whatever form they are held); and
- of access to such copies of, an extracts from, the books and accounts of the branch as have been transmitted to the principal office of the company;
- to require any of the following persons to provide him with such information or explanations as he thinks necessary for the performance of his duties as auditor:
  - (i) any director, officer or employee of the company;
  - (ii) any person holding or accountable for any of the company‘s books, accounts or vouchers;
  - (iii) any subsidiary undertaking of the company; and
  - (iv) any officer, employee or auditor of any such subsidiary undertaking of the company or any person holding or accountable for any books, accounts or vouchers of any such subsidiary undertaking of the company.

If any officer of a company refuses or fails, without lawful justification, the onus whereof will lie on him, to allow any auditor access to any books and papers in his custody or power, or to give any such information possessed by him as and when required, or otherwise hinders, obstructs or delays an auditor in the performance of his duties or the exercise of his powers or fails to give notice of any general meeting to the auditor or provides false or incorrect information, he shall be liable to penalty of level 3 on the standard scale.

Duties of auditor

A company's auditor will conduct the audit and prepare his report in compliance with the requirements of International Standards on Auditing as adopted by the Institute of Chartered Accountants of Pakistan.

A company's auditor must carry out such examination to enable him to form an opinion as to:

(a) whether adequate accounting records have been kept by the company and returns adequate for their audit have been received from branches not visited by him; and

(b) whether the company's financial statements are in agreement with the accounting records and returns.

The auditor will make out a report to the members of the company on the accounts and books of accounts of the company and on every financial statements and on every other document forming part of such statements including notes, statements or schedules appended thereto, which are to be laid before the company in general meeting and the report will state:

(a) whether or not they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purposes of the audit and if not, the details thereof and the effect of such information on the financial statements;

(b) whether or not in their opinion proper books of accounts as required by this Act have been kept by the company;

(c) whether or not in their opinion the statement of financial position and profit and loss account and other comprehensive income or the income and expenditure account and the cash flows have been drawn up in conformity with the requirements of accounting and reporting standards as notified under this Act and are in agreement with the books of accounts and returns;

(d) whether or not in their opinion and to the best of their information and according to the explanations given to them, the said accounts give the information required by this Act in the manner so required and give a true and fair view:

    (i) in the case of the statement of financial position, of the state of affairs of the company as at the end of the financial year;

    (ii) in the case of the profit and loss account and other comprehensive income or the income and expenditure account, of the profit or loss and other comprehensive income or surplus or deficit, as the case may be, for its financial year; and

    (iii) in the case of statement of cash flows, of the generation and utilisation of the cash and cash equivalents of the company for its financial year;

(e) whether or not in their opinion:

    (i) investments made, expenditure incurred and guarantees extended, during the year, were for the purpose of company's business; and

    (ii) zakat deductible at source under the Zakat and Usher Ordinance, 1980 (XVIII of 1980), was deducted by the company and deposited in the Central Zakat Fund established under section 7 of that Act.

Explanation.—Where the auditor's report contains a reference to any other report, statement or remarks which they have made on the financial statements examined by them, such statement or remarks will be annexed to the auditor's report and will be deemed to be a part of the auditor's report.

Where any of the matters referred above is answered in the negative or with a qualification, the report will state the reason for such answer along with the factual position to the best of the auditor's information.

The Commission may, by general or special order, direct that, in the case of all companies generally or such class or description of companies as may be specified in the order, the auditor's report will also include a statement of such additional matters as may be so specified.

The auditor will express unmodified or modified opinion in his report in compliance with the requirements of International Standards on Auditing as adopted by the Institute of Chartered Accountants of Pakistan.

The Commission may by general or special order, direct, that the statement of compliance as contained in the Act is reviewed by the auditor who will issue a review report to the members on the format specified by the Commission.

The auditor of a company will be entitled to attend any general meeting of the company, and to receive all notices of, and any communications relating to, any general meeting which any member of the company is entitled to receive, and to be heard at any general meeting which he attends on any part of the business which concerns him as auditor:

Provided that, in the case of a listed company, the auditor or a person authorised by him in writing will be present in the general meeting in which the financial statements and the auditor's report are to be considered.

3.6 Audit of cost accounts (s250 CA17)

Where any company or class of companies is required under the Act to include in its books of account the particulars referred to therein, the Commission may direct that an audit of cost accounts of the company should be conducted as may be specified in the order by an auditor who is a chartered accountant within the meaning of the Chartered Accountants Ordinance, 1961 (X of 1961), or a cost and management accountant within the meaning of the Cost and Management Accountants Act, 1966 (XIV of 1966); and such auditor will have the same powers, duties and liabilities as an auditor of a company and such other powers, duties and liabilities as may be specified.

The audit of cost accounts of the company under the circumstances mentioned above will be directed by the Commission subject to the recommendation of the regulatory authority supervising the business of relevant sector or any entity of the sector

4 INTERNATIONAL STANDARDS ON AUDITING (ISAs)

Section overview

- The role of auditing standards
- Introduction to IFAC and IAASB
- The process of issuing auditing standards
- International Auditing Practice Statements
- Preface to International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services
- ISA 200: Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing
- Scope of an interim and final audit

4.1 The role of auditing standards

The role of the audit is to provide a high level of assurance to the users of the financial statements. This assurance will be of greater value to users if they know that the audit has been carried out in accordance with established standards of practice.

In addition, if users compare the financial statements of a number of companies, it is important that the user has confidence that consistent **auditing standards** have been applied to the audits of all of the companies.

International Standards on Auditing (known as ISAs) apply primarily to the external audit process. However, their provisions can also often be seen as good practice for relevant areas of the work of the **internal** auditor.

4.2 Introduction to IFAC and IAASB

IFAC

Definition: IFAC (International Federation of Accountants)

ICAP is a member of IFAC. **IFAC is the global organization for the accountancy profession. It is dedicated to serving the public interest by strengthening the profession and contributing to the development of strong international economies. IFAC has 175 members and associates in 130 countries around the world, representing approximately 3 million accountants in public practice, education, government service, industry, and commerce.**

IFAC provides the structures and processes that support the development, adoption, and implementation of high quality international standards. The standards that IFAC supports in the areas of auditing, assurance, and quality control; public sector accounting; accounting education; and ethics are an important part of the global financial infrastructure and contribute to economic stability around the world. In addition, working closely with its member bodies, IFAC provides tools and guidance to support professional accountants in business and small and medium practices.

IFAC supports the development of the accountancy profession in emerging economies, and speaks out on public interest issues where the profession's voice is most relevant. Through all of these activities, IFAC promotes its values of integrity, transparency, and expertise.

IFAC includes four boards:

- IAASB: The International Auditing and Assurance Standards Board
- IAESB: The International Accounting Education Standards Board
- IESBA: The International Ethics Standards Board for Accountants
- IPSASB: The International Public Sector Accounting Standards Board

The IAASB

Definition: IAASB (International Auditing and Assurance Standards Board)

The IAASB is one of the boards within IFAC. It is an independent standard-setting body that serves the public interest by setting high-quality international standards for auditing, assurance, and other related standards, and by facilitating the convergence of international and national auditing and assurance standards. In doing so, the IAASB enhances the quality and consistency of practice throughout the world and strengthens public confidence in the global auditing and assurance profession.

4.3 The process of issuing auditing standards

Responsibility for ISAs

The Institute of Chartered Accountant of Pakistan adopts the International Standards on Auditing (ISAs) issued by the IAASB. The examination of this paper is based on the knowledge of ISAs.

Developing a new ISA

The process of developing an ISA is as follows:

- A subject is selected for detailed study, with a view to eventually issuing an ISA.
- After a period of study and research, if there is agreement to proceed, an **exposure draft** is produced. The exposure draft is approved by the IAASB and then distributed widely amongst the profession and others for comment.
- Comments and proposed amendments are considered by the IAASB. The draft standard is then modified and approved by the IAASB.
- The new ISA is then published.

4.4 International Auditing Practice Statements

In addition to ISAs, the IAASB also issues International Auditing Practice Statements (IAPSs). These do not have the same authority as ISAs.

IAPSs aim to:

- provide help to auditors in implementing ISAs
- promote good auditing practice in general.

4.5 Preface to International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services

The IAASB issues a number of other international standards, in addition to ISAs. The table below sets out these standards, including ISAs, and when the preface says they are to be applied.

Type of standard	When applied
International Standards on Auditing (ISAs)	In the audit of historical financial information
International Standards on Review Engagements (ISREs)	In the review of historical financial information
International Standards on Assurance Engagements (ISAEs)	In assurance engagements other than audits or reviews of historical financial information
International Standards on Related Services (ISRSs)	On compilation engagements, engagements to apply agreed upon procedures to information and other related services engagements
International Standards on Quality Control (ISQCs)	For all the above services

The IAASB's pronouncements do not override local laws or regulations. If local laws or regulations differ from, or conflict with, the IAASB's standards then a professional accountant should not state that he has complied with the IAASB's standards unless he has **fully complied** with all of those relevant to the engagement.

International Standards on Auditing (ISAs)

ISAs are written in the context of an audit of financial statements by an independent auditor. They are to be adapted as necessary when applied to audits of other historical financial statements.

Each ISA contains:

- an introduction
- objectives
- definitions (if necessary)
- requirements which are shown by the word "shall" and are to be applied as relevant to the audit
- application and other explanatory material which is for guidance only.

International Standards on Quality Control (ISQCs)

ISQCs apply to all services carried out under the IAASB's **engagement standards** (ISAs, ISREs, ISAEs and ISRSs).

Other International Standards

The other international standards (ISREs, ISAEs and ISRSs) contain:

- basic principles and essential procedures (identified in bold type and by the word "**should")**, and
- related guidance in the form of explanatory and other material, including appendices.

The basic principles and procedures must be followed. In exceptional circumstances, a professional accountant may judge it necessary not to follow a relevant essential procedure in order to achieve their objectives. In these circumstances, the auditor must be prepared to justify the departure from the requirements of the standard.

4.6 ISA 200: Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing

The **objectives** of the auditor are formally specified in ISA 200 as:

- 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 the applicable financial reporting framework.
- to **report on the financial statements**, and communicate as required by the ISAs, in accordance with the auditor's findings.

In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, the ISAs require that the auditor disclaim an opinion or withdraw(resign) from the engagement, where withdrawal is possible under applicable law or regulation.

ISA 200 **requires** the auditor to:

- comply with all **ISAs** relevant to the audit
- comply with relevant **ethical requirements**
- plan and perform an audit with ***professional scepticism**

- exercise **professional judgement** in planning and performing an audit
- obtain **sufficient appropriate audit evidence** to allow him to obtain reasonable assurance

*Professional skepticism –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.

**Professional judgment – The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

***Sufficient appropriate audit evidence- Sufficiency is the measure of the quantity of audit evidence. Appropriateness is the measure of the quality of audit evidence in terms of its relevance and reliability. The sufficiency and appropriateness of audit evidence are interrelated, obtaining more audit evidence may not compensate for its poor quality.

For example when the account balance of “cash at bank” is verified, two important audit procedures have to be performed to check the following assertion:

- **Accuracy and Existence:** Confirmation from the relevant banks;
- Completeness and Cut off: Bank reconciliations

You cannot check bank reconciliations only, although it’s a very relevant procedure and ensures that checks received or issued before year end but not cleared by the bank have been accounted for but without bank confirmation, checking bank reconciliation alone is not sufficient and will have no value.

4.7 Scope of an interim and final audit

The **scope** of the statutory audit as described in the independent auditor’s report contains the following points:

- An audit involves performing procedures to obtain sufficient appropriate audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s professional judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error.
- In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements 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.
- An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

Audit fieldwork is typically performed in two phases:

- Interim audit – this is performed before the end of the accounting period and may include:
  - Discussions with staff and management designed to enhance the auditor’s understanding of the entity and the environment. This will enable the auditor to more fully plan the audit and hopefully reduce the work performed at year end;
  - Recording information about the internal control systems that are relevant to the audit;
  - Performing some preliminary controls testing or substantive procedures
- Final audit – this is performed after the year-end when the draft financial statements are available and include full-year balances.

Normally the interim audit work is performed by fewer but more senior staff. The final audit is then much longer and involves the whole audit team.

5 ADVANTAGES AND LIMITATIONS OF STATUTORY AUDITS

Section overview

- Advantages of statutory audits
- Limitations of statutory audits

There are several advantages in having an external audit, but there are also some limitations.

5.1 Advantages of statutory audits

An external audit provides the following benefits:

- It increases the credibility of published financial statements.
- It confirms to management that they have performed their statutory duties correctly.
- It provides assurance to management that they have complied with non-statutory requirements, such as corporate governance requirements (where these are subject to audit or review).
- It provides feedback on the effectiveness of internal controls. Where internal controls are weak or inadequate, the auditor will give recommendations for improvement. This will assist management in reducing risk and improving the performance of the company.

Even where a statutory audit is not required, for example due to small company statutory exemption limits (in some countries), an audit will increase the credibility of published financial statements. This may be important for potential lenders to the company. Potential lenders, such as banks, may insist on the company having an audit as a pre-condition for lending money.

5.2 Limitations of statutory audits

The main limitations of an audit are as follows:

- Its cost. The cost of an audit can be very high. However, if the audit firm is already hired to carry out non-audit work such as advisory work, the additional cost of an audit may be fairly small.
- The disruption caused to a company's staff during the audit. The company's staff may be required to assist the auditors by answering questions, providing documents and other information.
- Some items in the subject matter might be estimates whose truth and fairness will not be known with certainty until some point in the future. This means the assurance opinion is ultimately subjective and judgmental.
- Most fraud will include an attempt to deliberately conceal the truth or misrepresent information.
- In order to balance cost and efficiency the auditor routinely uses sampling rather than tests every item.
- Irrespective of how robust a client's systems are they will always incorporate some degree of inherent limitation.
- Audit evidence is persuasive rather than conclusive, i.e, they persuade the auditor to believe that a particular assertion has been justified instead of providing a conclusion

6 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Define the terms audit and assurance and explain the overall objectives of the independent auditor
- Describe the regulatory framework relevant to statutory audit
- Explain the roles of IFAC and the IAASB
- Describe advantages and limitations of statutory audit
- Summarise the overall responsibilities of the independent auditor and management (and those charged with governance)
- Explain the nature and scope of an audit
- Understand the terms independence, materiality and true and fair

CHAPTER 2

Obtaining an engagement

Contents

1 Obtaining and accepting a new audit engagement
2 Agreeing the terms of audit engagements (ISA 210)
3 Chapter review

INTRODUCTION

Learning outcomes

The overall objective of the syllabus is acquiring knowledge of theory, skill and techniques of auditing and to enable the students to understand International Standards on Auditing, Assurance and Ethics.

General concepts and principles of audit

LO 1	**On the successful completion of this paper, candidates will be able to demonstrate knowledge of general concepts governing an audit**
LO 1.7.1	Describe the preconditions for an audit and upon which it is necessary for the auditor and the entity's management to agree
LO 1.7.2	Respond if preconditions are not present or limit is imposed on scope of audit in well explained simple situations
LO 1.7.3	State the contents of an audit engagement letter
LO 1.7.4	Discuss the requirement of issuance of engagement letter and factors that necessitate the issuance of engagement letter in case of recurring audit
LO 1.7.5	Discuss the circumstances of acceptances of changes in terms of engagement by the auditor

Professional ethics

LO 5	**Respond on audit matters in the light of fundamental principles given in the Code of Ethics**
LO 5.2.1	Explain the advertisement and publicity guidelines of ICAP Code of Ethics for obtaining the audit work.
LO 5.2.2	Apply the conceptual framework to identify, evaluate and address threats in case of fees, referral fees and tendering for audit work.
LO 5.2.3	Explain using simple examples the matters to be considered and the procedures that an audit firm/professional accountant should carry out in the following circumstances: • Client acceptance • Engagement acceptance • Changes in a professional appointment (including additional work, mid-term removal and non-reappointment)

1 OBTAINING AND ACCEPTING A NEW AUDIT ENGAGEMENT

Section overview

- Introduction
- Obtaining audit work
- Accepting an audit appointment: ethical matters

1.1 Introduction

Several commercial and ethical matters should be considered by an **external** auditor when considering the acceptance of a new audit engagement. Auditors and clients must also follow the legal requirements set out in the Companies Act, 2017.

Audit practices are a business, and their objective is to make a profit. However, this does not mean that the practice should automatically accept every audit engagement that is offered to it, in order to maximise profit. Circumstances may arise where it is appropriate to decline the offer of an audit appointment, for either commercial or ethical reasons.

1.2 Obtaining audit work

Advertising and publicity – general guidelines

Most audit member body codes of practice around the world allow members to seek publicity for their services and to advertise their services. However, whatever medium is used, it **must not reflect badly on the member, the member body or the accountancy profession**. Members must also take care that the way in which they market their services does not create a **self-interest threat** to the fundamental principle of **professional behaviour** (codes of ethics are discussed further in chapter 14).

Member codes typically also state that advertisements and promotional material must not:

- discredit the services offered by others (for example by claiming superiority);
- be misleading; or
- fall short of any local regulations or legislation.

Advertising and publicity - ICAP Code of Ethics

The ICAP Code of Ethics (paragraphs 250.1 and 250.2) states:

250.1 Undue publicity to be avoided

In any communications, announcements and public notices, chartered accountants should not:

- use means which bring the profession into disrepute;
- make exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained; and
- denigrate the work of other accountants.

A Chartered Accountant preparing or authorizing the issue of matter falling within this Section should do so with a due sense of responsibility to the profession and to the public as a whole. In particular such material should be in good taste both as to content and presentation and should not belittle services offered by others, whether members or not, either by claiming superiority for the services of a particular Chartered Accountant or otherwise. The same attitude should be adopted towards activities mentioned in subsequent paragraphs.

250.2 Advertising for solicitation must be avoided

All communications, announcements and public notices should be issued in such a manner and within the limits prescribed in the following paragraphs……

- All announcements, communications and public notices should:-
  - be aimed at informing the recipients or the public in an objective manner;
  - conform to the basic principles of legality, decency, clarity, honesty and truthfulness; and
  - not project an image, which is inconsistent with that of a professional person bound to high ethical and technical standards.
- Activities which may expressly be considered not to meet the above criteria and are therefore prohibited include those that:
  - create false, deceptive or unjustified expectations of favourable results;
  - imply the ability to influence any court, tribunal, regulatory agency or similar body or official;
  - consist of self-laudatory statements that are not based on verifiable facts;
  - make comparisons with other professional accountants in practice;
  - contain testimonials or endorsements;
  - contain any other representations that would be likely to cause a reasonable person to misunderstand or be deceived; and
  - make unjustified claims to be an expert or specialist in a particular field of accountancy.

Fees

Where reference is made in promotional material to fees:

- this must not be misleading with regard to the precise range of services and the time commitment covered;
- comparison may be made to the fees of others, provided that this is not misleading and that it follows local regulations or legislation; and
- discounts on existing fees may be offered, or a free consultation at which the level of fees will be discussed.

Introductions

Fees and commissions may be paid to third parties for the introduction of potential new clients, **but safeguards must be in place** to reduce the threats to the fundamental principles. Such safeguards would include disclosure to the client.

Tendering

When making a decision to appoint a new firm of auditors, it is standard practice amongst larger companies to invite tenders for the audit work from a number of audit firms.

A tendering process typically requires the interested audit firms to provide a detailed written proposal including an approximate fee estimate, based on the estimated time to be spent on the audit and the grade of staff to be used. A presentation to the potential client may also be required.

1.3 Accepting an audit appointment: ethical matters

The ICAP Code of Ethics [Section 210.1-23] includes procedures that auditors must follow to assure that their appointment is valid.

Note: You should refer to the later chapter on ethics for explanation of the ethical terms and principles referred to below

Client acceptance

Before accepting an appointment, the audit firm should:

- Assess whether acceptance would create any **threats** to compliance with the fundamental principles and consider the significance of any threat identified. For example, a personal relationship between a partner at the firm and a senior member of the client's staff could create a threat to objectivity. Lack of technical expertise could create a threat to professional competence and due care.
- Ensure that resources are available to complete the audit assignment; in particular, it must ensure that there will be sufficient staff (of the right level of expertise) available at the right time. Again, not to have sufficient resources available would create a threat to professional competence and due care.
- Take up references on the proposed client company and its directors, if they are not already known to the auditors. This is usually referred to as client **screening**.

Where it is not possible to reduce the threats to an acceptable level, a chartered accountant in practice should decline to enter into the client relationship.

Acceptance decisions should be periodically reviewed for recurring client engagements.

Engagement acceptance

A chartered accountant in practice should agree to provide only those services that they are competent to perform. Before accepting a specific client engagement, they should consider whether acceptance would create any threats to compliance with the fundamental principles. For example, a self-interest threat to professional competence and due care is created if the engagement team does not possess, or cannot acquire, the competencies necessary to properly carry out the engagement.

A chartered accountant in practice should evaluate the significance of identified threats and, if they are other than clearly insignificant, safeguards should be applied as necessary to eliminate them or reduce them to an acceptable level. Where it is not possible to reduce the threats to an acceptable level the chartered accountant should decline the engagement.

Safeguards may include:

- Acquiring an appropriate understanding of the nature of the client's business, the complexity of its operations, the specific requirements of the engagement and the purpose, nature and scope of the work to be performed.
- Acquiring knowledge of relevant industries or subject matters.
- Possessing or obtaining experience with relevant regulatory or reporting requirements.
- Assigning sufficient staff with the necessary competencies.
- Using experts where necessary.
- Agreeing on a realistic time frame for the performance of the engagement.
- Complying with quality control policies and procedures designed to provide reasonable assurance that specific engagements are accepted only when they can be performed competently.

When a chartered accountant in practice intends to rely on the advice or work of an expert, they should evaluate whether such reliance is warranted. They should consider factors such as reputation, expertise, resources available and applicable Professional and ethical standards. Such information may be gained from prior association with the expert or from consulting others.

For example in case of revaluation of fixed assets, the audit firm will check the credibility of the surveyor before placing reliance on his work.

Note that the accountant has an obligation to comply with ethical requirements continuously throughout the period of engagement. They should also review their acceptance decisions for recurring clients.

Procedures after accepting an appointment

After accepting the appointment as auditor, the audit firm should take the following measures:

- It should ensure that the current auditor (if any) has resigned from the audit in a proper manner, or has been removed from office in accordance with any appropriate local legislation.
- It should ensure that its appointment is valid in law and is properly documented.
- It should prepare and submit an engagement letter to the board of the new client (see below).

Changes in professional appointment

The firm should **communicate with the current auditors** (if there are any) to establish if there are any matters that it should be aware of when deciding whether or not to accept the appointment. Although this is partly a matter of courtesy between professionals, this will involve discussion of the appointment, the client and the audit work. Such discussion will allow the firm to decide if the client is someone for whom it would wish to act.

The following points should be noted in connection with communicating with the current auditors:

- Client permission is required for any such communication. If the client refuses to give its permission, the appointment as auditor should not be accepted.
- If the client does not give the current auditor permission to reply to any relevant questions, the appointment as auditor should not be accepted.
- If the current auditor does not provide any information relevant to the appointment, the new auditor should accept or reject the engagement based on other available knowledge.
- If the current auditor does provide such information, the new auditor should assess all the available information and take a decision about whether or not to accept the audit work.

Note that even where the current auditor provides information that is judged to be relevant to the acceptance of the engagement, the proposed new auditor may still accept the assignment. However, he should exercise appropriate professional and commercial judgement in doing so.

Additional work

A chartered accountant in practice may be asked to undertake work that is complementary or additional to the work of the existing accountant. Such circumstances may give rise to potential threats to professional competence and due care resulting from, for example, a lack of or incomplete information. Safeguards against such threats include notifying the existing accountant of the proposed work, which would give the existing accountant the opportunity to provide any relevant information needed for the proper conduct of the work.

Mid-term removal

Where the proprietors of the business remove an existing chartered accountant before he has completed the audit and submitted his report, the existing chartered accountant must immediately inform the Institute with relevant facts about his removal.

The proposed chartered accountant in practice should not only follow the procedure detailed in the preceding paragraphs of this section, he should also inform the Institute about the offer of appointment.

The proposed chartered accountant in practice should not accept the offer without prior clearance from the Institute, which clearance shall not be unreasonably withheld. Provided, however, in the case where the Institute refuses to give its clearance, the Institute shall communicate its decision within 15 (fifteen) days with reasons thereof.

Non re-appointment

Where an existing chartered accountant, though willing for reappointment has not been re-appointed, he shall file with the Institute a copy of the statement which he may have sent to the proprietors/Board of Directors of the Company for circulation among the shareholders under section 246 of the Companies Act, 2017. It shall be obligatory on the proposed chartered accountant before accepting the appointment, to obtain a copy of such a communication and follow the procedure detailed in preceding paragraphs of this Section.

2 AGREEING THE TERMS OF AUDIT ENGAGEMENTS (ISA 210)

Section overview

- Preconditions
- Engagement letters

2.1 Preconditions

The **objective** of the auditor, per ISA 210 *Agreeing the terms of audit engagements,* is to accept or continue an audit engagement **only when the basis upon which it is to be performed has been agreed**. This is done by:

- establishing whether the **preconditions for an audit are present**; and
- confirming that there is a **common understanding between the auditor and management**.

To establish if the preconditions for an audit are present ISA 210 **requires** the auditor to:

- establish if the financial reporting framework to be used in the preparation of the financial statements is acceptable, for example IFRS or IPSAS; and
- obtain the agreement of management that it **acknowledges and understands its responsibility (the 'premise'):**
  - for the preparation of the financial statements;
  - for internal controls to ensure that the financial statements are not materially misstated; and
  - to provide the auditor with all relevant and requested information and unrestricted access to all personnel.

Response if preconditions are not present

If the preconditions for an audit are not present, the auditor shall discuss the matter with management. The auditor should explain what the preconditions are and that they are required in order to comply with *ISA 210 Agreeing the terms of audit engagements*. The auditor should also explain that one of the purposes of the preconditions, and agreeing the terms of the audit engagement in general, is to avoid misunderstanding about the respective responsibilities of management and the auditor.

Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement where:

- a limitation on scope is imposed by management such that he auditor would be unable to express an opinion on the financial statements, or
- the financial reporting framework to be used in the preparation of the financial statements is unacceptable, or
- management do not agree to the above responsibilities (the 'premise') stated in the preconditions.

The only exception allowed by ISA 210 for accepting or continuing the engagement to the above is when law or regulation requires the auditor to do so.

Examples of Scope Limitation

- When auditors are appointed after year end and they are unable to do physical inventory count at year end
- When the management does not provide the auditors with the contact details of debtors to confirm the account head "Accounts Receivable"

- When the invoices file of raw material purchases is lost while moving to a new office building so the purchase supports and relevant controls on raw materials cannot be verified.

2.2 Engagement letters

Having accepted an appointment as auditor of a client company, the audit firm should submit an engagement letter to the board of directors of the client company. The engagement letter can be seen as the basis for **the contract between the company and the auditor**.

The content of the engagement letter

The engagement letter should include details of the following:

- The objective and scope of the audit.
- The responsibilities of the auditor.
- The responsibilities of management.
- Identification of the underlying financial reporting framework.
- Reference to the expected form and content of any reports to be issued.

In addition to the above, the auditor may feel that it is appropriate to include additional points in the engagement letter, such as:

- more details on the scope of the audit, such as reference to applicable legislation, regulations, ISAs, ethical and other pronouncements;
- the form of any other communication of results of 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 because of the inherent limitations of an audit, and the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected even though the audit was properly planned and performed in accordance with ISAs;
- arrangements regarding the planning and performance of the audit, including the composition of the audit team;
- the expectation that management will provide written representations;
- the expectation that management will provide access to all information that is relevant to the preparation of the financial statements and its disclosures
- The agreement of management to make available to the auditor draft financial statements, including all information relevant to their preparation, whether obtained from within or outside of the general and subsidiary ledgers (including all information relevant to the preparation of disclosures), and the other information if any, in time to allow the auditor to complete the audit in accordance with the proposed timetable.
- The agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued.
- the basis on which fees are computed and any billing arrangements;
- a request for management to acknowledge receipt of the engagement letter and to agree to its terms;
- arrangements concerning the involvement of other auditors, predecessor auditor, experts or internal auditors (or other staff of the entity);
- any restriction of the auditor's liability when such possibility exists
- A reference to any further agreements between the auditor and the entity' and
- Any obligations to provide audit working papers to other parties.

Example:

Explain why the auditor might wish to include each of the following points in the engagement letter:

- Basis on which fees are charged
- Outline timetable
- Formal acknowledgement of the contents of the letter
- Arrangements for the involvement of client staff

Answer

Basis on which fees are charged – to ensure that there is no misunderstanding (for example that more senior staff cost more and that "time is money"). This may help to encourage the client to provide as much assistance as possible and not to insist that all work is carried out by more senior members of the team.

Outline timetable – to ensure that the client will be prepared for the arrival of the audit team (for example, draft financial statements and supporting schedules of all ready and key staff available (and not on holiday). If necessary, the audit timetable could be changed at this stage.

Formal acknowledgement of the contents of the letter– to ensure that the directors cannot later claim that they did not understand the scope of the audit and their responsibility for the financial statements.

Arrangements for the involvement of client staff – to ensure that the client is able to plan for the involvement of the necessary staff and that they are available at the required time.

Recurring audits

The engagement letter issued on the initial appointment as auditors may state that its provisions will apply to all future annual audits, until it is revised. However, ISA 210 **requires** the auditor, for recurring audits, to assess whether:

- circumstances mean that the terms of engagement need to be revised
- management need to be reminded of the existing terms of the engagement.

The ISA suggests that the following factors may indicate that the above is appropriate:

- Any indication that the entity misunderstands the objective 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 adopted in the preparation of the financial statements.
- A change in other reporting requirements.

Acceptance of a change in the terms of engagement

The entity might, in certain circumstances, ask the auditor to change the terms of the audit engagement. This might result from a genuine change in circumstances or from a misunderstanding as to the nature of an audit as originally requested. However, it could result from a situation where the auditor is unable to obtain sufficient appropriate audit evidence regarding a material item. The entity might then ask for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

ISA 210 **requires** the auditor to consider the justification for the request and whether it is "reasonable".

- If the auditor considers that it is a reasonable request then revised terms should be agreed and recorded.
- If the auditor is unable to agree to a change of terms he should withdraw from the engagement and consider whether there is any obligation to report the circumstances to those charged with governance, owners or regulators.

3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain the ethical considerations with respect to client and engagement acceptance and changes in professional appointment.
- Describe the requirements of ISA 210 with respect to the preconditions for accepting appointment as an auditor and also for setting up the engagement letter.

CHAPTER 3

Planning and risk assessment

Contents

1 Planning an audit: ISA 300
2 Understanding the business and materiality: ISAs 315 and 320
3 Audit risk: ISA 330
4 Fraud: ISA 240
5 Not-for-profit organisations
6 Chapter review

INTRODUCTION

Learning outcomes

The overall objective of the syllabus is acquiring knowledge of theory, skill and techniques of auditing and to enable the students to understand International Standards on Auditing, Assurance and Ethics.

General concepts and principles of audit

LO 1	**On the successful completion of this paper, candidates will be able to demonstrate knowledge of general concepts governing an audit**
LO 1.3.8	Discuss the concept of professional scepticism
LO1.3.11	Discuss the concept of audit of Not-for-profit organisations.
LO 1.5.1	Distinguish between the terms 'error', 'fraud' and misstatement'
LO 1.5.2	Compare the respective responsibilities of management and auditors for fraud
LO 1.5.3	Describe the matters to be considered and procedures to be carried out to assist the auditor in identifying, assessing and detecting the risks of material misstatement due to fraud
LO 1.5.4	Identify the fraud risk factors in the simple scenario as given in the appendix 1 of ISA 240
LO 1.5.5	Identify the circumstances that indicate the possibility of fraud in the simple scenario as given in the appendix 3 of ISA 240

Performance of audit and reporting

LO 2	**On the successful completion of this paper, candidates will be able to demonstrate working knowledge in respect of performance of simple audit procedures and understand the audit report requirement under the Companies Act, 2017**
LO 2.1.1	Discuss the need for planning an audit including contents of an audit plan and its relation with risk assessment
LO 2.1.2	Discuss the contents of overall audit strategy and audit plan
LO 2.1.3	State who should be involved in planning and what preliminary engagement activities are necessary
LO 2.1.4	Discuss overall planning and the audit plan for a recurring audit
LO 2.1.5	Outline the additional considerations that should be identified while planning the initial audit
LO 2.2.1	Discuss the risk based approach to auditing including audit risk model
LO 2.2.2	Identify the inherent risk, control risk and detection risk in simple scenario
LO 2.2.3	Explain relationship between audit risk and its components i.e. inherent risk, control risk and detection risk
LO 2.2.4	Discuss the identification and assessment of the risks of material misstatement at both the financial statement level and assertion level, including understanding of entity, its environment, accounting and internal control systems
LO 2.3.1	Explain the concepts of materiality and performance materiality using simple examples

1 PLANNING AN AUDIT: ISA 300

Section overview

- The purpose of an audit plan
- Professional scepticism
- Introduction to ISA 300
- Contents of the overall audit strategy and the audit plan
- Interim audit and final audit
- Additional considerations in initial audit engagements

1.1 The purpose of an audit plan

A plan sets out what needs to be done to achieve an objective. In the case of an external or internal audit, the objective is the production of an audit report containing an opinion on the information subject to audit. An audit plan should be prepared as a means of achieving this objective efficiently and effectively.

Content of an audit plan

Preparing an audit plan is the first stage in the conduct of an audit engagement. The plan sets out answers to three main questions (the '3Ws'):

- **Who** will perform the audit work? (Staffing)
- **When** will the work be done? (Timing)
- **What** work is to be done? (The scope of the audit)

Risk assessment and the audit plan

To prepare a suitable audit plan, the auditor needs to have an in-depth knowledge and understanding of:

- the entity to be audited, and
- the environment in which the entity operates.

The auditor needs this knowledge and understanding in order to assess the risk attached to the audit. **Risk assessment** is a key feature of the audit planning process and the assessment of risk in the audit will affect:

- the amount of audit work performed in general, and
- the areas on which the auditor will focus his attention.

The planning process is essential to **all** audits, both internal and external. It is equally important to other assurance engagements such as a 'review' assignment.

1.2 Professional scepticism

It is a requirement of ISA 200 that, when planning and performing an audit, the auditor should adopt an attitude of **professional scepticism**. Professional scepticism is defined by ISA 200 as:

"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".

This does not mean that the auditors should disbelieve everything they are told, but they should view what they are told with a sceptical attitude, and consider whether it appears reasonable and whether it conflicts with any other evidence. In other words, they must not simply believe everything management tells them.

1.3 Introduction to ISA 300

Overview

The **objective** of the auditor, per ISA 300 *Planning an audit of financial statements* is to plan the audit work so that the audit will be performed **in an effective manner.** ISA 300 is written primarily in the context of recurring audits. Additional considerations in an initial audit engagement are separately identified too.

Adequate planning **benefits** the audit by:

- helping the auditor to devote appropriate attention to important areas of the audit
- helping the auditor to identify and resolve potential problems on a timely basis
- helping the auditor organise and manage the audit engagement so that it is performed in an effective and efficient manner
- assisting in the selection of staff with appropriate experience to respond to anticipated risk and the proper assignment of work to them
- allowing for the direction and supervision of staff and review of their work.
- assisting, where applicable, in coordination of work done by auditors of components and experts

ISA 300 **requires** the auditor to:

- involve the whole **engagement team** in planning the audit
- performing procedures regarding the **continuance of the client relationship**, **specific audit engagement**, evaluating **compliance with relevant ethical requirements** and **independence**, in accordance with ISA 220
- establish an understanding of the **terms of the engagement** as required by ISA 210
- establish an **overall strategy** for the audit that sets the scope, timing and direction of the audit and that guides the development of the audit plan
- develop an **audit plan** which includes a description of the nature, timing and extent of planned risk assessment procedures and planned further audit procedures
- **document** the overall audit strategy and the audit plan, including any significant changes made during the audit.

The above requirements are discussed in detail as follows:

Involvement of key engagement team members

- ISA 300 requires the engagement partner and other key members of the engagement team to be involved in planning the audit, including planning and participating in the discussion among engagement team members to enhance the efficiency and effectiveness of the planning process.

In practice there is likely to be a planning meeting (or series of meetings) between the auditor and the client that form the basis of the audit planning. Depending on the size of client, complexity and any other relevant factors, this may involve the engagement partner and other key members of the engagement team, for example an engagement manager, and for the client the finance director and financial controller.

Preliminary engagement activities

The auditor shall undertake the following activities at the beginning of each audit engagement:

- Perform procedures required by *ISA 220 Quality Control for an Audit of Financial Statements* regarding the continuance of the client relationship and the specific audit engagement. This will involve establishing whether the auditor:
  - is competent to perform the engagement and has the capabilities, including time and resources, to do so;

  - can comply with relevant ethical requirements;
  - has considered the integrity of the client, and does not have information that would lead it to conclude that the client lacks integrity; and
  - has considered significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.
- Evaluate compliance with relevant ethical requirements, including independence, in accordance with ISA 220.
  - This will involve confirming that the auditor remains compliant with ethical requirements, and will continue to do so during the audit, establishing appropriate safeguards against non-compliance where appropriate.
  - The engagement partner will need to provide the firm with relevant information about the client engagement, including the scope of services, to enable the firm to evaluate the overall impact, if any, on independence requirements.
- Establish an understanding of the terms of the engagement, as required by ISA 210 (see chapter 2).

Performing preliminary procedures on both client continuance and evaluation of relevant ethical requirements (including independence) at the beginning of the current audit engagement means that they are completed prior to the performance of other significant activities for the current audit engagement. For continuing audit engagements, such initial procedures often occur shortly after (or in connection with) the completion of the previous audit.

Planning Activities

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

- In establishing the overall audit strategy, the auditor shall:identify the characteristics of the engagement that define its scope;
- ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
- consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
- consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
- ascertain the nature, timing and extent of resources necessary to perform the engagement.

Documentation

The auditor shall include in the audit documentation:

- The overall audit strategy;
- The audit plan; and
- Any significant changes made during the audit engagement to the overall strategy or the audit plan along with reasons thereof.

The overall audit strategy and audit plan are considered in greater detail below.

1.4 Contents of the overall audit strategy and the audit plan

The overall audit strategy

As set out above, the overall audit strategy sets the **scope, timing and direction of the audit** and **guides the development of the more detailed audit plan.** The establishment of the overall audit strategy involves the following:

- Determining the characteristics of the engagement that define its **scope** such as:
  - the financial reporting framework used (for example, international financial reporting standards)
  - any industry specific reporting requirements
  - the location of the components of the entity (for example, there might be overseas branches).
  - The nature of the control relationships between a parent and its components and the extent to which components are audited by other auditors.
  - The nature of the business segments to be audited, including the need for specialized knowledge.
  - The reporting currency to be used, including any need for currency translation for the financial information audited.
  - The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.
  - Whether the entity has an internal audit function and, if so, whether, in which areas and to what extent, the work of the function can be used, or internal auditors can be used to provide direct assistance, for purposes of the audit.
  - The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them.
  - The expected use of audit evidence obtained in previous audits, for example,
  - Audit evidence related to risk assessment procedures and tests of controls.
  - The effect of information technology on the audit procedures, including the availability of data and the expected use of computer-assisted audit techniques.
  - The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect on the audit of the information obtained during such reviews.
  - The availability of client personnel and data.
- Ascertaining the **reporting objectives** of the engagement, such as reporting deadlines and the nature of communications required.
- Considering **important factors** which will determine the focus of the audit team's efforts, such as:
  - materiality thresholds
  - high risk areas of the audit
  - the audit approach (for example, whether the auditor is planning to rely on the entity's internal controls)
  - any recent developments in relation to the entity, the industry, legal environment or financial reporting requirements.
  - Process used by management to identify and prepare disclosures required by applicable financial reporting framework

The above will then allow the auditor to decide on the **nature, extent and timing of resources** needed to perform the engagement. In particular the auditor should consider:

- where experienced members of staff may be needed (for example, on high risk areas)
- the number of staff to be allocated to specific areas (for example, extra staff may be needed for attendance at the year-end inventory count)
- when the resources are needed (for example, are more staff needed at the final audit than at the interim audit)

- how such resources are to be managed, directed and supervised (for example, the timing of team briefing meetings and manager and partner reviews of work performed by other members of the audit team).

The audit plan

Once the overall audit strategy has been established the auditor can develop the more detailed audit plan.

The audit plan will set out:

- the procedures to be used in order to assess the **risk of misstatement** in the entity's accounting records/financial statements, and
- planned **further audit procedures** for each material audit area. These audit procedures might be in response to the risks assessed, or specific procedures to be carried out to ensure that the engagement complies with ISAs.

The audit procedures to be performed by audit team members will be those needed in order to:

- obtain sufficient appropriate audit evidence, and
- reduce audit risk to an acceptably low level.

Audit risk is considered in detail in the next section. What constitutes "sufficient appropriate audit evidence" is considered in a later chapter.

These procedures will be set out in a series of **audit programmes.** Audit programmes are sets of instructions to the audit team, specifying the audit procedures that should be performed in each area of the audit.

1.5 Interim audit and final audit

Most large audits will be split into two phases. Much of the systems assessment work and transaction testing will be carried out on the **interim audit** (taking place perhaps two-thirds of the way through the year) with the balance of the work and testing of statement of financial position items taking place at the **final audit** shortly after the year end.

A number of **key benefits** may arise from spreading the work across interim and final audit such as:

- More flexible resource planning within the firm – the timing of interim audit is typically more flexible than the timing of final audit. This helps reduce demand for audit staff during 'busy season' (traditionally the first few months of a calendar year when many clients require their final audit to take place)
- Earlier identification of significant matters
- Shareholders and other users receive audited accounts earlier
- Increased audit efficiency

ISA 330 also states:

"The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date".

Typical **interim audit procedures** include:

- Understanding the entity, assessing inherent risk (see ISA 315) and identifying significant matters which will be reflected in the subsequent audit strategy and audit plan.
- Recording, evaluating the design and testing the entity's system of internal control.
- Performing substantive testing to ensure the books and records are a sound basis for performing the year end audit.

Typical **final audit procedures** include:

- Substantive testing. Note that where substantive testing was performed at the interim phase auditors typically test the subsequent period between interim audit and period end
- Tests to ensure conclusions formed at interim audit remain valid
- Obtaining third party confirmations such as bank letters and trade receivables confirmations
- Analytical review and subsequent events review
- Subsequent events review
- Obtaining written representations
- ISA 330 specifically states that the following procedures can only be performed at or after the period end:
  - Agreeing the financial statements to the accounting records;
  - Examining adjustments made during the course of preparing the financial statements; and
  - Procedures to respond to a risk that, at the period end, the entity may have entered into improper sales contracts, or transactions may not have been finalized

1.6 Additional considerations in initial audit engagements

The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements. For an initial audit engagement, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:

- Unless prohibited by law or regulation, arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor's working papers;
- Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan;
- The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances;
- Other procedures required by the firm's system of quality control for initial audit engagements (for example, the firm's system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).

2 UNDERSTANDING THE BUSINESS AND MATERIALITY: ISAs 315 AND 320

Section overview

- Understanding the entity and its environment
- Understanding the accounting and internal control systems
- Risk and materiality
- Materiality: ISA 320

Auditor's Risk Assessment Process

The auditor performs risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement. ISA 315 **requires** the auditor's risk assessment procedures to include the following:

- **Inquiries** (i.e. asking questions and getting answers) of:
  - management;
  - appropriate individuals within the internal audit function if such a function exists (irrespective of whether the external auditor plans to use the work of internal audit and/or use them for direct assistance, as such inquiry will assist the external auditor's understanding of the role that internal audit plays in the monitoring of controls); and
  - others who may have information that is likely to assist in identifying risks of material misstatement due to fraud or error.
- **Analytical procedures**, which involves the study of ratios and trends to identify the existence of unusual transactions or events or amounts, ratios or trends that might have implications for the audit (information technology may be of use here in calculating changes to balances in the financial statements from previous years and graphing trends).

  For example, an analysis of payables days compared to previous years might indicate that the company is having difficulty in paying its debts. As a result, the auditor may plan to do more work on this area.
- **Observation and inspection** (for example, inspecting internal control manuals or business plans).

Each of these procedures or methods will be described in more detail in later chapters that deal with the techniques of gathering audit evidence as each of them is also a technique for gathering audit evidence. However, they are all used at this stage to help the auditor identify areas of risk and to plan his audit approach. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion.

The auditor should look for factors that could be significant and to which particular attention should be given by the audit team. For example, the auditor may be aware that there is a recession in the industry in which the client company operates, but that rising commodity prices have forced companies to raise the prices of their products and so pass on the higher costs to customers. In addition, the auditor may also be aware that the client company has a poor track record in collecting trade receivables. This knowledge of the business might make the auditor reach the conclusion that the audit should give particular attention to the measurement of trade receivables, and the estimates for bad and doubtful debts.

When the auditor draws on knowledge he has gained from audits of the client in previous years, it is important that he should take into account any significant changes in circumstances, or changes in the general environment. He should not routinely follow the same plan as in the previous year, because a significant change in circumstances may mean that the audit plan used in the previous year is no longer appropriate.

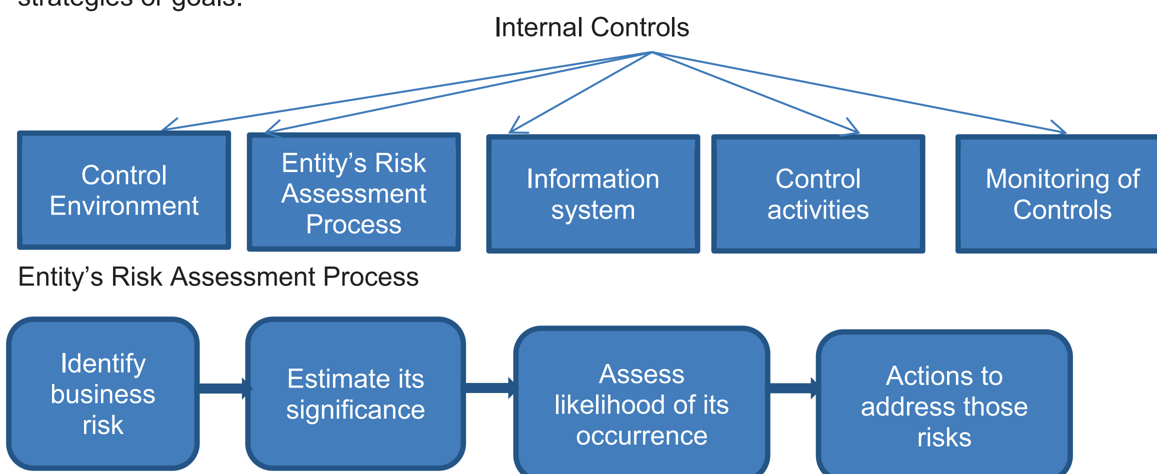
2.1 Understanding the entity and its environment

The auditor is required to o **identify and assess the risks of misstatement**, whether due to fraud or error, through understanding the entity and its environment, including its internal controls.

This will involve considering such factors as:

- Relevant industry, regulatory and other external factors, including the applicable financial reporting framework.
- The nature of the entity, including its operations, ownership, management structures and types of current and planned investments.
- The entity's selection and application of accounting policies, including whether they are appropriate for its business and consistent with the industry and the applicable financial reporting framework.
- The entity's objectives and strategies and those related business risks that may result in risks of material misstatement.
- The measurement and review of the entity's financial performance.

Business risks are risks occurring as a result of significant conditions, events, circumstances, actions or inactions that could affect an entity's ability to reach its objectives and carry out its strategies. Business risks can also occur as a result of setting of inappropriate objectives, strategies or goals.



All the remaining elements of internal controls are discussed in detail in Chapter 5; Internal control.

2.2 Understanding the accounting and internal control systems

ISA 315 **requires** the auditor to **obtain an understanding of internal controls relevant to the audit**. Although most of the entity's internal controls will relate to financial reporting, not all will be relevant to the audit.

If the entity has an internal audit function then auditor shall obtain an understanding of the nature of the internal audit function's responsibilities, its organizational status, and the activities performed, or to be performed.

The auditor should try to reach a judgement about how strong (or weak) the internal controls are, in order to make a decision about the amount of testing that should be carried out in the audit. He should consider:

- his previous knowledge of the client company
- any recent changes
- any known problems in the internal controls of the client
- the effect of any new auditing or accounting requirements.

ISA 315 emphasises that establishing communications with the appropriate individuals within an entity's internal audit function early in the engagement, and maintaining such communications throughout the engagement, can facilitate effective sharing of information. It creates an environment in which the auditor can be informed of significant matters that may come to the attention of the internal audit function when such matters may affect the work of the auditor.

The auditor's assessment of the entity's internal control systems is dealt with in more detail in later chapters.

2.3 Risk and materiality

The auditor is **required** by ISA 315 to identify and assess the **risks of material misstatement** at both the financial statement and assertion levels.

The **financial statement level** refers to risks which are pervasive to the financial statements as a whole and which potentially affect many assertions (see below). An example might be if management have a tendency to override internal controls – this would affect all areas of the accounting systems.

The **assertion level** refers to specific objectives of the financial statements, for example, that all liabilities have been recorded and that recorded assets exist. The use of financial statement assertions is considered in detail in a later chapter.

Risk assessment is an important aspect of planning an audit. Issues to consider are:

- the areas where risk of misstatement (error) appear to exist, and the nature of the risk
- when an error should be considered material, and when it may be ignored
- what aspects of the audit will be the most difficult to plan because of the high risk of misstatement.

The auditor should consider:

- assessments of **inherent** risks and **control** risks, and the identification of significant audit areas
- setting materiality levels
- the possibility of material misstatements, including those arising because of fraud (rather than unintentional error)
- the identification of complex accounting areas, particularly those involving accounting estimates. (Areas of accounting where the estimates used will be more difficult to audit.)

The auditor will then focus his work on balances in the financial statements where he considers there is a **material risk of misstatement**. High risk/material items will be audited in detail, but low risk/immaterial items will receive less attention. Inherent risk, control risk and risk assessment are explained in detail later in this chapter.

This **audit risk approach** was developed in the 1980s. Previous approaches included the following:

- The **substantive approach** whereby every item in the financial statements is tested and vouched to supporting documents. This approach is still sometimes used for small entities where internal controls are weak and there are few transactions. It may be more efficient to just test everything (especially if the auditor is also providing accountancy services, where he will see all of the supporting documents in any case).
- The **systems approach** which was developed to avoid over-auditing. Under this method the underlying accounting systems were tested with less emphasis on the testing of individual transactions and balances. However, this approach could still lead to over-auditing as systems covering low-risk/immaterial areas were also tested.

Most firms now use a mixture of the audit risk approach and a systems-based approach.

2.4 Materiality: ISA 320

Materiality is a fundamental concept in both auditing and accounting. It reflects the fact that the users of financial statements find the statements useful even if they are not 100% accurate. Financial statements will normally be useful provided they do not contain 'material' errors or misstatements. The IASB's *Framework for the preparation and presentation of financial statements* states that:

"Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements."

ISA 320 *Materiality in planning and performing an audit* states that, assessing what is or is not material is a matter of professional judgement, in this context auditors are entitled to assume that users:

- have a reasonable knowledge of business and are willing to study the information in the financial statements diligently
- understand that financial statements are prepared, presented and audited to levels of materiality
- recognise the uncertainties inherent in certain amounts in the financial statements (such as provisions)
- make reasonable economic decisions based on the information in the financial statements.

ISA 320 requires the auditor to apply the concept of materiality:

- when **planning and performing the audit**, and
- when **evaluating the effect of misstatements** on the financial statements and therefore on his audit opinion

At the audit planning stage, risk and materiality are the two key factors which determine the auditor's answer to the 'what audit work is to be done?' question.

ISA 320 contains the following **requirements.**

At the planning stage, the auditor must determine **materiality** for the financial statements as a whole. This is often referred to as the **materiality level** or **materiality threshold**. If lower thresholds are required for some areas (for example, directors' remuneration, as discussed below) these must also be set at this stage.

The auditor must also set what ISA 320 refers to as **performance materiality**. Performance materiality recognises the fact that if all areas of the audit are carried out to detect all errors/omissions under the (overall) materiality level, that objective could be achieved, but when all the individual immaterial errors/omissions are added together, overall materiality could in fact be breached. Performance materiality is a way of taking this risk into account and will be set at a lower figure than overall materiality. There may be one or more performance materiality levels, as the level could vary by area.

As the audit progresses, the auditor must revise materiality (and, if appropriate, materiality for particular areas and performance materiality) if he becomes aware of information which would have caused him to have initially set different levels, had that information been known to him at the time.

Documentation must include details of all materiality levels set and any revision of these levels as the audit progresses.

Setting materiality levels

Materiality levels are often based on 'quantitative' factors, and expressed as a percentage of profit before tax, total revenue, gross profit and total expenses, total equity or net asset value , such as 1% of revenue or 5% of profit before tax t. For example, the materiality level for inventory valuation may be set at 5% of profit before tax . If the auditor finds, as a result of audit tests, that his estimate of inventory differs from the client's measurement by an amount that is more than 5% of profit before tax , the error would be considered material. The performance materiality will be set at a lower level such as 0.5% of profit before tax for testing individual transactions, account balances and disclosures.

However, it is important to bear in mind that for setting overall materiality 'qualitative' characteristics may also be taken into account. For example, many auditors would take the view that certain figures in financial statements should be absolutely correct and that **any** errors in those figures would be judged to be material. Examples might include a requirement for 100% accuracy in reporting issued share capital and directors' remuneration.

When considering whether misstatements in qualitative disclosures could be material, the auditor may identify relevant factors such as:

- The circumstances of the entity for the period (for example, the entity may have undertaken a significant business combination during the period)
- The applicable financial reporting framework, including changes therein(for example, a new financial reporting standard may require new qualitative disclosures that re significant to the entity)
- Qualitative disclosures that are important to users of the financial statements because of the nature of the entity (for example, liquidity risk disclosures may be important to users of the financial statements for a financial institution)

Illustration: Materiality

Draft financial statements for XYZ Ltd show the following:

- Revenue: Rs. 100m
- Pre-tax profit: Rs. 8m
- Inventory: Rs. 4m
- Trade payables: Rs. 3m

Materiality for the financial statements as a whole

The auditors might consider setting materiality for the financial statements as a whole at say 0.5% of revenue (Rs. 500k) or 5% of pre-tax profits (Rs. 400k). Let's assume for this illustration that they decide to use the pre-tax profits basis of Rs. 400k.

Performance materiality

The auditors have assessed the risk of material misstatement for individual account balances as follows:

- Inventory = high risk of material misstatement
- Trade payables = low risk of material misstatement

One method of calculating performance materiality is to apply risk-based weightings to overall materiality e.g. an 80% factor for low risk balances, 70% for moderate risk balances and 60% for high risk balances.

So in this illustration the auditor would use the following performance materiality levels:

- Inventory: 60% x Rs. 400k = Rs. 240k (high risk of material misstatement)
- Trade payables: 80% x Rs. 400k = Rs. 320k (low risk)

3 AUDIT RISK: ISA 330

Section overview

- Risk-based approach to auditing
- Responses to assessed risks: ISA 330
- The audit risk model
- Exam technique: identifying risks

3.1 Risk-based approach to auditing

As discussed above, a key feature of modern auditing is the 'risk-based' approach that is taken in most audits. At the planning stage, as required by ISA 315, the auditor will identify and assess the main risks associated with the business to be audited. He will prepare an overall audit strategy and an audit plan, as required by ISA 300, to focus the audit work on the high risk areas.

This area of risk assessment is also covered by ISA 330 *The auditor's responses to assessed risks*. The **objective** of ISA 330 is to gather adequate appropriate audit evidence about assessed risks of material misstatement, by designing and putting in place appropriate responses to the risks.

3.2 Responses to assessed risks: ISA 330

At the **financial statement level** these "responses" are overall ones, which may include:

- emphasising to the audit team the need to maintain an attitude of professional scepticism
- assigning more experienced staff or increased supervision of staff
- the use of experts
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
- changing the nature, timing and extent of audit procedures (for example, performing more substantive procedures at the final rather than at the interim audit, or obtaining more "persuasive" audit evidence).

The assessment of the risks at this level and therefore the auditor's response is very much affected by the auditor's assessment of the **control environment**. An effective control environment will be likely to increase the auditor's confidence in controls in all areas and allow him to carry out more procedures at the interim audit and to carry out less **tests of detail**. Both of these terms are considered in later chapters.

At the **assertion level** these "responses" take the form of further audit procedures, discussed in detail in later chapters. Audit procedures can take the form of **tests of controls** and/or **substantive procedures**.

In summary, the auditor is required to:

- assess the risks involved in the audit
- plan the audit work so that any material misstatements are identified and corrected if necessary.

This should then ensure that a 'true and fair view' is presented by the financial statements.

3.3 The audit risk model

A standard audit risk model is available to help auditors identify and quantify the main elements making up overall audit risk.

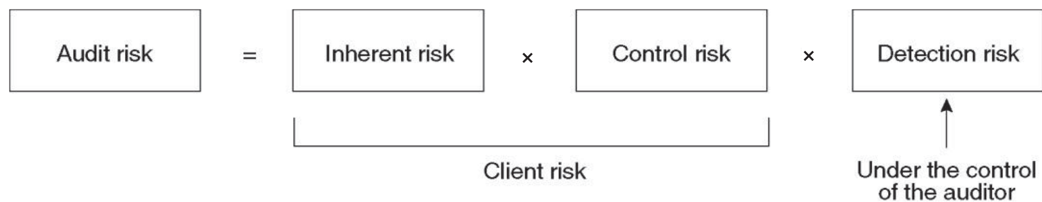
Definition: Audit risk

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

IAASB Handbook – Glossary of terms

Audit risk is the risk (chance) that the auditor reaches an inappropriate (wrong) conclusion on the area under audit. The audit risk is derived from errors arising out of inherent risk which are not prevented/detected by entity's internal controls and are not detected by further audit procedures. For example, if the audit risk is 5%, this means that the auditor accepts that there will be a 5% risk that the audited item will be misstated in the financial statements, and only a 95% probability that it is materially correct.

The audit risk model can be expressed as follows:



This model can be stated as a formula:

AR = IR × CR × DR

where:

AR = audit risk IR = inherent risk

CR = control risk, and DR = detection risk.

Risks are expressed as proportions, so a risk of 10% would be included in the formula as 0.10.

Inherent risk

Definition: 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 controls.

IAASB Handbook – Glossary of terms

Inherent risk is the risk that items may be misstated as a result of their inherent characteristics. Inherent risk may result from either:

- the nature of the items themselves. For example, estimated items are inherently risky because their measurement depends on an estimate rather than a precise measure; or
- the nature of the entity and the industry in which it operates. For example, a company in the construction industry operates in a volatile and high-risk environment, and items in its financial statements are more likely to be misstated than items in the financial statements of companies in a more low-risk environment, such as a manufacturer of food and drinks.

When inherent risk is high, this means that there is a high risk of misstatement of an item in the financial statements.

Inherent risk operates independently of controls. It cannot be controlled. The auditor must accept that the risk exists and will not 'go away'.

Control risk

Definition: Control risk

The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either 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.

IAASB Handbook – Glossary of terms

Control risk is the risk that a misstatement would **not** be prevented or detected by the **internal control systems** that the client has in operation.

In preparing an audit plan, the auditor needs to make an assessment of control risk for different areas of the audit. Evidence about control risk can be obtained through 'tests of control'.

The initial assumption should be that control risk is very high, and that existing internal controls are insufficient to prevent the risk of material misstatement. However, tests of control may provide sufficient evidence to justify a reduction in the estimated control risk, for the purpose of audit planning. Tests of control are covered in detail in a later chapter.

Detection risk

Definition: 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.

IAASB Handbook – Glossary of terms

Detection risk is the risk that the **audit testing procedures will fail to detect a misstatement** in a transaction or in an account balance. For example, if detection risk is 10%, this means that there is a 10% probability that the audit tests will fail to detect a material misstatement.

Detection risk can be lowered by carrying out more tests in the audit. For example, to reduce the detection risk from 10% to 5%, the auditor should carry out more tests.

In preparing an audit plan, the auditor will usually:

- **set** an overall level of audit risk which he judges to be acceptable for the particular audit,
- **assess** the levels of inherent risk and control risk, and then
- **adjust** the level of detection risk in order to achieve the overall required level of risk in the audit.

In other words, the detection risk can be managed by the auditor in order to control the overall audit risk. Inherent risk cannot be controlled. Control risk can be reduced by improving the quality of internal controls. However, recommendations to the client about improvements in its internal controls can only affect control risk in the future, not control risk for the financial period that is subject to audit. However, audit risk can be reduced by increasing testing, and reducing detection risk.

Example:

An auditor has set an overall level of acceptable audit risk in respect of a client of 10%. Inherent risk has been assessed at 50% and control risk at 80%.

Required

(a) **Explain the meaning of a 10% level of audit risk.**

(b) **What level of detection risk is implied by this information?**

(c) **If the level of audit risk were only 5%, how would this affect the level of detection risk and how would the audit work be affected by this change?**

Answer

(a) A 10% level of audit risk means that the auditor will be 90% certain that his opinion on the financial statements is correct (or there is a 10% risk that his opinion will be incorrect).

(b) AR = IR × CR × DR

then DR = AR / (IR × CR)

DR = 0.10 / (0.50 × 0.80)

Therefore DR = 0.25 = 25%

(c) If AR is reduced to 5%, DR would now be 12.5%. More audit work will be needed to achieve this lower level of detection risk.

3.4 Exam technique: identifying risks

In the exam, you could be presented with an audit scenario and a requirement to identify and explain the risks in this scenario. You should view such a scenario as containing a number of "clues". These clues will be matters which would impact on the auditor's assessment of the inherent, control and, possibly, detection, risks at this particular client. Your answer needs to demonstrate that you can spot these clues (identify) and understand why they represent risks (explain).

Example: identifying risks

Your assurance firm is the auditor of Risky Sounds, a retailer selling hi-tech recording equipment. Risky Sounds was started up just under a year ago by its sole shareholder and director, Sam Smith. Sam has employed a series of book-keepers to help him with the accounting records and financial statements, and the most recent one has just left. In order to start up the business Sam re-mortgaged his house and, in addition, took out a business loan. As a condition of continuing to provide the loan, the bank has asked to be provided with a copy of the annual financial statements.

Required

Identify the risks in the above scenario and explain why they are risks.

Answer

Hi-tech recording equipment. Any hi-tech product is likely to become obsolete very quickly, as more advanced products come on to the market. There is therefore a risk of obsolete inventory, which will need to be written down, and ultimately, if the entity cannot keep up with trends, the business may not be able to continue in existence.

Started up just under a year ago. Any start-up business is inherently risky, as many businesses fail in their first year. Also, this must mean that the first set of annual financial statements is due (a problem, given the lack of a book-keeper). Also, this creates detection risk, as the assurance firm will also be unfamiliar with the business and no prior year figures will be available for comparison.

Sole shareholder and director. This may give Sam personal motivation to misstate the figures. There is also no other (perhaps, more experienced) director to keep Sam in check and ensure that he is making sound business decisions. This could increase the risk of business failure.

A series of book-keepers. This perhaps indicates that Sam is putting undue pressure on his book-keeper (perhaps to misstate the figures) or that the business is so chaotic that the book-keepers have perhaps all despaired of ever being able to put a decent accounting system in place. Either of the factors indicates a high risk of misstatement (intentional or otherwise).

The most recent book-keeper has just left. Again, this indicates a high risk of misstatement in the financial statements as there is currently no book-keeper to prepare them. Even assuming that one is recruited, he will be unfamiliar with the business and any accounting systems.

Mortgage and bank loan. Both of these give Sam possible personal motivation to misstate the figures to ensure that the business does not go under and his home is safe from repossession.

4 FRAUD: ISA 240

Section overview

- Fraud and the role of the external auditor
- The auditor's responsibilities relating to fraud: ISA 240
- Fraud risk factors relating to misstatements arising from fraudulent financial reporting and misappropriation of assets
- Examples of circumstances that indicate the possibility of fraud
- Communications to Management and Those Charged with Governance

4.1 Fraud and the role of the external auditor

Fraud is an **intentional act** by one or more persons, involving the use of deception to gain an unjust or illegal advantage.

Fraud is distinguished from **error**. Error results from a genuine mistake or omission, and is **not intentional**.

The objective of a statutory audit (an external audit) is to express an opinion on the truth and fairness of the view presented by the financial statements. Its objective is **not** primarily the prevention or detection of fraud. The auditor will be concerned with fraud only to the extent that it might impact on the view shown by the financial statements. He will therefore be concerned with the risk of **material fraud**. This is discussed below in the context of ISA 240.

It is primarily the responsibility of management to establish systems and controls to prevent or detect fraud (and errors). These systems and controls may then be monitored by internal audit. Internal audit may also be required by management to specifically review the entity's exposure to error or fraud or to undertake a special investigation to look into suspected error or fraud.

4.2 The auditor's responsibilities relating to fraud: ISA 240

The role of the external auditor with regard to fraud is covered by ISA 240. The auditor's responsibilities relating to fraud in an audit of financial statements.

The **objectives of the auditor** under ISA 240 are the same as for any other area: to identify and assess the risks of **material misstatement** and to obtain sufficient appropriate evidence about those risks through appropriate audit procedures. He must also respond appropriately to fraud or suspected fraud identified during the audit.

However, it is particularly important in relation to fraud that the auditor maintains an attitude of **professional scepticism** as required by ISA 200. ISA 240 states that:

- unless the auditor has reason to believe the contrary, he may accept records and documents as genuine; and
- where responses to inquiries of management are inconsistent, the auditor shall investigate the inconsistencies (as this could indicate potential fraud).

Two types of fraud are identified by ISA 240: **fraudulent financial reporting** and **misappropriation of assets**.

Fraudulent financial reporting includes:

- manipulating, forging or altering accounting records or supporting documentation which form the basis of the financial statements
- misrepresenting or intentionally omitting events or transactions from the financial statements
- intentionally misapplying accounting principles,

Fraudulent financial reporting often involves **management override of controls.**

Misappropriation of assets includes:

- embezzling receipts (for example, diverting them to personal bank accounts)
- stealing physical assets (such as inventory) or intellectual property (for example, by selling "trade secrets" to a competitor)
- causing an entity to pay for goods and services not received (for example, by the creation of fictitious suppliers)
- using an entity's assets for personal use.

Management override of controls

Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- Altering records and terms related to significant and unusual transactions.

Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to:

Procedures to identify risk of material misstatement

ISA 240 **requires** the auditor to perform the following procedures to identify the risks of material misstatement due to fraud:

- Make enquiries of management in respect of:
  - their assessment of the risk of material fraud
  - their process in place for identifying and responding to the risks of fraud including any specific risks of fraud identified or likely to exist any communications within the entity in respect of fraud (including to employees regarding management's views on business practices and ethical behaviour).
- Make inquiries of management and others within the entity as to whether they have any knowledge of any actual, suspected or alleged frauds and to obtain views about the risks of fraud.
- Make inquires of internal audit.
- Evaluate any unusual or unexpected relationships identified in performing analytical procedures (covered in a later chapter) which might indicate a risk of material fraud.
- Evaluate information obtained from other risk assessment procedures to see if any **fraud risk factors** are present.

4.3 Fraud risk factors relating to misstatements arising from fraudulent financial reporting and misappropriation of assets

ISA 240 states that fraud involves:

- **Incentive or pressure to commit fraud** – for example, management may be under pressure from sources outside or inside the entity to achieve an expected (and perhaps unrealistic) earnings target or financial outcome. This may be necessary to trigger a management bonus, or to avoid breaching a loan covenant.
- **The opportunity to commit fraud** – for example, a perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.
- **Rationalisation for committing a fraudulent act**. Some individuals may possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. For example, someone may feel aggrieved that they did not receive a bonus they think they were entitled to and hence rationalise theft as taking 'what is owed'.

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting and misappropriation of assets.

	Fraudulent Financial Reporting	Misappropriation of Assets:
Incentives / Pressures	▪ Financial stability or the profitability of entity is threatened ▪ Pressure on management to meet the exception of third parties ▪ Personal financial situation of management threatened by entity's financial performance ▪ Excessive pressure on management or operating personnel to meet financial targets.	▪ Personal financial obligations ▪ Adverse relationship between the entity and employees with access to cash or other assets susceptible to the theft.
Opportunities	▪ Significant related party transaction ▪ Assets/ liabilities ,revenue, expenditures based on significant estimates ▪ Domination of management by single person or group ▪ Complex or unstable organizational structure ▪ Internal control components are deficient.	▪ Large amount of cash in hand or processed ▪ Inventory items that are small in size and high in value or are in high demand ▪ Easily convertible assets e.g. diamonds, bearer bonds and gold ▪ Inadequate internal controls over assets.
Attitudes / Rationalizations	▪ Ineffective communication or enforcement of entity's values or ethical standards by management ▪ Known history of violation of security laws or other laws ▪ A practice by management of committing to aggressive or unrealistic forces ▪ Low morale among senior management.	▪ Overriding existing controls ▪ Failing to correct known internal control deficiencies ▪ Behavior indicating displeasure or dissatisfaction with the entity ▪ Changes in behavior or lifestyle.

4.4 Examples of circumstances that indicate the possibility of fraud

The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud.

Discrepancies in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorized balances or transactions.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties.
- Tips or complaints to the auditor about alleged fraud.

Conflicting or missing evidence, including:

- Missing documents.
- Documents that appear to have been altered.
- Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.
- Significant unexplained items on reconciliations.
- Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships – for example, receivables growing faster than revenues.
- Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.
- Unusual discrepancies between the entity's records and confirmation replies.
- Large numbers of credit entries and other adjustments made to accounts receivable records.
- Unexplained or inadequately explained differences between the accounts receivable sub-ledger and the control account, or between the customer statements and the accounts receivable sub-ledger.
- Missing or non-existent cancelled checks in circumstances where cancelled checks are ordinarily returned to the entity with the bank statement.
- Missing inventory or physical assets of significant magnitude.
- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies.
- Fewer responses to confirmations than anticipated or a greater number of responses than anticipated.
- Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments.

Problematic or unusual relationships between the auditor and management, including:

- Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.
- Undue time pressures imposed by management to resolve complex or contentious issues.
- Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management.
- Unusual delays by the entity in providing requested information.
- Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.

- Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel.
- An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
- An unwillingness to address identified deficiencies in internal control on a timely basis.

Other

- Unwillingness by management to permit the auditor to meet privately with those charged with governance.
- Accounting policies that appear to be at variance with industry norms.
- Frequent changes in accounting estimates that do not appear to result from changed circumstances.
- Tolerance of violations of the entity's code of conduct.

Example:

Ayeza has been appointed as the Chief Internal Auditor of Shayan& Co. She made the following observations in the first quarter of the year ending December 31, 2016. Which of the following matters are alarming and need her immediate attention?

(a) **The accountant keeps the original invoices in the approvals file and sends the photocopies of invoices and approvals to the cashier for payment**

(b) **The accounts payable employee has not taken a leave of absence 3 years in a row**

(c) **The number of payslips issued to employees are in excess of the number of employees maintained by Human Resource Department**

(d) **All above**

Answer

The answer is "(d) all above" due to the following reasons:

(a) **The accountant can forge the photocopies of invoices & approvals and pocket in the differential amount through collusion with the supplier**

(b) **When a key employee of the finance department does not take a leave of absence it shows he is overriding internal controls or making forged payments and do not want others to find out in his absence**

(c) **If there are more payslip issued than the number of employees as per Human resource department record, it shows that there are ghost employees and the payroll employee is misappropriating cash.**

4.5 Communications to Management and Those Charged with Governance

When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter is brought to the attention of the appropriate level of management as soon as practicable, even if the matter is considered inconsequential. Whilst determination of an appropriate level of management is a matter of professional judgment, ordinarily the appropriate level of management is at least one level above the person(s) who appear to be involved with the suspected fraud.

Whilst *ISA 260 communication with Those Charged with Governance* is outside the scope of the CAF-9 syllabus you should be aware that there may be instances where it is appropriate for the auditor to communicate with Those Charged with Governance regarding an actual or suspected fraud. Ordinarily such instances would always include cases where management were involved in the fraud or suspected fraud, but the auditors may also judge that cases where those other than management were involved also need communicating.

In the exceptional circumstances where the auditor has doubts about the integrity or honesty of management or those charged with governance, the auditor may consider it appropriate to obtain legal advice to assist in determining the appropriate course of action.

5 NOT-FOR-PROFIT ORGANISATIONS

Section overview

- Auditing of not-for-profit organisations (NFPOs)
- NFPOs: the audit approach

5.1 Auditing of not-for-profit organisations (NFPOs)

In any audit or review, it is important to understand the entity and its environment. A key aspect of an audit or review may be the objective that the entity is trying to achieve.

- In commercial organisations, the objective is to make a profit for the shareholders.
- In the case of not-for-profit organisations (NFPOs), the objective is very different. It is usually the provision of a service to society as a whole or to a group in society. Examples are charities, clubs and societies and publicly-owned organisations.
- The service provided by an NFPO will have to be provided within the constraints of the resources it has at its disposal. In other words, an NFPO will seek to achieve its objective as far as possible with the money and other resources available.

Example: Charity

A charity organisation is an example of an NFPO:

- **It has certain defined beneficiaries, since it was established for the purpose of providing benefits to them.**
- **It raises funds from the public.**
- **It seeks to spend those funds as effectively as possible to help its beneficiaries.**

NFPOs may be required to have an audit performed under local law, or may choose to have an audit performed on a voluntary basis in order to add credibility to their financial statements.

The difference in the objectives of an NFPO, compared with the objectives of a commercial company, will influence the approach to the audit.

In addition, there may be specific auditing and reporting requirements set out in local law for certain types of NFPOs. This may also influence the audit work performed and the form and content of the opinion issued.

If the NFPO requests an audit to be performed on a voluntary basis, or requires a review to be carried out, the scope of the work and the nature of any report issued will be agreed in advance between the auditor and the NFPO.

5.2 NFPOs: the audit approach

The auditor should recognise the specific features of the NFPO. However, it is important to realise that the auditor is still performing an audit, and the overall **structure** of the audit of an NFPO will be similar to the audit of a commercial organisation. However, the detail of the audit will probably differ.

The main points to bear in mind with the audit of an NFPO are summarised below. These are general principles. They should be modified as appropriate to reflect the circumstances of each particular NFPO.

Audit area	Comments
Planning	Consider: ■ the objectives and scope of the audit work ■ any local regulations that apply

<table>
<tr><th>Audit area</th><th>Comments</th></tr>
<tr><td></td><td>■ the environment in which the organisation operates
■ the form and content of the final financial statements and the audit opinion
■ key audit areas, including risk.</td></tr>
<tr><td>Risk</td><td>Carry out an audit risk analysis under the usual headings of inherent risk, control risk and detection risk:
■ inherent risk (reflecting the nature of the entity’s activities and the environment)
■ control risk (internal controls, and the risk that these may be inadequate: controls over cash collection and cash payments may be a key area for an NFPO such as a charity, because large amounts of cash may be collected from the public by volunteers)
■ detection risk (the risk that the auditor will fail to identify any material error or misstatement in performing the audit).</td></tr>
<tr><td>Internal control</td><td>Key areas of internal control in an NFPO might include:
■ segregation of duties (although this may be difficult in a small NFPO with only a few employees)
■ authorisation of spending
■ cash controls
■ controls over income (donations, cash collections, membership fees, grants)
■ the use of funds only for authorised purposes.</td></tr>
<tr><td>Audit evidence</td><td>■ A substantive testing approach (rather than a systems based approach) is likely to be necessary in a small NFPO, because of weaknesses in its internal control system.
■ Key areas may include:
– the completeness of recording transactions, assets and liabilities
– the possibility of misuse of funds.
■ Analytical procedures may be used to ‘make sense’ of the reported figures.
■ There should be a review of the final financial statements, including a review of the appropriateness of the accounting policies.</td></tr>
<tr><td>Reporting</td><td>■ If a report on an NFPO is required by law, the standard external audit report may be applicable.
■ If the audit is performed on a voluntary basis, the report needs to reflect the agreed objective of the audit. However, it is good practice for the report to follow the general structure laid down by ISA 700 (see later chapter)</td></tr>
</table>

Other factors to consider include:

- Cash may be significant in small NFPOs and controls are likely to be limited.
- Income could be a risk area, particularly where money is donated or raised informally.
- There may be a limitation on the scope of the audit if obtaining audit evidence is a problem.

- There may be a lack of predictable income or identifiable relationship between expenditure and income which could make analytical review less appropriate.
- Restricted funds may exist where the organisation is only allowed to use certain funds for specific purposes.
- There may be sensitivity to key statistics such as the proportion of revenue used in administration (particularly for a charity).

Example: identifying inherent risks

A charitable organisation relies for its funding on donations from the general public, which is mainly in the form of cash collected in the streets by volunteers and cheques sent in by post to the charity's head office. Wealthy individuals occasionally provide large donations, sometimes on condition that the money is used for a specific purpose.

The constitution of the charity specifies the purpose of the charity, and also states that no more than 15% of the charity's income each year may be spent on administration costs.

Required

Identify the inherent risks for this charitable organisation that an auditor of its financial statements would need to consider.

Answer

Inherent risks are risks that cannot be removed by the application of controls. In the case of this charity, there are several risks for which it would be difficult, or perhaps impossible, to devise and apply internal controls.

(1) Volunteers collecting cash from the general public may keep for themselves some or all of the cash they collect.

(2) There are no controls that can ensure that all the money received by the charity is properly recorded. This is because there are no sales invoices against which receipts of income can be checked.

(3) When money is given to the charity for spending on a specific purpose, there are no controls to ensure that the money is actually spent on its intended purpose.

(4) Similarly there are no controls to ensure that the money collected by the charity is spent on the purposes specified in the constitution of the charity.

(5) There are possibly no controls to ensure that money spent on administration is actually recorded as administration costs. The charity may get round the restriction on administration spending by classifying items of expense incorrectly.

You may think that controls to remove these risks could be devised and implemented, but given the nature of charitable organisations it is doubtful whether any of the above risks could be suitably controlled in practice. If these are inherent risks that cannot be controlled, the auditor will need to take a view on the following.

- The nature and extent of audit checks that should be carried out to obtain assurance that the financial statements do not contain any material misstatement.
- Whether any audit checks are possible that would give the auditor such assurance. For example, it would be difficult to devise audit checks into the completeness of reported income. If suitable audit checks cannot be applied, the auditor would have to consider including a comment in the audit report to the effect that it has not been possible to verify the completeness of the reported income for the charity in its financial statements.

6 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Describe the purpose and process of planning and explain professional scepticism
- Differentiate between the audit strategy and audit plan
- Describe the need and what is involved in understanding the entity and environment
- Explain the concepts of materiality and performance materiality
- Explain the audit risk model and define the terms inherent risk, control risk and audit risk
- Distinguish between fraud and error, summarise the respective responsibilities of management and the auditor with respect to fraud
- Explain the auditor's approach to the risk or material misstatement due to fraud
- Summarise the key points of auditing not-for-profit organisations

CHAPTER 4

Evidence and sampling

Contents

1 Audit evidence: ISA 500 and ISA 315
2 Audit documentation: ISA 230
3 Audit sampling: ISA 530
4 Chapter review

INTRODUCTION

Learning outcomes

The overall objective of the syllabus is acquiring knowledge of theory, skill and techniques of auditing and to enable the students to understand International Standards on Auditing, Assurance and Ethics.

General concepts and principles of audit

Performance of audit and reporting

LO 2	**On the successful completion of this paper, candidates will be able to demonstrate working knowledge in respect of performance of simple audit procedures and understand the audit report requirement under the Companies Act, 2017**

Audit Evidence (ISA 500)

LO 2.4.1	Explain, using examples, sufficient appropriate audit evidence
LO 2.4.2	Discuss the general principles assisting the auditor in assessing the relevance and reliability of audit evidence
LO 2.4.3	Discuss audit procedures to obtain audit evidence including types of audit procedures
LO 2.4.4	Discuss the course of action available to auditor in case sufficient appropriate audit evidence is not obtained.
LO 2.4.5	Explain the financial statement assertions including assertions about class of transactions, account balances and presentation and disclosure
LO 2.4.6	Explain what information can be used as audit evidence

Audit Sampling (ISA 530)

LO 2.5.1	Explain audit sampling, statistical sampling and sampling and non-sampling risk using simple examples
LO 2.5.2	Discuss the relationship between sampling and audit risk model.
LO 2.5.3	Explain what matters are considered by auditors in respect of sample design, size and selection of items for testing using simple examples including sample selection method.
LO 2.5.4	Discuss the concept of misstatement and rate of deviation including expected and tolerated
LO 2.5.5	State the audit procedures to be performed on selected sample
LO 2.5.6	Discuss the concept of Projecting misstatement and evaluating the results of audit sampling

Substantive procedures (ISA 330)

LO 2.6.1	Understand the financial statement assertions
LO 2.6.2	Identify the financial statement assertions in simple scenarios

Documentation (ISA 230)

LO 2.9.1	Explain the nature and purpose of audit documentation
LO 2.9.2	Describe the form, content and extent of audit documentation using simple examples
LO 2.9.3	Discuss the use of computer based audit working papers
LO 2.9.4	Discuss the ownership, custody and confidentiality of audit working papers
LO 2.9.5	Understand the nature of assembly of the final audit file

1 AUDIT EVIDENCE: ISA 500 AND ISA 315

Section overview

- General principles of gathering audit evidence
- Sufficient and appropriate audit evidence
- The quality of audit evidence
- Procedures for generating audit evidence
- What if the audit evidence is not sufficient?
- The financial statement assertions (ISA 315)
- Types of audit procedures

1.1 General principles of gathering audit evidence

Before moving on to chapters dealing with the practical processes involved in performing an audit, we need to consider the general principles behind the gathering of audit evidence.

- The **outcome** of an audit is a report, usually expressing an opinion.
- That report and opinion must be **supportable** by the auditor, if challenged.
- Therefore, the auditor will collect **evidence** on which to base his report and opinion.
- The auditor carries out procedures known as '**audit tests**' in order to generate this evidence.
- These tests, the evidence and the conclusions drawn must be **documented** in the audit files.

ISA 500 *Audit evidence* sets out the **objective** of the auditor as being to design and perform audit procedures in such a way to enable him to:

- obtain **sufficient, appropriate** audit evidence
- to be able to draw **reasonable** conclusions
- on which to base his audit opinion.

Following on from this, the auditor is **required** by ISA 500 to **design and perform appropriate audit procedures for the purpose of obtaining sufficient, appropriate audit evidence.**

Other **requirements** of ISA 500 are as follows:

- Consider the **relevance and reliability** of the information to be used as audit evidence.
- If information to be used as audit evidence has been prepared using the work of a **management's expert**:
  - evaluate the competence, capabilities and objectivity of that expert
  - obtain an understanding of the expert's work, and
  - evaluate the appropriateness of his report as audit evidence.
- When using **information produced by the entity** evaluate whether the information is sufficiently reliable (accurate, complete, precise and detailed).
- Use effective means of **selecting items for testing** (covered in detail later in this chapter under ISA 530 *Audit sampling*).
- If audit evidence from one source is **inconsistent** with that obtained from another source, or the auditor has **doubts over the reliability of evidence** – consider:
  - what additional audit procedures are needed, and
  - the effects on any other aspects of the audit.

1.2 Sufficient and appropriate audit evidence

Sufficient relates to the **quantity** of evidence.

Appropriate relates to the **quality** (relevance and reliability – see below) of the evidence.

The auditor will need to exercise professional judgement on both of these aspects; the quantity and the quality of evidence.

- When is there enough evidence to support a conclusion?
- What is the quality of a given piece of evidence, and is this sufficient to justify the audit opinion?

The two characteristics of quantity and quality are also inter-related:

- An auditor may be able to reach a conclusion based on a smaller quantity of high quality evidence,
- but a larger quantity of lower quality evidence may be required to reach the same conclusion.

Deciding how much audit evidence is needed

As stated previously, deciding how much audit evidence will be sufficient, or whether existing audit evidence is sufficient, is a matter of judgement by the auditor and the quantity of audit evidence required will depend to a large extent on the quality of that evidence. (The quality will depend on the source of the evidence and its reliability.)

Other factors that the auditor will consider are:

- the seriousness of the risk that the financial statements might not give a true and fair view: when this risk is high, more audit evidence will be required
- the materiality of the item
- the strength of the internal controls in the client's accounting systems
- the sampling method that the auditor will use to obtain the audit evidence: the chosen method will affect the size of the audit sample that the auditor requires.

1.3 The quality of audit evidence

Relevant

There are a number of general principles set out in ISA 500 to assist the auditor in assessing the relevance of audit evidence. These can be summarised as follows:

- **Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure**, and, where appropriate, the assertion under consideration. E.g. Relevance may be affected by the direction of testing, say when testing for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure.

  On the other hand, when testing for understatement, testing the recorded accounts payable would not be relevant, but rather testing subsequent disbursements, unpaid invoices, suppliers' statements and unmatched receiving reports may be relevant.

- **A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others**. E.g. Inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cut-off.
- Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. **Relevant audit evidence would include identifying conditions that indicate performance of a control, and deviation conditions**. The presence or absence of those conditions can then be tested by the auditor.

- Substantive procedures are designed to detect material misstatements at the assertion level. **Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.**

Reliable

There are a number of general principles set out in ISA 500 to assist the auditor in assessing the reliability of audit evidence. These can be summarised as follows:

- **Audit evidence is more reliable when it is obtained from independent sources outside the entity under audit**. As specified above, ISA 500 requires that the auditor should be satisfied as to the accuracy and reliability of any internal evidence used in reaching a conclusion.
- **Internally generated audit evidence is more reliable when the related controls are effective.**
- **Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference**. For example, observation of the operation of a control by the auditor is more reliable than inquiry about the operation of that control.
- **Audit evidence is more reliable when it exists in documentary form**. This could be paper, electronic or other medium. For example, a written record of a meeting made at the time is more reliable than a subsequent oral representation of the matters discussed.
- **Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies**, or documents that have been filmed, or otherwise transformed into electronic form. This is because the reliability of those other forms may depend on the controls over their preparation and maintenance.

1.4 Procedures for generating audit evidence

A number of audit testing procedures are available to the auditor as a means of generating audit evidence. Note that:

- more than one procedure may be used in collecting evidence in a particular area.
- not all procedures may be appropriate to a given objective of the audit.

The auditor should select the most appropriate procedures in each situation. ISA 500 identifies seven main testing procedures for gathering audit evidence:

- Inspection (of an item)
- Observation (of a procedure)
- Inquiry (of a personnel)
- External confirmation
- Recalculation
- Re-performance
- Analytical procedures.

For your exam, you need to learn this list of audit procedures and what each of them means. A case study-type exam question may ask you to discuss which audit procedures would be most appropriate for obtaining audit evidence in a specific situation.

The table below explains these seven main procedures, and gives examples of how they are used and applied.

Procedure	Explanation/application
Inspection (looking at an item)	▪ Of tangible assets ▪ Of entries in accounting records ▪ Of documents (e.g. invoices)

Procedure	Explanation/application
Observation	▪ Watching a procedure (e.g physical inventory counts, distribution of wages, opening of mail) ▪ Limited to the point in time when the observation takes place ▪ The person performing the procedure may act differently when being observed
Inquiry	▪ Seeking information from knowledgeable persons inside or outside the entity, ▪ Evaluating responses to those enquiries, and ▪ Corroborating those responses with other audit evidence
External confirmation	▪ A specific type of inquiry – seeking confirmation from a third party (e.g. a bank or trade receivable)
Recalculation	▪ Checking the mathematical accuracy of documents or records (e.g. adding up the list of year-end trade receivables)
Reperformance	▪ Independently carrying out procedures or controls, which were originally performed by the client (e.g. reperforming the aging of year-end trade receivables)
Analytical procedures	▪ Evaluating and comparing financial and/or non-financial data for plausible relationships and investigating unexpected fluctuations ▪ For example, comparing last year's gross profit percentage to this year's and ensuring any change is in line with expectations

Example:

An auditor wishes to:

(a) test that the plant and equipment recorded in the financial statements of the client does actually exist

(b) confirm the accuracy of the figures for the directors' bonuses

(c) understand the nature of an unusual payment recorded in the cash book.

Required

State which one of the audit testing procedures set out in the table above would be **most** useful to the auditor in each of the above contexts.

Answer

(a) (Physical) inspection. The best way of getting the evidence of non-current assets is to go and look at them.

(b) Recalculation. The figures for bonuses computed by the client can be checked by recalculating what they should be.

(c) Inquiry (of management). The auditor should ask management to explain the nature of the unusual item, and should expect a satisfactory answer which can be corroborated by other evidence.

1.5 What if the audit evidence is not sufficient?

Having obtained audit evidence, the auditor must assess whether it is sufficient to allow him to reach the opinion that the financial statements give a true and fair view. If the auditor decides that the evidence obtained is insufficient to reach this opinion (or any other opinion) he may take any of the following actions, depending on the circumstances.

- Obtain more evidence. He may obtain additional audit evidence by means of:
  - More tests of controls: further tests may indicate that the controls are not as weak as the auditor initially suspected
  - More substantive testing procedures. This would be appropriate where the auditor has concluded that the internal control system is not functioning well and the audit task is therefore to obtain more evidence to quantify the potential size of the error in the financial statements.
  - Tests of controls and substantive tests are described in later chapters.
- Discuss the problem with the client's senior management or the audit committee, so that they are aware of the problem
- Indicate the findings from the audit evidence obtained: these should be included in the management letter prepared by the auditor for the client
- Qualify the audit report. This should only be used as an extreme measure, which the auditor should only use if other methods fail to resolve the problem.

1.6 The financial statement assertions (ISA 315)

Definition: Assertions

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

IAASB Handbook – Glossary of terms

Modern auditing theory takes the view that the financial statements prepared by the management comprise a number of '**assertions**' or representations. These assertions are set out in ISA 315 and fall into the following categories:

- Assertions about **classes of transactions and events** and related **disclosures** for the period under audit (i.e. income statement assertions)
- Assertions about **account balances** and **related disclosures** at the period end (i.e. statement of financial position assertions)

Assertions about **classes of transactions and events** and related **disclosures** are as follows:

- **Occurrence**: Transactions and events that have been recorded or disclosed have occurred and relate to the entity.
- **Completeness**: There are no unrecorded transactions, events and disclosures.
- **Accuracy**: Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.
- **Cut-off:** Transactions and events have been recorded in the correct accounting period.
- **Classification:** Transactions and events have been recorded in the proper accounts.
- **Presentation:** Transactions and events are appropriately aggregated or disaggregated and clearly described and related disclosures are relevant and understandable.

Assertions about **account balances and related disclosures** are as follows:

- **Existence**: Assets, liabilities and equity interests exist.
- **Rights and obligations**: The entity holds or controls the rights to assets, and liabilities are those of the entity.
- **Completeness**: There are no unrecorded assets, liabilities or equity interests and all related disclosures have been included.
- **Accuracy, valuation and allocation:** Assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation

adjustments are appropriately recorded and related disclosures have been appropriately measured and described.

- **Classification:** Assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable.

For each financial statement item being audited, the auditor should therefore generate evidence designed to reach a conclusion on the reliability of the appropriate assertions.

Summary of assertions	
About transactions/events and related disclosures	**About account balances and related disclosures**
Occurrence	Existence
Completeness	Rights and obligations
Accuracy	Completeness
Cut-off	Accuracy, valuation and allocation
Classification	Classification
Presentation	Presentation

Example:

Required

Using your accounting knowledge , apply the appropriate assertions to the audit of sales of goods.

Answer

Transaction& events and disclosure assertions:

Occurrence: All sales invoices reflected in the accounting records relate to goods despatched by the entity during the current year. The figure for "Revenue" in the financial statements agrees to the sales account in the nominal ledger.

Completeness: All goods despatched have been invoiced and all such sales invoices have been entered into the accounting records. All entries in the sales account in the nominal ledger have been included within "Revenue".

Accuracy: All invoices have been correctly priced and discounts properly applied, and they have been accurately entered in the accounting records. The sales account in the nominal ledger has been properly added to arrive at the "Revenue" figure in the financial statements.

Cut-off: Goods despatched just before the year end have been invoiced and included in sales. Goods despatched just after the year end have not been included in sales.

Classification: All sales invoices have been posted to the sales account in the nominal ledger."Revenue" is properly disclosed in the financial statements in the income statement (under IAS 1's two statement format) or statement of comprehensive income (single statement format) for the currentyear.

Tutorial note: *The other assertions relate to assets, liabilities and equity and so are not relevant.*

1.7 Types of audit procedures

In order to gather audit evidence on the above financial statement assertions, the auditor will have to choose what types of procedures to carry out. ISA 500 identifies the following types of procedures:

- Risk assessment procedures

- Further audit procedures, which comprise:
  - Tests of controls
  - Substantive procedures

  Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

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

In general, the auditor will carry out tests of controls to assess the system under audit. If those tests show that the system is working effectively then he will carry out a reduced amount of substantive procedures. If the results are poor then he will carry out more substantive procedures. Substantive procedures include both **tests of detail** and **analytical procedures.**

Tests of controls and substantive procedures are considered in detail in later chapters.

2 AUDIT DOCUMENTATION: ISA 230

Section overview

- Audit documentation (audit file)
- Reasons for preparing sufficient and appropriate audit documentation
- The form, content and extent of audit documentation
- The use of computer-based audit working papers
- Ownership, custody and confidentiality

2.1 Audit documentation (audit file)

Audit documentation is the record of:

- audit procedures performed
- audit evidence obtained, and
- conclusions reached.

Terms such as **audit working papers** are also used.

The **audit file** is one or more folders (or other storage media) in physical or electronic form, containing the records that comprise the audit documentation for the whole engagement.

The **objective** of the auditor in respect of ISA 230 *Audit documentation* is to prepare documentation that provides:

- a **sufficient and appropriate record** of the basis for the auditor's report, and
- evidence that the audit was **planned and performed in accordance with ISAs** and applicable legal and regulatory requirements.

ISA 230 **requires** the auditor to prepare documentation **on a timely basis**, sufficient to enable an experienced auditor, with no previous connection with the audit to understand:

- the **nature, timing and extent of the audit procedures** performed
- the results of the audit procedures and the audit evidence obtained, and
- significant matters arising during the audit and the conclusions reached thereon.

The auditor is also **required** to document:

- discussions of all significant matters
- how any inconsistencies with the final conclusion on significant matters were resolved
- and justify any departure from a basic principle or relevant procedure specified by an ISA.

2.2 Reasons for preparing sufficient and appropriate audit documentation

Preparing sufficient and appropriate audit documentation on a timely basis helps to:

- **enhance the quality of the audit**, and
- **facilitate the effective review and evaluation of the audit evidence** obtained and conclusions reached, before the audit report is finalised.

Documentation **prepared at the time the work is performed** is likely to be **more accurate** than documentation prepared later.

Other purposes of audit documentation include the following.

- Assisting the audit team to plan and perform the audit.
- Assisting supervisors in directing and supervising audit work.

- Ensuring members of the audit team are accountable for their work.
- Keeping a record of matters of continuing significance to future audits.
- Enabling an experienced auditor, with no previous connection with that audit, to conduct quality control reviews or other inspections i.e. by understanding the work that has been performed and the conclusions that have been reached.

2.3 The form, content and extent of audit documentation

Audit documentation may be recorded on **paper**, or on **electronic or other media**. The audit documentation for a specific engagement is assembled in an **audit file.** The precise contents of the audit file varies, depending on the nature and size of the client and the complexity of the audit processes required to reach a conclusion but will include:

- audit programs
- analyses
- summaries of significant matters
- letters of confirmation and representation
- checklists, and
- correspondence.

Traditionally, it has been normal practice in the case of on-going audits to maintain two types of audit files:

- a permanent file, and
- a current file.

Permanent file

The permanent file records information that is likely to be of significance to **every** annual audit of that client. Examples of such information might include:

- the legal constitution of the company
- other important legal documents such as loan agreements
- a summary of the history, development and ownership of the business
- a summary of accounting systems and procedures
- copies of previous years' financial statements, together with key ratios and trends.

As such information is of continuing significance, it is important that the auditor reviews the contents of the permanent file regularly and updates it as appropriate.

Current file

The current file contains information of relevance to the **current** year's audit. This is the evidence on which the conclusion of the current audit will be primarily based. Examples of the contents of a current audit file include the following:

- The final financial statements and audit report.
- A summary of audit adjustments, including those not included in the final reported figures.
- Audit planning material (the audit plan, materiality threshold calculations, risk assessments).
- Audit control material (these are items used to control the progress of the audit, such as time budgets, review points, and points for consideration by the audit partner)
- Audit letters (audit letters are explained in a later chapter)

- For each audit area (for example, inventory, receivables)
  - an audit programme (detailing the work to be done on that area)
  - details of items selected for testing, the tests performed, problems encountered (together with their resolution) and the conclusion reached on that area
  - 'lead schedules' giving the figures for the audit area, as they appear in the final financial statements, cross-referenced to relevant audit tests.

All audit working papers should clearly show the following (where relevant):

- The name of the client
- The accounting date
- A file reference
- The name of the person preparing the working paper
- The date the paper was prepared
- The name of any person reviewing the work and the extent of such review
- The date of the review
- A key to 'audit ticks' or other symbols used in the papers
- A listing of any errors or omissions identified
- A conclusion on the area.

Illustration: Audit working paper

Client:	**ABC Limited**				**WP Reference: TP 3.1**	
Subject:	**Trade payables**	Prepared by:	**DG**	Date:	**13.4.X4**	
Period end:	**31 March 20X4**	Reviewed by:	**TR**	Date:	**17.4.X4**	

Objective: To ensure trade payables is fairly stated (valuation)

Work performed: Selected a sample of 5 trade payables balances as at 31 March and reconciled the supplier statements to the year end trade payables ledger. Reconciling items were vouched to source documentation.

Results:

Client		Payables ledger	Supplier stmt.	Difference	Agreed
		Rs.	Rs.	Rs.	
X Ltd	›	1,000 00	1,000 00		✓
Y Ltd	›	2,500 00	2,500 00		✓
Z Ltd	›	1,320 00	1,420 00	100 00	Note 1
M Ltd	›	625 00	625 00		✓
N Ltd	›	400 00	1,200 00	800 00	Note 2
		5,845 00	6,745 00		
		▲	▲		

Note 1: Vouched to credit note - timing difference, no adjustment needed

Note 2: Invoice from N Ltd had not been accounted for and adjustment is required.

Dr Purchases	Rs. 800	
Cr Trade payables		Rs. 800

Conclusion: After making the adjustment described above, trade payables is fairly stated.

Key

✓	Agreed
▲	Cast (additions checked)
›	Agreed to payables ledger

Assembly of the final audit file

The auditor is **required** to assemble the **final audit file**(s) on a timely basis after the date of the auditor's report. This usually excludes drafts of working papers or financial statements, or notes that reflect incomplete or preliminary thinking. After the assembly of the final audit file has been completed, the auditor **must not delete or discard audit documentation** before the end of its retention period (see below).

Modifications in the documentation

If it does become necessary to modify existing or add new documentation after this stage, the auditor is **required** to document:

- when and by whom the modifications were made
- the reasons for making them.

If **exceptional circumstances arise after the date of the audit report**, such that the auditor:

- has to **perform new or additional procedures**, or
- **reaches new conclusions**

the auditor is **required** to document:

- the circumstances
- the new or additional procedures performed, audit evidence obtained, conclusions reached and their effect on the auditor's report, and
- when and by whom the resulting changes to audit documentation were made and who reviewed them.

2.4 The use of computer-based audit working papers

One of the features of modern auditing is the use of computer packages (often used in conjunction with laptop computers) to make the preparation of audit documentation more efficient for the auditor. These packages can be used to help prepare:

- analysis schedules, especially where the firm uses standardised documentation
- lead schedules, and
- draft financial statements

These can usually be automatically cross-referenced and updated as the audit proceeds.

Using these packages has several advantages:

- The documentation is neat, easy to read and in a standard format.
- The risk of errors in processing adjustments (updates, amendments, corrections) is reduced.
- The review process can be carried out 'remotely', without it being necessary for the review to take place at the client's premises.
- Significant time saving may result from the automatic processing of adjustments.

2.5 Ownership, custody and confidentiality

Ownership of the audit documentation rests with the auditor. The working papers **do not** form part of the accounting records of the client, and do not belong to the client.

The auditor needs to decide how long to keep the audit files. ISA 230 requires a minimum period of **five years** from the date of the audit report (or group audit report if later).

Note: It is important to note that Companies Act, 2017 specifies a 10 year retention requirement for all books and records including documents of the companies.

Auditing standards require the auditor to ensure that working papers are kept safe and their contents are kept **confidential**. Information should only be made available to third parties in accordance with ethical guidelines (described in an earlier chapter).

3 AUDIT SAMPLING: ISA 530

Section overview

- The nature of sampling
- The relationship between sampling and the audit risk model
- Sampling risk and statistical sampling
- Sample design, size and selection of items for testing
- Performing audit procedures on the sample
- Projecting misstatements and evaluating the results of audit sampling

3.1 The nature of sampling

Checking 100% Populations

Auditors do not normally check 100% of transactions and balances that go into the production of financial statements. For example, they do not count every item of inventory, and do not check 100% of customer balances in the trade receivables ledger. Instead, they select a sample of items for testing, and test the sample for accuracy/reliability.

However, sampling is not always appropriate for auditing. For example, if a population consists of a small number of large items, it may well be appropriate to apply audit tests to the entire population. Also, sampling is only appropriate where the population is **homogeneous** (i.e. where all the items in the population share common characteristics). If this condition is not satisfied, it may be necessary for the auditor to test the entire population.

Suppose that a company owns just three very large machines, and each machine serves a different purpose. It would be appropriate to carry out audit tests on all three machines instead of testing just one or two machines as a 'sample' of the entire population of three machines.

Using Sampling

Sampling in auditing involves applying audit testing procedures to less than the entire population of items subject to audit. So, if a company has issued 1,000 sales invoices in a period and the auditor tests 999 of them, this is a sampling exercise – although the size of the sample would be very large, given the size of the total population!

The auditor is not interested in the results of the sample itself. The sample is used as a basis for reaching a conclusion on the entire population. For example, if an auditor tests 500 sales invoices out of a population of 1,000 invoices, the purpose of the audit test is to make a conclusion about all 1,000 invoices, not just the 500 that are tested.

It is therefore important that the sample chosen should be **representative** of the population, and should reflect the characteristics of the population as a whole. The larger the sample, the more likely it will be to be representative and to reflect the characteristics of the entire population. However, large samples are more time-consuming for the auditor to select and test. For reasons of time and cost, the auditor will want to test as small a sample as possible, consistent with the aim of achieving the required level of detection risk and limiting audit risk to a particular level.

3.2 The relationship between sampling and the audit risk model

Sampling is the application of audit procedures to less than 100% of items within a population, in order to draw conclusions about the population as a whole.

Detection risk is the risk of failure to detect a material misstatement of an item in the financial statements as a result of insufficient audit testing. It can be analysed into two sub-risks:

- **sampling risk**, and
- **non-sampling risk**.

Sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion had he tested the entire population. This will happen if the sample is **not representative** of the population as a whole. If an auditor uses a sample that is not representative of the entire population, he will reach a conclusion about the accuracy of the client's financial statements that may be unjustified and incorrect. In order to decrease sampling risk, the auditor could select a larger sample. By the laws of probability, sampling risk should be lower when a larger sample is taken.

Non-sampling risk is the risk that the auditor reaches an incorrect conclusion for reasons other than sampling risk. Because this could only occur due to factors involving errors by the auditors or incompetence of the audit team, or the need to work on very tight deadlines, in practice, the non-sampling risk will usually be set at zero.

In order to control detection risk, the auditor therefore needs to control the sampling risk. This means that detection risk is affected by the size of the sample and the way in which the sample is selected. The way in which the auditor selects his sample and evaluates the results of his testing of that sample is therefore fundamental to the risk-based audit.

3.3 Sampling risk and statistical sampling

Per ISA 530 *Audit sampling* the **objective** of the auditor, when using audit sampling, is **to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is drawn**. This will mean designing and selecting the sample and evaluating the results of testing in such a way that sampling risk is kept to the desired level.

The auditor can never be certain that a sample is fully representative of the population. Even if the auditor tests 999 out of 1,000 invoices and finds no audit problems, it could be that the remaining single invoice contains a material error or omission. This is the problem of **sampling risk**.

Per ISA 530 sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion had he tested the entire population. As discussed above, this will happen if the sample is not representative of the population as a whole.

Sampling risk can lead to **two types of incorrect conclusions**:

	Acceptance of Wrong	Rejection of Right
Test of Controls	Controls are more effective than they actually are	Controls are less effective than they actually are
Test of Details	Material misstatement does not exist when in fact it does	Material misstatement exists when in fact it does not
Effect on Audit	Affects audit **effectiveness** (lead to an inappropriate opinion)	Affects audit **efficiency** (lead to additional work)

The usual technique for obtaining a representative sample is **random selection**. In this context, 'random' means that each item in the sample has an equal chance of selection, so that there is no bias in the sample selection process.

ISA 530 distinguishes between statistical sampling and non-statistical sampling:

- **Statistical sampling** is any sampling approach that involves random selection and applies probability theory to the evaluation of the sample results and the measurement of sampling risk.
- **Non-statistical sampling** (also known as **judgemental sampling**) is any sampling technique not based on probability theory. Instead, it is based on a judgemental opinion by the auditor about the results of the sample.

3.4 Sample design, size and selection of items for testing

If an audit sampling exercise is to be effective – if sampling risk is to be reduced and therefore detection risk reduced – the sample must be designed in an appropriate way.

When designing a sample, the auditor is **required** by ISA 530 to:

- consider the purpose of the audit procedure and the population from which the sample will be drawn
- determine a sample size sufficient to reduce sampling risk to an acceptably low level
- select items for the sample in such a way that each sampling unit in the population has an equal chance of selection.

The auditor will therefore have to make a number of **key decisions**:

- the sampling approach to be used (statistical or non-statistical)
- the characteristics of the population from which the sample is to be drawn
- the sample selection method
- what constitutes a misstatement or deviation
- the 'tolerable' misstatement or rate of deviation
- the 'expected' misstatement or rate of deviation.

All of the above decisions will influence the sample size required.

Statistical sampling or non-statistical sampling?

Statistical sampling techniques are now widely used in auditing. However, not all audit practices are convinced of their value and worth.

The benefits of statistical sampling techniques are as follows:

- Statistical sampling provides an objective, mathematically precise basis for the sampling process.
- The required sample size can be calculated precisely (using statistical probability techniques).
- There may be circumstances where statistical sampling is the only means of auditing efficiently (for example, in the case of very large 'populations' of items).

The disadvantages of statistical sampling techniques are as follows:

- A degree of training and technical expertise is required if auditors are to use statistical sampling techniques effectively.
- This requires an investment in the necessary training for audit staff.
- Sample sizes may be larger than under a judgemental approach, thus increasing the time (and the cost) involved in the audit.
- Some auditors take the view that it is preferable to rely on the skill, experience and judgement of the auditor, rather than on mathematical/statistical models.

The characteristics of the population from which the sample is to be drawn

The population is defined by ISA 530 as **the entire set of data from which a sample is to be selected and about which the auditor wishes to draw conclusions**.

The population from which a sample is to be drawn should be appropriate for the audit objective to be achieved, and the population should be complete. (In other words, all relevant items must be included in the population.)

For example, if the objective of the audit testing is to confirm the accuracy of trade receivable balances, the population should include **all** trade receivables balances as at a specified date. Alternatively, the audit objective might be more limited in scope – perhaps to confirm the accuracy of those trade receivables balances in excess of Rs.500,000. The population should then consist of all receivables balances over Rs.500,000.

Each individual item in the population (trade receivables in the example above) is referred to as a **sampling unit**. It is important that all sampling units should be homogeneous, (have the same characteristics). In the example of the trade receivables balances above, the auditor would have to ensure that all the individual balances have been processed by the same accounting methods.

If this is not the case, the population may not be sufficiently homogeneous to allow a valid sample to be taken. However, it may be possible to turn a non-homogeneous population into two or more homogeneous populations and then sample from each of these.

For example, suppose that trade receivables balances have been processed through two different accounting systems (perhaps a computerised accounting system and a manual, paper-based system). The entire population of receivables could be divided into two segments (or **strata**) and a sample could be selected for testing from each segment. This technique is known as **stratified sampling**.

The sample selection method

ISA 530 requires auditors to select a sample in such a way that each item in the population (each 'sampling unit') has an equal chance of being selected.

A wide range of sample selection methods is available to the auditor:

- **Random sampling**: All items in the population have an equal chance of selection. This is typically achieved by the use of random numbers to select items for testing.
- **Systematic sampling**: With systematic sampling, a random starting point is chosen from the population and then items are selected with a standard gap between them (for example, every 10th item). For example, suppose that a sample will be 10% of the items in a population and the items in the population can be arranged in a sequence, such as listed in invoice number order, or account number order or date order. A systematic sample would be to select one of the first 10 items in the list at random, and then to select every 10th item in the list for testing in order to obtain the 10% sample.
- **Haphazard sampling**: The auditor selects the sample on an arbitrary basis, for example, choosing any 100 invoices from a file. This is not a scientifically valid method and the resulting sample may contain a degree of bias. It is therefore not recommended for use with statistical sampling techniques.
- **Block sampling**: The auditor selects a complete block of sampling units from the population (for example all invoices of the month of May).

What constitutes a misstatement or deviation

ISA 530's requirement for the auditor to consider the purpose of the audit procedure means that the auditor needs a clear understanding of what constitutes a misstatement or deviation.

For example, if the purpose of the audit procedure is to gain evidence on the accuracy of the statement of financial position figure for trade receivables, an error involving the posting of an invoice to a wrong customer account does not affect the statement of financial position total and has no impact on the objective of the testing. (The total trade receivables will not be wrong. Only the balances on the individual accounts of two customers will be wrong.)

The meanings of "misstatement" and "deviation" are only set out in ISA 530 in the context of "tolerable" misstatements or rates of deviations.

Tolerable misstatement or rate of deviation

Tolerable misstatement is a monetary amount set by the auditor in order to address the risk that the total of individually immaterial misstatements may cause the financial statements to be materially misstated. It is the application of performance materiality (as discussed in a previous chapter) to a particular sampling procedure. A misstatement above "tolerable misstatement" would therefore be considered material.

Following on from the above, the **tolerable rate of deviation** is a rate of deviation from prescribed control procedures which the auditor is prepared to accept and still be able to conclude that the financial statements are materially correct.

The smaller the tolerable misstatement or rate of deviation, the greater the required sample size.

For example, if the auditor is willing to accept only a small tolerable misstatement in, say, the amount reported on the statement of financial position for trade receivables, he will need to audit a large proportion of the receivables balances in order to be able to reach a conclusion that the financial statements are materially correct. Taking this to its extreme, if the auditor will accept no misstatement at all in the receivables balances, he will need to test all the balances in order to reach the same conclusion.

Expected misstatement or rate of deviation

The auditor will also need to form a judgement on the amount of misstatement or rate of deviation that may be **expected** to arise in the population.

The higher the expected misstatement or rate of deviation, the greater the required sample size.

The amount of expected misstatement or rate of deviation may be based on such factors as:

- experience of the population from previous audits
- experiences from the current audit on areas relating to the population. For example, if the auditor has discovered inaccuracies in the client's sales invoicing procedures, the expected misstatement relating to trade receivables will also be high.

3.5 Performing audit procedures on the sample

When designing a sample, the auditor is **required** by ISA 530 to:

- **perform appropriate audit procedures** on each item selected
- **if the audit procedure is not applicable to the selected item, the auditor must perform the procedure on a replacement item**. For example, the auditor might select a sample of cheques to test for evidence of authorisation. One of these might be a cheque which has been cancelled. Provided the cheque has been legitimately and properly cancelled then the auditor may choose another cheque number to test in its place
- **if the auditor is unable to apply the procedure** (or a suitable alterative) to the selected item (for example, because a document has been lost), **that item must be treated as a misstatement/deviation**.

The auditor is also **required** to:

- investigate the **nature and cause** of any misstatements/deviations and evaluate their possible effect.

  Investigation of the nature and cause of the misstatements/deviations may lead the auditor to conclude that the problem lies within one time period, type of transaction, or location (for example, perhaps when a temporary member of staff was being employed). In this case he might decide to extend audit procedures performed on that time-period/type of transaction/location.
- if the auditor considers the misstatement or deviation to be an **anomaly** he must obtain a high degree of certainty about this and perform additional audit procedures to obtain sufficient evidence that the misstatement or deviation does not affect the rest of the population.

  An anomaly is defined by ISA 530 as a misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

3.6 Projecting misstatements and evaluating the results of audit sampling

The auditor is **required** to evaluate:

- the results of the sample. For **tests of details** this will include projecting the misstatements found in the sample to the entire population

- whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. If the conclusion is that it has not then the auditor will need to consider carrying out additional audit procedures.

The auditor wants to reach a conclusion about the population as a whole from the results of the sample. As required above, for **tests of details** this will mean using the sample results to estimate the likely misstatement that exists in the population. This is done by **extrapolating** the error found in the sample over the whole population.

Example:

The results of tests of detail on a sample of receivables balances recorded as Rs.2,000,000 indicate that the correct balances should be Rs.1,950,000.

The total of balances for similar items has been recorded as Rs.10,000,000.

Required

Explain:

(a) what the auditors might conclude about the projected misstatement in the population of trade receivables

(b) the relevance of the concept of tolerable misstatement in this situation.

Answer

(a) The misstatement in the sample is Rs.50,000 (Rs.2,000,000 - Rs.1,950,000).

The misstatement rate in the sample is 2.5% (50,000/2,000,000). Extrapolating this over the population as a whole, the projected misstatement is that total trade receivables contain errors of Rs.250,000 (Rs.10,000,000 × 2.5%) and trade receivables should therefore be stated at Rs.9,750,000 (Rs.10,000,000 – Rs.250,000).

(b) The auditor will compare the projected misstatement in the population to his pre-set tolerable misstatement. If the tolerable misstatement in the population was, say, Rs.300,000 then the error is, in effect, not material and could be ignored.

For tests of controls, the sample deviation rate will be the projected deviation rate for the whole population. An unexpectedly high sample deviation rate may cause the auditor to review the assessed risk of misstatement and therefore increase the extent of tests of detail to be performed.

4 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Describe the general principles of gathering audit evidence
- Explain the terms sufficient and appropriate
- Discuss different procedures for generating evidence and its relative quality
- List and explain the financial statement assertions
- Describe different types of audit procedures
- Explain what audit documentation is and why it is prepared
- Describe the form, content and extent of audit documentation
- Explain the use of computer-based audit working papers
- Summarise documentation ownership rules, custody and confidentiality
- Explain audit sampling, statistical sampling, sampling risk and non-sampling risk
- Describe how samples are designed and items selected for testing
- Understand how to project misstatements and evaluate the results of audit sampling

CHAPTER 5

Internal control

Contents

1 The importance of internal control
2 The elements of internal control
3 Limitations of internal control systems
4 Evaluation of controls and audit risk assessment
5 The risks of specialised IT systems
6 Chapter review

INTRODUCTION

Learning outcomes

The overall objective of the syllabus is acquiring knowledge of theory, skill and techniques of auditing and to enable the students to understand International Standards on Auditing, Assurance and Ethics.

Performance of audit and reporting

LO 2	**On the successful completion of this paper, candidates will be able to demonstrate working knowledge in respect of performance of simple audit procedures and understand the audit report requirement under the Companies Act, 2017**

Assessment of audit risks (ISA 315 and 330)

LO 2.2.5	Explain the elements of internal control
LO 2.2.6	Discuss the evaluation of controls and control environment and communication of deficiencies to the management
LO 2.2.7	Explain the categories of control activities (internal controls) by using simple examples including Application and General IT Controls
LO 2.2.8	Differentiate between control activities relevant and irrelevant to audit in a well explained scenario
LO 2.2.9	Explain and identify the control weaknesses in the given scenario and suggest appropriate recommendations to remove these weaknesses
LO 2.2.10	Discuss and explain the limitations of internal control system
LO 2.2.11	Discuss and explain the risks in specialized IT systems

Computer programming and IT controls

LO 4	**On the successful completion of this paper, candidates will be able to demonstrate familiarity with computer programming and IT controls relevant to financial reporting**
LO 4.4.1	Describe appropriate controls while designing the system using simple examples
LO 4.5.1	Describe general controls and classify them into environment, development, maintenance and operational controls using simple examples
LO 4.6.1	Describe preventative, detective and corrective controls using simple examples
LO 4.7.1	Describe the concept of an audit trail in a computerized environment using simple examples
LO 4.8.1	Describe logical access controls for a given situation/system
LO 4.10.1	Describe checks/controls into the software system to protect data from corruption and unauthorized access

1 THE IMPORTANCE OF INTERNAL CONTROL

Section overview

- The auditor's assessment of internal controls
- The meaning of internal control
- How the auditor uses internal controls
- Summary of the audit approach: tests of controls or substantive tests?

1.1 The auditor's assessment of internal controls

The auditor is required by ISA 315 to **make an assessment of risk**. This is made at both the financial statement level and at the assertion level.

The auditor is then required by ISA 330 to **respond to those risks**. The overall responses in relation to the financial statement level risks were discussed in a separate chapter.

The responses at the assertion level involve the auditor selecting appropriate audit procedures. The choice of audit procedures will depend on the auditor's assessment of both:

- inherent risk, and
- control risk.

This chapter looks at this requirement in detail and considers how the auditor's assessment of internal controls will influence his selection of the approach to the audit.

1.2 The meaning of internal control

Internal control may be defined as the process designed, put in place and maintained to provide assurance of a reasonable level regarding the achievement of the objectives of an entity. These objectives relate to the reliability of the financial reports, the efficiency and effectiveness of operations and adherence to relevant and applicable laws and regulations.

The following points should be noted from this definition:

- It is the responsibility of management to 'design' and put in place a suitable system of internal controls.
- Internal controls are designed to deal with financial risks, operational risks and compliance risks.
- Since internal controls are established by management, the auditor has to accept what controls there are. However, he can assess and evaluate the controls, and will plan his audit on the basis of his assessment.

1.3 How the auditor uses internal controls

Modern auditing is, wherever possible, based on a 'systems' based approach. With this approach, the auditor **relies** on the accounting systems and the related controls to ensure that transactions are properly recorded.

- His assumption is that if the systems and the internal controls are adequate, the transactions should be processed correctly.
- The audit emphasis is therefore, as much as possible, on the systems processing the transactions rather than on the transactions themselves.

Before the auditor can rely on the systems and controls that are in place, he must establish what those systems and controls are, and carry out an evaluation of the effectiveness of the controls.

In other words, the systems-based audit approach is based on the premise that accounting systems and their related internal controls are sufficient to record transactions properly. However, the auditor should first test the controls, in order to satisfy himself that this approach to the audit is valid.

The degree of effectiveness of an internal control system will depend on the following two factors:

- The **design of the internal control system** and the individual internal controls. Is the control system able to prevent material misstatements, or is it able to detect and correct material misstatements if they occur?
- The proper **implementation of the controls**. Are the controls operated properly by the client's management and other employees?

The outcome of this evaluation helps the auditor to assess **control risk** – which is one of the key elements in the audit risk model (described in an earlier chapter).

1.4 Summary of the audit approach: tests of controls or substantive tests?

As far as possible, the auditor will **rely** on the internal controls that are in operation. However, all internal control systems have inherent limitations, and controls can never be 'perfect' and 100% certain to be effective. It will therefore never be possible for the auditor to rely on them completely.

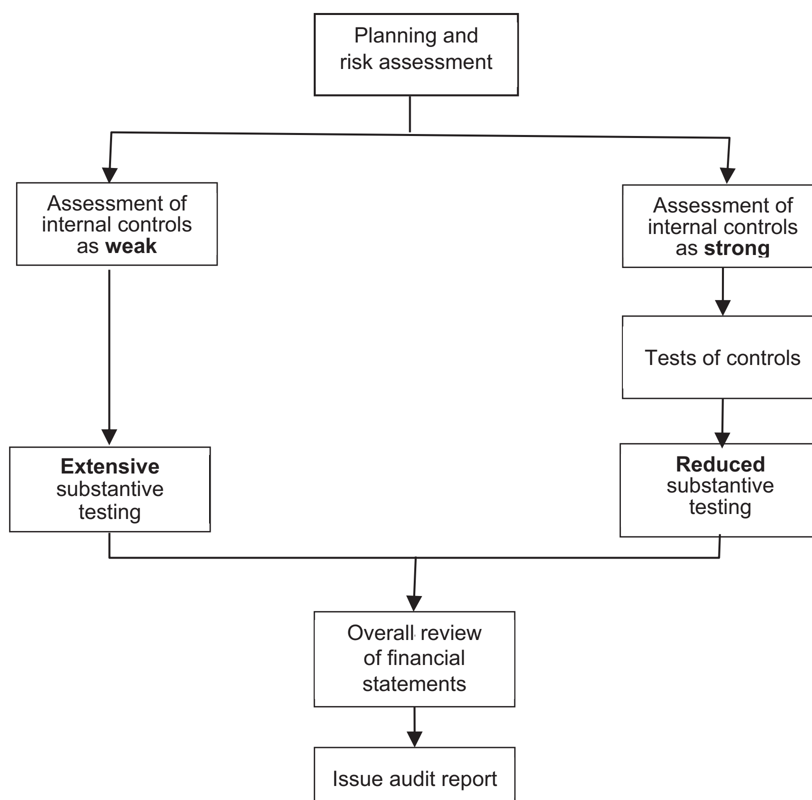
The auditor must therefore:

- test the underlying internal control systems themselves, using **tests of controls**, and
- perform some tests on the transactions and balances in the financial statements.

As discussed in a previous chapter, these tests on transactions and balances are referred to as **substantive procedures**:

- Where the auditor concludes that the system of controls is weak, and that the controls therefore cannot be relied on, he will have to carry out extensive substantive procedures. When an audit relies heavily on substantive procedures, the approach to the audit is called a **transactions-based approach.**
- If the auditor judges that the internal controls are strong, he will carry out tests on the controls (in order to verify his opinion about them) and should need a smaller amount of substantive testing. When an audit is based mainly on a favourable assessment of the internal controls, the approach to the audit is called a **systems-based approach**.

The diagram below summarises the audit approach.



2 THE ELEMENTS OF INTERNAL CONTROL

Section overview

- The internal control system and internal controls
- The five elements of internal control
- The control environment
- The entity's risk assessment process
- The information system
- Control activities
- Internal controls in IT systems: general controls and application controls
- Control weaknesses and the exam
- Monitoring of controls
- Understanding the control system: walk-through tests
- Specific IT controls

2.1 The internal control system and internal controls

A distinction should be made between:

- an internal control system, and
- internal controls.

Internal controls are a part of the internal control system, but the internal control system is more than just the internal controls.

2.2 The five elements of internal control system

ISA 315 identifies five elements which together make up the internal control system. These are:

(1) The control environment

(2) The entity's risk assessment process

(3) The information system

(4) Control activities (internal controls)

(5) Monitoring of controls

ISA 315 requires the auditor to:

- gain an understanding of each of these elements as part of his evaluation of the control systems operating within an entity; and
- document the relevant features of the control systems together with his evaluation of their effectiveness.

Once this understanding has been gained, the auditor should confirm that his understanding is correct by performing **'walk-through' tests** on each major transaction type (for example, revenue, purchases and payroll).

Walk-through testing involves the auditor selecting a small sample of transactions and following them through the various stages in their processing in order to establish whether his understanding of the process is correct.

2.3 The control environment

The 'control environment' is often referred to as the general 'attitude' to internal control of management and employees in the organisation.

The control environment includes the views, awareness and actions of management regarding an entity's internal control. It also includes the governance and functions of management and asserts the premise of an organisation. It is the basis for good internal control, providing guidance and structure.

The control environment includes the following elements:

- Communication and enforcement of integrity and ethical values
- Commitment to competence
- Participation of management
- Management's philosophy and operating style
- Organisational structure
- Assignment of authority and responsibility
- Human resource policies and practices

A strong control environment is typically one where management shows a high level of commitment to establishing and operating appropriate controls.

The existence of a strong control environment cannot guarantee that controls are operating effectively, but it is seen as a positive factor in the auditor's risk assessment process. Without a strong control environment, the control system as a whole is likely to be weak.

Evaluating the control environment

ISA 315 requires auditors to gain an understanding of the control environment. Part of this understanding involves the auditor evaluating the control environment, and assessing its effectiveness.

In evaluating the control environment, the auditor should consider such factors as:

- management participation in the control process, including participation by the board of directors;
- management's commitment to a control culture;
- the existence of an appropriate organisation structure with clear divisions of authority and responsibility;
- an organisation culture that expects ethically-acceptable behaviour from its managers and employees; and
- appropriate human resources policies, covering recruitment, training, development and motivation, which reflect a commitment to quality and competence in the organisation.

2.4 The entity's risk assessment process

Within a strong system of internal control, management should identify, assess and manage business risks, on a continual basis. Significant business risks are any events or omissions that may prevent the entity from achieving its objectives.

Identifying risks means recognising the existence of risks or potential risks. Assessing the risks means deciding whether the risks are significant, and possibly ranking risks in order of significance. Managing risks means developing and implementing controls and other measures to deal with those risks.

ISA 315 requires the auditor to gain an understanding of these risk assessment processes used by the client company's management, to the extent that those risk assessment processes may affect the financial reporting process.

Risks can arise or change due to circumstances such as:

- changes in the entity's operating environment
- new personnel
- new or revamped information systems
- rapid growth
- new technology
- new business models, products or activities
- corporate restructurings
- expanded foreign operations
- new accounting pronouncements.

These are the sort of factors which the examiner might build into a scenario to see if you can identify such factors as potential risks.

The quality of the risk assessment and management process within the client company can be used by the auditor to assess the overall level of audit risk. If management has no such process in place, the auditor will need to do more work on this aspect of the audit planning.

2.5 The information system

An information system consists of:

- infrastructure (physical and hardware components)
- software
- people
- procedures, and
- data.

Infrastructure and software will be absent, or have less significance, in systems that are exclusively or primarily manual, as opposed to computerised. Since most modern systems, even in small entities, make extensive use of information technology (IT), most questions in the exam are likely to be based on computerised systems in some shape or form. It is important that you recognise this and ensure that any audit tests or controls you suggest for such a system are appropriate. For example, if orders are placed via a website there is no point in suggesting that staff is observed writing out order documents. The appropriate approach would be to place a "test" order via the website and ensure the order has been recorded in the system by viewing it on screen.

ISA 315 requires the auditor to gain an understanding of the business information systems (including the accounting systems) used by management to the extent that they may affect the financial reporting process.

This aspect of the auditor's work will involve identifying and understanding the following:

- the entity's principal business transactions;
- how these transactions and other events relevant to the financial reporting process are 'captured' (identified and recorded) by the entity;
- the processing methods, both manual and computerised, applied to those transactions;
- the accounting records used, both manual and computerised, to support the figures appearing in the financial statements; and
- the processes used in the preparation of the financial statements.

2.6 Control activities

Control activities are the policies and procedures, other than the control environment, used to ensure that the entity's objectives are achieved. They are the application of internal controls.

Control activities are the specific procedures designed:

- to prevent errors that may arise in processing information, or
- to detect and correct errors that may arise in processing information.

Categories of control activities (internal controls)

ISA 315 categorises internal controls into the following types: (In the examination, if you are asked to suggest suitable internal controls within a given system this list should provide a useful checklist.)

- **Performance reviews.** These include reviews and analyses of actual performance against budgets, forecasts and prior period performance. Most of these control activities will be performed by management and are often referred to as **management controls**. They include supervision by management of the work of subordinates, management review of performance and control reporting (including management accounting techniques such as variance analysis).
- **Information processing.** A variety of controls are used to check the **accuracy, completeness and authorisation of transactions**. These controls are split into two broad groupings which are discussed further below:
  - **Application controls**
  - **General IT controls**
- **Physical controls**. These include controls over the physical security of **assets and records** to prevent unauthorised use, theft or damage. Examples include limiting access to inventory areas to a restricted number of authorised personnel, and requiring authorisation for access to computer programs and data files.
- **Segregation of duties**. This control involves assigning different people the responsibilities of authorising and recording transactions and maintaining the custody of assets. This reduces the likelihood of an employee being able to both carry out and conceal errors or fraud. This type of control is explained further below.

Example: Control activities

One part of the sales system at Dolally operates as set out below:

- **Orders are received by telephone. On receipt of an order a clerk enters the details into the system.**
- **The system checks that the goods are available and, if so, a despatch note is produced and e-mailed to the distribution centre.**
- **Distribution centre staff pack the goods and despatch them with two copies of the despatch note.**
- **On receipt of the goods the customer signs the despatch notes and one copy is returned to the accounts department at Dolally.**
- **The accounts department flag up the despatch note on the system to indicate that the goods have been delivered and the system automatically produces an invoice and e-mails it to the customer.**
- **An exception report of un-invoiced despatch notes is produced weekly.**

Required

Set out an example of each of the above five types of control activities set out in ISA 315 as they might operate in Dolally's system.

Answer

Performance reviews: Management should compare budgeted sales to actual sales on a monthly basis (provided that the budgets are reliable, this would detect where significant sales had not been recorded).

Information processing – application: Manual follow up of the exception report of un-invoiced despatch notes.

Information processing – general IT: Controls over the development and testing of the sales system to ensure it will lead to accurate processing (such as documentation and testing of any changes to programs).

Physical controls: Access controls over the sales price master files such as access only being possible via a high-level password, known only to senior employees (such as the sales director) (as invoices are produced automatically by the system it is important that the integrity of this file is maintained).

Segregation of duties: Different employees should be responsible for taking and inputting orders, despatching goods and flagging up the despatch note.

Tutorial note: *There are a number of other possible examples other than those set out above.*

2.7 Internal controls in IT systems: general controls and application controls

Internal controls within IT systems can be categorised into general controls and specific application controls.

General IT controls

General IT controls are policies and procedures that **relate to many different applications** (such as revenue, purchases and payroll). They support the effective functioning of application controls (explained later) by ensuring the continued proper operation of IT systems.

Because these general IT controls will apply to most or all of the entity's IT applications, if general IT controls are weak, it is unlikely that the processing undertaken by the system will be complete and accurate.

The auditor will therefore firstly review and test the general IT controls, in order to reach a conclusion on their effectiveness. This will enable him to assess the control risk attached to the entity's IT systems as a whole. If control risk is assessed as low he will then move on and test application controls, in order to decide if he can rely on specific systems and reduce his substantive testing.

Many of the general controls apply to large computer systems that are written, developed and maintained by the client company. However, some general controls also apply to smaller entities and users of off-the-shelf accounting software.

The main categories of general controls that an auditor would expect to find in a computer-based information system are:

- controls over the development of new computer information systems and applications
- controls over the documentation and testing of changes to programs
- the prevention or detection of unauthorised changes to programs (for example, by an employee committing fraud or by a 'hacker' accessing the system)
- controls to prevent the use of incorrect data files or programs
- controls to prevent unauthorised amendments to data files
- controls to ensure that there will be continuity in computer operations (and that the system will not 'break down' and cease to be operational).

Examples of general controls

Examples of each of these categories of general controls are set out in the table below:

Control area	Controls
Development of computer-based information systems and applications	New computer systems may be designed and developed for a 'computer user' (the client company) by an in-house IT department or by an external software company. ■ Appropriate IT Standards should be used when designing, developing, programming and documenting a new computer system. ■ There should be controls to ensure that tests are carried out on new systems before they are introduced. ■ A new computer system design should be formally approved by the system 'user'. ■ There should be a segregation of duties between the designers and testers of systems. ■ Staff should be given training in the use of a new system before they use it for 'live' operations.
Documentation and testing of program changes	■ When a computer system is operational, it may be necessary to update and amend some of the programs in the system. There should be suitable general controls over the development of new versions of programs. ■ There should be controls to ensure that formal testing procedures on new program versions before they are used for 'live' operations ■ All new versions of programs must be authorised at an appropriate level of management. ■ Staff should be given training, where appropriate, in the use of a new program version before they use it for 'live' operations.
Prevention or detection of unauthorised program changes	There is a risk that new programs will be introduced without proper authorisation. The risks are particularly serious in companies that have large purpose-written computer systems, and where the computer systems are operated on large computers (mainframe computers or minicomputers) in a centralised computer centre. ■ There should be a segregation between the tasks of programmers (who write new programs) and computer operators (who use the programs). ■ There should be full documentation of all program changes. ■ There should be restricted access to programs (program files), and only authorised programmers should have access to them. ■ Program logs should be maintained, to record which programs and which versions are used. ■ There should be virus protection for programs (using anti-virus software) and there should be back-up copies of all programs (in the event of 'malicious' changes to programs used in operations).
Prevention of the use of incorrect programs or data files	In large computer systems, there may be several versions of a program at any time, not just one 'current version'. For example, when a new version is written, the 'old' version may be kept. It is important to ensure that the correct version of the program is used.

Examples of general controls

Examples of each of these categories of general controls are set out in the table below:

Control area	Controls
	■ Computer operating staff should be suitably trained, and should follow standard operating procedures for checking the version of the program they are using. ■ Job scheduling: there should be formal job scheduling in large computer centres, and a job schedule should specify the version of the program to be used. ■ Supervision. Supervisors should monitor the activities of operating staff. ■ Reviews by management. Management should carry out periodic reviews, to make sure that the correct versions of programs are being used.
Prevention of unauthorised amendments to data files	In addition to the risk that there may be unauthorised access to program files and unauthorised amendment of programs, there is also a risk that data files will be accessed without authorisation (by an employee or an external 'hacker'). ■ Physical access to computer terminals may be restricted to authorised employees. ■ Access to programs and data files may be restricted using passwords. There should be rigorous checks by management to ensure that a password system is being used effectively by employees (so that passwords are not easy to 'guess') ■ Firewalls (software and hardware) can be used to prevent unauthorised external access via the internet.
Ensuring continuity of operations	When problems occur in a computer system, the system may be at risk of ceasing to function. This could happen if there is physical damage to computer equipment or files, or if program files or data files are 'corrupted' or altered without authorisation. ■ There should be controls over maintaining secure second copies of all programs and data files ('back-up copies'). The back-up copies can be used if the original copies are damaged or corrupted. ■ There should be measures for the protection of equipment against fire, power failure and other hazards. ■ The company should have disaster recovery plans, such as an agreement with another entity to make use of its computer centre in the event of a disaster such as a fire or flood. ■ The company should make suitable maintenance and service agreements with software companies, to provide 'technical support' in the event of operating difficulties with the system.

Application controls

Application controls apply to the processing of **individual applications** (such as revenue, purchases or payroll). These controls help to ensure that transactions occurred, are authorised and are completely and accurately recorded and processed. These controls could be manual or computerised, depending on the system in question. Examples include:

- All significant transactions being authorised at an appropriate level (**authorisation controls)**.

- Checking the arithmetic accuracy of records. These are often referred to as **arithmetic controls**. These are checks on the arithmetical accuracy of processing. An example is checking invoices from suppliers, to make sure that the amount payable has been calculated correctly.
- Maintaining and reviewing accounts and trial balances. These are often referred to as **accounting controls**. These are controls that are provided within accounting procedures to ensure the accuracy or completeness of records. An example is the use of control account reconciliations to check the accuracy of total trade receivables or total trade payables.
- IT controls such as edit checks of input data (see below)
- Numerical sequence checks
- Manual follow-up of exception reports

In a manual processing system, controls vary by application. For example, specific internal controls over inventory are different from internal controls over payroll. Similarly, the application controls that should be used in an IT system will vary depending on the particular application.

However, in IT systems, application controls share a number of common features regardless of the particular application involved. These common features can be categorised as:

- input controls (controls over input data);
- processing controls;
- data file controls; and
- controls over the output from the system (output controls).

Each of these areas is considered in turn below.

Control area	Controls
Input	Application controls should place a high degree of emphasis on controls over **input**: if the input is not correct, the output from the application cannot possibly be correct. **Authorisation controls** ■ Data for input is authorised ■ Data is input only by authorised personnel **Completeness controls** ■ Document counts (for example, a physical count of the number of invoices input for processing) ■ Control totals ■ Checking output to input ■ Review of output against expected values: check for reasonableness. (For example, is the total payroll cost broadly in line with expectations?) **Accuracy controls** (see below) ■ Check digits ■ Range checks (is a particular figure input value feasible?) ■ Existence checks (does a customer reference number exist?) ■ Use of control totals
Processing controls	These are controls to check that the correct number of transactions has been processed and that they have all been fully processed ■ Control totals (see below) ■ Batch totals (see below) ■ Manual review ■ Screen warning ('screen prompts') that processing is not complete

Control area	Controls
Controls over master files and standing data	These are controls to check that data held on master files and standing files is correct. For example there may be a check in the sales invoicing system to make sure that the price list for products is up-to-date. There may also be a check to make sure that the master file of customers seems complete, for example by looking at the total of records on file. ■ Management review of master files and standing data ■ Regular updates of master files ■ Record counts
Output controls	■ Only authorised personnel should have access to output from the system (for example, invoices or payroll details). ■ Output can be checked visually for reasonableness.

Segregation of duties

Segregation of duties means dividing the work to be done between two or more individuals, so that the work done by one individual acts as a check on the work of the others. This reduces the risk of error or fraud.

- If several individuals are involved in the completion of an overall task, this increases the likelihood that errors will be detected when they are made. Individuals can often identify mistakes of other people more easily than they can identify their own.
- It is more difficult for a person to commit fraud, because a colleague may identify suspicious transactions by a colleague who is trying to commit a fraud.

Example: Segregation of duties

The purchasing of inventory involves several different tasks. Someone has to initiate a purchase requisition for a new supply of inventory. Someone has to place a purchase order with a supplier. Someone has to check that the items are delivered by the supplier. Someone has to record the amount payable in the accounting system, and someone has to make the payment at the appropriate time.

Control risks include the risks that inventory will be ordered when it is not needed, that the supplier will not deliver any inventory or will deliver the incorrect quantity, or that the supplier will be paid too much or will be paid for items that he has not delivered.

A segregation of duties can help to reduce these risks:

Transaction stage	Responsibility
Initiation – Replenishment of inventory item is required	Warehouse staff/stores staff
Purchase order – Item ordered	Purchasing officer. The purchasing officer is able to check the material requisition from the stores staff
Custody – Item received	Goods inwards officer. The items actually delivered are checked physically and counted. This is a check that items have actually been delivered in good condition, as stated in the supplier's delivery note
Recording – Invoice received, checked and processed	Accounts clerk. The invoice from the supplier is checked against the delivery note and the original purchase order. The amount payable is recorded in the accounts system.
Payment – Invoice is paid	Cashier. The amount payable to the supplier is eventually paid by a different person in the accounts department.

Additional controls will also be applied. For example, there should be authorisation controls, and both the placing of a purchase order with the supplier and the payment to the supplier should be authorised at an appropriate level of management.

2.8 Control weaknesses and the exam

IAS 315 categorises internal controls into performance reviews, information processing controls (general controls and application controls, in the case of IT systems), physical controls and segregation of duties. It was also suggested that these categories may provide a useful framework for a discussion of internal controls in answer to an exam question.

The exam may include a question based on a case study in which you are asked to comment on **weaknesses** in the controls of a client entity. You may be required to identify weaknesses, explain why they are weaknesses and the nature of the risk that they create, and then suggest improvements in the control system to remove the risk.

An alternative framework for structuring an answer to this type of question may be to look for control weaknesses in the following categories.

(1) **Control environment**. An effective system of internal control depends on having a suitable control environment. This is provided through leadership of senior management, who should promote a risk awareness culture. If senior management show little concern for risks and controls, it is probable that the entire system of internal controls will be weak and ineffective.

(2) **A lack of checks and controls**. In some cases, there may be control weaknesses because suitable controls simply do not exist. Auditors look for weaknesses in control systems and recommend improvements to the clients. Tests of controls are described in a later chapter.

(3) **Segregation of duties**. This aspect of control has been explained previously. You should consider whether the risk of error or fraud might be reduced by separating particular tasks and responsibilities.

(4) **Physical controls**. These have also been described earlier. There should be controls to protect the physical security of assets and records, to protect them against theft, loss or unauthorised access.

(5) **Personnel**. Consider whether there are any weaknesses in the personnel who perform particular tasks: for example the use of inexperienced or unqualified employees to do certain work may create a high risk of error.

(6) **Management structure and organisation structure**. There may be weaknesses in management or weaknesses in the organisation structure of the client entity. For example it may be appropriate for some work to be supervised (and checked by supervisors): a lack of supervision may be a control weakness. In a weak organisation structure, lines of responsibility and reporting may not be clear: when this happens, management may not exercise control effectively because they are unsure of their exact responsibilities. The system of performance reporting and control reporting may also be inadequate: in other words there may be a weakness in **management controls**.

(7) **IT controls**. If you are commenting on weaknesses in a client's IT system, look for weaknesses in both general controls and specific application controls.

(8) **Computational work and risk of computational error**. There may be weaknesses in the procedures for making and checking calculations. For example in an entity that provides services and charges customers on a time-related fee basis, there may be weaknesses in the computation of fees to charge to customers.

(9) **Lack of internal audit**. The lack of an internal audit department could be seen as a control weakness.

2.9 Monitoring of controls

It is important within an internal control system that management should review and monitor the operation of the controls, on a systematic basis, to satisfy themselves that the controls remain adequate and that they are being applied properly. ISA 315 requires the auditor to obtain an understanding of this monitoring process.

2.10 Understanding the control system: walk-through tests

ISA 315 requires the auditor to:

- gain an understanding of each of the five elements of the client's internal control system (control environment, risk assessment process, information system, control activities and monitoring of controls), and
- document the relevant features of the control systems.

Once this understanding has been gained, the auditor should confirm that his understanding is correct by performing **'walk-through' tests** on each major type of transaction (for example, sales transactions, purchase transactions, payroll).

As explained earlier, walk-through testing involves the auditor selecting a small sample of transactions and following them through the various stages in their processing in order to establish whether his understanding of the process is correct.

If he understands the controls that are in place, the auditor can go on to assess their effectiveness, and the extent to which he can rely on those controls for the purpose of the audit.

2.11 Specific IT controls

You may not be familiar with all the IT application controls described earlier. Some of them are therefore described in more detail below. The purpose of these specific application controls in an IT system is to reduce the risk of errors in transactions input to the computer for processing, or to make sure that all transactions are fully processed.

Control totals

Control totals may be used when several transactions are input for processing at the same time. A control total is a total value for all the transactions input. For example, an accounts clerk might be processing 20 purchase invoices. A control total for the 20 transactions can be calculated (manually, with a calculator): this may be a total, say, of the value of the 20 invoices. A manual record may be kept of the control total.

When the 20 transactions have been processed, the computer program may output its own control total for the value of the items processed. This can be checked against the control total taken manually, to make sure that they agree.

Check digits

Check digits are checks within a computer program on the validity of key numerical codes, such as customer codes, supplier codes and employee identification numbers.

When check digits are used, every code is given an extra digit, the check digit. This is a unique digit obtained from the other digits in the code.

An example might illustrate how check digits operate. In this example, a Modulus 11 check digit system is used, where the check digit can be any of 11 'numbers' – 0 to 9 or X (10).

The basic coding system is for a five-digit code, and a sixth digit (the check digit) will be added to complete the code. Suppose that a customer's five-digit code is 23467. The check digit is calculated as follows (in the Modulus 11 system).

Code digit	Weighting	
2	× 6	12
3	× 5	15
4	× 4	16
6	× 3	18
7	× 2	14
		75
Check digit = 2	× 1	2
		77

In a Modulus 11 system, the check digit is given a weighting of 1, and it is calculated so that the total of all the digits in the code multiplied by their weightings will add up to a multiple of 11. In this example, the multiple of 11 is 77, and the check digit 2 makes the total add up to 77.

The six-digit customer code is therefore 234672.

A computer program can carry out a mathematical check on the code for every transaction input for processing. The program will check that the total of the code digits, when weighted as shown above, is a multiple of 11.

If the weighted total is not a multiple of 11, there must be an error in the code. This means that the computer program will detect any errors in input data for the particular code, and will not process the transaction. Instead, the program will output an error report, so that the error can be investigated and corrected.

Range checks and existence checks

Range checks and existence checks are other examples of 'data validation checks' that can be written into a computer program to test the validity of input data. The program looks at the value for a particular item of data in the input transaction, and if it is invalid, it produces an error report and will not process the transaction.

- A **range check**. The value of an item of data might have to be within a particular range. For example, inventory codes may be within the range 2000 – 3999. If so, the program can be written so that it checks the inventory code for every transaction, and produces an error report if the code is not within that range.
- An **existence check** is similar, but the program checks the actual existence of a particular code. For example, in a payroll system, input transactions may include a department code for each employee. Department codes may be B, C and P. A program check can be carried out on the department code for all input transactions, and if the code is not B, C or P, an error report will be produced.

Batch totals

A batch total is a form of control total. Transaction data is input to the computer system in batches, and a control total is calculated. It may simply be a total of the number of transactions in the batch. The batch total is input to the computer system for processing, and the computer program will check the batch total that has been input with its own batch total count.

The program will report any discrepancy between the manually counted batch total and its own batch total, as an error report.

Batch totals can be useful in helping to make sure that every transaction in a batch is actually input for processing and is actually processed.

On-screen prompts

On-screen prompts are often used in computer systems where data is input by keyboard, mouse and computer screen, typically by the user's own accounts staff. The screen will display 'prompts', telling the user what to input next or what to do next. They help to make sure that transactions are fully processed, and that operators do not leave transactions only partly processed.

3 LIMITATIONS OF INTERNAL CONTROL SYSTEMS

Section overview

- Reasons why internal controls may be ineffective
- Problems for small entities

3.1 Reasons why internal controls may be ineffective

Internal control systems are never fool proof. All systems, no matter how effective they may appear to be, have several limitations:

- Human error may result in incomplete or inaccurate processing which may not be detected by control systems.
- It may not be cost-effective to establish certain types of controls within an organisation.
- Controls may be in place, but they may be ignored or overridden by employees or management.
- Collusion may mean that segregation of duties is ineffective. Collusion means that two or more people work together to avoid a control, possibly for the purpose of committing fraud.

Although modern auditing is based on testing the systems and controls rather than transactions, auditors will never rely solely on such tests in reaching a conclusion. This is because of the limitations inherent in **all** control systems. Auditors will always supplement their work on systems with some testing of transactions and balances themselves (substantive testing). The amount of substantive testing will depend on the auditor's evaluation of the effectiveness of the controls.

3.2 Problems for small entities

Many of the control activities that are typically found in a large company may be inappropriate for a small entity because they are too costly or impractical.

Segregation of duties is an obvious example of this. It is difficult to segregate duties in a small company with only a few employees. The same individual has to carry out a variety of different tasks.

Often, control systems in small entities are based on a high level of involvement by the directors or owners. Authorisation and performance review controls, with the owner-manager personally authorising many transactions, might therefore be a key feature of control systems in small entities. The active involvement of an owner-manager might mitigate risks arising from a lack of segregation of duties.

However, because of the likely active involvement of the owner-manager the attitudes and actions of that person will be key to the auditor's risk assessment. There is unlikely to be a written code of conduct so a culture of integrity and ethical behaviour, as demonstrated by management example, will be important.

However, the auditor will often see this management involvement as only a partial substitute for 'normal' control systems. The following problems may arise when control systems rely excessively on the involvement of senior management.

- There may be a lack of evidence as to how systems are supposed to operate. The auditor will need to rely more on enquiry than on review of documentation.
- There may be lack of evidence of controls. (How does the auditor know that the controls exist and are being applied?).
- Management may override other controls that are in place.
- Management may lack the expertise necessary to control the entity effectively.

- There is unlikely to be any independent person within the management team as there would be within “those charged with governance” in a large entity.

When auditing a small entity, the auditor needs to understand and evaluate whatever controls are in place and plan his audit work accordingly. It is likely that a lower level of reliance will be placed on controls in a smaller entity, and that a large amount of substantive testing will therefore be required.

4 EVALUATION OF CONTROLS AND AUDIT RISK ASSESSMENT

Section overview

- The purpose of evaluating controls
- The evaluation process
- Management letter

4.1 The purpose of evaluating controls

Having established the control systems that are in place, and having recorded them in the audit working papers, the auditor should now evaluate the controls and establish their effectiveness. The results of this evaluation will allow the auditor to identify the control risk (which is an element of audit risk). The auditor can then decide on a systems-based or a transactions-based approach to the audit.

The evaluation of accounting and control systems is a two-stage process. The auditor will need to establish:

- Whether controls are effective 'on paper'. This means that if it can be assumed that the controls are applied properly in practice, are they sufficient?
- Whether the controls are applied properly, and so whether they are actually working and operating effectively. Controls may be adequate if they are applied properly, but in practice they might not be applied as they should be. This aspect of the auditor's evaluation is described in more detail in a later chapter on tests of controls.

4.2 The evaluation process

The auditor should obtain a general picture of the effectiveness of the controls established by management, by reviewing his documentation of the internal control system. This is the evaluation of the controls 'on paper'.

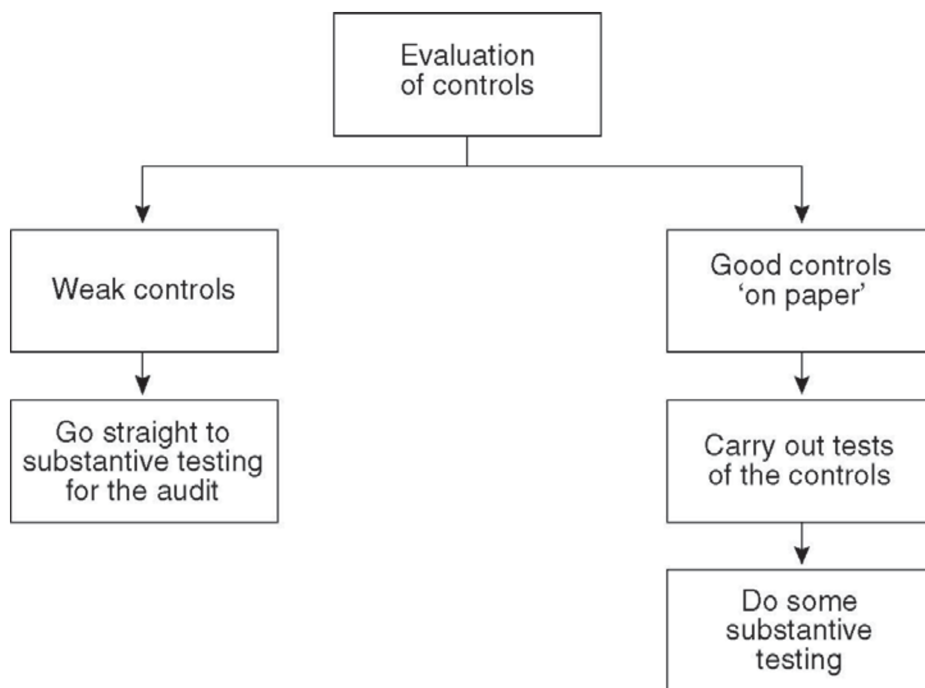
If this 'paper' review of the controls indicates that major weaknesses exist, the auditor will probably take the view that the audit approach will have to focus on tests of transactions (substantive tests) rather than on tests of controls (a systems-based approach). A systems-based audit approach will not be appropriate if there is a high level of control risk.

If the auditor's initial assessment of the control systems shows that those systems are weak, then he will move straight to substantive testing and will not bother to carry out tests of controls.

Even if the controls appear to be acceptable on paper, the auditor cannot rely on them and perform a systems-based audit unless he is confident that the controls are actually working. In this situation, the next stage in the audit process is to carry out **tests of controls**.

If the outcome of the tests of controls indicates that controls are actually operating effectively, the audit can be systems based, with a reduced amount of substantive testing. Remember that the auditor will always need to perform **some** substantive testing – because of the inherent limitations in any system of internal controls.

In view of this ISA 330 **requires** that substantive procedures are carried out for each **material class of transactions, account balances and disclosure**. These terms are considered in a later chapter on substantive procedures.



4.3 Management letter

Whilst the requirements of *ISA 265 'Communicating Deficiencies in Internal Control to Those Charged with Governance and Management'* are outside the scope of this syllabus you do need to know that it is common practice for the external auditor to prepare a 'management letter' for the client.

A management letter is a report typically presented in columnar fashion detailing weaknesses observed in the client's system of internal controls. Remember though that the identification of control weaknesses is a by-product of performing the external audit rather than the objective of an audit.

Illustration: Management letter

Weakness	Possible effect	Recommendation	Management's response
Details of employees leaving the company are sent on an e-mail from the personnel department to payroll without subsequent confirmation.	There is no check to ensure that all e-mails sent are actually received in the payroll department. This could result in payments being made to former employees.	Introduce a control to ensure all e-mails are received. Personnel should use sequentially-numbered e-mails. Payroll should send a confirmation for each 'leaver email' received.	Agreed. New control to be installed immediately.

5 THE RISKS OF SPECIALISED IT SYSTEMS

Section overview

- Microcomputer systems
- Online systems
- Electronic data interchange (EDI) systems

When evaluating the general controls and application controls in a client's computer systems, the auditor needs to take account of the type of computer-based information system that the client is using.

Common types of system that may require special attention include:

- microcomputer systems;
- online systems; and
- electronic data interchange systems.

5.1 Microcomputer systems

A microcomputer system is a system where the client company uses a number of 'desktop' computers located throughout the organisation, rather than a large 'centralised' computer-based information system with a mainframe computer or minicomputer.

Companies may use a microcomputer system because it is more efficient and cost-effective than a centralised system with a large single computer. Another commercial advantage of microcomputer systems is that the systems can often be operated (and possibly even programmed) by the user's operating staff (for example, accounts clerks) with little technical training.

Microcomputer systems may, however, generate problems of audit risk for the auditor, for the following reasons:

- It may be difficult to ensure adequate physical security of the equipment, because desktop computers for the system may be in many different locations.
- For similar reasons, there may be problems in connection with security of the data and storage media (disks of data files).
- The wide access available in most of these systems introduces problems of authorisation. There is the possibility of unauthorised amendments to programs or data files. The risks in this area can be minimised by the use of passwords to restrict access to certain files.
- Programs may be written or modified by the user (one of the potential attractions to the entity of the use of 'micros') but this may cause processing and software problems.
- The auditor should want to see adequate documentation for software systems. When software is purchased 'off-the-shelf' documentation should be provided by the software supplier.

5.2 Online systems

These are computer-based information systems that allow users direct access to centrally-held data and programs through remote terminals linked together in a network.

Companies use online systems because they can offer several benefits, such as:

- immediate entry of transactions into the system (for example, sales transactions in a retail outlet can be input from the check-out desk from 'electronic point of sale' terminals linked to a central computer in a network);
- immediate updating of master files (such as the immediate updating of inventory records as soon as inventory is requisitioned); and
- enquiry systems (such as immediate answers to price enquiries from customers).

Again, although they can be efficient and effective for the client company, online systems can create concerns about audit risk for the auditor. Controls should be in place to minimise the risks that arise from the use of on line processing systems by the client.

Controls in an online system are a mixture of general controls and application controls.

General controls in online systems

- Access controls need to be strong because transactions are processed immediately by online systems. It is therefore important that unauthorised access to the programs and data files should be prevented.
- Programming controls should be built in to prevent or detect unauthorised changes to programs or standing data.
- Transaction logs should be used to create an 'audit trail'. An **audit trail** refers to the ability of the auditor to trace a transaction through all its processing stages. An audit trail can be provided by a record ('log') of how the computer has processed any transaction. An audit trail may not exist in 'paper form' in an online system, but the computer program should be written so as to generate the audit trail on request for any transaction.
- Firewalls should be used. These are software or hardware devices that protect the network 'server' (computer) from unauthorised access via the internet.

Application controls in online systems

Applications systems that run on online computer systems should have application controls that are suitable for the nature of the processing system. For example:

- There should be pre-processing authorisation. This means that individuals should be required to log on to the system before they can use the program.
- Program checks (data validation checks) can be carried out on the input data. These include check digit checks, range checks, existence checks and completeness checks. These programmed checks help to ensure the completeness and accuracy of processing (for example, the correct number of digits in product codes).
- 'Balancing'. This is the immediate checking of control totals of data submitted from a remote terminal, before and after processing.

5.3 Electronic data interchange (EDI) systems

EDI systems are systems that allow the electronic transmission of business documents, such as purchase orders, invoices or payroll information.

EDI systems may operate:

- within the organisation (for example, the sales department may use an EDI system to send copies of customer orders to the accounting department), or
- externally (for example, a company may submit payroll data to an external agency or 'bureau' for processing, and a company may send a purchase order electronically to a supplier).

In an EDI system, the transmitted 'documents' are automatically entered into the (different) computer system of the receiver of the message. For example, a purchase order sent to a supplier by EDI is read automatically into the sales order computer system of the supplier, and so can be processed without the need for manual intervention.

Once again, although EDI systems may improve the operational efficiency of the organisation, they may create the following additional problems for the auditor:

- There is a lack of a paper audit trail. (A 'paper' audit trail is one where a transaction can be followed through the stages of its processing, by going from one paper document to another. With EDI, the system needs an electronic audit trail for transactions, and the computer system should be able to provide one.)

- There is an increased level of dependency on the computer systems of the organisation and possibly on outsiders. Any computer failure may therefore have an increased impact on the client's organisation. General controls for IT will therefore be extremely important.
- There is a risk of possible loss or corruption of data in the process of transmission.
- There are also security risks in the transmission of data. Unauthorised individuals may be able to read transmitted data.

Auditors should expect to see controls in place to minimise the risks inherent in EDI systems. Typically, controls will cover such matters as:

- controls over transmission of data (encryption, acknowledgement systems, authentication codes);
- monitoring and checking of output;
- virus protection systems; and
- contingency plans and back up arrangements.

(Note: Authentication codes are used so that senders and receivers of transmitted data have to authenticate their identity before data is transmitted. Encryption involves translating data into 'coded' form for transmission, and then re-translating it at the recipient's end.)

6 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Understand the meaning, importance and relevance of internal control
- Understand how the auditor assess and uses internal controls
- Explain the five elements of internal control
- Discuss the limitations of internal controls
- Explain the different types of controls
- Evaluate internal controls and explain the impact of this evaluation on the auditor’s risk response
- Provide an overview of the risks of some specialised IT systems including on-line systems and Electronic data interchanges

CHAPTER 6

Flowcharts and IT concepts

Contents

1 Narrative notes and questionnaires
2 Systems flowcharts
3 IT concepts
4 Chapter review

INTRODUCTION

Learning outcomes

The overall objective of the syllabus is acquiring knowledge of theory, skill and techniques of auditing and to enable the students to understand International Standards on Auditing, Assurance and Ethics.

Performance of audit and reporting

LO 2	**On the successful completion of this paper, candidates will be able to demonstrate working knowledge in respect of performance of simple audit procedures and understand the audit report requirement under the Companies Act, 2017**
LO 2.2.12	Explain the different methods of recording internal control systems

Computer programming and IT controls

	On the successful completion of this paper, candidates will be able to demonstrate familiarity with computer programming and IT controls relevant to financial reporting
LO 4.1.1	Describe the macro, mini and micro level details of flowcharts
LO 4.1.2	State the benefits and limitations of flowcharts using simple examples
LO 4.2.1	Classify and distinguish between types of flowcharts, namely, linear, deployment and opportunity flowcharts
LO 4.2.2	Draw different types of flowcharts for given situations
LO 4.3.1	Describe general controls and classify them into environment, development, maintenance and operational controls using simple examples
LO 4.3.2	Describe IT application controls using simple examples
LO 4.3.3	Discuss the evaluation of various IT controls including authorization, separation of duties/functions, adequacy of documentation, access controls, safeguard of IT assets, independent check on performance, verification of accounting records, comparison of accounting records with assets, computer-dependent controls (edit, validation, etc.), user controls (control balancing, manual follow-up, etc.), audit trails
LO 4.3.4	State controls over data transmission
LO 4.4.1	Describe preventative, detective and corrective controls using simple examples.
LO 4.4.2	Describe procedures and controls for identification/investigation /correction / tracking of errors in IT systems/environment
LO 4.5.1	Describe logical access controls for a given situation/system.
LO 4.5.2	Describe the usefulness of system logs for analysing a system's performance

1 NARRATIVE NOTES AND QUESTIONNAIRES

Section overview

- Recording internal control systems
- Narrative notes
- System flowcharts
- Questionnaires

1.1 Recording internal control systems

The need to record internal control systems

The auditor must gain an understanding of each of the five elements that make up the client's internal control system. This is to enable the auditor to carry out an evaluation of the systems and to conduct an audit risk assessment. The outcome of this assessment and evaluation will establish his overall approach to the audit – whether it will be systems-based or transactions-based.

The auditor's work on internal control is therefore an important element of gathering audit evidence, because it influences the direction that the audit work will take. As with all other significant audit evidence, it must be properly documented in the audit working papers – probably in the permanent audit file.

Recording methods

The principal methods available to the auditor for recording internal control systems are:

- narrative notes
- questionnaires
- systems flowcharts (see next section)

1.2 Narrative notes

Narrative notes are a written description of the control system and the controls that are in place. They are used mainly to make a record of the control activities involved in processing transactions.

Narrative notes are simple to prepare, but can become lengthy. They may be time-consuming to prepare initially. When narrative notes are long, it may also be time-consuming to update them when the system or the controls change.

Ideally, narrative notes should be written clearly, but should not be longer than necessary to provide a full description.

1.3 Systems flowcharts

Systems flowcharts provide a representation of accounting systems in the form of a diagram. For each type of transaction, they show the documents generated, the processes applied to the documents and the flow of the documents between the various departments involved. Flowcharts therefore show the flow of work by showing how documents are transferred within a system (and filed) and how they are used.

As they are in the form of a diagram, flowcharts present an immediate visual impact of the system. This can sometimes help the auditor to identify weaknesses in controls more easily than by reading narrative notes.

However, some expertise is needed to draw a good flowchart and to use it to assess the effectiveness of controls. In addition, although flowcharts work well with standard accounting systems and transactions, they may not be appropriate for documenting specialised areas of accounting.

Accounting and Control System Flowcharts

Flowchart construction is a method to document the auditors' understanding of internal controls. A well-developed flowchart depicts clarity in stating all relevant information about separation of duties, authorization and accounting and control activities.

Systems flowcharts provide a representation of accounting systems in the form of a diagram. For each type of transaction, they show the documents generated, the processes applied to the documents and the flow of the documents between the various departments involved. Flowcharts therefore show the flow of work by showing how documents are transferred within a system (and filed) and how they are used.

Benefits and limitations of flowcharts

The advantages of flowcharts are

- Flowcharts can enhance auditors' evaluations.
- The annual updating of a chart is relatively easy with additions or deletions to the symbols and lines.
- A complete flowchart is an easily evaluated and informative description of the system.
- Moreover, showing the various duties performed by one individual or group also provides graphic evidence of any conflicting responsibilities (i.e., lack of separation of duties).
- The information is presented in a logical sense thus facilitating easy understanding of a system.
- Flowcharts ensure that a system is recorded in its entirety as all documents have to be traced from the beginning to end.
- It serves as a permanent record of a system that can be subject to a minor amendment on a year to year basis.
- Additionally, it highlights the strengths and weaknesses of a system and also makes it easier to spot any missing controls due to the use of standard symbols for controls.
- Constructing a flowchart does not require a person with high technical expertise and thus can be prepared easily by inexperienced staff.
- There are some limitations to accounting and control system flowcharts.
- These are only suitable for describing standard systems rather than recording systems with numerous unusual transactions.
- Flowcharts are also not appropriate for recording systems with further classifications of subsystems or subroutines.
- According to (Louwers, Ramsay, Sinason, Strawser, & Thibadeau, 2011) constructing a flow chart is a time consuming process because an auditor must learn about the operating personnel involved in the system and gather samples of relevant documents. This, the information for the flowchart, such as the narrative description, involves a lot of effort and observation.
- There is a possibility of recording and checking areas that are of no audit significance.
- Another major limitation is that flowcharts are difficult to amend because a single amendment may require changes in the entire chart.

1.4 Questionnaires

Questionnaires are widely used by auditors to document systems. Questionnaires can be prepared in advance as standard documents. They are also ideally suited for use by the auditor in an electronic form, which means that standard questionnaires are available and ready for use on the auditor's laptop computer.

A questionnaire is a list of questions about controls in a particular aspect of operations or accounting.

- There are two main types of questionnaire. Each has a different objective. They are:
- the internal control questionnaire (ICQ)
- the internal control evaluation questionnaire (ICEQ).

Internal control questionnaire (ICQ)

An internal control questionnaire (ICQ) is designed to establish whether appropriate controls exist, that meet specific control objectives. Each question requires a 'Yes' or a 'No' answer, and deals with a particular type of control. The auditor has to establish the answer to each of the questions, and fill in the questionnaire.

ICQs are usually drawn up in such a way that:

- a 'Yes' answer to a question indicates a control strength, and
- a 'No' answer to a question indicates a control weakness.

For example, the following ICQ questions might be included in a questionnaire dealing with procedures for assessing the credit-worthiness of potential new customers:

Are credit references taken on all potential new customers?	YES/NO
Are credit limits set for customers?	YES/NO

Example:

As part of his evaluation of internal controls, the auditor wishes to establish each of the following:

(a) **That the correct product prices are charged on sales invoices to customers.**

(b) **That raw materials delivered are of the correct specification and in the correct quantity.**

Required

Draft ICQ questions that could be used to establish the existence of appropriate controls.

Answer

(a)	**Is a check carried out to match the price on a sales invoice to the official price list?**	**YES/NO**
(b)	**Are raw materials counted and checked against the purchase order when the materials are delivered?**	**YES/NO**

An ICQ not only provides the auditor with a means of recording the system and its controls; it also assists with the evaluation process. The auditor can review the Yes/No answers to gain an overall picture of the reliability of the system under review.

The ICQ approach above has the advantage of producing a document that is relatively simple for the auditor to complete. So the questionnaire can often be completed by a relatively junior member of the audit team. However, the questionnaire can become lengthy (with a large number of questions) and so time-consuming to complete.

Checking ICQs

Instead of preparing new internal control questionnaires each year, it is often more practical and sensible to take the ICQs from the previous year's audit, check their accuracy and where appropriate bring them up to date. To do this the following steps should be taken:

- Obtain the ICQs from the previous year's audit file.
- Look at any control weaknesses that are indicated in these ICQs and find out whether the client entity has taken any action during the year to deal with them.
- Check the accuracy of each ICQ through a series of checks and enquiries: review the system documentation, interview the staff responsible for the controls and carry out walk-through tests. Identify the controls that apply and compare these with the findings in the ICQ. Make any amendments and updates as necessary.
- Having obtained an up-to-date set of ICQs, assess whether control weaknesses exist.

Internal control evaluation questionnaire (ICEQ)

In recent years the auditing profession has responded to this by developing a second type of questionnaire, the internal control evaluation questionnaire (ICEQ).

The idea behind the ICEQ is to draw up a small number of **key control questions** designed to establish whether major weaknesses may exist in a control system:

- Using an ICQ, the auditor is looking for 'good news' and expects to find particular controls in place.
- Using an ICEQ, the auditor is on the look-out for 'bad news' and the possibility that controls may be weak.

Like an ICQ, an ICEQ contains a (shorter) list of questions, for which the answer is Yes or No. A questionnaire is normally designed so that a Yes answer indicates good controls and a No answer indicates weak controls.

An earlier example showed how ICQ questions might be written, relating to controls over the creditworthiness of customers. An ICEQ approach in this same area might consider just one key control question, as follows:

Is there reasonable assurance that goods can only be despatched to authorised customers whose account balance is within their credit limit?	YES/NO

Although the ICEQ approach typically produces a document that is shorter than an ICQ, ICEQs may suffer from the disadvantage that the questions are less precise and may need more knowledge and experience on the part of the auditor to answer them.

Choosing which type of questionnaire to use is a matter of preference for the auditor or the audit firm.

As in the case of the ICQ, the ICEQ approach also serves a dual purpose for the auditor – both to record and to evaluate the internal control system.

2 SYSTEMS FLOWCHARTS

Section overview

- Introduction
- Levels within a flowchart
- Different types of flowcharts
- Drawing flowcharts

2.1 Introduction

Systems flowcharts provide a representation of accounting systems in the form of a diagram. For each type of transaction, they show the documents generated, the processes applied to the documents and the flow of the documents between the various departments involved. Flowcharts therefore show the flow of work by showing how documents are transferred within a system (and filed) and how they are used.

As they are in the form of a diagram, flowcharts present an immediate visual impact of the system. This can sometimes help the auditor to identify weaknesses in controls more easily than by reading narrative notes.

However, some expertise is needed to draw a good flowchart and to use it to assess the effectiveness of controls. In addition, although flowcharts work well with standard accounting systems and transactions, they may not be appropriate for documenting specialised areas of accounting.

2.2 Levels within a flowchart

Macro

The macro level flowchart is the 'big-picture' executive summary of the system. This is sometimes called the 'Helicopter view' or 10,000 metre above sea level view.

The macro flowchart would be more useful to senior management who need to know broadly what the system does. Lower level employees would need much more detail than provided at the macro level.

Macro level flowcharts typically have fewer than six steps.

Mini

The mini level (also called 'midi') falls somewhere between big picture macro and fine detail micro.

A mini level flowchart typically focuses on just one part from the macro-level flowchart.

Think of this as the plane flying at 3,000 metres above sea level.

Micro

A micro level flowchart provides the most detail and is useful for analysing the way processes operate. Also called 'ground level', the micro view provides a highly details picture of a specific portion of the process by documenting every action and decision.

The micro level flowchart is commonly used to chart how a particular task is performed.

2.3 Different types of flowcharts

There are three main types of flowchart, each of which can be depicted at the macro, mini and micro levels.

Linear

A linear flowchart displays the sequence of work steps that make up a process. This is invaluable in identifying redundant or unnecessary steps within a process.

Deployment

A deployment flowchart shows the actual process flow and identifies the people or groups involved in each step. A deployment chart shows where the people or groups fit into the process sequence and how they relate to one another throughout the process.

Horizontal lines are used to define the customer-supplier relationships.

Opportunity

An opportunity flowchart is a variation on the linear flowchart. The opportunity flowchart differentiates between:

- Process activities that add value – these are essential for producing the required product or service. Without them the output cannot be produced.
- Process activities that add cost only – these are not essential for producing the required product or service, for example waiting for an approval or for some equipment to become available.

2.4 Drawing flowcharts

Symbols

There are six symbols commonly used in flowcharts which have specific meanings and are connected by arrows indicating the flow from one step to another. These are:

Symbol	Description
Oval	Ovals are used to indicate the starting and ending points of the process
Box	A box represents an individual activity or step in the process
Diamond	Diamonds are used to show decision points. These might be yes/no or go/no-go. Each path emerging from the diamond must be labelled with one of the potential answers
Circle	A circle indicates that a particular step is connected within the page. A numerical value shown within a circle indicates the sequence continuation
Pentagon	A pentagon is used to link a particular step of the process to another page or part of the flowchart. Letters are placed in the circle to clarify continuation
Flow line	A flow line indicates the direction flow of the process

Approach to drawing a flowchart

The steps to successfully drawing a flowchart are:

- Big picture – draw a macro-level flowchart first
- Observe the current process – this can be done by walking through the current process and observing it in action
- Record the process steps you observed – note where there are logical groupings of steps
- Arrange the steps in sequence
- Draw the flowchart – this should be drawn exactly as you observed, recorded and sequenced the steps

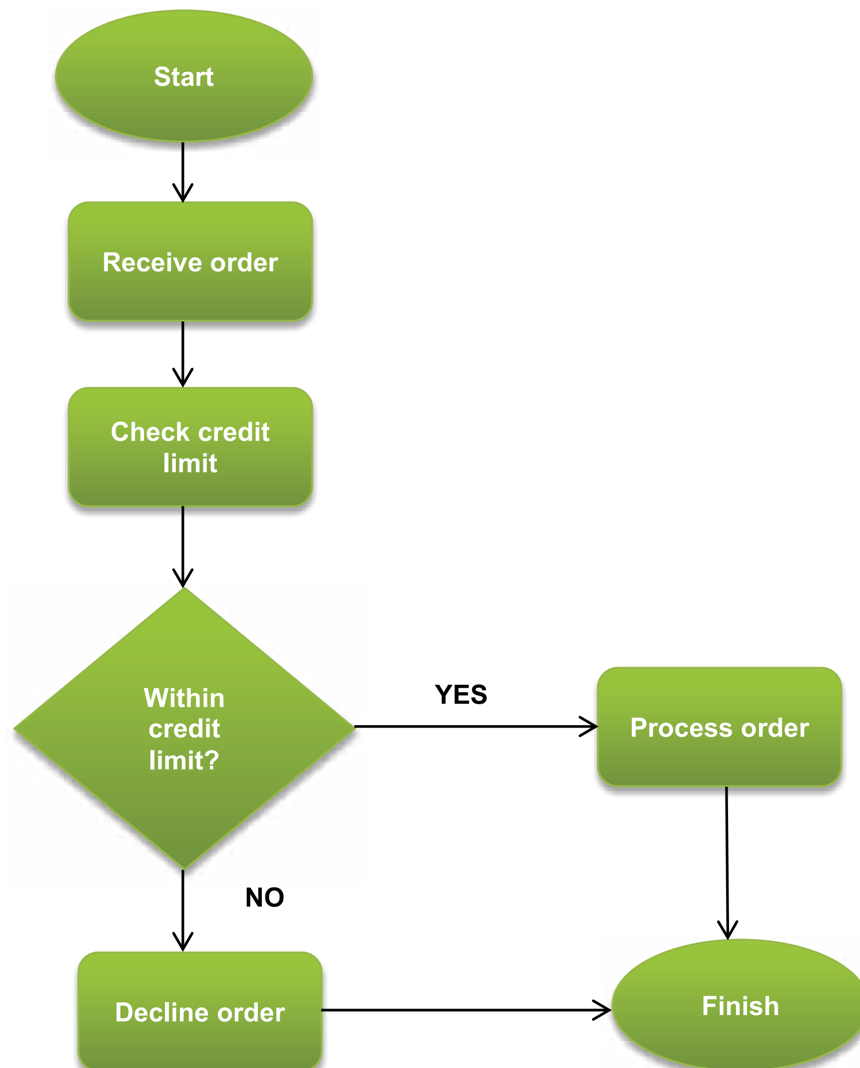
In order to perform the above steps you will need to ensure you are speaking to the right people. Think about who will use the flow chart and how it will be used. Consider any short-cuts in terminology that the readership will understand that you can use to help make the recording process more efficient

Remember to establish the boundaries of the process that you are recording.

According to (Louwers, Ramsay, Sinason, Strawser, & Thibadeau, 2011) the starting point in the system, if possible, should be placed at the upper-left-hand corner. The flow of procedures and documents should be from left to right and from top to bottom as much as is possible. The shapes of the symbols are commonly understood and fairly obvious. For example, rectangles are processes, circles are connectors, quadrilaterals are manual processes, and so on. Narrative explanations should be written on the face of the chart as annotations or in a readily available reference key.

The flowchart must be developed in a way so that it is easily understandable by the audit supervisor. Usually, the flowcharts are created with audit-specific flowcharting software such as Visio and Lucid Chart. However, they can also be easily created with Excel and/or PowerPoint.

Example: Order processing – mini level flowchart



3 IT CONCEPTS

Section overview

- Physical access controls
- Data encryption techniques
- Communications protocol
- Open system interconnection (OSI) model
- System logs
- Controls over data transmission

3.1 Physical access controls

Physical controls that help safeguard IT equipment might include:

- Fences, doors and door-locks
- Alarms
- Surveillance video
- Cables that allow a user to lock a laptop to a desk to prevent a casual thief stealing the laptop
- Fingerprint readers to log-in to a system
- Lockable briefcase

3.2 Data encryption techniques

Encryption is the process of transforming information (referred to as plaintext) using an algorithm (called a cipher) to make it unreadable to anyone except those possessing special knowledge (called a key).

Data can be encrypted in one of two ways:

- At rest – for example in a database or on a flash memory stick
- In transit – when data flows across a network such as via web applications and smart phones.

Many different algorithms are used by encryption software. One popular standard specification is “Advanced Encryption Standard” (AES) which is particularly robust given the length of its key (128+ bits).

Algorithms can be either symmetric or asymmetric key ciphers:

- Symmetric key ciphers – these use related (often identical) keys to both encrypt and decrypt information. This is sometimes called ‘shared secret’ between two or more parties.
- Asymmetric key ciphers – these use different keys to encrypt and decrypt information (one to lock, the other to unlock). This is sometimes called ‘public/private’ key.

There are broadly two types of symmetric key cipher:

- Block ciphers – fixed length blocks are encrypted
- Stream ciphers – data is encrypted one ’data unit’ (typically 1 byte) at a time in the same order it was received. The simplest method is to use translation tables which offset the input blocks across an array of the table. Enhanced encryption can be achieved by combining two or more tables.

Note that any mathematical procedure, encryption algorithms included, is technically reversible. However, the objective of encryption is to ensure that the output at least appears random, otherwise programs can be used to analyse the data and work out the key.

3.3 Communications protocol

A communications protocol is a system of digital rules for message exchange within or between computers.

When systems communicate they use pre-defined formats for exchanging the messages. This ensures that each part of the message is recognized and interpreted by the recipient in the intended fashion.

For each communication a protocol must define:

- Syntax – the arguments used to create the message
- Semantics – how each argument is to be interpreted
- Synchronization – how the sender and receiver will actually exchange the message

Communications protocols are implemented through a combination of hardware and software.

3.4 Open system interconnection (OSI) model

The OSI model has been developed by the world's largest developer of voluntary international standards – the international organisation for standardization (ISO). The ISO develops state of the art specifications for products, services and good practice which help make industry more efficient and effective.

Open system interconnection (OSI) is a conceptual model that standardizes the internal functions of a communication system by partitioning them into seven logical layers. Each layer serves the layer above it and is served by the layer below it.

The seven layers are as follows:

Layer	Data unit	Function
7. Application	Data	Network process to application
6. Presentation	Data	Data representation, encryption and decryption, convert machine dependent data to machine independent data
5. Session	Data	Inter-host communication, managing sessions between applications
4. Transport	Segments	End-to-end connections, reliability and flow control
3. Network	Packet/datagram	Path determination and logical addressing
2. Data link	Frame	Physical addressing
1. Physical	Bit	Media, signal and binary transmission

Describing each in turn:

- Physical – defines electrical and physical specifications for devices – e.g. copper vs. fibre optic cable
- Data link – provides the functional and procedural means to transfer data between network entities and to detect and correct errors that may occur in the physical layer
- Network layer – Provides functional and procedural means of transferring variable length data sequences from a source host on one network to a destination host on a different network
- Transport layer – provides transparent transfer of data between end users providing reliable data transfer services to the upper layers

- Session layer – controls the connections (dialogues) between computers. The session layer establishes, manages and terminates the connections between the local and remote application.
- Presentation layer – establishes context between application-layer entities in which the higher-layer entities may use different syntax and semantics if the presentation service provides a mapping between them
- Application layer – This is the OSI layer closest to the end user as it interacts with software applications that implement a communicating component.

3.5 System logs

A log file is a file that records events taking place in the execution of a system. This generates an audit trail that can be used to understand the activity of the system and to diagnose problems.

Logs are essential for understanding the activities of complex systems and for analysing a system's performance, particularly where there is little user interaction.

Examples of system logs include:

- Which user logged-in, when and where from
- Failed log-in attempts
- Who accessed and amended data in a file
- Changes made to a program – what, when and by whom
- When employees entered and left the building
- Black box flight recorders
- CPU speed
- Broadband speed
- Which web pages a user accessed
- Attempted cyber intrusions

All of the above logs provide essential information that can assist in analysing and improving a system's performance.

3.6 Controls over data transmission

Similar to doctors and lawyers, accountants routinely work with highly confidential client information. They must ensure they comply with the fundamental principle of confidentiality from the accountant's code of ethics.

Controls over data transmission help to ensure data is transmitted both intact (complete and as intended) and also securely without fear of breach of confidentiality.

Controls over data transmission include:

- Programme controls that ensure data is transmitted in the correct format
- Firewalls to prevent intrusion into the programs that send and receive data
- Restricting access to source data that is transmitted
- Only using secured Wi-Fi with password protection
- Using check sums and check digits to ensure that data received is intact
- Data encryption

4 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Describe different methods used for recording internal control systems including narrative notes, questionnaires and flowcharts
- Design basic questionnaires including internal control questionnaires and internal control evaluation questionnaires
- State the benefits and limitations of each method of recording internal controls
- Draw basic flowcharts
- Explain the following IT concepts:
  - Physical access controls
  - Data encryption techniques
  - Communications protocol
  - Open system interconnection (OSI) model
  - System logs
  - Controls over data transmission

CHAPTER 7

Tests of controls

Contents

1 Tests of controls and the main transaction cycles
2 The sales system
3 The purchases and expenses system
4 The payroll system
5 The bank and cash system
6 The inventory system and non-current assets
7 Other issues with tests of controls
8 Chapter review

INTRODUCTION

Learning outcomes

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Performance of audit and reporting

LO 2	**On the successful completion of this paper, candidates will be able to demonstrate working knowledge in respect of performance of simple audit procedures and understand the audit report requirement under the Companies Act, 2017**

Test of controls (ISA 330)

LO 2.7.1	Explain the nature, extent and timing of test of controls using simple examples
LO 2.7.2	Explain the concept of Computer Assisted Audit Techniques
LO 2.7.3	Explain how auditors evaluate the operating effectiveness of controls using simple examples
LO 2.7.4	Explain the controls over major transaction cycles including related risks, weaknesses control objectives and designing appropriate tests of controls

1 TESTS OF CONTROLS AND THE MAIN TRANSACTION CYCLES

Section overview

- Planning tests of controls
- Computer-assisted audit techniques
- The major transaction cycles
- Controls and tests of controls in the exam

1.1 Planning tests of controls

The auditor takes a systems-based approach wherever possible. He focuses on testing the systems and internal controls that produce the financial reporting figures, rather than the figures themselves. If the systems and the controls are satisfactory, the figures produced by the systems should be reliable.

Two conditions are necessary before the auditor can adopt a systems-based approach:

- The systems and controls in place should be **designed** to minimise the risks of misstatements. The auditor carries out this check of controls in his procedures for the documentation and evaluation of the controls.
- The systems and controls should actually **operate** effectively. The auditor gains evidence that the controls operate in practice by performing **tests of control**.

1.2 Computer-assisted audit techniques

Where systems are IT based, specialised techniques of obtaining audit evidence may be required. These are known as **computer-assisted audit techniques** (CAATs).

CAATs can be defined as any technique that enables the auditor to use IT systems as a source of generating audit evidence. They involve the use of computer techniques by the auditor to obtain audit evidence.

- CAATs are often necessary in the audit of IT systems because these systems may not provide an adequate audit trail.
- In addition, processing is 'invisible' because it is electronic. Therefore, the auditor needs to 'get inside the computer' to check the completeness and accuracy of the processing. CAATs allow the auditor to achieve this.

Two commonly-used types of CAATs are:

- audit software, and
- test data.

It is **test data** which is of most relevance to **tests of control**. The technique provides evidence of the operation of specific application controls in a given system. Audit software is more relevant to substantive testing and is therefore considered in a later chapter.

Test data

The use of test data involves the auditor processing a sample of data through the IT system and comparing the results obtained from the processing with pre-determined results.

A potential problem with using test data is that it will only give audit evidence at the time that test data is processed. Procedures may therefore be written into the client entity's computer information systems that will generate data for audit purposes **every time the process is run**. One way of achieving this without corrupting the client's data files with the test data is to establish an extra 'dummy' department, to which the test data results are allocated. Only the auditor should have access to the data stored in this dummy department.

Disadvantages of CAATs

CAATs give the auditor the ability to audit the processing of transactions in an IT system. However, there are some disadvantages of using CAATs. They can be expensive, and the use of CAATs should be evaluated on a cost benefit basis.

The costs related to the use of CAATs may include:

- purchasing or developing the programs
- keeping programs up-to-date for changes in hardware and software
- training audit staff in the use of computer systems to run the CAATs. CAATs are of no value unless auditors are properly trained in how to use them.

Example:

Looking back to the system described in the previous chapter in relation to Dolally, set out four examples of how test data could be used to test that system. You need not restrict the controls you are testing to those in your previous answer.

Answer

1. **Input a dummy order where you are aware that the goods are out of stock and ensure that the order does not lead to a despatch note being produced). (The system above did not specify how this situation would be dealt with. There would probably be some sort of pending orders file, checked against inventory levels daily).**
2. **Input a dummy order where you know that the goods are in stock and ensure that a despatch note is produced. View the despatch note on screen and trace it through to the copy in the distribution centre.**
3. **Input dummy despatch notes without subsequently flagging them up for invoicing and ensure they appear on the exception report.**
4. **Flag up dummy despatch notes and check invoices are raised.**

1.3 The major transaction cycles

The auditor will focus much of his audit work on the major '**transaction cycles**' which taken together cover the majority of the day-to-day transactions of the business.

The major transaction cycles are:

- sales (revenue),
- purchases, and
- payroll.

These three transaction cycles will have a direct effect on both the statement of financial position and the income statement (two statement format) or statement of comprehensive income (one statement format). Tests of control are also applied to key statement of financial position headings linking into the main transaction cycles:

- bank and cash
- inventory, and
- revenue and capital expenditure (non-current assets).

Much of this chapter presents lists of risks, control objectives, suitable controls and tests of controls, for different aspects of the main transaction cycles. These lists are not complete or comprehensive, instead they are intended to provide detailed guidance about how tests of control may be designed and applied.

1.4 Controls and tests of controls in the exam

The exam paper may include a scenario based question that describes a transaction cycle of a client entity. You may be required to identify suitable internal controls and tests of controls that would be appropriate. Alternatively you may be required to comment on control weaknesses in the system.

The following sections of this chapter describe in general terms the control objectives, controls for achieving those objectives and ways of testing the effectiveness of those controls, for each of the main transaction cycles. Remember however that in the exam itself you may be required to apply these general concepts to a specific scenario.

You may find it useful to think about controls and tests of controls in terms of:

- Risks. What are the risks that weaknesses in the transaction processing system could mean that the financial statements do not give a true and fair view?
- What should be the control objective? What is the purpose of having controls? What should the control be intended to achieve, or prevent? The objective of controls should be to eliminate or reduce the risk.
- Having established the reason for needing controls, the next step is to devise controls that will help to achieve the control objective.
- An auditor should be aware of the control objectives for each of the transaction cycles, and should assess the effectiveness of the controls that the client entity has in place to achieve those objectives. (If there are obvious weaknesses in the controls, the auditor should notify these to the client entity's management).
- If the auditor is satisfied that the controls seem adequate, he should devise tests to establish whether they work in practice. The auditor therefore devises and carries out tests of control.

Tests of control should therefore be seen within the context of:

- Risks
- Control objectives
- Controls
- Tests of those controls.

If you are required to suggest suitable tests of controls in answer to an exam question, you should be able to explain **why** the control is needed and how the test will establish the effectiveness of the control. It may help you to present tests of controls in a tabular form in your answer, as follows:

Test of control	Reason for the control

2 THE SALES SYSTEM

Section overview

- Elements of the sales system
- Customer ordering
- Despatch of goods and invoicing
- Recording sales and accounting

2.1 Elements of the sales system

Excluding the collection of payments from credit customers, the main elements of the sales accounting system may be classified as follows:

- Receiving orders from customers
- Dispatching the goods and invoicing customers
- Recording sales and amounts receivable in the accounts

For each of these elements of the system, we can identify risks, control objectives, design internal controls and devise ways of checking whether the controls are applied in practice (tests of control).

2.2 Customer ordering

Risks

So what are the risks in a system of receiving and processing customer orders? The following list is not complete, but contains some of the risks.

- Orders may be accepted from new customers and new customers may be given credit, without checking the customer's references or without formal authorisation of a credit account for the customer with a credit limit.
- Orders may be accepted from existing customers that take them over their credit limit.
- Some orders are overlooked and are not processed. Some orders are processed twice.
- The customer is given a price discount without proper authorisation.

Control objectives

Suitable control objectives may therefore be as follows:

- Giving credit to new customers and existing customers must be controlled, and must be consistent with company policy.
- All orders from customers are processed correctly. Orders should not be processed if they would take the customer above his agreed credit limit.

Principal controls

Suitable controls may be as follows:

- There should be a segregation of duties, and the individuals who process orders from customers should not also carry out credit reference checks on new customers or credit limit checks on existing customers. The latter could be done manually by reference to a file of approved credit limits, or it could be a programmed control whereby the system will only accept an order if the customer will still be within his credit limit.

- All new customer accounts, and their credit limit, should be authorised.
- Orders should be recorded on sequentially-numbered documents or the system should allocate sequential numbers to documents.
- For every sales order, a despatch note should be produced (manually, or generated by the system from the order details). Goods should not be despatched to customers without a despatch note.

Tests of control

How might an auditor test whether these controls are actually applied in practice? The client can assist the auditor by collecting evidence that the controls have been applied. One way of doing this is to use the customer order document to record that checks have been completed; for example, by providing space on the order form for individuals to sign their name or write their initials as confirmation that they have carried out a particular task.

Here are some suggested tests of control:

- The auditor can establish which individuals take orders and process them, and which individuals carry out credit reference checks on new customers and credit limit checks on existing customers. The auditor could observe these individuals to see if procedures are being properly followed. In an IT system he could use test data to check that orders which would take a customer over his credit limit would be rejected by the system.
- Further evidence that credit checks have been carried out can be checked by looking at the signatures or initials of credit checking staff on customer orders or by using test data as described above.
- Evidence that new customer accounts have been approved should be checked by looking for the signature of the manager giving the authorisation on the appropriate approval document.
- The auditor can look at lists of customer orders, sequentially numbered, and confirm that for every customer order there is a despatch note number. Alternatively, for an integrated IT system, he can follow test data through from order to despatch note and confirm that sequences are complete by viewing documents on screen.

It is important to remember that this list of controls and tests of controls is not complete, but it may help you to understand the process by which tests of control are carried out, and the way in which they should give the auditor the evidence that he needs for a systems-based approach to the audit. You need to take care in the exam that the controls or tests of controls you suggest are appropriate to the system described, taking careful note of which parts of the system are manual and which are IT-based. The control objectives will be the same for both types of systems – it is the specific controls (and therefore also tests of controls) that will sometimes be different.

2.3 Despatch of goods and invoicing

The same approach can be applied to the despatch of goods and invoicing.

Risks

Here are some of the risks in this part of the sales system:

- For some customer orders, goods are not despatched, or the goods are despatched twice.
- Goods are despatched to customers who do not have sufficient credit (either because no credit terms have been agreed, in the case of a new customer, or because the order takes an existing customer above his credit limit).
- Invoices are not produced for goods that have been despatched to some customers.
- Customers may claim that they did not receive the goods that have actually been delivered to them.
- Returns from customers are not properly recorded, so that the client company does not know the correct figure for sales net of sales returns.

Control objectives

Control objectives may therefore be as follows:

- Goods should be despatched for every authorised customer order.
- Goods should not be despatched twice, for the same sales order.
- Customers should acknowledge the receipt of goods.
- For every despatch note, there must be an invoice.
- Invoices should be for the correct amount.
- For all goods returned by customers, there must be an authorised credit note.

Principal controls

Suitable controls may be as follows:

- Despatch notes or Goods Delivery Notes (GDNs) should be numbered sequentially, and should be attached to a copy of a specific customer order. The GDN should be signed by an authorised member of the despatch staff. Sequential numbering of GDNs allows a check to be made that all deliveries can be accounted for.
- Customers should sign a delivery note for the receipt of goods, as confirmation of receipt.
- The signed delivery note should be attached to a copy of the despatch note and customer order. Copies of these documents should be transferred to the accounts department after despatch, so that a sales invoice can be produced.
- Each sales invoice should be linked to a copy of the despatch note and customer order or produced automatically from them.
- Sales invoices should be sequentially numbered or the system should allocate sequential numbers to documents.
- There should be a segregation of duties, and the individuals who despatch goods should not be the same as those who prepare sales invoices or process the customer orders.
- Credit notes should be sequentially numbered and authorised.
- There should be periodic checks by someone in the accounts staff on the accuracy of invoices or strong IT controls to ensure the accuracy of invoices.

Tests of control

The auditor needs to test whether these controls operate properly. Here are some suggested tests of control:

- Some delivery notes should be checked to confirm that customers do sign them.
- The auditor can check that the segregation of duties does exist.
- There should be a check to ensure that all GDNs have been sequentially numbered, and that if there is any non-sequential numbering of GDNs an error report has been produced by the system to explain the reason for the error.
- The auditor should check that (sequential) lists of invoices show a customer order number and a despatch note number.
- The auditor should check a list of credit notes to make sure that they cross-refer to a sales invoice number.
- Credit notes should be checked to make sure that they contain the authorisation signature of the appropriate manager or have been raised, on the computer, only by a member of staff with authority to do so.
- The auditor can observe the despatch process in operation.
- There should be documentary evidence that a member of the accounts staff has carried out arithmetical checks on the accuracy of invoices. Alternatively, the auditor may prove that there are strong IT controls which will ensure the accuracy of invoices by checking the calculations himself.

Remember that for each test of control, there should be a purpose. In other words, what control is being tested and how does the test succeed in doing this? For example:

Test of control	Reason for the control
Review error reports on non-numerical sequencing of GDNs and ask about action taken to investigate or deal with the error.	Test to ensure that all GDNs have been in numerical sequence, and if not that errors can be satisfactorily explained.
Test a sample of GDNs for the customer's signature	To ensure that the customer did receive the goods and has acknowledged receipt.
Observe the despatch process	To check that goods are despatched only where a GDN exists and that the goods actually despatched correspond with the details on the GDN.
Observe the credit checking process	To ensure that authorisation is not given for the despatch of goods if this would take the customer over his credit limit.

2.4 Recording sales and accounting

Again, a similar approach can be taken in identifying tests of control for the recording of sales in the accounting system.

Risks and control objectives

Here are some of the risks and control objectives in this part of the sales system:

- There is a risk that invoices and credit notes may not be recorded in the accounting system. A control objective is to ensure that they are all recorded.
- There is a risk that invoices and credit notes are recorded in the wrong customer accounts. A control objective is to prevent this from happening, or to detect errors when they do occur.
- There is a risk that debts may be written off as uncollectable ('bad') without proper consideration. A control objective is to make sure that this does not happen.

Principal controls

Suitable controls may be as follows:

- Invoices and credit notes should be sequentially numbered.
- Regular statements should be sent to customers.
- Control account reconciliations should be carried out on trade receivables.
- Bad debts must be authorised.
- There are procedures for identification and follow-up of overdue accounts and unpaid invoices.

Tests of control

Here are some suggested tests of control:

- Lists of invoices and credit notes can be checked to make sure that there is sequential numbering or documents can be viewed on screen.
- There should be a segregation of duties between the individuals who prepare and send out invoices, and individuals who collect payments, and individuals who follow up late payments.
- The auditor can check that statements are produced and despatched to customers.

- The auditor can look for documentary evidence that control total checks have been made.
- There should be documentary evidence that proper authorisation is given for a debt to be written off as bad.
- There should be individuals responsible for collecting overdue debts, and evidence of their work. Alternatively the auditor might check that an exception report is regularly produced by the system, listing all overdue debts, and look for evidence that this is followed up.

3 THE PURCHASES AND EXPENSES SYSTEM

Section overview

- Elements of the purchases and expenses system
- Placing orders
- Receiving goods and invoices
- Recording and accounting for purchases and expenses

3.1 Elements of the purchases and expenses system

Excluding the procedures for making payments to suppliers, the main elements of the accounting system for purchases and other expenses may be classified as follows:

- Placing orders
- Receiving goods (or services) and receiving invoices
- Recording and accounting for purchases and expenses.

The same basic approach to devising tests of control can be taken as for the sales system. The risks, control objectives, controls and tests of control listed here are not comprehensive. They are intended to show you the approach that can be taken.

Again, the control objectives will be the same for all systems, but the controls and therefore tests of controls, are likely to differ to some extent between manual and IT systems.

3.2 Placing orders

Risks

So what are the risks in a system of ordering goods or services from suppliers? The following list is not complete, but contains some of the risks:

- Orders for goods or services are made without approval or authorisation.
- Orders may be placed with suppliers who are not on the 'approved list'.
- For large orders, suppliers are not asked to submit tenders. When suppliers are asked to tender, the order might not be given to the supplier quoting the lowest price.

Control objectives

Suitable control objectives may therefore be as follows:

- All purchase orders must be properly authorised.
- Orders should not be placed with 'non-approved' suppliers.
- Competitive price quotations should be obtained for all large orders.

Principal controls

Suitable controls may be as follows:

- There should be a segregation of duties. Individuals who make a requisition for new supplies of inventory should not be the individuals who place the order with the supplier.
- Purchase orders should be sequentially numbered.
- There should be a procedure for placing suppliers on the 'approved list'. In an IT system, physical controls must exist over access to the master file of approved suppliers.
- All orders must be placed with suppliers on an approved list. The purchase order may include an 'approved supplier reference number'. In an IT system the system must only be able to address orders to approved suppliers as on the master file.

- Orders above a certain value must be authorised by a senior manager, who should confirm that competitive tenders have been obtained from suppliers.

Tests of control

Here are some suggested tests of control:

- The auditor can check that the segregation of duties does exist.
- The auditor can look at lists of sequentially-numbered purchase orders or view documents on screen. Alternatively, he could submit test data in the form of an order and check it is allocated the next number in the sequence.
- The auditor should ask management to provide documentary evidence that the procedure for placing suppliers on the approved list operates as intended. In an IT system, the controls over the master file of approved suppliers will need to be tested.
- Purchase orders can be checked to make sure that they contain an approved supplier reference number.
- Large orders can be checked for management authorisation.

3.3 Receiving goods and invoices

Risks and control objectives

Here are some risks and control objectives for this part of the purchases transaction cycle:

- There is a risk that goods may be accepted from a supplier without having been ordered. Or suppliers may claim to have delivered goods, but may actually not have done so. A control objective is therefore to make sure that all receipts of goods are recorded and checked against a purchase order.
- There is a risk that the company may fail to claim discounts from suppliers for orders above a certain size, or as regular customers of the supplier. A control objective should be that discounts are given by suppliers where these are available.
- There is a risk that suppliers may invoice for goods that have not actually been provided. A control objective is to prevent this from happening, or detect when it does happen.

Principal controls

In this area there is little difference between manual and IT systems as this part of an IT system will be dependent on controls over the physical receipt of goods and invoices, which will be carried out by employees as opposed to by a computer program. Suitable controls may be as follows:

- A copy of all delivery notes should be retained, with a signature of the member of staff who took receipt and checked the goods.
- Goods received notes should be produced for each delivery, from the delivery note or after a physical count of the items received.
- A member of the accounts staff or purchasing staff must be responsible for checking discounts allowed by suppliers.
- There should be a segregation of duties between the individuals who take delivery of goods, those who place the orders and those who record the purchase invoices in the accounting system.
- All purchase invoices should be checked against a purchase order and a goods received note.

Tests of control

Here are some suggested tests of control:

- The auditor should check that delivery notes, goods received notes and purchase invoices are matched with each other. There should be evidence that they have been checked against each other; for example, the person making the check should sign or initial the purchase invoice.
- The auditor should look for any evidence that invoices, purchase orders or goods received notes cannot be properly matched (indicating that the controls are not working in practice and a control objective is not being achieved).
- The auditor should look for documentary evidence that discounts are checked and claimed from suppliers when available.
- The auditor should check that the segregation of duties does exist.

3.4 Recording and accounting for purchases and expenses

Risks and control objectives

Here are some risks and control objectives for this part of the purchases transaction cycle:

- There is a risk that purchase invoices will be recorded for goods or services that were not provided. A control objective is to make sure that this does not happen.
- There is a risk that purchase invoices will be incorrectly recorded in the accounts of suppliers. A control objective is to identify and correct any such errors that may occur.
- There is a risk that credit will not be claimed from suppliers for goods returned. A control objective is to make sure that credit is taken for purchase returns.

Principal controls

Suitable controls may be as follows:

- Purchase invoices must be checked against purchase orders before they are recorded in the accounts. If the purchase order number is not printed on an invoice, it should be written on the invoice by the individual making the check or entered onto the system alongside the invoice details.
- Regular statements should be received from suppliers, and the balance on the statement should be checked against the account balance in the trade payables ledger.
- There should be regular control account reconciliations for trade payables.
- A debit note should be created each time that goods are returned to a supplier. Debit notes should be sequentially numbered and matched with the supplier's credit note when it is received. An IT system could produce a regular exception report of unmatched debit notes for follow up by an employee.

Tests of control

Here are some suggested tests of control:

- The auditor should look for evidence that purchase invoices are matched against purchase orders. Evidence may be provided by a signature or initials on the purchase invoice of the individual making the check or by checking references on screen.
- There should be evidence that statements from suppliers are checked and approved. Again, evidence may be provided by a signature or initials on statements of the individual making the check.
- The auditor should look for documentary evidence of control account reconciliations.
- The auditor should be able to check a list of sequentially-numbered debit notes, cross-referenced to a supplier's credit note.

4 THE PAYROLL SYSTEM

Section overview

- Elements of the payroll system
- Calculating gross wages and salaries
- The calculation of tax and other deductions
- Recording wages and salaries payable in the accounts
- Payment of wages and salaries
- Possible control weaknesses in a payroll system

4.1 Elements of the payroll system

A similar approach can be taken to designing tests of controls in the payroll system. Elements of the payroll system may be classified as follows:

- Calculating gross wages and salaries
- Recording wages and salaries payable in the accounts
- The calculation of tax and other deductions from wages and salaries
- The payment of wages and salaries.

Some risks, control objectives, principal controls and tests of control are suggested below for each element of the payroll transaction cycle. However, the control objectives, principal controls and tests of control are now presented in tabular form, for ease of reading.

4.2 Calculating gross wages and salaries

Risks

- Wages and salaries may be paid to individuals who are not employees.
- Employees may be paid for work they have not done.
- Gross wages and salaries could be calculated incorrectly.
- Taxation and other deductions could be calculated incorrectly.

Control objectives

- Ensure that only 'real' employees are paid: for example wages or salaries should not continue to be paid to former employees who have now left, or that payments are not made to 'phantom' employees.
- Ensure that employees are paid only for work they have done: for example to make sure that employees are not paid for overtime work if they have not done it.
- Ensure that gross pay, deductions (tax and other deductions) and net pay are calculated correctly.

Examples of control objectives	Examples of principal controls	Tests of control
Wages and salaries should not be paid to individuals who are not employees.,	There should be a segregation of duties: the individual responsible for preparing wages and salaries should not be the person who actually pays them.	The auditor can check that the segregation of duties does exist.
	The gross pay for each individual employee should be authorised by an appropriate person.	The auditor should check that departmental payroll lists are properly authorised.
	There should be formal authorisation of new employees.	Documentation for authorising new employees and putting them on the payroll file (manual or computerised) should be checked.
Salaries should be calculated correctly.	There should be formal personnel records, giving details of each employee and his or her rate of pay, and dates of starting and leaving employment.	The payroll file should be checked.
Employees paid time-based wages should only be paid for time they have worked.	There should be time sheets for hourly-based employees, and these should be authorised by an appropriate supervisor.	Time sheets can be checked. These should include the signature of the manager or supervisor confirming the hours worked by the individual employee.
	Alternatively, a clock card system might operate.	For a clock card system, the auditor will need to test the controls in operation (such as to ensure that employees cannot clock in for each other).
Payments should not be made except for work done and unless properly authorised. Payroll calculations should be accurate.	A senior manager should check the total payroll cost each week or month, to make sure that the total amount does not appear excessive.	Authorised payroll lists should be checked. These should contain the signature or initials of the manager who checked the list.
	In a computerised payroll system, exception reports might also be produced, for example, reporting gross wages over pre-set parameters and then followed up by management.	Test data could be used to check that the exception reporting system is working properly. Exception reports could be reviewed for evidence of follow up (e.g. annotated explanations).
	Bonus payments to individuals must be authorised.	Check a sample of bonus payments to ensure that the payments are properly calculated and authorised.

4.3 The calculation of tax and other deductions

Examples of control objectives	Examples of principal controls	Tests of control
Taxation and other deductions from pay should be calculated correctly.	Payroll procedures (IT or manual) should provide for the deduction of all appropriate deductions, using up-to-date rates of tax.	The auditor can review any manual procedures for calculating deductions, and the tax rates used. In an IT system, general IT controls will be important to check that the system was properly developed, tested and implemented. Test data could be used and results compared to independently calculated figures.
Voluntary deductions from pay (for example, for pension contributions) should only be made with the consent of the employee.	Senior management should check the total amount of deductions each week or month.	The auditor can check that a senior manager has approved total deductions, evidenced by his or her signature on the appropriate document.
	All voluntary deductions must be authorised in writing by the employee, and this written authorisation should be kept in the payroll file.	The payroll file can be checked against the calculation of deductions in employee wages or salaries, to confirm that voluntary deductions are authorised.

4.4 Recording wages and salaries payable in the accounts

Risk and control objective

The principal risk is that gross pay, deductions and net pay may not be properly recorded in the accounts. The control objective should therefore be to ensure that gross pay, deductions and net pay are all properly and accurately recorded in the accounts.

Examples of control objectives	Examples of principal controls	Tests of control
Gross pay, deductions and net pay should be properly and accurately recorded in the accounts.	The accounts are prepared from payroll data that has been approved by a senior manager.	There should be evidence that the payroll has been formally approved. (In an integrated IT system, the nominal ledger accounts will be automatically updated.)
	Accounting for payroll should be completed within a strict timescale.	There should be checks on the procedures for recording payroll and the time within which the work is done.
	There should be control accounts for payroll, with regular reconciliations between control totals and the payroll records of all individual employees.	There should be documentary evidence of control account reconciliations and review of these reconciliations.

4.5 Payment of wages and salaries

Risks

- Incorrect amounts of net pay could be paid over to employees.
- Incorrect amounts of deductions could be paid over to the authorities.
- Payment could be made to the wrong employee.

Examples of control objectives	Examples of principal controls	Tests of control
The correct amounts of net pay should be paid to employees.	When wages and salaries are paid by automated bank transfer, the list of payments should be authorised by an appropriate manager.	Authorised lists of payments can be checked.
The correct amount of deductions is paid to the appropriate authority (for example, the tax authority).	There should be formal procedures and a formal timetable for the payment of deductions, and recording payments in the accounts.	The procedures for payments of deductions and manual recording of payments in the accounts can be checked. (In an integrated IT system, the nominal ledger accounts will be automatically updated for deductions.)
Payments of net wages and salaries are made only to the proper person (the employee).	Bank statements should be used to check that payments have been properly recorded in the accounts.	Evidence of bank reconciliation checks can be obtained.
Payments are correctly recorded in the accounts.	There should be controls within the accounting system to ensure that there is reconciliation between total amounts payable and total paid.	The accounts can be checked to confirm that payrolls each week or month (total payable and total paid) are reconciled. Again, this will not be necessary in an integrated IT system, provided that the auditor is satisfied that the system is working properly, perhaps by processing a "dummy" payroll run.

Note: The suggested control objectives, controls and tests of control in the above table assume that all wages and salaries are paid by bank transfer. When payments of wages are in cash, or where casual labour is paid in cash, additional controls will be needed.

4.6 Possible control weaknesses in a payroll system

Remember that in the exam, you may be asked to identify control weaknesses in a payroll system, given information about procedures in a client entity described in a scenario based question. The following are possible weaknesses that may exist.

- Weaknesses in the system for recording time spent at work. When employees are paid by the hour, there will be a system of 'clocking on' and 'clocking off', typically using employee identity cards and a time recording device. Alternatively, employees may be required to arrive at work at a given time, and use identity cards and a recording device to record their arrival at work. The risk is that employees will 'clock on' on behalf of a colleague, using the identity card that the colleague has given him. (A control to prevent this from happening is that the 'clocking on' process should be carried out using biometric attendance system

where attendance of the employee will be marked by recognising him/her through his facial image, finger prints, iris prints or voice)

- Overtime payments may not be properly authorised. Is the overtime authorised? If so, has the amount of the payment been checked and authorised?
- Responsibility for making the payroll payments. The actual payments of wages and salaries (often direct payments through the banking system) may be made by a junior person in the accounts department without proper authorisation.
- The payroll lists for each department may not be properly authorised. This creates a risk that payments may be made to 'phantom' employees.

Some weaknesses in a payroll system may be risks that are common to other types of IT system too, for example:

- Weaknesses in the use of passwords. An IT system may use passwords to prevent unauthorised access to files and records. However, the passwords used may be 'guessed at', particularly if they are names of family members or domestic pets, or names included in home addresses.
- Passwords should be difficult to guess (ideally a combination of letters and numbers) and should be changed regularly.
- Weaknesses in the use of e-mails. Important information may be sent by e-mail. However, since the information is not on paper (in 'hard copy' form) there is a greater risk that it will be overlooked or forgotten. In a payroll system, notification that employees have left their job may be sent to the payroll department by e-mail. If the e-mail is not acted upon, there is a risk that former employees will continue to be paid, even after they have left.

5 THE BANK AND CASH SYSTEM

Section overview

- Risks and control objectives
- Principal controls and tests of control
- Petty cash

5.1 Risks and control objectives

Bank and cash is often one of the most sensitive areas of an audit, in the sense that it is the asset which is most likely to be misappropriated. However, it may not be an area of high audit risk in practice, because the client company should be aware of the potential high level of risk and should therefore set up appropriate control systems.

Auditors will be particularly interested in establishing that **all** receipts belonging to the organisation have been recorded – **completeness** is a key assertion in the area of cash receipts.

The term 'cash' is used below to mean both notes and coins, and also money in a bank account. Many entities try to reduce the risks of misappropriation of cash (banknotes) by arranging receipts and payments through their bank.

Cash payments are also an area of potential risk. Payments might be made to unauthorised persons, or individuals might be paid more than they should be paid.

Some control objectives for cash might therefore be as follows:

- All money received is recorded.
- All money received is banked.
- All money held as cheques, notes and coins is properly safeguarded.
- All payments are properly authorised.

5.2 Principal controls and tests of control

Some of the principal controls for cash, and tests of those controls, are suggested below:

Control objectives	Principal controls	Tests of control
All money received is recorded	There should be segregation of duties. The handling of cash should be kept separate from other accounting functions.	Check that segregation of duties does exist.
	Controls over receipts by post	**Controls over receipts by post**
	There should be supervision of the opening of mail. There should be a listing of all money received. Mail and cheques should be date-stamped.	Observe that mail opening and cash handling procedures are being followed. Check amounts recorded as receipts from customers against the remittance advices (document from the customer confirming the amount paid).

Control objectives	Principal controls	Tests of control
	Cash sales	**Cash sales**
	Only a restricted number of employees should be authorised to receive cash. Cash tills and till rolls should be used to record cash sales. Another person should check the actual cash received against the till roll total. Restrict the employees who are able to receive cash If the till rolls are not produced, receipts should be given for cash receipts, and a copy of receipts retained. Receipts should be sequentially numbered.	Check amounts in receipt books or on till rolls to paying-in slips, the cash book and bank statements. Check whether bankings are made daily. Check payments out of cash takings, if any. Check for evidence that till roll totals or receipts totals are checked against cash received by an authorised person.
All money received is banked	There should be daily banking, if possible. The amount of cash payments received should be recorded, and subsequently checked against the amount banked.	Check the frequency of banking receipts. Check that receipts are recorded in the cash book and that the bank statement matches the cash receipts recorded on a daily basis.
Proper safeguards should exist over money held	**Bank** There should be established procedures for opening new bank accounts. There should be restrictions on individuals authorised to prepare and hold cheques. There should be safe custody of cheque books. In a manual system there should be no pre-signed cheques. In an IT system there must be strong physical controls over access to pre-signed cheques, such as being kept in a safe until the next payment run and batch and control totals used over cheque numbers.	**Bank** Confirm that new bank accounts have only been opened under established procedures. Observe which individuals are involved with company cheques. Enquire as to custody of cheque books and check to see whether any cheques are blank and pre-signed. In an IT system, observe a payment run and that pre-signed cheques are removed from the safe immediately before being printed and returned immediately afterwards. Arrange for a cheque to be missed out of the run and ensure the system flags it up as missing.

Control objectives	Principal controls	Tests of control
	Cash Notes and coin should be kept in a secure place, such as a safe. Only a very limited number of employees should have access to the cash. Receipts of cash and payments of cash must be recorded.	**Cash** Review the nature of cash payments made. Observe cash custody procedures.
All payments should be properly authorised, made to the correct person and are properly recorded	**Cheque payments** Cheque requisition forms should be used to request payments, backed by supporting documentation. Cancellation of documentation once cheque has been prepared. There should be established authority levels for cheque signing (usually two signatures required for cheques above a certain amount). Payments must be recorded promptly. All cheques must be numbered sequentially.	**Cheque payments** Review paid cheques for payee, date, amount and signature. Agree payments in the cheque book or BACS listing to entries in the accounting records, bank statements and supplier statements. Review the documents supporting requisitions for payment. Review the sequence of cheque numbers (see also above under safeguarding pre-signed cheques).

5.3 Petty cash

Control objectives

There should be several control objectives for petty cash.

- To avoid or reduce the risk of petty cash being stolen.
- To ensure that all spending out of petty cash is properly authorised.
- To ensure that only the correct amounts of cash are withdrawn from the bank to go into petty cash.
- To ensure that all spending out of petty cash is accounted for.

Controls

The controls that commonly apply to petty cash systems (where the imprest system is used) are as follows.

- The maximum amount held in petty cash should be restricted to about one month of petty cash spending. This is to avoid holding unnecessarily large amounts of cash that might be stolen.
- Petty cash should be kept in a locked cash box in the office safe, or if there is no safe in a locked drawer in the accountant’s desk. This is a basic physical control over cash.

- All withdrawals of petty cash should be recorded on a petty cash voucher and vouchers must be sequentially numbered. This is to prevent the fraudulent withdrawal of cash and failures to record cash withdrawals
- All petty cash spending should be authorised in advance by a properly authorised person (and not by the person withdrawing the cash). Authorisation should be indicated by signing and dating the petty cash voucher which is kept in the petty cash box until the petty cash is 'topped up' the next time and the petty cash expenses are recorded in the petty cash book.
- Receipts should be provided for petty cash spending and attached to the petty cash voucher.
- When money is withdrawn from the bank to 'top up' petty cash, the amount of the cheque for the cash withdrawal should be checked against the total of the petty cash vouchers in the petty cash box. The amount of cash withdrawn should equal the total on the petty cash vouchers since the previous cash withdrawal from the bank.
- There should be occasional checks of petty cash by a senior person (not the person responsible for holding and issuing petty cash) to ensure that the person responsible for holding petty cash has not been taking money fraudulently.
- There should be a system for the regular recording of petty cash expenses in the petty cash book. Each entry in the petty cash book should include the voucher number, to provide a check that all expenses are recorded (a check on completeness).

6 THE INVENTORY SYSTEM AND NON-CURRENT ASSETS

Section overview

- The inventory system
- Non-current assets

6.1 The inventory system

Inventory is often a 'material' aspect of the financial statements and can also be a relatively high risk area. Consequently, the auditor will usually want some assurance as to controls in place for inventory.

The tests of control suggested below do **not** repeat tests which have been dealt with in respect of sales and purchases. The tests here focus on other aspects, primarily inventory movements and security. Audit work on the accuracy, valuation and allocation of inventory is normally performed at the substantive testing stage and will be dealt with in a later chapter.

The main **risks** associated with inventory are as follows:

- Inventory records are inaccurate.
- Inventory may be stolen or damaged.
- Inventory may be valued at incorrect amounts.
- Too little inventory may be held, so that customers' orders cannot be fulfilled.
- Too much inventory may be held, and therefore too much money tied up.

Control objectives	Principal controls	Tests of control
Recording inventory		
Inventory records should be complete, accurate and include only items belonging to the company. All inventory movements should be recorded and authorised.	There should be segregation of duties (ordering inventory, custody of inventory, accounting for inventory). There should be proper documentation for all issues of inventory from the store. All goods received should be checked and recorded Appropriate inventory records should be properly maintained.	The auditor can look for evidence that inventory movements (as recorded in the inventory department) agree with despatch documents and goods received documents. The auditor should look for documentation providing evidence that inventory movements are properly authorised.
Physical safeguards		
Inventory is protected against loss and damage.	There should be restricted access to storage areas. Regular inventory counts should be performed using appropriate procedures.	The auditor should look for compliance with access restrictions. The auditor should obtain confirmation that periodic inventory counts are performed, and that counts are checked against records of what inventory levels should be.

Control objectives	Principal controls	Tests of control
Valuation		
Inventory should be correctly valued at the lower of cost and net realisable value.	IAS 2 should be applied. There should be procedures for identifying obsolete and slow moving inventory items.	The auditor should look for evidence of how inventory valuations are reviewed, in order to apply the principles of IAS 2.
Inventory management		
Appropriate levels of inventory should be held at all times.	There should be maximum and minimum inventory levels for all inventory items of value. There should be appropriate re-order levels and re-order quantities.	The auditor should carry out a review for excessive inventory levels (possibly via exception reports in an IT system). (This check is often performed in conjunction with the inventory count or 'stock take"). The auditor should also monitor the frequency of out-of-stock situations.

6.2 Non-current assets

The main **risks** associated with non-current assets are as follows:

- Non-current assets which the company does not need could be ordered.
- Expenditure on non-current assets may be recorded at incorrect amounts, or as revenue instead of capital expenditure.

Control objectives	Principal controls	Tests of control
Authorisation		
All expenditure on non-current assets should be properly authorised.	Appropriate authorisation procedures should be in place. Documentation and analysis should be produced to support (capital) expenditure requests. There should be approval procedures for the payment of invoices to the suppliers of non-current assets.	Many tests of control for the purchase of non-current assets are similar to those for the purchase of inventory items. The auditor should also look for documentary evidence of capital expenditure authorisations.
Recording		
All expenditure on non-current assets should be properly recorded. Expenditure should be properly analysed as capital or revenue.	Invoices must be analysed and account codes entered on the invoices. Management should review the analysis of purchased items as capital or revenue items, to ensure compliance with standard accounting practice.	The auditor should check the capital/revenue analysis of invoices. The auditor should check that entries are made in the non-current asset register.

7 OTHER ISSUES WITH TESTS OF CONTROLS

Section overview

- Tests of controls in smaller entities
- Exam technique: generating controls and tests of control

7.1 Tests of controls in smaller entities

Control systems in smaller entities are often less sophisticated than those in larger organisations. This is largely due to a lack of resources. In particular, a proper segregation of duties is often very difficult in small entities. It is also likely in small entities that there will be extensive involvement in control activity by senior management or the entity's owner.

In the case of smaller entities, the auditor will look for the existence of 'minimum business controls'. The minimum business controls should be identified, recorded and tested, as in any other type of control system.

The auditor is unlikely to be able to use the controls existing in a small entity as a basis for using a systems-based approach to the audit; therefore, a large amount of substantive testing is likely to be adopted. However, the auditor may be able to rely on the controls which are in place as a means of gaining assurance on certain aspects of the audit, for example on the completeness of the accounting records.

7.2 Exam technique: generating controls and tests of control

Most of this chapter has presented lists of risks, control objectives, internal controls and tests of control, for different aspects of business and accounting operations. You do not have to learn all these lists, because each accounting system and each business is different. Their control objectives and appropriate controls also differ.

What you may need to be able to do in the exam is to apply general principles to any particular system or business described in an exam question.

The approach that we recommend is the approach that has been explained and illustrated in this chapter. However, it is extremely important that you should understand this approach so that you can apply it in the exam. It is worth summarising again!

- Consider the things that could go wrong with the system. This should give you the **risks.**
- Consider what the controls will need to achieve in order to mitigate those risks. This should give you the **control objectives**.
- Think of **controls** which would help to **prevent** or **detect** the problem. You may be able to base these on some of the examples given in this chapter. Alternatively, you may find it helpful to use the list of control activities from ISA 315 and their sub-types (performance reviews (including management controls), application controls (including authorisation, arithmetic and accounting controls), general IT controls, physical controls and segregation of duties).
- Design audit procedures to **test** the operation of the control. In doing this, you may find it helpful to think of the key audit testing procedures – inspection, observation, enquiry, confirmation, re-calculation and re-performance and to consider the use of test data.

Example:

Your audit client operates a chain of fast-food restaurants. Six types of standard meals are available and are heated when customers place their orders. The meals are ordered weekly by the restaurant managers from the distribution centre at head office. At the end of each week, unused meals from the previous week are sent back to the distribution centre for disposal.

Required

List the controls which your client should have in operation to prevent losses to the entity as a result of the above system.

Answer

- Managers should be required to produce a monthly reconciliation of meals bought, meals sold and meals returned to head office.
- Meals sold per this reconciliation should be agreed to the monthly sales figure (a difference could indicate theft).
- Where returns are above a pre-determined level, management at head office should investigate to identify over-ordering or a downturn in demand.
- Where returns are very low, management at head office should investigate to ensure that customers have not been turned away due to a lack of inventory.
- Strict physical controls should operate to ensure that inventory is not damaged in transit (e.g. refrigerated lorries) or once at the branch (e.g. sufficient, properly working refrigerators).
- Authorisation limits should be set for the number of meals any branch can order (based on budgets and past usage).
- Head office should carry out surprise inventory counts at branches.

As an alternative, the examiner might require you to identify the risks to which a business might be exposed as a result of poor internal controls. These risks are the same as the control objectives not being met (for example, for sales, the risk that not all goods despatched are invoiced). However, you could also be asked to set out the **consequences of those risks** and suggest **controls** which would address them.

Example:

An entity selling goods on credit terms is exposed to the risk of invoicing errors.

Required

Set out the possible consequences of the above risk and suggest suitable internal controls which could be implemented to address the above risk.

Answer

Possible consequences

- Sales and receivables will be misstated.
- Customer goodwill may be lost if they are charged too high a price (especially if this happens repeatedly).
- The time taken to correct the errors will result in delays in the payment of invoices by customers and could lead to cash flow problems. (If customers have been undercharged the difference may never be recovered.)
- If process charged or quantities entered are too low goods could be despatched to customers who would have been over their credit limits if the correct price had been charged. Again, this may result in the non-recovery of debts.

Internal controls to address

- Invoice checked for accuracy with respect to despatch note details, price list and any discounts agreed with that customer (or generally available for bulk purchases) and casts checked.
- Or, in an IT system, invoice produced automatically with strong physical controls over master files and good general IT controls).
- Data entry edit controls (e.g. field and range checks) if invoices are raised individually but then put onto an IT system.
- Independent authorisation of amendments to customer details and price lists.
- Amendments to standing data printed out and reviewed.

Example:

Using the list of internal controls in the example immediately above, set out the audit procedures you could use to test the operation of each of those controls.

Answer

- Select a sample of sales invoices, check costs and agree to details per despatch note, master price list and bulk/customer specific discounts.
- Input a sample of dummy despatch notes and ensure invoice generated by the system is accurate.
- Input a sample of dummy sales invoices, with prices/amounts outside the preset parameters and with incomplete files to ensure these are rejected by the system.
- Review amendment forms for customer details or prices and ensure properly authorised.
- Review print outs of standing data amendments for evidence of review.

8 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Understand the key transaction cycles and associated controls for
  - Sales
  - Purchases & expenses
  - Payroll
  - Bank and cash
  - Inventory
  - Non-current assets
  - Discuss controls in smaller entities
  - Plan tests of controls
  - Describe computer assisted audit techniques

CHAPTER 8

Introduction to substantive procedures

Contents

1 The role of substantive procedures
2 Analytical procedures: ISA 520
3 Chapter review

INTRODUCTION

Learning outcomes

The overall objective of the syllabus is acquiring knowledge of theory, skill and techniques of auditing and to enable the students to understand International Standards on Auditing, Assurance and Ethics.

Performance of audit and reporting

LO 2	**On the successful completion of this paper, candidates will be able to demonstrate working knowledge in respect of performance of simple audit procedures and understand the audit report requirement under the Companies Act, 2017**

Substantive Procedures (ISA 330)

LO2.6.3	Discuss the use of computer software in substantive testing, auditing around the computer and directional testing
LO2.6.4	Discuss the methods of obtaining audit evidence for substantive testing
LO2.6.5	Explain the nature, extent and timing of substantive procedures for different items of financial statements
	[Note: 2.6.4 and 2.6.5 are covered in chapters 8, 9, 10 and 11]

Analytical procedures (ISA 520)

LO2.8.1	Explain the nature and purpose of substantive analytical procedures using simple examples
LO2.8.2	State the purpose of analytical procedures performed near the end of the audit
LO2.8.3	Apply analytical procedures through calculations of different ratios for different items of financial statements

1 THE ROLE OF SUBSTANTIVE PROCEDURES

Section overview

- The nature of substantive procedures
- Financial statement assertions
- Exam technique: devising tests of detail
- Use of audit software
- Auditing around the computer
- Methods of obtaining audit evidence for substantive testing
- Directional testing
- The significance of the audit of statement of financial position items

1.1 The nature of substantive procedures

Previous chapters have dealt with the planning stage of the audit and with the auditor's work on understanding, evaluating and testing the accounting system and control systems in place.

In accordance with ISA 330, the auditor will also do some substantive testing. He may decide, as a result of his risk assessment, to adopt a systems-based audit approach to the audit. On the other hand, his assessment may lead him to adopt a transactions-based approach (a wholly substantive approach). No matter which approach he takes, systems-based or transactions-based, he will do some substantive testing.

Substantive procedures are audit procedures performed to detect material misstatements in the figures and presentation & disclosures reported in the financial statements.

- They are designed to generate evidence about the **financial statement assertions** (discussed in a previous chapter, as set out in ISA 315).
- They include:
  - **tests of detail** on transactions, account balances and disclosures, and
  - analytical procedures.

ISA 330 also **requires** that, whatever level of substantive procedures are carried out, the auditor must carry out the following procedures:

- Agree or reconcile the financial statements to the underlying accounting records.
- Examine material journal entries.
- Examine other adjustments made during the course of preparing the financial statements.

1.2 Financial statement assertions

Evidence is obtained by the auditor to enable him to form an opinion and prepare an audit report on the financial statements. In order to do this, the auditor has to look for evidence that supports the financial statement assertions. These are the assertions that are made in the financial statements by the directors of the company.

These assertions have been described in an earlier chapter, but it is important that you should be able to recognise and understand them. The assertions are also useful when you are asked to generate tests of detail for a particular area, as discussed later in this section.

Financial statement assertions fall into the following categories:

- **Assertions about classes of transactions and events** (income statement), and related disclosures:
  - occurrence

- completeness
- accuracy
- cut-off
- classification
- presentation

❑ **Assertions about account balances** (statement of financial position), and related disclsoures:

- existence
- rights and obligations
- completeness
- accuracy, valuation and allocation
- classification
- presentation

Occurrence

Occurrence is the assertion that **disclosed transactions** included in the financial statements did actually occur during the financial period. The assertion of occurrence:

❑ relates to **transactions**, and **presentation and disclosure**, rather than assets and liabilities, and

❑ is an assertion that **there is no overstatement** of the amount of transactions reported in the financial statements.

Completeness

In preparing their financial statements, the directors of a company are making the assertion that the financial statements are complete. No assets, liabilities, equity, transactions, events, presentation and disclosures have been omitted that should be included.

The assertion of completeness is therefore an assertion that **there is no understatement** of recorded amounts or unrecorded provisions in the financial statements.

Existence

This is the equivalent to the occurrence assertion for **assets, liabilities and equity**. The directors are making the assertion that assets, liabilities and equity reported in the statement of financial position did exist at the end of the reporting period.

As with the occurrence assertion for transactions, it is an assertion that **there is no overstatement** of assets, liabilities or equity in the statement of financial position.

This assertion of existence is extremely important, and a large part of an audit is directed towards obtaining evidence that this assertion is correct.

Accuracy, Valuation and allocation

This is the assertion that transactions, events, assets, liabilities and equity are recorded at appropriate amounts in the financial statements.

For **transactions** in the income statement/statement of comprehensive income, particularly the measurement of revenue, purchases and other expenses only the accuracy assertion will be considered.

In case of **assets, liabilities and equity**, it will be checked that their **Accuracy, Valuation and Allocation** have been carried out in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

Rights and obligations

The assertion of rights and obligations relates to **assets and liabilities**, i.e., the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

- The directors are asserting that the reporting entity has the rights to the assets disclosed in the statement of financial position. These are often the legal right of ownership, but they could be other rights. (Leased assets, for example, are not legally owned by the lessee, but the lessee has economic rights over the leased asset.) For example, the auditor may need to check the legal ownership of inventory that is held by a company: the company may have the legal title to the inventory; on the other hand, the legal ownership may still belong to the supplier, who has provided the inventory on a 'sale or return' basis.
- The directors also assert that the reporting entity has obligations for the liabilities disclosed in the statement of financial position.

Cut-off

The cut-off assertion relates to **transactions and events**. The directors assert that transactions have been **recorded in the correct accounting period**. This will be particularly important where revenue is received in advance or expenses are paid in advance or arrears.

Classification

The classification assertion relates to **transactions, events, assets, liabilities and equity interests**. The directors assert that transactions have been **recorded in the proper accounts.** So, for example, purchases of goods for resale have been posted to a "purchases" account, and purchases of machinery to "plant and machinery" account.

Presentation

The presentation assertion relates to assets, liabilities and equity interests. The directors assert that assets, liabilities and euity are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

1.3 Exam technique: devising tests of detail

The following chapters describe a variety of substantive procedures that an auditor might carry out. In your exam, you might be asked to suggest what substantive procedures ought to be carried out in a particular situation. Each accounting system and business is different, and substantive procedures that might be appropriate in one situation would be inappropriate in another. What you need to be able to do in the examination is apply general principles of substantive testing to the particular system or business described in the question.

One possible approach to devising tests of detail is as follows (analytical procedures are considered later in this chapter):

- **What am I being asked to test?** Start by asking what it is that you should be trying to test, and obtain evidence about. Usually you will be asked to test for any misstatement, but sometimes you might be asked to test only for:
  - overstatement (occurrence of transactions or existence of assets or liabilities) or
  - understatement (completeness), or
  - one particular aspect of an item (for example, the valuation of an asset).

  To decide what you are testing for, think about the financial statement assertions. Which of these do you want to test?
- **How does the system operate and what documents exist?** You should think about the specific system described in the examination question, and write down some ideas at this stage.

- **What special tests are used for this area?** There may be some audit tests that are particularly relevant to the system described in the question. Certain statement of financial position items have specific tests, such as a year-end inventory count for inventory (that the auditor can attend) or 'direct confirmation' as a method of verifying receivables' balances.
- **What tests can I think of?** To devise tests of detail, you should think about what method or methods are appropriate for gathering the evidence you are looking for. For example, in an IT system, the auditor will need to consider the use of audit software (see below).

1.4 Use of audit software

In a previous chapter, the use of computer-assisted audit techniques (CAATs) was introduced. There are two types of CAATs: test data and audit software. Test data is primarily used in the testing of controls. **Audit software** is primarily used for **substantive testing**.

Audit software is computer programs used by the auditor to extract information from a computer-based information system, for use in the audit. The main types of audit software include:

- interrogation programs, to access the client's files and records and extract data for auditing
- interactive software, for use in interrogation of on-line IT systems
- 'resident code' or 'embedded' software, to monitor and review transactions as they are being processed by the client's programs. This type of software is called 'embedded audit facilities'.

Audit software is used to extract and analyse information in the entity's IT systems for use in the audit work. Here are some examples:

- Account analysis. Audit software may be used to interrogate the client's data files for the general ledger, and extract from the files all items above Rs.50,000 in the repairs expense account.
- Calculating ratios and making comparisons. Audit software can be used to assist the auditor with analytical procedures (which are described later in this chapter).

Example: using audit software to test the receivables balance

Audit software may be used in several ways to help with testing the receivables balance, where the client operates a computerised sales and receivables accounting system.

Software can be used to total the balances on the accounts in the receivables ledger, for comparison with the balance on the receivables control account.

Software can also be used to check the balance on each account in the receivables ledger with the credit limit for that customer, to check that credit limits have not been exceeded.

There may also be a computerised reasonableness check on the balances in each customer account in the receivables ledger. This check looks for unusually high or low balances in individual accounts, given the total volume and value of transactions in the account.

- Software can be used to prepare an aged receivables list, if these are not already produced by the client as a matter of operational routine. The audit software can interrogate the trade receivables file, and produce a list and analysis in date order of unpaid invoices. This listing can be used by the auditor to make an assessment of the receivables that may be irrecoverable.
- Software can be used to select the sample of receivables ledger balances for substantive testing in the audit.
- Software can also be used to calculate ratios (analytical procedures): for example an analysis of 'average days to pay' and changes in this ratio over time may help the auditor with an assessment of likely irrecoverable debts and possibly also the going concern assumption for the client.

Example:

You have been put in charge of the audit of inventory at Kitchen Magic, a wholesaler of kitchen goods. Kitchen Magic keeps a permanent record of inventory on its IT system and carries out a rolling programme of inventory counts to check that the record on the system is reflected by actual goods held. The year-end inventory will be listed for you, showing for each product: date of last purchase, date of last sale, cost, selling price, quantity and year-end valuation. This schedule will be available on the last day of the year.

Required

List the tests which could be performed by audit software which will assist you in your audit of inventory. You will need to use your knowledge of IAS 2 *Inventories* from Paper CAF5.

Answer

- Cast the year-end inventory schedule.
- List out all items over a pre-set amount (at least the materiality threshold) (for subsequent physical verification).
- For each item on the schedule multiply the lower of cost and selling price × quantity and list out any items where this figure does not agree to the year-end valuation.
- Compare prices to those on the current sales price master file.
- List out any items where the date of the last purchase was more than, say, one month ago (as this may indicate that the product is obsolete/damaged/no longer in vogue and may need to be written down).
- List out any items where the date of the last sale was more than, say, one month ago (as, again, this may indicate that the product is obsolete/no longer in vogue and may need to be written down).
- List out any items which do not appear on the post year-end sales listing for the first, say, month of the year (again, may indicate that a provision is needed).

***Tutorial note:** If these tests were being carried out manually then only a sample would be checked. Due to the speed of computer software it is feasible to check all items.*

Embedded audit facilities

Embedded audit facilities may also be called 'resident audit software' or an 'integrated audit module'. It is audit software that is built into the client's IT system, either temporarily or permanently.

The purpose of embedded audit facilities is to allow the audit to carry out tests at the time that transactions are being processed, in 'real time'.

This can be very useful for the audit of online systems where:

- data is continually processed and master files are being continually updated, and/or
- it is difficult, if not impossible, for the system to provide a satisfactory audit trail for following transactions through the system.

An embedded audit facility may also print out details of the transactions it has monitored, or copy them to a computer file, so that the auditor can study the transactions.

Problems with using audit software

Audit software may need to be written so that it is compatible with the client entity's IT system, and can therefore be expensive to use, particularly in the following circumstances.

- When it is being used for the first time for a client, so that the audit firm has set-up costs.
- The client entity changes its accounting system, so that new audit software is needed.

- There may be problems with producing suitable audit software when the client has an old purpose-written IT accounting system for which there is incomplete system documentation.

The auditor should also be aware of the possibility that if he uses copies of the client's files for carrying out tests with audit software that the client may provide a file that is not actually a copy of the current 'live' files. When using copies of client files, the auditor should insist on being present to observe the copying of the files, to make sure that they are 'genuine'.

1.5 Auditing around the computer

An alternative to using audit software to carry out checks within the client's IT system, an auditor may choose to audit 'around the computer'. With auditing around the computer, the client's internal software is not audited. Instead, inputs to the system are checked and agreed with the outputs from the system. The auditor looks at input to the system, and compares the actual output with the output that should be expected.

Auditing around the computer has greater audit risk than auditing of the client's internal software, because:

- If the actual files or programs are not tested, there will be no audit evidence that the programs are functioning properly, as documented
- Where the auditor finds discrepancies between the input to the system and the output from the system, there is no way of finding out how the discrepancy has occurred. This in turn increases the risk that the auditor will be unable to write an unqualified audit report.

1.6 Methods of obtaining audit evidence for substantive testing

The methods of obtaining audit evidence have been described in an earlier chapter. It is important that you should know what they are, and be familiar with them. They are:

- **Inspection**. Obtain evidence about an item by going to look at it. For example, an auditor can obtain evidence about the existence of tangible non-current assets by going to look at them.
- **Observation**. The auditor can obtain evidence by watching a procedure and seeing how it is carried out.
- **Inquiry**. Evidence can be obtained by asking questions. For example, evidence about the existence of trade receivables can be obtained by asking customers on the list of trade receivables to confirm that they do owe the amount of money that the client company asserts.
- **Confirmation.** This is a specific type of enquiry where the auditor seeks confirmation from a party outside the entity, for example, from a bank or a customer.
- **Re-calculation.** The auditor checks the arithmetical accuracy of documents or records.
- **Reperformance.** The auditor re-performs a check or control originally carried out by the client.
- **Analytical procedures**. These are described in more detail later in this chapter.

Example:

Continuing with the example above concerning the audit of year-end inventory at Kitchen Goods.

Required

Describe a test using each of the above procedures (with the exception of analytical procedures).

Answer

Inspection: **Trace items from the year-end inventory schedule to the actual goods.**

Observation: **Observe counting of inventory during the year to gain evidence as to the accuracy of the inventory records.**

Inquiry: **Inquire of management as to the need for a year-end inventory provision.**

Confirmation: Write to third parties who the client says hold goods included in the entity's year-end inventory to confirm the existence and condition of that inventory.

Recalculation: Use audit software to cast the year-end inventory schedule.

Re-performance: Use audit software to re-perform the aging of the year-end inventory schedule.

1.7 Directional testing

With substantive testing, the auditor is normally interested in detecting two main types of misstatement:

- **errors** which may result in either **under or overstatement** of figures
- **omissions**, which result in **understatement**.

Understatement is much more difficult to detect than overstatement. This is because when he is looking for understatement of items in the financial statements, the auditor is trying to audit something that isn't there – he is checking for **completeness**. With overstatement, he is checking that what is there is valid, and this is a check for **existence** or **occurrence**.

Directional testing is used by the auditor to detect both over and understatements. This technique is based on double entry principles.

The basic principle of directional testing takes, as a starting point, that the trial balance of the client entity balances, and that therefore the total of debit balances in the general ledger equals the total of credit balances. Finding one error in the balances means that there must also be at least one other error somewhere else in the balances.

The following conclusions can therefore be made when the auditor finds an error with substantive testing.

- If the auditor finds, say, an overstatement of a debit entry, there must also be a corresponding understatement of another debit entry or an overstatement of a credit entry. (Otherwise, the trial balance totals of debits and credits would not be equal.)
- Similarly, if the auditor finds an understatement of a credit balance for one item, there must be either an overstatement of another credit balance or an understatement of a debit balance.

This approach also allows the auditor to work in a cost-effective and efficient way. Using directional testing:

- **the auditor tests debit items (assets and expenses) for overstatement only**
- **he tests credit items (liabilities, income and equity) for understatement only**.

For directional testing to be effective, it is important that the auditor selects the correct starting point for the test.

- If the auditor is carrying out tests to detect **overstatement**, the starting point should be the figures **in the accounting records**.
- If the auditor is carrying out tests to detect **understatement**, the starting point should be a source **outside the accounting records**.

Example:

Testing trade receivables balances for overstatement/existence

A starting point for testing will be the entity's list of receivables balances (the list of customers owing money as at the end of the reporting period). The auditor wants to check that these receivables do in fact exist. One way of doing this is to write directly to customers on the list asking them to confirm the amount that they owe the entity.

Alternatively, if the auditor is checking documentation within the client entity, he can take a sample of receivables from the list of balances, and trace their existence back through the accounting records, from receivables ledger to sales day book (receivables day book) to invoice.

Testing trade payables balances for understatement/completeness

To test payables for completeness, there is no point in taking as a starting point the entity's list of payables balances – because this may not be complete, and the auditor is testing for completeness.

Instead, the auditor may write to regular suppliers who might possibly be year-end payables, based on the total amount of purchases from the supplier during the year. If the supplier is not on the list of trade payables, or is listed as a payable for only a small amount, the auditor can ask the supplier to confirm this fact. This is often referred to as testing the 'reciprocal population'.

Alternatively, if the auditor is checking documentation within the client entity, he may take, as a starting point, a sample of documents indicating that goods have been purchased or received – such as a sample of goods received notes – and then trace the purchase through the system from purchase invoice to purchases day book to payables ledger.

1.8 The significance of the audit of statement of financial position items

The auditor will usually pay more attention to the statement of financial position than to the income statement/statement of comprehensive income. The reason for this is that if the current statement of financial position is 'correct' and if the previous statement of financial position was correct, then the profit figure linking the two statements of financial position must also be correct.

The emphasis of the statement of financial position audit will be on the verification of assets and liabilities, rather than the verification of equity. If assets and liabilities are correctly stated, equity (assets minus liabilities) will also be correctly stated.

This is all a question of emphasis – the auditor will not ignore the income statement /statement of comprehensive income or equity, but these items will generally receive a lower level of audit attention (and audit time and resources) than assets and liabilities.

The auditor will carry out tests to gain evidence on all the relevant financial statement assertions, but to make the audit as efficient as possible, the emphasis of the audit will be focused as follows:

- Assets:
  - existence
  - rights and obligations (ownership), and
  - accuracy, valuation and allocation
- Liabilities:
  - completeness,
  - cut-off, and
  - accuracy

2 ANALYTICAL PROCEDURES: ISA 520

Section overview

- Using analytical procedures
- The nature of analytical procedures
- Analytical procedures in substantive testing
- Investigation of fluctuations and relationships
- Common ratios

2.1 Using analytical procedures

Analytical procedures were referred to earlier as one of the procedures for generating audit evidence. Analytical procedures must be used:

- **at the audit planning stage**, in order to:
  - gain a better understanding of the client entity and its business, and
  - help identify areas of high audit risk: audit procedures can then be targeted at the areas of highest risk. This stage is covered by ISA 315, as discussed in a previous chapter.
- at the end of the audit, **in the overall review of the audit**, to assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with his understanding of the entity.

Analytical procedures may also be used:

- **as a substantive procedure** during the audit, in the audit work on the income statement and statement of financial position (to look for possible material misstatements during the audit rather than later, in the end-of-audit review).

ISA 520 *Analytical procedures* is concerned with the second two stages – using analytical procedures in the overall review and as substantive procedures.

2.2 The nature of analytical procedures

"Analytical procedures" are defined by ISA 520 as "evaluations of financial information through analysis of plausible relationships among both financial and non-financial data". Much of the analysis consists of measuring ratios, and comparing the ratios obtained from the current year's financial results with:

- expected ratios, and
- ratios from previous financial periods.

Ratios are used to make comparisons and to assess whether they seem reasonable. The auditor can look for unusual feature or inconsistencies. If a ratio seems unusually high or low, this might indicate that one of the two figures used to calculate the ratio is either abnormally high or abnormally low. The oddity can then be checked in more detail.

If key ratios are close to what they are expected to be, the auditor may take this as evidence that the relevant balances or transaction amounts are reliable and 'accurate'. If a ratio is very different from what is expected, the auditor should investigate the reason for the variation. There may be a good reason why a ratio differs from its expected value. On the other hand, a ratio might have an unusual value because there is a misstatement in the financial statements.

Comparisons

The essential feature of analytical procedures in auditing is 'comparison'. The auditor will calculate key relationships between figures (non-financial figures as well as financial figures) and then make comparisons.

Comparison with	
Prior accounting periods	To establish patterns and trends, and to look for unusual fluctuations in amounts in the current financial year that seem inconsistent with what has happened previously.
Expected results	Actual results can be compared with the budgeted results or with forecasts, or with results that the auditor was expecting.
Industry average results	Comparable information may be obtained for other entities in the industry or about individual entities in the same industry. Information may be obtainable for the industry as a whole from an industry body or a financial information service. Information about individual companies in the same industry may be obtainable as published financial statements.
Comparable parts of the same entity	The auditor may be able to compare the results of different branches or divisions within the same entity, where there are similar branches or divisions within the entity.

Once the calculations have been performed, the auditor will then examine them for unexpected or unusual relationships. The auditor will then make enquiries of management in order to establish explanations for the relationships revealed.

Many of the accounting ratios used in analytical procedures may be familiar to you already from your other studies. If you have not as yet studied ratios then some common ratios are set out for you at the end of this chapter. You should ensure you are familiar with these as you could be required to both **compute and interpret** key ratios in the exam.

Remember that ratio analysis is subject to limitations:

- Its usefulness depends on the quality of the underlying financial information. It is usual for the auditor to calculate financial ratios from the client's management accounts, which are more detailed than financial statements and can provide a source of more and better information.
- For comparison purposes, the information must be calculated on a consistent basis.
- The two figures used to calculate a ratio must be logically related.
- The auditor needs to understand the client's business, so that he is able to understand the potential significance of ratios, or reasons for differences (for example, differences between one year and the next).

Analytical procedures and the exam

An exam question may ask you to carry out analytical procedures for an entity described in a small case study. The purpose of such a question will be to test your ability to:

- identify unusual features in the draft financial statements of a client entity
- suggest what might be done to investigate the unusual figures more closely
- provide possible explanations for the unusual figures in the financial statements.

Examples of unusual items in the financial statements that analytical procedures would reveal are:

- a substantial increase in sales revenue but a substantial decrease in the cost of sales
- a significant change in the gross profit margin
- a significant increase or decrease in administrative expenses
- a significant increase or decrease in selling and distribution expenditure
- a significant increase or decrease in interest costs or investment income
- A significant change in the net profit margin.

Example:

Here are just a few more of the ratios that an auditor might use. Other common ratios are set out at the end of this section.

Payroll costs

Ratios can be used to assess whether the total recorded amount for payroll costs appears to be reasonable:

- One way of doing this is to look at the total payroll costs each month, and in each month of previous years. Changes in the total payroll cost should be reasonable, allowing for increases in wages and salaries, and for changes in the composition of the work force, and for leavers and starters in the period. Monthly payroll costs should be consistent with each other and reasonable.
- Another way of assessing payroll costs would be to measure the average monthly or annual pay per employee, and compare this with other months or previous years. Any unexpected changes should be investigated.

Other expenses

Another simple ratio that can be useful for an auditor is the ratio of expenses to annual revenue. Unusual changes in any ratio, such as the ratio of cost of sales to sales (and so gross profit to sales) should be investigated. Similarly, ratios of distribution costs, selling costs and administration costs to revenue can also be measured and compared.

Working capital ratios

Working capital ratios, such as days' sales outstanding and the average inventory turnover period, can be used to assess whether the total balance for trade receivables or inventory is reasonable (or whether the figures for sales income and purchases appear reasonable).

2.3 Analytical procedures in substantive testing

Several factors should determine the extent to which the auditor can use analytical procedures as a form of substantive audit evidence. ISA 520 **requires** the auditor to:

- determine the suitability of particular substantive analytical procedures for given assertions – i.e. how effective they will be in detecting a particular type of material misstatement.

  This usually depends on the closeness of relationships between items of data. Analytical procedures are more appropriate when relationships are plausible and predictable. For example, there is normally a close relationship between sales commission and sales revenue, whereas the relationship between administration costs and sales revenue is less close and so less predictable.
- develop an expectation of recorded amounts or ratios and evaluate whether that expectation is sufficiently precise to identify a misstatement. How effectively this can be done depends on factors such as:
  - the accuracy with which amounts can be predicted;
  - the extent to which information can be disaggregated (e.g. sales split out by product line); and
  - the availability of information.
- evaluate the reliability of the data from which the expectation has been developed. If data is unreliable then it will be of little use. The auditor should consider such factors as:
  - the source of the information;
  - comparability of the information available (broad industry data may not be suitable for an entity with more specialised products);
  - the nature and relevance of the information available (budgets may not be suitable if they have been prepared as goals rather than expectations); and
  - controls over the preparation of the data.

- determine what level of difference from expected amounts is acceptable without further investigation (i.e. link to materiality).

The auditor will normally use analytical procedures to obtain **supplementary** audit evidence. It would not normally be appropriate to base the audit conclusion on analytical procedures alone.

However, substantive analytical procedures may provide sufficient appropriate audit evidence for a particular assertion if:

- the assessed risk of material misstatement is not considered significant; and
- the outcome is sufficiently accurately predictable such that sufficient appropriate audit evidence could be obtained through the use of substantive analytical procedures alone.

Analytical procedures are therefore generally designed to provide evidence that supports or corroborates (or possibly contradicts) the outcome of other, more specific, audit testing procedures.

2.4 Investigation of fluctuations and relationships

If the auditor finds:

- fluctuations or relationships which are inconsistent with other information, or
- unacceptable levels of differences from expected amounts

then ISA 520 **requires** him to:

- make enquiries of management and verify management's responses, and
- perform other audit procedures as necessary.

The calculations performed in analytical procedures are only a part of the process. They are used to indicate areas where further audit work may be required.

If, for example, an entity's usual gross profit percentage is 20% and the auditor is not aware of any factors which would cause this to change in the current year – then no further investigation of a current year gross profit percentage of 20% should be necessary.

However, if the auditor knows that there have been significant changes in the nature of the business that should affect the gross profit percentage and yet that percentage is still 20%, he will need to make further enquiries.

These enquiries, following analytical procedures, will involve:

- using other audit evidence to help explain the ratios obtained from analytical procedures, and their unexpected and unusual value
- asking management for explanations of the unusual/unexpected ratios. Since explanations from management are being obtained as audit evidence, and oral evidence is not particularly reliable, they should be confirmed by further audit work.

Example:

You are currently planning the audit of Numero for the year ended 31 December 20X4. You are aware that revenue was budgeted to fall by 20% from last year. The following information has been made available to you:

Revenue Rs.4,000,000 (20X3: Rs.5,000,000)

Cost of sales Rs.3,000,000 (20X3: Rs.3,000,000)

Expenses Rs.200,000 (20X3: Rs.500,000)

Trade receivables Rs.600,000 (Year 1: Rs.300,000)

Required

Explain which of the above amounts you believe might need further investigation and why.

Answer

Cost of sales has remained constant and yet revenue has fallen by the anticipated 20%. Cost of sales would generally be expected to move in line with revenue. *(Tutorial note: An alternative comment would be that the gross profit percentage has fallen from 40% to 25%.)*

Expenses have decreased by 60%. This could be due to the fall in revenue or it could indicate a misallocation between cost of sales and expenses.

Trade receivables days have increased from 22 days to 55 days. This may indicate a change in credit terms (to attract new/large customers in the light of falling sales) or that not all debts are recoverable and that a write-down is needed.

2.5 Common ratios

Profitability ratios

$$\text{ROCE} = \frac{\text{Profit before interest and taxation}}{\text{Share capital and reserves} + \text{Long-term debt capital}} \times 100\%$$

$$\text{Profit/sales ratio} = \frac{\text{Profit}}{\text{Sales}} \times 100\%$$

This could be calculated as a **net profit ratio** or a **gross profit ratio** (commonly referred to as the gross profit percentage).

$$\text{Asset turnover ratio} = \frac{\text{Sales}}{\text{Share capital and reserves} + \text{Long-term debt capital}}$$

Working capital efficiency ratios

$$\text{Average days to collect} = \frac{\text{Trade receivables}}{\text{Sales}} \times 365 \text{ days}$$

$$\text{Inventory turnover} = \frac{\text{Inventory}}{\text{Cost of sales}} \times 365 \text{ days}$$

$$\text{Average time to pay} = \frac{\text{Trade payables}}{\text{Cost of purchases}} \times 365 \text{ days}$$

Liquidity ratios

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$\text{Quick ratio} = \frac{\text{Current assets excluding inventory}}{\text{Current liabilities}}$$

Debt ratios

$$\text{Gearing} = \frac{\text{Long - term debt}}{\text{Share capital and reserves}} \times 100\%$$

$$\text{Interest cover} = \frac{\text{Profit before interest and tax}}{\text{Interest charges in the year}}$$

Investor ratios

$$\text{Earnings per share} = \frac{\text{Profits attributable to ordinary shareholders}}{\text{No. of shares}}$$

$$\text{P/E ratio} = \frac{\text{Current market price per share}}{\text{Earnings per share}}$$

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Current market price per share}} \times 100\%$$

$$\text{Dividend cover} = \frac{\text{Earnings per share}}{\text{Dividend per share}} \text{ or } \frac{\text{Profit before dividends}}{\text{Dividends}}$$

3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Describe the nature of substantive procedures
- Explain the financial statement assertions
- Understand different methods of obtaining substantive evidence
- Describe directional testing
- Understand when and why analytical procedures are used
- Use common ratios

CHAPTER 9

Substantive procedures: non-current assets

Contents

1 Tangible non-current assets
2 Intangible non-current assets
3 Chapter review

INTRODUCTION

Learning outcomes

The overall objective of the syllabus is acquiring knowledge of theory, skill and techniques of auditing and to enable the students to understand International Standards on Auditing, Assurance and Ethics.

Performance of audit and reporting

LO 2	**On the successful completion of this paper, candidates will be able to demonstrate working knowledge in respect of performance of simple audit procedures and understand the audit report requirement under the Companies Act, 2017**

Substantive procedures (ISA 330)

LO 2.6.4	Discuss the methods of obtaining audit evidence for substantive testing
LO 2.6.5	Explain the nature, extent and timing of substantive procedures for different items of financial statements
	[Note: 2.6.4 and 2.6.5 are covered in chapters 8, 9, 10 and 11]

1 TANGIBLE NON-CURRENT ASSETS

Section overview

- Tangible non-current assets: the information subject to audit
- Principal risks of misstatement
- Substantive procedures for tangible non-current assets
- Substantive procedures – additions and disposals

1.1 Tangible non-current assets: the information subject to audit

Before looking at substantive tests for tangible non-current assets, it is useful to remind yourself of the information about these assets that is presented in the financial statements.

The figures in the statement of financial position itself are supplemented by a note to the accounts, which may be presented as follows:

	Land and buildings	**Plant, equipment, fixtures and fittings and motor vehicles**	**Total**
	Rs.	Rs.	Rs.
Cost			
At 31 December Year 1	X	X	X
Additions	X	X	X
Acquisitions through business combinations	X	X	X
Disposals	(X)	(X)	(X)
At 31 December Year 2	X	X	X
Accumulated depreciation and impairment losses			
At 31 December Year 1	X	X	X
Depreciation charge for the year	X	X	X
Disposals	(X)	(X)	(X)
Impairment losses	X	X	X
Reversal of impairment losses	(X)	(X)	(X)
At 31 December Year 2	X	X	X
Net carrying amount			
At 31 December Year 1	X	X	X
At 31 December Year 2	X	X	X

When tangible non-current assets are included in the statement of financial position at a valuation, a note should disclose:

- the basis used to revalue the assets
- the date when the assets were revalued
- whether an independent valuer was involved in the revaluation, and
- the nature of any cost index that was used as a basis for calculating replacement cost
- the carrying amount of each class of assets that would have been reported if the assets had been reported using the cost method (and so if the assets had been valued at cost minus accumulated depreciation)
- the revaluation surplus, and any movements in this surplus during the financial period.

In addition, a note should disclose the basis used for the depreciation of each class of assets.

When assets are disposed of, the gain or loss on disposal is the difference between the proceeds from the disposal and the carrying amount of the asset at the date of disposal.

When non-current assets are a significant item in the statement of financial position of a company, the disclosures relating to them are therefore both extensive and of some significance in terms of obtaining audit evidence.

1.2 Principal risks of misstatement

The principal risks of tangible non-current asset balances in the financial statements being misstated relate to the following assertions:

- **Completeness assertion**. There is a risk that assets owned by the reporting entity have not been included in the financial statements.
- **Existence assertion**. There is a risk that assets reported in the financial statements do not actually exist (for example, they may have been sold or scrapped).
- **Accuracy, valuation and allocation assertion**. There is a risk that the assets have been incorrectly recorded in financial statements at inappropriate amounts and any resulting valuation or allocation adjustments have been inappropriately recorded and related disclosures have been inappropriately measured and described.
- **Rights and obligations assertion**. There is a risk that the reporting entity does not actually own assets that are included in the financial statements.
- **Classification assertion.** There is a risk that assets have been recorded in the improper accounts.
- **Presentation assertion**. There is also a risk that the assets have not been correctly presented and disclosed in the financial statements.

The auditor can use substantive testing to obtain evidence that the various assertions relating to tangible non-current assets are valid.

1.3 Substantive procedures for tangible non-current assets

The substantive procedures used by an auditor for tangible non-current assets will therefore be designed to obtain sufficient appropriate evidence about the above assertions. The tests will therefore be directed to:

- completeness (no understatement)
- existence (no overstatement)
- accuracy, valuation and allocation
- rights and obligations,
- classification, and
- presentation

Possible substantive procedures to obtain this evidence are listed below.

Completeness

- Obtain or prepare a schedule of tangible non-current assets, showing cost or valuation, depreciation and carrying amount.
- Reconcile this list with the corresponding opening balances (see the notes below on substantive tests for additions and disposals).
- Select a sample of assets that physically exist (and whose existence has been verified, possibly by means of inspection by the auditor) and trace these assets to the asset register.
- Obtain or prepare a reconciliation of ledger balances for tangible non-current assets with the asset register and investigate any differences.

Existence

- Select a sample of assets from the non-current asset register and physically inspect them. During the inspection, note whether the asset is in use and the condition that it is in. For an asset register held on an IT system, audit software could be used to assist in the selection of a sample.
- Establish and investigate the reasons for any assets in the sample that are not found by the auditor.

Accuracy, Valuation and allocation

At cost

- **Land and buildings**: Confirm the figures for cost with the purchase contract for the asset and the invoices for associated costs (such as professional fees). Check that the purchase expenditure is analysed reasonably between land, buildings and equipment.
- **Equipment and vehicles**: Check the cost in the financial statements against the purchase invoices for the assets.
- Review the allocation of total expenditure on non-current assets between capital and revenue amounts.

At valuation

- Verify amounts in the financial statements with the valuer’s report.
- Consider the reasonableness of the valuation.
- Check that valuations are regularly updated.
- Check the accounting for the rise or fall in value on revaluation.

Depreciation and impairment

- Review depreciation rates for reasonableness in the light of the nature of the asset, its estimated useful life and residual value.
- Ensure that consistent depreciation methods are in use.
- Review gains or losses on sale disposal (and the accumulated depreciation and impairment at the time of disposal).
- Consider the possibility that assets are obsolete or suffering impairment. This matter may have to be discussed with the directors of the client company.
- Check the depreciation calculations for accuracy, using the entity’s stated policy. Again, in an IT system, audit software could be used to check these calculations.
- Ensure that fully-depreciated assets are not subject to further depreciation.
- Perform analytical procedures to verify the total charge for depreciation (for example, by taking the ratio of depreciation to total asset value, and comparing this with the ratio in previous years).
- Confirm that the entity has adequate insurance for its assets.

Rights and obligations (ownership)

- **Land and buildings**: Verify legal title to the assets by inspecting appropriate documents (such as legal documents of ownership, or lease agreements).
- **Vehicles**: Examine vehicle registration documents or similar documentation giving evidence of title.
- **Other assets**: Examine invoices or other documents transferring title.
- Ensure that documents are in the name of the entity (the client company).
- Review legal documents, bank documents and other documents for evidence of any loans that are secured by charges on assets.

Classification

- Ensure that the non-current assets have been classified in the appropriate account.

Presentation

- Review the disclosures in the financial statements and ensure they are correct and clear.
- Ensure the schedule of tangible non-current assets agrees to the figures in the financial statements.

1.4 Substantive procedures – additions and disposals

In the interests of audit efficiency, auditors will pay particular attention to substantive testing of additions and disposals of tangible non-current assets. These transactions, together with the depreciation charge for the year, will normally account for most of the changes between the valuations in the opening and closing statements of financial position. Typical substantive procedures in these areas are listed below.

Additions

- Obtain/prepare a schedule of additions for the period.
- Check the authorisation of the expenditure to purchase these additions.
- Confirm that the total additions reconcile with the movement between the opening and closing balances in the note to the financial statements.
- Inspect a purchase invoice or other document as evidence of the cost of any addition, and confirm that these documents are in the company name.
- Verify the existence of the acquired non-current assets, by means of physical inspection where appropriate.
- Check that the entries in the accounting records are correct, confirming the allocation of total expenditure between capital and revenue expenditure.

Disposals

- Obtain/prepare a schedule of disposals for the period.
- Check the authorisation of the disposals.
- Verify that the cost and related accumulated depreciation have been removed from the accounting records.
- Verify the calculation of the figure for the gain or loss on disposal, and verify that this figure has been correctly recorded in the ledger.
- Discuss with management (including non-financial management) the possibility of unrecorded disposals of assets.

As always, the precise nature of substantive procedures performed by the auditor must reflect the circumstances involved. This is mirrored in the exam by the particular scenarios set. For example, an entity may construct its own non-current assets rather than buy them from an outside supplier. In this event, the substantive procedures will focus on confirming that internal costs (materials, labour, other direct expenses and overheads) have been properly accounted for as capital expenditure.

Example:

During the year ended 30 June Year 6, Constructico acquired freehold land at a cost of Rs.50m and built a distribution centre on it, using a mixture of sub-contract and own labour. The distribution centre cost a total of Rs.20m to construct. The construction was completed by the end of April.

Required

Set out the audit objectives in respect of the above and the substantive procedures you would carry out to achieve those objectives.

Answer

The land and the distribution centre exist at 30 June Year 6

- Visit site and confirm that the distribution centre has been built and is in use.

Constructico owns the land and the distribution centre at 30 June Year 6

- Inspect the land registry certificate or write to third party for confirmation (e.g. bank or solicitor).
- Inspect correspondence confirming that local planning permission was granted and ensure any conditions were met.

Expenditure capitalised in respect of the distribution centre is complete

- Discuss with management their policy for capitalising expenditure incurred in building the distribution centre.
- If a formal system is in place for the identification and capitalisation of construction expenses, test that system.
- Review a sample of invoices not capitalised during the period and ensure treatment was correct.

The land and the distribution centre are appropriately valued at cost

- Inspect completion statement for purchase of land.
- Obtain an analysis of costs of building the distribution centre. Inspect:
  - purchase invoices for a sample of raw material and sub-contract costs
  - time records for a sample of internal labour costs
  - evidence in respect of any overheads capitalised.
- Recalculate the depreciation charge for the year, taking into account that the distribution centre was not completed until the end of April.

The land and the distribution centre are appropriately presented and disclosed in the financial statements

- Review the disclosures in the financial statements and ensure they are correct and clear.

Ensure the schedule of costs agrees to the figures in the financial statements.

2 INTANGIBLE NON-CURRENT ASSETS

Section overview

- Substantive procedures for intangible assets
- Tests of detail for purchased goodwill
- Tests of detail for other intangibles (excluding development costs)
- Tests of detail for development costs

2.1 Substantive procedures for intangible assets

The risks of misstatement and substantive procedures relating to intangible assets such as goodwill and brands should be similar to those set out above in respect of tangible assets. The emphasis of the substantive procedures will be on:

- existence and
- valuation.

Remember that the only intangible assets that can be recognised in the statement of financial position are:

- purchased goodwill
- intangibles having a readily ascertainable market value, and
- development costs, subject to the conditions set out in IAS 38.

There should therefore be adequate audit evidence available to enable a conclusion to be reached on these assets.

The main substantive procedures are listed below.

2.2 Tests of detail for purchased goodwill

The tests listed below relate mainly to the valuation of purchased goodwill:

- Confirm that a business was acquired and confirm the consideration paid for the business acquired. (This is a measure required to check the existence of purchased goodwill as well as to confirm its valuation.)
- Review the reasonableness of the valuation placed on the net assets acquired.
- Check the calculation of the purchased goodwill (as the difference between the consideration paid and the fair value of the net assets acquired).
- Review for the possibility of an impairment having arisen.
- Ensure that any impairment loss has been correctly calculated and recorded in the ledger.

2.3 Tests of detail for other intangibles (excluding development costs)

The tests for other intangible assets, other than development costs, are similar to those that may be applied to tangible non-current assets.

- The auditor should confirm the existence, the cost and the client entity's legal rights to the acquired assets, by looking at the purchase documentation.
- Check the amortisation calculations for accuracy, using the entity's stated policy.
- Consider the possibility that the assets are suffering impairment. This matter may have to be discussed with the directors of the client company.
- Ensure that any impairment has been correctly dealt with in the ledger.

2.4 Tests of detail for development costs

The tests for development costs must enable the auditor to conclude whether or not the provisions of IAS 38 for the recognition of development costs have been met.

IAS 38 states that an intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

- the technical feasibility of completing the intangible asset so that it will be available for use or sale.
- its intention to complete the intangible asset and use or sell it.
- its ability to use or sell the intangible asset.
- how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
- the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
- its ability to measure reliably the expenditure attributable to the intangible asset during its development.

Audit tests might include the following:

- discuss the development project with management, other relevant senior personnel and other key stakeholders to assess the feasibility of the project and product:
  - review projections and forecasts for using resources and generating future economic benefits.
  - assess production and marketing plans and whether a market (or use) actually exists.
  - consider funding requirements to completion.
  - whether the entity will actually be able to use or sell the asset.
  - discuss management's intention to complete the asset and either use or sell it.
- inspect development contracts and records supporting and safeguarding patents.
- test controls around the documentation and safekeeping of scientists notes, discoveries and conclusions.
- test a sample of development costs for appropriate capitalisation.
- obtain written representation from management as to their commitment to complete the project and either use or sell the asset(s).

3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain the principle risks of misstatement for non-current assets
- Describe the key substantive procedures for auditing both tangible and intangible non-current assets

CHAPTER 10

Substantive procedures: current assets

Contents

1 Introduction to substantive procedures for inventory
2 Valuation of inventory
3 Inventory quantity: the physical inventory count and ISA 501
4 Substantive procedures: trade receivables and prepayments
5 Substantive procedures: bank and cash balances
6 Chapter review

INTRODUCTION

Learning outcomes

The overall objective of the syllabus is acquiring knowledge of theory, skill and techniques of auditing and to enable the students to understand International Standards on Auditing, Assurance and Ethics.

Performance of audit and reporting

LO 2	**On the successful completion of this paper, candidates will be able to demonstrate working knowledge in respect of performance of simple audit procedures and understand the audit report requirement under the Companies Act, 2017**
LO 2.6.4	Discuss the methods of obtaining audit evidence for substantive testing
LO 2.6.5	Explain the nature, extent and timing of substantive procedures for different items of financial statements
	[Note: 2.6.4 and 2.6.5 are covered in chapters 8, 9, 10 and 11]
LO 3	**Understand the requirement and application guidelines relating to some of the specific areas of audit procedures including external confirmation, review of subsequent event etc.**
LO 3.1.1	Describe the significance of using external confirmation procedures for obtaining relevant and reliable audit evidence
LO 3.1.2	Describe the steps involved in external confirmation procedures
LO 3.1.3	Differentiate between the positive confirmation request and negative confirmation request, including their appropriateness in different situations
LO 3.1.4	Discuss the conditions of sending negative confirmations
LO 3.1.5	Discuss the auditor’s course of action if management refuses to allow auditor to send confirmation

1 INTRODUCTION TO SUBSTANTIVE PROCEDURES FOR INVENTORY

Section overview

- The importance of closing inventory for audit testing
- Principal risks of misstatement
- Substantive procedures for inventory

1.1 The importance of closing inventory for audit testing

For many businesses (although service organisations are often an exception) inventory is one of the areas needing most attention from the auditor. The reasons for the importance of closing inventory for the auditor include the following:

- Inventory is often a material item in the financial statements.
- Inventory may be a high risk area, involving a high degree of judgement in areas such as valuation. For example, judgement may be needed to estimate the stage of completion of work in progress.
- Inventory may suffer from deterioration, loss or theft that may not be recognised in the client company's financial statements.
- Inventory may be highly technical in nature. Where inventory is complex, the auditor may need to consider whether to rely on the work of an expert.
- Establishing a closing inventory figure may be a lengthy and complex process for the client, with a high risk of error.
- Closing inventory is often not part of the double entry system, so directional testing (tests on other areas and other balances) may not reveal misstatements in inventory.

Audit work on inventory is often given to more experienced members of the audit team. The work will typically be subject to a process of rigorous review and quality control. In addition, analytical procedures are widely used to obtain evidence to supplement the detailed substantive testing on inventory in the audit.

1.2 Principal risks of misstatement

The principal risks of inventory being misstated are due to the following:

- Not all inventory that is owned by the reporting entity being included in the financial statements (the **completeness** assertion).
- Inventory in the financial statements not actually existing (the **existence** assertion).
- Inventory being recorded at inappropriate amounts(which could be due to incorrect recording of costs, or failing to value at net realisable value, if lower, or miscalculation or relevant overheads not being added in the cost) (the **accuracy, valuation and allocation** assertion).
- Inventory being included in the financial statements which actually belongs to third parties (the **rights and obligations** assertion).
- Inventory being incorrectly disclosed in the financial statements (the classification and **presentation** assertion).

1.3 Substantive procedures for inventory

The figure for inventory in the financial statements reflects:

- the **quantity** of inventory on hand at the end of the reporting period, and
- the **value** of each item of that inventory.

Substantive procedures for inventory will therefore focus largely on the **existence** and **valuation** assertions and these are covered in the following sections. However, by carrying out test counts in both directions (see section on the physical inventory count below) the **completeness** assertion will also be covered.

In order to satisfy the **rights and obligations** assertion the auditor will need to check, when he attends the year-end physical inventory count (see below), that inventory belonging to third parties is separated and not included in the count.

To satisfy the **classification and presentation**assertion the auditor will need to ensure that:

- the schedule of year-end inventory (on which he bases his substantive procedures below) agrees to the financial statements
- inventory is correctly presented and classified (e.g. between raw materials, work in progress and finished goods) in the financial statements.

2 VALUATION OF INVENTORY

Section overview

- IAS 2: Inventories
- Substantive procedures
- Cost or net realisable value?

2.1 IAS 2: Inventories

IAS 2 requires that inventory should be valued at the lower of cost or net realisable value, on an item-by-item basis:

- **Cost** includes the costs of purchase and all other costs incurred in bringing inventories to their present location and condition. In the case of work-in-progress and manufactured finished goods, this includes an amount for production overheads. (The absorption rate for production overheads should be based on normal levels of activity). Cost can be estimated by using a number of methods (such as first-in-first-out or average cost). The method chosen should provide a close approximation to the actual cost of the inventory.
- **Net realisable value** (NRV) is the estimated selling price of the inventory in the ordinary course of business, minus (1) any estimated costs to complete the items (and make them available for sale) and (2) the estimated costs of making the sale.

2.2 Substantive procedures

Substantive procedures on inventory should be designed to allow for the nature of the inventory and the nature of the situation that the auditor is facing.

- If the entity is a retailing organisation, the only major component of the cost of inventory is likely to be the purchase cost of the goods for resale.
- If the entity is involved in manufacturing or processing, the cost of inventory will include an amount for direct labour and production overhead, in addition to the cost of the raw materials and components.

Substantive procedures for the valuation of inventory items are suggested below. In the exam, which procedures are the most appropriate will depend on the particular scenario given.

Cost of raw materials or the cost of goods purchased for resale

For raw materials and goods held for resale, the cost of inventory will be the actual purchase cost of the items (plus any costs of delivery that the entity may have had to pay). The auditor should carry out the following tests for valuation:

- Confirm the approach adopted by the client company to estimate the cost of materials or goods used/sold (for example first-in-first-out, or weighted average cost).
- Check the figures for the cost of inventory by comparing them with prices in purchase invoices or official supplier price lists.

Cost of manufactured goods and work in progress

For work-in-progress and items of finished (manufactured) goods, the auditor needs to check each of the elements in the cost: direct materials, direct labour and production overheads. He should therefore carry out the following tests:

- Obtain schedules showing the make-up of the cost figures for each item of work-in-progress and finished goods.
- Check the accuracy of the calculations.
- Materials
  - Perform the same substantive tests as for raw materials, shown above.
  - Check that the correct **quantity** of materials has been used in the valuation.

- Labour
  - Check pay rates for direct labour cost against payroll/personnel records for the employees who produced the work-in-progress or finished goods items.
  - Check the hours worked (and used to calculate labour costs in the inventory) with the time records for the employees concerned.
- Production overheads
  - Confirm that only production overheads (as opposed to selling and administration overheads) are included in the valuation.
  - Confirm that overhead absorption rates are based on **normal levels of output**.
- Work in progress: in addition to the above tests, the auditor may also need to check the stage of completion of the work in progress, in respect of both materials and conversion costs (labour and overheads).

2.3 Cost or net realisable value?

In his substantive testing of inventory, the auditor should also look at the procedures of the client entity for deciding whether each item of inventory should be valued at cost or at net realisable value (NRV). The auditor may therefore carry out the following tests:

- Review and test the procedures in place for comparing NRV with cost for each item of inventory.
- Follow up any information obtained from other audit work suggesting that for certain items of inventory, NRV may be lower than cost. Information may be obtained from the physical inventory count (where the auditor has observed evidence of deterioration of the inventory) or from the amount of returns and allowances granted to customers.
- Review inventory records and order books for evidence of slow-moving items, whose selling price might need to be reduced and whose NRV may therefore be less than cost.
- Review prices at which goods have been sold after the reporting period, for evidence that NRV is higher than cost
- In the case of work in progress, compare costs incurred to date with selling price minus costs to complete (NRV). Estimated costs to complete may be assessed by the auditor from the client’s management accounts.

As discussed in a previous chapter, where the client has an IT system in place over inventory, audit software may be used to improve the efficiency and accuracy of audit testing in this area.

3 INVENTORY QUANTITY: THE PHYSICAL INVENTORY COUNT AND ISA 501

Section overview

- Physical inventory counts: purpose and responsibilities
- Audit work after the count: follow up
- Possible control weaknesses in an inventory count

3.1 Physical inventory counts: purpose and responsibilities

Many organisations rely on a physical inventory count at the end of their financial year in order to arrive at a figure for inventory in their financial statements. Even if an entity maintains 'sophisticated' inventory records, with continuous accounting records for inventory, the accuracy of these records should be checked by means of regular physical counts of inventory.

There are several reasons for physical counts of inventory:

- Physical counts may be fairly easy to arrange, particularly where most items of inventory are held in a limited number of physical locations.
- Physical counts provide evidence of the actual existence of the inventory. This evidence is important to the client company (for preparing the financial statements) as well as for the auditor (for checking the reliability of those statements).
- Physical counts can be used by the entity to check the accuracy of its inventory records, where it maintains continuous inventory records.
- Where the entity does not have continuous inventory records, a physical count of inventory is probably the only way of establishing the quantity of inventory at the year-end.
- Discrepancies between the physical count of inventory and the entity's inventory records may indicate weaknesses in physical controls over inventory, and losses due to theft or for losses from other causes.
- A physical count of inventory can also be used to check the physical condition of inventory, and whether there has been any deterioration in condition.

It is important to appreciate the relative responsibilities of management and auditors with respect to inventory counts.

- It is the responsibility of management to arrange for physical counts to be made and to establish appropriate procedures for counting, to ensure that a complete and accurate count is taken. (It is the responsibility of the company's directors to ensure that the valuation of inventory in the financial statements is reliable.)
- It is the responsibility of the auditor to gather evidence from which he can reach a conclusion on the figure for inventory in the financial statements. Observation and other audit procedures performed by the auditor at the inventory count will provide some of this audit evidence.

The auditor's attendance at the physical inventory count is covered by ISA 501 *Audit evidence – Additional considerations for specific items*. The **requirements** of ISA 501 in respect of inventory state that if inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding the **existence** and **condition** of inventory by **attendance at physical inventory counting** unless impracticable. The purpose of such attendance is given as being to:

- Evaluate management's instructions and procedures for recording and controlling the results of the count.
- Observe the performance of management's count procedures.
- Inspect the inventory.
- Perform tests counts.

- Perform audit procedures over the final inventory records to determine whether they accurately reflect the results of the count.

3.2 Audit work after the count: follow up

The final audit work on inventory may take place several weeks after the inventory count itself. In the intervening period the client should have calculated a final inventory figure for the financial statements.

One of the main objectives of the audit work on inventory quantity at this stage is to ensure that the inventory quantities that existed at the count date are properly reflected in the final inventory figure in the financial statements (the **completeness** and **classification & presentation** assertions). (Note: At this stage, the auditor should also carry out his checks on the valuation of inventory items, as described earlier.)

The audit work involved in verifying inventory **quantities** will include the following:

- Obtaining the final inventory sheets that were prepared by the client's staff during their inventory count.
- Check the numerical sequence of the sheets and the auditor's record of the last sheet number, to confirm that no sheets are missing.
- Check the numerical sequence of tag numbers listed on the sheets and the auditor's record of the final tag number, to confirm that no inventory items are missing from the sheets.
- Check the arithmetical accuracy of the calculations on the sheets.
- Confirm that inventory records have been amended as appropriate. For some inventory items, there is likely to be a difference between the physical count numbers and the quantity of stock shown in the client's inventory records (where a continuous recording system is used). In these situations, the client's inventory records will be incorrect. The auditor should therefore check that the inventory records were amended.
- Confirm that inventory belonging to the client, but held by third parties, is included on the inventory sheets.
- Confirm that inventory belonging to third parties, but on the client's premises at the date of the count, is not included on the inventory sheets.
- Check that cut-off is correct. This is done by reference to the cut-off information recorded at the time of the count.

Having done all this work, the auditor should be able to reach a final conclusion on the quantity of inventory held at the end of the reporting period.

Example:

You are the senior in charge of the audit of inventory at Spares R Us. Inventory is comprised of large quantities of spare parts for the car industry. Spares R Us operates a perpetual inventory recording system, backed up by a rolling programme of physical counts throughout the year. There is no year-end physical inventory count and the amount for inventory in the year-end financial statements is based on the computer records.

Required

Briefly summarise the audit procedures that you would undertake to obtain evidence on the amount for inventory in the year-end financial statements.

Answer

- Carry out spot checks during the year.
- Conduct sample counts at the year end, compare to perpetual records and investigate any differences.
- Review the results of the rolling counts and ensure any differences from book to actual are investigated and adjusted for.
- Check a sample of cost prices to purchase invoices.
- Assess obsolesce.
- Consider the use of audit software on the year-end inventory file.

3.3 Possible control weaknesses in an inventory count

Control weaknesses in the client's inventory counting procedures may be observed by the auditor. These might include:

- **Failure to pre-number the count sheets**. All count sheets should be pre-numbered, so that they can all be accounted for at the end of the count and none are 'lost' (and none are counted twice).
- Including on the count sheet for each inventory item the quantity of the inventory as recorded in the entity's inventory records. The counters should not be told what quantity of inventory to 'expect' for each item, because this may influence them to expect in advance how much inventory to 'look for'.
- **Entering the quantities counted on the count sheets in pencil**. Entries in pencil can be erased and altered later, fraudulently, without leaving trace of the alteration.
- Stores staff is commonly used to do the counting. However if all the counters are from the stores staff, there is a risk that they may collaborate to hide errors or missing inventory. The client should therefore use some other non-stores staff to assist in the count, such as some employees from the accounts department.
- **Inventory may not be marked when it is counted**. This gives rise to a risk that items of inventory will be counted twice, and possibly that some items will not be counted at all.
- **Count sheets may not be signed** by the individual counter who prepared them. If there is no signature on the count sheet, it may be difficult to refer queries back to the counter if a problem arises.
- **Lack of precise instructions to the counting team**. The counting team must be given precise and specific instructions about how to perform the count. If the counting team is left to decide itself how the count should be conducted, this will increase the risk of mistakes in counting – such as missing out some items and double counting others.

4 SUBSTANTIVE PROCEDURES: TRADE RECEIVABLES AND PREPAYMENTS

Section overview

- Confirmation of receivables balances
- ISA 505: External confirmations
- Planning the confirmation exercise
- Positive or negative confirmation?
- Sample selection and performing the confirmation exercise
- Audit procedures following the receipt of replies (with positive confirmation requests)
- Preparing a summary and reaching a conclusion
- Other audit procedures for receivables
- The audit of prepayments

4.1 Confirmation of receivables balances

The balance for trade receivables is usually a material amount in a company's statement of financial position. A significant amount of audit work on trade receivables is therefore likely to be needed to check the reliability of this amount.

The **principal risks of misstatement** of the trade receivables balance are due to:

- receivables being irrecoverable (the **valuation** assertion)
- receivables being contested by customers (the **existence** and **rights and obligations** assertions)
- cut-off between goods outwards and receivables recording being incorrect (the **cut-off** assertion – an **income statement** assertion that has a knock-on effect to the audit of trade receivables (see below)).

Because assets are typically tested for overstatement, the **completeness** assertion is less relevant.

An important audit technique for trade receivables is **direct confirmation of balances** with customers. This is sometimes known as '**circularisation**'.

Direct confirmation involves asking customers to provide written confirmation, direct to the auditors, of their account balance with the client entity. Written confirmation by customers can normally be taken as high-quality audit evidence because it is a strong source of written, external audit evidence.

However, the reliability of this evidence depends on two factors that are not entirely within the auditor's control:

- A large proportion of the customers who are asked to provide written confirmation should do so. Customers are not obliged to provide confirmation, and some time and effort may be required to get some customers to provide the information required.
- Some customers may provide written confirmation without properly checking the details.

As discussed above, the auditor will be concerned to check that the balance for trade receivables is not overstated. The confirmation process is therefore based on the company's own list of receivables ledger balances (customer account balances). This is the main accounting record used in this part of the audit.

A direct confirmation of receivables is intended to check the following assertions:

- **Existence** assertion. That the receivables do in fact exist, and there is no over-statement of receivables in the financial statements.

- **Rights and obligations** assertion. That the client entity has the legal right to the amounts receivable.
- **Accuracy, valuation and allocation** assertion. That the receivables are stated at their appropriate amount.
- **Cut-off** assertion. That transactions have been recorded in the correct accounting period.

4.2 ISA 505: External confirmations

The confirmation process is covered by ISA 505 *External confirmations*. In line with the generalisations about the reliability of audit evidence in ISA 500, audit evidence in the form of external confirmations received directly by the auditor are likely to be **more reliable** than evidence generated within the client entity.

It is therefore likely that, where it is reasonable to expect customers to respond to requests for confirmation of their balance, direct confirmation of balances **will be a part of the substantive testing process** for trade receivables.

The requirements of ISA 505

The **auditor should maintain control over external confirmation requests**, including:

- deciding on the information to be confirmed/requested;
- selecting the "confirming party" (e.g. the financial director/controller at the entity contacted);
- designing the confirmation requests (including an instruction for responses to be sent **directly to the auditor**); and
- sending the requests himself.

Although the letter to customers is sent out by the auditor, it must contain authorisation from the client's management for the customer to provide the required information direct to the auditor. (An example of the form that this letter might take is shown later.)

Various requirements are set out in relation to the **results of the external confirmation procedures:**

- If there are doubts about the reliability of any response the auditor should obtain further evidence to resolve those doubts.
- If a response is determined not to be reliable, the auditor should consider the implications of this on risk assessment and other audit procedures.
- For any non-response, the auditor should perform alternative audit procedures (though for a non-response to a vital positive confirmation request (see below) the auditor will need to consider the implications for his audit report).
- The auditor should investigate all exceptions to determine whether they indicate misstatements. They could indicate fraud or a breakdown in internal control or might just be due to timing differences and therefore not indicative of misstatements.
- The auditor should evaluate the results as a whole to decide whether they provide relevant and reliable audit evidence or whether further evidence is needed.

Management's refusal to allow the auditor to send a confirmation request

If **management refuse to allow the auditor to send a confirmation request** the auditor should:

- inquire as to management's reasons for the refusal, and seek audit evidence as to the validity and reasonableness of those reasons;
- evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and

- perform alternative audit procedures designed to obtain relevant and reliable audit evidence. (Possible alternative audit procedures are considered in a later section).

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with ISA 260. The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with ISA 705 given such a limitation on scope (see chapter 15).

Audit procedures

Audit procedures relating to confirmation of receivables balances are summarised below, under the following headings:

- Planning the confirmation exercise
- Positive or negative confirmation?
- Sample selection and performing the confirmation exercise
- Audit procedures following the receipt of replies (with positive confirmation requests)
- Preparing a summary and reaching a conclusion

4.3 Planning the confirmation exercise

The auditor needs to plan the exercise for the confirmation of balances:

- **Decide on the timing of the confirmation**. Ideally, the confirmation of balances should take place after the reporting period, and should be based on customers' account balances as at the end of the reporting period.

  However, to reduce the time pressure at the final audit stage, the confirmation process is often based on balances at an interim date before the end of the financial year (normally no more than three months before the end of the reporting period). In this case, the auditor will need to check the changes in the receivables balances between the confirmation date and the end of the reporting period. This check will consist mainly of checking entries in the receivables control account with the transactions entered in the books of prime entry during the same period.

- **Decide on the number of customer balances to be confirmed**. The confirmation process is normally based on a sampling approach. There are often many customers and the time and effort required to obtain a confirmation from all of them is not worth the benefit obtained. The auditor should be able to reach a reasonable conclusion from a representative sample of accounts.

- **Decide on the confirmation method to be used**. This will be a **positive** or **negative** confirmation request. These methods are explained below.

4.4 Positive or negative confirmation?

The confirmation will be either positive or negative. The auditor should decide which type of confirmation to obtain.

Positive confirmation

A **positive confirmation request** asks the customer to reply to the auditor **whether or not he agrees with the balance** on his account that is in the client company's accounting records (receivables ledger) as at the date selected for the confirmation. Positive confirmation can be obtained in either of two ways:

- **Method 1**. By providing the customer with details of the balance on his account, and asking him to indicate his agreement that this information is correct, or to indicate that it is wrong.

- **Method 2**. By asking the respondent to provide details of his balance at the selected date, but not providing any details of the balance in the client company's receivables ledger.

This should provide reliable audit evidence. However, there is a risk with Method 1 that a customer may reply to a confirmation request without checking that the information is correct. This risk can be reduced by using Method 2. However, with Method 2 there may be a lower response rate from customers, because they are being asked to do more work to provide the confirmation.

Negative confirmation

A **negative confirmation request** asks the customer to reply to the auditor **only where he disagrees** with the balance recorded by the company. If no reply is received, there is no explicit audit evidence in respect of the customer's balance. The absence of a reply could mean that the customer agrees with the balance, but is not required to provide written evidence. On the other hand, the absence of a reply could mean that the customer has not carried out any check of the balance at all.

The use of negative confirmation requests therefore provides audit evidence that is **less reliable** than evidence obtained with positive confirmation requests.

ISA 505 only permits the sole use of negative confirmation **where all of the following conditions are met**:

- The risk of material misstatement has been assessed as low and controls have been tested.
- The population is comprised of a large number of small account balances or transactions.
- A very low exception rate is expected.
- The auditor is not aware of circumstances which would case the respondent to ignore his request for confirmation.

Example: request for a confirmation of balance (positive confirmation)

A sample letter to a customer asking for confirmation of the outstanding balance, using the positive confirmation method, is shown below.

Note that it appears to be written by the management of the client company. In practice, this provides authorisation for the customer to provide the required information direct to the auditor. As discussed above, the letter will also be sent out to customers by the auditor (to make sure that the letters are actually sent to the customers in the selected sample). Replies should go directly to the auditor.

A COMPANY
25 South Street
Anytown

Customer's name and address

Date ………..……..

Dear ……………….

In accordance with the request of our auditors, Arthur Dailey and Co we ask that you kindly confirm to them directly your indebtedness to us at (*insert date*) which, according to our records, amounted to Rs.………..….. 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,

A COMPANY

Confirmation No ……………

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 attached

4.5 Sample selection and performing the confirmation exercise

The auditor will normally select a sample of customers who will be asked to provide a confirmation of the balance on their account with the client company. The audit procedures for selecting the sample and for the confirmation process are as follows:

- Obtain or prepare an aged listing of receivables ledger balances at the chosen date.
- If the list is prepared by the client, check the completeness and accuracy of the list of balances and the total of the balances in the list. This can be done by checking the list against (1) the total balance for trade receivables in the receivables control account in the main ledger and (2) a sample of customers' account balances in the receivables ledger.
- A suitable sampling method should be chosen. As with all sampling, the sample selection process should as far as possible ensure that the sample is representative of the 'population' of receivables.
- If the 'population' of receivables ledger balances is not homogeneous, stratified sampling might be used. (Stratified sampling was explained in an earlier chapter.)
- In selecting the sample, certain types of account should be considered for inclusion:
  - Overdue accounts
  - Credit balances or 'negative balances' (accounts where the client entity owes money to its customer, having issued credit notes to the customer)
  - Accounts on which round sum payments are received (for example, where the customer makes payments of Rs.5,000, or Rs.10,000 or Rs.30,000, instead of paying specific invoices)
  - Nil balances. (A check on nil balances provides a check on the completeness of trade receivables.)
  - Any individual balances that are considered 'material'.

  In an IT system, with many year-end receivables balances audit software can be used to help select the main sample (for by selecting every 500th Rupee for sampling or selecting all balances over a certain amount, as well as nil and credit balances).
- Having selected items for circularisation, details should be extracted from the receivables ledger, and letters to the customer should be prepared.
- In the case of an external audit, the confirmation requests are issued **by the auditor**, not by the client, and replies are sent directly to the auditor. However, the request will need to contain **management's authorisation** to the customer to disclose the necessary information. Should the client refuse to give permission for a confirmation letter to be sent to a particular customer, the auditor should look for a reason for the refusal. As that customer has been included in the sample selection, the auditor will need to carry out alternative audit work (see below) to verify that customer balance.
- The letters should be sent out by post.
- With positive confirmation requests, if the auditor does not receive a reply from a customer within a reasonable period of time, follow-up procedures should be initiated. For example,

second request and third request letters could be sent, or the client could be asked to contact the customer and ask for a reply.

4.6 Audit procedures following the receipt of replies (with positive confirmation requests)

On receipt of the replies from customers, the auditor should check that the letters are signed by a responsible official. The replies are filed in the receivables section of the current audit file. The current audit file should classify the customers in the sample as follows:

- **Balance agreed**. The customer has replied and agrees with the balance in the client entity's accounting records (or has provided a balance that corresponds with the entity's accounting records – depending on whether Method 1 or Method 2 of positive confirmation is used). No further audit work is required.
- **Balance not agreed**. The customer has replied but does not agree with the balance in the client entity's accounting records. The auditor should ask the client to review the replies and try to reconcile the balance in their records with the balance confirmed by the customer. The auditor should then check the reconciliation, looking for evidence of errors in the client company's figures which may represent misstatements of their accounts receivable balances. However, many of the reconciling items will often be '**timing differences**' – invoices, credit notes or cash may be recorded in the accounts of one party (the customer or the client entity), but not yet recorded by the other. Provided that the auditor is confident that the difference in the balances is due to timing differences, they should not be seen as evidence of errors in receivables balances.
- **No reply received**. No reply has been received from the customer. The auditor cannot ignore these customer accounts. They have been chosen as part of a representative sample and the auditor needs to reach a conclusion on the accuracy of the balances on **all** the accounts included in the sample for the confirmation process.

Further checking where no reply is received

Where no reply has been received, the auditor should therefore perform **alternative procedures** in order to obtain evidence to confirm the customer's balance.

- If the customer has subsequently paid all of the amount due at the confirmation date, this is strong evidence of the validity of the receivable.
- If no payment (or only part-payment) has been received, all the relevant documentation supporting the amount still due should be examined. For each invoice outstanding at the confirmation date, the auditor should examine:
  - a signed customer purchase order
  - signed delivery documentation (the customer's signature on the delivery note)
  - a sales invoice addressed to the customer.

4.7 Preparing a summary and reaching a conclusion

On completion of the confirmation exercise, the auditor should produce a **summary** of the responses. This should clearly indicate the amounts of the balances subject to confirmation for which the auditor has not been able to establish supporting evidence. These amounts indicate misstatement of receivables balances. In particular, they may indicate the existence of irrecoverable receivables.

As always with a sampling exercise, the auditor should draw a **conclusion** on the likely level of misstatement in the total population of receivables balances based on the result of the sample, and whether this is material.

Such a summary might be prepared as follows:

	Value of balances	% of total
	Rs.	
Replies received and agreed	465,600	80.3
Replies received and reconciled	56,400	9.7
Non-replies agreed using alternative procedures	43,200	7.5
Balances still unresolved	14,300	2.5
	579,500	100

Total value of receivables = Rs.1,248,900.

Extrapolation of potential error = Rs.1,248,900 × 2.5% = Rs.31,222 – Transferred to the cumulative errors schedule

Note: The cumulative errors schedule is a list of items where the auditor's view of the amount of the item differs from the amount in the client company's accounting records/draft financial statements. The auditor builds up this schedule as the audit progresses, and will use it when reaching his final audit opinion.

4.8 Other audit procedures for receivables

In addition to the confirmation process, the auditor should consider the following additional audit procedures in respect of trade receivables:

Irrecoverable receivables

The auditor needs to be satisfied that the amount of irrecoverable receivables written off and any allowance made for receivables are reliable. These will affect the amount included in the statement of financial position for trade receivables. The following substantive procedures should therefore be performed:

- Review the company's procedures for identifying irrecoverable and doubtful receivables.
- Review aged listings of receivables balances ('aged receivables lists'). Irrecoverable receivables and allowances for doubtful receivables should only relate to overdue accounts. The auditor should enquire as to whether the overdue receivables are collectable.
- Review any correspondence of the client company with customers, lawyers and collection agencies that deal with unpaid or disputed debts.
- Review the calculation of any allowances against doubtful receivables.
- Examine credit notes issued after the year-end, as evidence that some balances were overstated at the year-end. (The customer and the client company may have been in dispute about an invoice at the end of the financial year, and the dispute may subsequently have been resolved by the issue of a credit note and a reduction in the amount receivable.)
- Review the replies from customers for the confirmation of balances exercise, for evidence of receivables that may not be collectable.

Cut-off

The audit work after the physical inventory count will also give evidence of the accuracy of sales cut-off. The **cut-off assertion** was explained in an earlier chapter. It is concerned with ensuring that revenue (and therefore receivables) is properly recorded **in the correct accounting period**. Sales that occur just before or after the year-end need to be allocated to the correct financial year.

Additional work on this area might include the following:

- The use of analytical procedures to confirm that inventory levels, cost of sales and gross margins can be explained in terms of known business facts.

- Checking that sales invoices and credit notes dated shortly before and after the year end are recorded in the correct financial year.
- Review of the control account entries shortly before and after the year end for unusual items, which the client should then be asked to explain.

Classification and Presentation

To satisfy the **classification and presentation** assertion the auditor will need to ensure that:

- the list of receivables ledger balances (on which he bases his substantive procedures below) agrees to the financial statements
- receivables are correctly classified and presented in the financial statements.

Example:

The following is a summary of the year-end receivables balances at Mike's Manufacturing and the equivalent figures for the previous year. Performance materiality has been set at Rs.50,000.

Customer	20X5	20X4
	Rs.	Rs.
Jones	25,000	24,000
Smith	60,000	30,000
Brown	20,000	20,000
White	10,000	11,000
Crane	205,000	189,000
Other customers (all balances under Rs.10,000)	166,000	74,000
	486,000	348,000

Brown went into liquidation during the year.

Required

Set out which of the above balances, as a minimum, the auditor should select for testing and explain why.

Answer

- Smith should be selected as this balance is above performance materiality. Also, the balance has doubled since the previous year.
- Brown should probably be selected. Although it is below performance materiality it would seem likely that the receivable is irrecoverable.
- Crane should be selected as individually material.
- Although the "other customers" balances all fall well within the performance materiality threshold, they are material in total, and so a sample of these should be verified. This would particularly be the case if the auditor was not expecting sales to smaller customers to have increased during the year. There could be a deliberate attempt to overstate a number of small balances (or invent fictitious customers and balances) in a deliberate attempt to boost assets and avoid audit detection.

4.9 The audit of prepayments

Prepaid expenses are often **estimated amounts** and so may not be open to precise and specific audit checking procedures. The problem of auditing accounting estimates was discussed in a previous chapter. In addition, for many business entities, prepayments are not material and so may not justify significant audit attention.

Substantive procedures on prepayments may include the following:

- Obtain or prepare a list of prepayments with supporting calculations.
- Check the calculations if the list has been prepared by the client’s staff.
- Apply analytical procedures (for example, by comparing the balances for prepayments with the balances at the end of the previous financial year).
- Review the list of prepayments for any obvious errors or omissions, based on the auditor’s knowledge of the business.

5 SUBSTANTIVE PROCEDURES: BANK AND CASH BALANCES

Section overview

- Features of the audit of bank and cash balances
- Bank balances: confirmation of balances
- Audit work on receipt of the banks' replies
- Cash balances: physical count

5.1 Features of the audit of bank and cash balances

For the purpose of this chapter, bank balances are amounts held in a bank account, and cash balances are bank notes and coins (although coins are likely to be immaterial).

Assets held as bank balances and cash can be at risk of loss. There may be fraudulent activity, or the misappropriation of money by employees or others, particularly when many individuals have authority for dealing with receipts and payments.

However, bank balances and cash are also easily checked and verified. Bank balances can be confirmed directly in writing by the banks (third parties) and cash can be physically counted.

Bank balances and cash are also usually subject to rigorous internal controls, to prevent loss and theft. In many countries, it is regular practice for business entities to receive regular bank statements from their bank. A feature of internal control for bank balances is the reconciliation of the balance shown in a bank statement with the balance recorded in the entity's own accounting records (cash book).

The audit work on **cash** balances will be determined largely by materiality (how much cash does the entity hold and is it a material amount?) and the effectiveness of the client's internal controls for cash.

The **principal risks of misstatement** of the bank and cash balances in the financial statements are that:

- not all bank balances owned by the client are disclosed (the **rights and obligations** and **existence** assertions)
- reconciliation differences between bank statements and the client's cash book balances are incorrectly dealt with (the **accuracy, valuation and allocation** assertion)
- material cash balances are omitted (the **completeness** assertion).

The **presentation and classification** assertion is low risk as the disclosures in this area are straightforward.

5.2 Bank balances: confirmation of balances

Checking the accuracy of bank balances can be done effectively by means of **direct confirmation** to the auditor by the banks at which the entity's bank accounts are held. This is similar to written confirmation of balances from customers, in order to check trade receivables.

The bank confirmation letter

The auditor must decide, taking a risk-based approach, which banks to contact for confirmation. Typically, all banks that hold accounts for the client entity are contacted. However, the auditor may choose to omit some banks for reasons of immateriality.

The auditor can use either of two possible approaches to the confirmation of bank balances:

- **Method 1**. The auditor lists information about the bank balances from the client's accounting records and asks each bank to confirm that the balances are correct. (Note: Banks may operate several different accounts for the same customer.)

- **Method 2**. The auditor requests confirmation of the relevant bank balance(s) without providing any details to the bank. This method provides stronger audit evidence but it may be more time-consuming for the bank to provide the required confirmation.

The two methods are similar to the two methods of positive confirmation of balances from customers for trade receivables.

In the case of the external audit, permission must be given to the bank by the client to release information to the auditor. The letter should be written in a standard form that is acceptable to banks and should include the client entity's authorisation to the bank to release the information to the auditor. (The client entity may give standing authority to the bank to release the information to the auditor each year: if so, the letter should refer to this standing authority.) The letter should be sent by the auditor to the bank.

The reply should be sent by the bank direct to the auditor. (This is also the same as for the confirmation of balances from customers for trade receivables.)

Typical areas covered by the confirmation letter include the following:

- Confirmation of balances on all bank accounts at the end of the reporting period.
- Details of any unpaid bank charges.
- Details of any liens (charges) over assets of the client entity.
- Details of any assets of the client entity held by the bank as security for lending.
- Details of any other client bank accounts that are known to the bank but not listed in the request to the bank for confirmation of balances.

5.3 Audit work on receipt of the banks' replies

The main audit work will focus on the confirmation letters from the bank (or the confirmation letter from the client's bank, if there is just one bank) and the client company's bank reconciliation statement. A statement should be provided by the bank for the end of the reporting period.

- Obtain or prepare a bank reconciliation statement for each bank account.
- If the reconciliation is prepared by the company, check it for arithmetical accuracy.
- Check the bank balance confirmed in the bank's confirmation letter against the balance used in the bank reconciliation statement.
- Relate other information contained in the confirmation letter to other areas of the audit (for example, accrued bank charges must be provided for in the financial statements).
- Check items appearing in the bank reconciliation statement against any available supporting evidence (for example, unpresented cheques in the bank reconciliation statement should be shown as having been presented in a subsequent bank statement).
- Review the cash book and bank statements for unusual items, including unusual delays between cash book and bank statement entries. Investigate the reasons for any unusual item.
- Review the confirmation letter from the bank for any other information to be disclosed in the financial statements (for example, charges on assets and security for loans).

5.4 Cash balances: physical count

The audit work performed on cash balances (as opposed to bank balances) will be largely dictated by materiality considerations. In this context, materiality should be considered not only in terms of the statement of financial position amount, but also in terms of the value of total transactions passing through the cash account during the period.

In addition, the auditor needs to appreciate that certain businesses hold cash in a large number of locations (for example, in a company that operates a chain of hotels or supermarkets). In total, these balances may be material, whereas the amount of cash held in any single location may be insignificant.

The main audit work involved in verifying cash balances is a **physical count**.

Audit procedures include the following:

- The auditor should count cash at all locations **simultaneously** and in the presence of a company official. (Simultaneous counting is necessary, to prevent the client from moving cash that has been counted at one location to another location ready for the next count.)
- After the count the auditor should obtain a signed receipt for the amount of cash returned to the official, after the count.
- The auditor should check the cash balance obtained from the count against the client's cash records and cash balance in the draft financial statements.
- Where appropriate, the auditor should also investigate the treatment of any money advances to employees (for example, against wages or salary).

6 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain the principle risks of misstatement for current assets
- Describe the key substantive procedures for auditing
  - Inventory
  - Trade receivables
  - Bank and cash

CHAPTER 11

Substantive procedures: other areas

Contents

1 Substantive procedures: trade payables
2 Substantive procedures: accruals, provisions and contingencies
3 Substantive procedures: non-current liabilities
4 The audit of equity
5 Key income statement figures
6 Chapter review

INTRODUCTION

Learning outcomes

The overall objective of the syllabus is acquiring knowledge of theory, skill and techniques of auditing and to enable the students to understand International Standards on Auditing, Assurance and Ethics.

Performance of audit and reporting

LO 2	**On the successful completion of this paper, candidates will be able to demonstrate working knowledge in respect of performance of simple audit procedures and understand the audit report requirement under the Companies Act, 2017**

Substantive Procedures (ISA 330)

LO 2.6.4	Discuss the methods of obtaining audit evidence for substantive testing
LO 2.6.5	Explain the nature, extent and timing of substantive procedures for different items of financial statements
	[Note: 2.6.4 and 2.6.5 are covered in chapters 8, 9, 10 and 11]

1 SUBSTANTIVE PROCEDURES: TRADE PAYABLES

Section overview

- Principal risks of misstatement in the audit of liabilities
- The general approach to the substantive testing of trade payables
- Substantive procedures for trade payables
- Purchases cut-off

1.1 Principal risks of misstatement in the audit of liabilities

As discussed in previous chapters, **directional testing** is an approach to audit testing that an auditor may use to improve the efficiency of an audit. With directional testing, liabilities, income and equity are usually tested for **understatement** only. This is testing the financial statement assertion of **completeness**. The reason for this approach is that an auditor will consider it much more likely that an entity will understate its liabilities (in order to present a better financial position) than overstate its liabilities.

Because auditing liabilities involves testing for completeness, auditing liabilities is often more difficult than auditing assets (where the emphasis of audit testing is on overstatement/existence). The auditor is looking for something that is not recorded, rather than verifying something that has been recorded. This influences the audit approach and the type of audit work performed.

The **principal risks of misstatement** in respect of liabilities are therefore due to the following:

- Not all liabilities of the reporting entity being included in the financial statements. This is considered to be the main risk.
- Cut-off between goods inwards and liability recording being incorrect (the **cut-off** assertion – an **income statement** assertion that has a knock-on effect to the audit of trade payables (see below)).
- Non-existent liabilities being included in the financial statements (the **existence** and **rights and obligations** assertions). This risk is more rare, and will often not be considered a risk at all.
- Liabilities not being properly disclosed in the financial statements (the **classification and presentation** assertion).

1.2 The general approach to the substantive testing of trade payables

Trade payables are a material item in the statement of financial position of many entities. Therefore, this area is likely to receive a significant level of audit attention.

In some respects, the audit approach is similar to the approach used for the audit of trade receivables. However, a major difference lies in the fact that direct confirmation of balances with suppliers, although sometimes used, is **not** a typical audit testing procedure.

The reason why direct confirmation is not widely used is that the auditor normally has an alternative external source of written evidence. This evidence is provided in the form of supplier's statements.

- A supplier's statement is a printed statement, received at regular intervals from a supplier (usually each month), showing details of transactions between the supplier and its customer (purchases, purchase returns and payments) since the previous statement, and the amount owing as at the date of the statement.
- These statements and the entity's own listing of trade payables are the main records used by the auditor for testing trade payables.

Audit work performed on purchases, cash payments and inventory (including purchases cut-off) will also generate valuable audit evidence relating to trade payables.

1.3 Substantive procedures for trade payables

The following substantive procedures can be used to gather audit evidence on trade payables:

- Obtain or prepare a listing of balances on supplier accounts in the payables ledger (a listing of trade payables)
- If this listing is obtained from the client company, check it for arithmetical accuracy (perhaps by using audit software). In addition, check the payables for existence by taking a sample of the balances and checking them against the balance on the supplier's account in the payables ledger.
- Similarly, take a sample of balances from supplier accounts in the payables ledger and confirm that they are included in the listing at appropriate amounts. This is a test for accuracy, valuation & allocation and completeness.
- Check that the total of the balances in the listing agrees with the balance for total trade payables in the trade payables control account in the main ledger.
- In selecting the sample of balances for testing, the auditor should consider the following points:
  - It is **not** important to select large balances, as the main audit emphasis is on completeness and understatement (not existence and overstatement).
  - For the same reason, it **is** important to select a number of accounts showing nil balances and debit balances. (When there is a debit balance, the supplier owes the client entity, presumably because goods have been returned and a credit note has been issued by the supplier, or because an invoice was over-paid or paid twice.)
  - Include major suppliers in the sample. Identification of major suppliers should be based on the auditor's knowledge of the business. This knowledge may be derived from information gained at the inventory count or from audit work on the purchases system.

  As with trade receivables, for an IT-based system , audit software can be used to assist in sample selection.
- For each supplier account balance in the sample, compare the balance from the payables listing with the balance shown in the supplier's statement. (The first supplier's statement received after the reporting period should be used, because this will include the position as at the end of the reporting period.)
- If there is a difference between the balance in the payables listing and the balance shown in the supplier's statement, the auditor should ask the client company to prepare a reconciliation to explain the difference. The auditor should then check these reconciling items with the relevant supporting documentation.

In order to gain additional assurance about the **completeness** of trade payables balances, the auditor should also carry out the following procedures:

- Review the list of account balances for any suppliers who are not in the listing of trade payables, but who would be expected to be in the listing. These would include regular suppliers of frequently-purchased items.
- Compare the list of trade payables balances with the listing that was prepared for the previous year's audit (at the same date in the previous year). Look for explanations as to why any major balances do not appear on the current year's listing when a major balance for the same supplier is in the listing in the previous year.
- Apply other analytical procedures and obtain explanations for any significant differences identified with this method of testing. For example, the auditor might compare the ratio of trade payables to purchases in the year, and compare this with the same ratio in previous years. He might expect the ratio to remain fairly stable between one year and the next.

1.4 Purchases cut-off

Purchases cut-off was explained in an earlier chapter. It is concerned with making sure that purchases transactions just before or after the year end are allocated to the correct financial year, so that purchases (for the income statement/statement of comprehensive income) and inventory and trade payables (for the statement of financial position) are correctly recorded.

- Work performed on cut-off (and recorded at the physical inventory count) will provide evidence as to the accuracy of purchases cut-off.
- This work is based on preparing a list of the goods received notes that were prepared by the client entity immediately before and after the end of the reporting period. The auditor should confirm that goods included in closing inventory have also been recorded as a liability (trade payable) and that purchased goods not recorded in closing inventory have not generated such a liability.

2 SUBSTANTIVE PROCEDURES: ACCRUALS, PROVISIONS AND CONTINGENCIES

Section overview

- Difficulties of obtaining evidence in this area
- Accruals
- IAS 37 Provisions, Contingent Liabilities and Contingent Assets
- Provisions and contingencies: substantive procedures

2.1 Difficulties of obtaining evidence in this area

The audit of accruals, provisions and contingencies can also be difficult areas for the auditor. Accruals are usually estimated amounts and will be subject to audit techniques which are similar to those applied to prepayments. Provisions and contingencies can be highly subjective areas where a considerable amount of judgement may be called for. Evidence may be needed from outside experts such as legal advisors.

2.2 Accruals

Accruals balances are difficult to audit as the figures reported are often based on estimates. However, the amounts involved may not be material, in which case the auditor will not devote a significant amount of time and resources to this area.

As with all liabilities, the emphasis will be on **completeness**. The nature of the items involved means that analytical procedures and the auditor's knowledge of the business are useful in reaching a conclusion on this area.

Substantive procedures include the following:

- Obtain or prepare a listing of accruals as at the end of the reporting period.
- If the list is prepared by the client company, check the calculations and additions for arithmetical accuracy. Check the amounts in the listing against the balances in the relevant main ledger expense accounts and ensure that the amounts are the same.
- Where invoices have been received, or payments made, after the year end, confirm that the amount accrued appears reasonable in relation to this evidence. For example, suppose that a company makes an accrual for two months of electricity charges, and receives an invoice for three months' supply of electricity one month after the year-end. If the accrual for electricity is, say, Rs.60,000 (Rs.30,000 per month), the auditor should expect the total invoice to be for about Rs.90,000.
- Compare the list of accruals with the list that was prepared at the same date in the previous financial year, and enquire about items not listed in the current year that were in the list in the previous year.
- Review the list of accruals for completeness, based on the auditor's knowledge of the business.
- Relate items on the list of accruals to other audit areas, such as the bank confirmation letter (which might provide details of unpaid/accrued bank charges).

Accrued wages and salaries may be more material than other items and may require a higher level of audit attention:

- Consider what items should be accrued for at the end of the reporting period, such as unpaid wages, overtime, holiday pay, bonuses.
- Check the amounts for accrued wages and salaries by comparing them with personnel records and payroll records (records of time worked, records of wage rates and salaries, details of dates for the payment of wages and salaries, and so on) and to payments made after the year end.

- Confirm that any additional costs (such as employer's payroll taxes) have been accounted for.
- Perform analytical procedures on accrued wages and salaries. For example, the auditor might measure the ratio of accrued payroll expenses to total payroll costs for the year, and compare this with the similar ratio in previous years. Significant differences should be investigated.

2.3 IAS 37 Provisions, Contingent Liabilities and Contingent Assets

Accounting for provisions and contingencies can be a subjective area, which may require a high level of audit attention because the amounts involved could be material. Part of the work of the auditor will be to establish whether the provisions of IAS 37 have been complied with. You therefore need to be aware of the key points of IAS 37.

Provisions

IAS 37 gives the following definitions:

- A **provision** is a type of liability. It is a liability of **uncertain timing** and **uncertain amount**.
- A **liability** is:
  - a present obligation
  - arising from past events
  - the settlement of which is expected to result in an outflow of economic benefits.

An 'ordinary' liability is for a **known amount**. For example, an amount payable under the terms of a finance lease agreement is a liability. The obligation arises from the lease agreement. The settlement of the obligation by means of the lease payments will result in a known outflow of cash on known dates.

A provision is a liability of an **uncertain amount** or **uncertain timing**, such as:

- amounts that an entity might have to pay under a guarantee, or
- amounts that an entity might have to pay as the result of a legal claim.

An entity may know that it will have to incur expenses or will have to make a payment under guarantees it has given to customers. It therefore has a liability – an obligation that already exists arising from past events that will result in an outflow of economic benefits in the future. However, it will not know for certain when claims might be made under the guarantees and how much the claims will cost. The entity should therefore make a provision for expenses or payments that it expects to make under the terms of its guarantees.

Recognising a provision

IAS 37 states the criteria for recognising a provision as a liability in the financial statements. A provision should only be recognised when:

- an entity has a present obligation as a result of a past event
- it is probable that an outflow of economic benefits will be required to settle the obligation, and
- a reliable estimate can be made of the amount of the obligation.

There must be an obligation already in existence. The obligation may be legal or constructive:

- A **legal obligation** is one arising from a contract, or some other aspect of the law.
- A **constructive obligation** is one arising from the entity's actions, whereby
  - through established past practice, published policies, or a specific current statement, the entity has indicated to other parties that it will accept certain responsibilities, and

- as a result, the entity has created a valid expectation that it will discharge those responsibilities. For example, a clothing retailer may have a policy of taking back items of clothing that customers have purchased, and refunding the purchase price, simply because the purchaser has changed his or her mind after purchase. The retailer is not under a legal obligation to take back purchased items in this way, so there is no legal obligation. However, if this is the usual practice of a particular retailer, then a constructive obligation arises.

The event leading to the obligation must be **past**, and must have occurred before the end of the reporting period when the provision is first recognised. No provision is made for costs that may be incurred in the future but where no obligation yet exists. For example, if an entity is planning a reorganisation but does not yet have an obligation (legal or constructive) to undertake the reorganisation, it cannot create a provision for reorganisation costs.

The outflow of benefits must be **probable**. 'Probable' is defined by IAS 37 as '**more likely than not**'. For example, an entity may have given a guarantee but may not expect to have to honour it. In such a situation, it cannot create a provision for the cost of expenses that it may have to incur under the terms of the guarantee. This is because a payment under the guarantee is not probable.

Measuring a provision

The amount recognised as a provision should be the best estimate of the expenditure required to settle the obligation at the end of the reporting period.

Risks and uncertainties should be taken into account in reaching the best estimate. Events after the reporting period will provide useful evidence. However, entities should:

- **avoid** creating **excessive provisions** (which could be used as a way of manipulating profits between financial years), or
- avoid underestimating provisions.

Contingent liabilities

A contingent liability is **either of the following**:

A contingent liability is:

- a possible obligation
- arising from past events
- whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events.

A contingent liability is:

- a present obligation
- arising from past events
- which is not recognised as an actual liability because
  - an outflow of economic benefits is not probable, or
  - the amount of the obligation cannot be estimated reliably.

A contingent liability arises when some, but not all, of the criteria for recognising a provision are met. For example, a contingent liability exists, but not a provision or an actual liability if:

- a reliable estimate cannot be made, or
- no legal obligation or constructive obligation exists: there is merely a **possible** obligation.

Contingent assets

A contingent asset is:

- a possible asset
- arising from past events
- whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events.

An example of a contingent asset might be a possible gain arising from an outstanding legal action against a third party. The existence of the asset (the money receivable) will only be confirmed by the outcome of the legal dispute.

Recognising contingent liabilities or contingent assets

Unlike provisions, contingent liabilities and assets:

- **are not recognised** in the financial statements and
- are not recorded in the ledger accounts of an entity. (They are not included in the double entry ledger accounting system.)

In some circumstances, the existence of a contingent asset or a contingent liability is **disclosed** in the notes to the financial statements:

- Contingent liabilities are disclosed **unless** the possibility of any outflow in settlement is remote (the meaning of 'remote' is not defined in IAS 37).
- **Contingent assets** are **only disclosed where** an inflow in settlement is **probable**. 'Probable' is defined by IAS 37 as 'more likely than not'.

Disclosures about contingent liabilities and contingent assets

Where disclosure of a contingent liability or a contingent asset is appropriate, IAS 37 requires the following disclosures in notes to the financial statements:

- A brief description of the nature of the contingent liability/asset
- Where practicable:
  - an estimate of its financial effect
  - an indication of the uncertainties.

For contingent liabilities, the possibility of any reimbursement.

2.4 Provisions and contingencies: substantive procedures

The auditor needs to be satisfied that the client has correctly distinguished between provisions (included in the financial statements), contingent liabilities (not included in the financial statements but disclosed in a note) and items that should not even be disclosed.

Similarly, it may be necessary to assess whether an item is an actual asset (included in the financial statements), a contingent asset (not included in the financial statements but disclosed in a note) or not likely to happen and so not disclosed.

The auditor must also be satisfied about the measurement/valuation of the items in the financial statements or disclosed by way of a note.

Provisions

Substantive procedures to provide evidence on provisions should normally include the following:

- Obtain a listing of provisions that the client has included in the (draft) financial statements.
- For each item in the listing, confirm that the accounting provisions of IAS 37 have been complied with. Does the item meet the definition of provision?
- Review the changes in the provision for the period during the financial period.

- Review the measurement of the closing balance for each provision and discuss these with management if appropriate. Consider whether it might be appropriate to take expert advice on the existence or measurement of a provision.
- Review the list for possible omissions, based on the auditor's knowledge of the business and the industry in which it operates.
- Compare provisions for the current financial year with provisions in previous years, and investigate any major differences or omissions.
- Relate the testing of provisions to other areas of the audit work, such as correspondence with lawyers (which might reveal more information about matters to which the provisions relate).

Contingencies

The audit approach to gathering evidence on contingencies may be as follows:

- Ascertain the approach taken by the client's management to identifying contingencies.
- Review the minutes of board meetings (where such matters are likely to be discussed).
- Review relevant sections of the business press and trade journals for areas in which possible industry-wide contingencies may arise.
- Review the client's correspondence with lawyers and invoices for legal services. These may help the auditor to identify contingencies that the client has not disclosed in the notes to the draft financial statements, or that provide additional information for the auditor about contingencies that have been disclosed.
- Consider direct confirmation from lawyers of matters handled on behalf of the entity under audit. Any letter should be sent by management with an instruction for the reply to be sent directly to the auditor. It is more likely that lawyers will respond if the letter lists specific areas where contingencies may exist, together with an assessment by management of the possible outcome. The lawyers should then be asked to comment on the information in the letter.
- Consider whether expert advice may be required from outside sources other than lawyers.

3 SUBSTANTIVE PROCEDURES: NON-CURRENT LIABILITIES

Section overview

- Aspects of reporting non-current liabilities
- Substantive procedures for non-current liabilities

3.1 Aspects of reporting non-current liabilities

Non-current liabilities are liabilities repayable after more than one year from the end of the reporting period. They may include:

- debentures
- loan stock
- loan notes
- bank loans
- finance lease obligations.

It may be that loans are repayable at regular intervals throughout the term of the loan, in which case a part of the overall balance owing may be a current liability (repayable within the next 12 months) with the remaining part being a non-current liability. This is an important point for the auditor to consider, in terms of ensuring the proper disclosure of information in the financial statements (and the classification of liabilities as non-current or current).

The agreements under which these non-current liabilities are taken out may impose conditions on the company which, if broken, may give the lender the right to impose penalties or possibly withdraw the finance. This is another significant consideration for the auditor.

3.2 Substantive procedures for non-current liabilities

Substantive procedures in respect of non-current liabilities may be as follows:

- Obtain or prepare a listing of long-term borrowings/non-current liabilities. The listing should include, for each item, details of the lender and the movement on the borrowing in the financial period. (Opening balance plus interest charges minus payments on the loan equals closing balance.)
- If the list is obtained from the client entity, check it for accuracy.
- Agree the opening balances on the listing with the amount for non-current liabilities in last year's statement of financial position.
- Check that any new borrowings during the year have been authorised in accordance with the correct company procedures.
- Agree the details of each loan with the loan agreement/documentation.
- Check whether any restrictions contained in the lending agreements have been complied with. For example, check that the client entity has not been in breach of any covenant in a borrowing agreement.
- Confirm loan repayments in the listing with payments recorded in the cash book, entries in bank statements and also with any correspondence or receipts or statements from lenders.
- Check the interest calculations and confirm that the correct accounting entries for interest have been made, recognising any opening and closing accruals for interest expenses.
- Obtain direct confirmation from lenders of amounts outstanding.
- Confirm that any relevant statutory requirements have been complied with (such as whether charges on assets have been properly registered, if there is a legal obligation to register charges).

- Confirm the correct allocation of the total amounts outstanding between current liabilities (repayable within 12 months) and non-current.
- Review cash book entries for unusual cash receipts that may represent new loans taken out during the period. Where unusual cash book entries are found, obtain an explanation.

4 THE AUDIT OF EQUITY

Section overview

- Introduction
- Substantive procedures: share capital
- Substantive procedures: reserves
- The audit of statutory books

4.1 Introduction

To some extent, the nature of the specific audit work performed on equity in the statement of financial position will be dictated by the requirements of local company law. The procedures described here cover general audit principles which are likely to be relevant in most countries.

The amount of audit work performed on this area is usually not significant. If the auditor is confident that assets and liabilities are correctly stated, the total of equity (capital and reserves = assets minus liabilities) must also be correct.

4.2 Substantive procedures: share capital

The auditor will usually carry out the following substantive procedures on share capital:

- ❑ Where local law requires that companies should have an authorised share capital, the auditor should check that the total authorised capital in the draft financial statements is consistent with the company's constitution.
- ❑ The auditor should check the nominal value of shares issued during the year, by reading the supporting documentation, and should ensure terms of issue were properly complied with.
- ❑ If new shares were issued during the year, check that cash received for them has been properly recorded in the main ledger.
- ❑ Check that the amount reported as issued share capital agrees with the amount recorded in the register of members/shareholders, if the company has such a register. (In some countries there is a legal requirement to maintain a register of members.)

4.3 Substantive procedures: reserves

The auditor will usually carry out the following substantive procedures on reserves:

- ❑ Obtain an analysis of movements on all reserves during the period.
- ❑ Check the accuracy of these movements by checking supporting documentation.
- ❑ Ensure that any specific legal requirements relating to reserves have been complied with. (For example, check that the entity has not breached legal restrictions on use of the share premium account.)
- ❑ Confirm that dividends have been deducted only from those reserves that are legally distributable (usually the accumulated profits reserve/retained earnings).
- ❑ Check the authorisation for the amount of dividends paid.
- ❑ Check the dividend calculations and check that the total dividends paid are consistent with the amount of issued share capital at the relevant date.

4.4 The audit of statutory books

Most countries require companies to maintain certain ‘books’ or records containing defined information, in addition to their normal accounting records. The nature of these ‘**statutory books**’ varies from country to country, but they may include the following:

- Minutes of board meetings and minutes of general meetings of the company.
- Register of members/shareholders.
- Register of directors and their interests in the shares and loan capital of the company.
- Register of charges on the company’s assets.
- Copies of directors’ service contracts and details of directors’ remuneration packages. (Audit work on this area can be included in payroll testing procedures. The auditor should confirm that national company law disclosure requirements are complied with.)

The auditor should confirm that the required statutory records are maintained by the client company and are up-to-date.

5 KEY INCOME STATEMENT FIGURES

Section overview

- Introduction
- Sales
- Purchases
- Payroll costs
- Interest paid and received
- Expenses

5.1 Introduction

Tests of controls on key income statement figures were covered in a previous chapter. Whatever the results of those tests, some degree of substantive procedures will need to be performed. For some clients, with strong internal controls, this could be limited to analytical procedures. These and other possible substantive procedures are considered below.

5.2 Sales

Occurrence	▪ Select a sample of recorded transactions from Sales Journal, and vouch for complete audit trail i.e. from recording Journal to initiative document e.g. G.L. Sales Invoice, Delivery Note, Customer Order.
Completeness	▪ Select a sample of Shipping Documents, and vouch for complete audit trail i.e. from Shipping documents to Sales Invoice, recording in GL to obtain evidence that all goods dispatched have been accounted for. ▪ Review reconciliation between Individual Sales Invoices and Total posted in Debtors' Control Account.
Accuracy	▪ Recalculate amount of bill for a sample of sales invoices by using quantity from Dispatch Note, Rate from authorized rate list, and also check mathematical accuracy of invoices.
Classification & Presentation	▪ Review ledger for any unusual debits/credits to identify any misclassification. ▪ Examine a sample of sales invoices for proper classification into revenue accounts.
Cut off	▪ Perform Cut off Test i.e. Select a sample of sales invoice just before and after year end and compare dates of shipment with the dates they were recorded in the sales journal.

5.3 Purchases

As with substantive testing of revenue, it should be possible to obtain strong evidence about purchases from analytical procedures, due to the strong relationships that normally exist between purchases and other key figures in the financial statements (such as revenue (via the gross profit percentage) and trade payables).

As with revenue, purchases can also be substantively tested by vouching transactions. If the major risk is one of **understatement**, then the auditor will wish to test for **completeness**. He may therefore wish to check that:

❑ all purchase orders are recorded and that the order details are correct

❑ for every purchase order the goods were actually received

❑ all goods received were properly recorded in the inventory accounting system.

Substantive procedures on purchases (other than analytical procedures) include the following.

- Obtain a sample of copies of purchase orders and trace these to the purchasing IT system. Check the accuracy of the recorded order details in the system.
- Obtain a sample of purchase orders in the purchasing IT system and trace these to the signed copies of the goods received notes in the stores department (goods inward department).
- For this same sample of purchase orders, check that the details of the goods received were properly recorded in the inventory accounting system.

Substantive tests can also be carried out on **purchase invoices**, in order to ensure that:

- details in the purchase invoices have been correctly entered in the payables ledger
- entries are made in the purchase ledger only for goods that have actually been received
- the liability was recorded in the correct supplier account.

Methods of performing these tests include:

- Obtain a sample of purchase invoices recorded in the purchases day book and agree the details (of supplier and price) with the entry in the purchase ledger.
- For a sample of purchase invoices in the purchases day book, agree the invoice details by checking with the corresponding goods received note.
- Carry out arithmetical checks on a sample of suppler invoices (quantities delivered multiplied by price and total invoice amounts; also check prices against the original purchase orders).

5.4 Payroll costs

Analytical procedures are often carried out on payroll costs as there is a strong relationship between rates of pay and numbers of employees (for gross pay) and between gross pay and deductions (such as employer's national insurance and pension deductions).

An example of analytical procedures for payroll costs is as follows. For a department where employees all receive fixed salaries, compare salary costs in the current year with salary costs in the preceding year. Unless there has been a significant change in staff numbers, the two totals should be similar, except for any inflationary increase in salaries during the year.

Another check would be to compare total salary payments for the same department between one month and the next. Except for a month in which a salary increase is applied, total salary costs for the department should be constant from one month to the next.

Other substantive procedures to verify payroll costs might include selecting a sample of payroll records and checking that:

- the employee exists (by reference to personnel records)
- gross pay has been correctly calculated (by reference to personnel records for salaries or time worked multiplied by documented rates of pay)
- deductions have been correctly calculated (by re-performance on a sample of payroll payments).

5.5 Interest paid and received

Interest paid and received will usually be verified via:

- bank statements
- "proof in total" (average interest rates for the period multiplied by average balance outstanding).

5.6 Expenses

Occurrence	Select a sample of transactions from expense account and perform following procedures: ▪ Check supporting documents ▪ Check mathematical accuracy ▪ Check acknowledgement of receipt of goods/services. ▪ Check approval and authorisation (e.g. Invoices) ▪ Check tax deduction ▪ Check evidence of payment (e.g. copy of cheque, receiving signature, and/or payment from bank statement) ▪ Check supporting duly stamped "Processed" or "Paid". ▪ Ensure that the expense relates to the year and business
Completeness	▪ Review the period end accrual of expenses. ▪ Search for unrecorded liabilities.
Accuracy	▪ Recalculate invoices and ensure preparation of vouchers is accurate on the basis of invoices. ▪ Test that calculation of expenses is based on reasonable rates based on market rates.
Cut off	▪ From selected sample of transactions, check date of acknowledgement of receipt of goods/services.
Classification & Presentation	▪ Check allocation of payment between expense and prepayments ▪ Scan accounts in G.L. for unusual transactions e.g. credit items in expense accounts, Larger amounts in Repair and Maintenance Account etc.

6 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain the principle risks of misstatement for the areas listed below
- Describe the key substantive procedures for auditing
  - Trade payables
  - Accruals, provisions and contingencies
  - Non-current liabilities
  - Equity
  - Directors' emoluments
  - Key income statement figures

CHAPTER 12

Related party transactions

Contents

1 Related parties: ISA 550
2 Chapter review

INTRODUCTION

Learning outcomes

The overall objective of the syllabus is acquiring knowledge of theory, skill and techniques of auditing and to enable the students to understand International Standards on Auditing, Assurance and Ethics.

Performance of audit and reporting

LO 3	**Understand the requirement and application guidelines relating to some of the specific areas of audit procedures including external confirmation, review of subsequent event etc.**

Consideration of related parties (ISA 550)

LO 3.4.1	Describe the term related party using simple examples
LO 3.4.2	Discuss how related party transactions can give rise to the risk of material misstatement using simple examples
LO 3.4.3	Describe the audit procedures including risk assessment procedures and related activities to obtain information relevant to identifying the related party relationships and transactions including responses to the assessed risk of material misstatement

1 RELATED PARTIES: ISA 550

Section overview

- Related parties and related party transactions
- The impact on the audit of related party relationships and transactions
- The requirements of ISA 550

1.1 Related parties and related party transactions

Related parties are individuals or organisations that might have, or might be expected to have, an undue influence on the company that is being audited. Examples of related parties include:

- the directors and key management of a company
- their families
- other companies controlled by directors, key managers and members of their close family
- other companies in the same group.

Related party transactions are material transactions between the client company and a related party of the company.

It is the responsibility of the client company's management to record and disclose all material **related party transactions**, because these transactions may be carried out on more favourable terms than similar transactions with an independent third party.

The approach required by IAS 24 *Related party disclosures* is to disclose the relevant amounts of related party transactions and the nature of the related party relationships, so that the users of the financial statements can decide for themselves whether these transactions might have resulted in a manipulation of the financial statements.

1.2 The impact on the audit of related party relationships and transactions

Although many related party transactions are in the normal course of business and therefore may carry no higher a risk of material misstatement than ordinary transactions, in some circumstances related party transactions may lead to higher risks. For example:

- related parties may operate through complex structures and relationships and the resulting transactions may therefore also be complex
- accounting systems may not be effective at identifying and summarising related party transactions and balances
- related party transactions may not be conducted on normal market terms – some may even be conducted with nil consideration.

The **objectives** of the auditor with regard to ISA 550 are to obtain:

- an **understanding** of the entity's related party relationships and transactions, and
- sufficient appropriate audit evidence about whether related party relationships and transactions have been **appropriately identified, accounted for and disclosed** in the financial statements.

The understanding must be sufficient for the auditor to be able to:

- recognise **fraud risk factors** arising from related party relationships and transactions
- conclude whether the financial statements achieve **fair presentation** in respect of related party relationships and transactions.

There is an increased risk of fraud in this area as related party relationships may present a greater opportunity for collusion, concealment or manipulation by management. It is therefore particularly important that the auditor approaches this area of the audit with **professional scepticism.**

1.3 The requirements of ISA 550

Most material misstatements linked to related party transactions arise from failure by the management of the client company to disclose related party relationships and transactions to the auditor.

ISA 550 therefore sets out a minimum set of risk assessment procedures specifically directed towards the identification of related party relationships and transactions that have not been identified or disclosed by management.

Risk assessment procedures

The auditor is required to perform the following procedures in order to **understand the entity's related party relationships and transactions**:

- Consider the risk of material misstatement due to fraud or error arising from related party relationships and transactions.
- Make inquiries of management in respect of:
  - the identity of related parties
  - the nature of relationships with those related parties
  - the nature of any transactions entered into with those parties during the period.
- Obtain an understanding of the internal controls in operation over:
  - the identification of, accounting for and disclosure of related party relationships and transactions
  - the authorisation and approval of significant related party transactions
  - the authorisation and approval of significant transactions outside the normal course of business.

Identifying related parties and related party transactions

In making inquiries of management in respect of the identity of related parties, the auditor will obtain a list of related parties from the directors, and consider if this list is complete. **Tests for completeness** could include the following:

- Review working papers for previous years, to look for names of known related parties.
- Review the company's procedures for identifying related parties.
- Inquire about the relationships between directors and other entities (for example, does any director own another company, and have there been any transactions between that company and the client company?)
- Review shareholder records for the names of major shareholders.
- Review minutes of shareholder meetings (general meetings of the company).
- Ask any other audit firms involved in the audit about related parties (if the audit is the audit of a group of companies and more than one firm of auditors is involved). Or
- Ask previous auditors of the company about their knowledge of related parties.

The auditor may have difficulty in obtaining a complete list of related parties. This is because their main source of information about related parties is the client's management, who may wish to keep related party relationships hidden. Particular problem areas where the disclosure of related parties may be incomplete are:

- close family relationships
- where the related party is another business entity which is owned or influenced by a director of the client company: however two companies are not necessarily related parties just because the same individual is a director or shareholder in both – the key issue is whether the individual is in a position of influence in both companies.

The auditor may also have difficulty in identifying all related party transactions that have occurred, unless the client entity has recorded them separately. Related party transactions may be 'hidden' within all the other transactions recorded in the accounts of the entity.

During the audit the auditor must remain alert, **when inspecting records or documents**, for information which might indicate the existence of previously unidentified or undisclosed related party relationships or related party transactions. The auditor is also specifically required to inspect the following:

- Any bank and legal confirmations obtained as part of his audit work.
- Minutes of shareholder and management meetings.
- Any other records or documents the auditor considers necessary in the specific circumstances.

If the auditor identifies **significant transactions outside the entity's normal course of business** he must inquire as to the nature of these transactions and whether related parties could be involved. This is because these carry a higher risk of involving related parties who have previously been unidentified or undisclosed. ISA 550 states that any significant related party transactions outside the entity's normal course of business must be treated as giving rise to significant risks of material misstatement.

The whole audit team should be made aware of information obtained about the entity's related parties so that they can identify any previously undisclosed transactions with related parties.

If any fraud risk factors are found these must be taken into account when the auditor identifies and assesses the risks of material misstatement due to fraud in accordance with ISA 240. A key fraud risk factor identified by ISA 550 is the existence of a party who exerts **dominant influence** over the entity. Any such party (an individual or a company) is likely to be able to override the views of the entity's management and force the entity to enter into a transaction in which the dominant party has an interest.

Indicators that a person or entity might be a dominant party include:

- the party vetoing significant business decisions of the entity
- significant transactions being referred to the party for final approval
- little or no debate among management in respect of business proposals made by the party
- transactions involving the party (or its close family members) are rarely independently reviewed or approved.

Responses to the risks of material misstatement

As discussed in a previous chapter, the auditor is required by ISA 330 to respond to assessed risks. In the context of the assessed risks of material misstatement arising from related party relationships and transactions ISA 550 requires the following audit procedures.

If the auditor discovers **previously unidentified or undisclosed related parties or (significant) related party transactions** he must:

- Determine whether the underlying circumstances confirm the existence of those relationships or transactions.
- Communicate the relevant information to the audit team.
- Request management to identify all transactions with the newly identified related parties.
- Inquire as to why the entity's system failed to identify or disclose these related party relationships or transactions.
- Perform appropriate substantive procedures on the newly identified related parties or significant related party transactions.
- Reconsider the risk of there being unidentified or undisclosed related parties or (significant) related party transactions and perform additional procedures as necessary.
- If the non-disclosure appears intentional, evaluate the implications for the audit.

If the auditor discovers **significant related party transactions outside the entity's normal course of business** he must:

- ❑ Inspect the underlying contracts or agreements to evaluate whether:
  - the contracts etc. were entered into in order to engage in fraudulent financial reporting or to hide the misappropriation of assets (a lack of business rationale might indicate this)
  - the terms of the contracts etc. are consistent with management's explanations, and
  - the transactions have been properly accounted for and disclosed.
- ❑ Obtain evidence that the transactions were properly authorised.

If management has made a statement in the notes to the financial statements that a related party transaction was made on the same terms as an arm's length transaction, the auditor must obtain evidence to support this assertion.

Materiality of related party transactions

ISA 450 *Evaluation of misstatements identified during the audit*, requires the auditor to consider both the **size and the nature** of a misstatement, and the **particular circumstances of its occurrence**, when evaluating whether a misstatement is material.

In the context of related party transactions, this means that much smaller transactions in monetary terms may be material as the significance of the transaction to the users of the financial statements may not depend solely on the recorded amount of the transaction but also on the nature of the related party relationship. It may be tempting to assume that materiality means 'large', but in the case of related party transactions, a transaction could be material if it has a value as low as Rs.0 (for example, a transaction involving the sale of the company's assets to a related party for a very low price).

Other requirements

Written representations must always be obtained by the auditor from the directors about related parties and related party transactions. The directors are in the best position to know the identities of any related parties. The written representation from the directors must cover:

- ❑ the completeness of the information that has been provided about the identity of related parties and related party relationships and transactions, and
- ❑ the adequacy of accounting for and disclosure of such related party relationships and transactions in the financial statements.

Unless all of those charged with governance are involved in managing the entity, the auditor **must communicate to those charged with governance** significant matters arising during the audit in connection with the entity's related parties.

The names of all identified related parties and the nature of the related party relationships must be **documented**.

Example: Audit matters and audit evidence

The draft statement of financial position of ABC Company includes an amount of Rs.300,000 owed by DE Company. The total assets of ABC Company are Rs.200 million.

The auditor has obtained the following audit evidence:

- ❑ **DE Company is controlled by the chairman of ABC Company, who is its majority shareholder.**
- ❑ **The draft financial statements of ABC Company do not provide any disclosures about the Rs.300,000 transaction, on the grounds that it is immaterial.**
- ❑ **There is no information about the nature of the transaction, but the Rs.300,000 had been included in receivables at the end of the previous financial year.**

Required

What further measures should the auditor take?

Answer

The auditor should first establish whether DE Company is a related party of ABC Company. From the information available it would seem that it is a related party, because the chairman of ABC Company, as a majority shareholder in DE Company, would appear to be in a position of influence in both companies.

Although the amount receivable is not material in terms of value (in relation to the value of total assets of ABC), the materiality of related party transactions should not be judged only on the basis of value. The nature of the transaction is also relevant for judging materiality. The auditor needs to obtain more information. The chairman should be asked to provide more details. In addition, the auditor should review the written terms of the transaction (if there are any), and should obtain a written representation from the chairman about the nature of his influence over DE Company, whether the amount receivable by ABC Company is likely to be recoverable and when it is likely to be paid. The auditor should also review board minutes of ABC Company for any recorded discussions by the board of the transaction with DE Company.

If the auditor takes the view that the transaction is a related party transaction, he should notify management of the need for disclosure in the financial statements. Disclosure is required of the nature and amount of the transaction, the amount of any balances (and details of any security given) and any allowances that have been made for an irrecoverable amount. Since the amount was receivable one year ago, the auditor should also consider the expected date of payment, and whether the balance is more in the nature of a long-term loan receivable than a current asset.

2 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Define the terms related party and related party transactions
- Discuss the impact on the audit of related party relationships and transactions
- Explain the requirements of ISA 550 and relevant audit procedures

CHAPTER 13

Reliance on others

Contents

1 Using the work of internal auditors: ISA 610 (Revised)
2 Using the work of an auditor's expert: ISA 620
3 Chapter review

INTRODUCTION

Learning outcomes

The overall objective of the syllabus is acquiring knowledge of theory, skill and techniques of auditing and to enable the students to understand International Standards on Auditing, Assurance and Ethics.

Performance of audit and reporting

LO 3	**Understand the requirement and application guidelines relating to some of the specific areas of audit procedures including external confirmation, review of subsequent event etc.**

Using the work of internal auditors and auditor’s experts (ISA 610, ISA 620)

LO 3.5.1	Explain the relationship between the external auditor with internal auditors and auditor’s experts
LO 3.5.2	Explain the internal audit function including internal audit activities.
LO 3.5.3	Discuss the factors determining the independence of internal auditors and weaknesses and limitations of internal audit
LO 3.5.4	Discuss how external auditors determine whether and to what extent they use the work of internal audit
LO 3.5.5	Discuss how the auditor assess the work of an expert
LO 3.5.6	Discuss how the external auditor uses the work of an auditor’s expert when that work is used to assist in obtaining sufficient appropriate audit evidence

1 USING THE WORK OF INTERNAL AUDITORS: ISA 610 (REVISED)

Section overview

- Concept and role of internal audit
- Introduction to ISA 610 (Revised)
- Evaluating internal audit function
- Using the work of internal auditors
- Direct assistance

1.1 Concept and role of internal audit

Purpose and functions of internal audit

Internal audit consists of audit, investigation or review work carried out on a voluntary basis by an entity, for its own control purposes. The internal audit work may be carried out by the entity's own full-time internal audit staff, or by an external accountancy firm.

There is no regulatory or statutory requirement for internal audit; therefore an entity will only carry out internal audit work if it considers the benefits sufficient to justify the cost.

Internal audit functions

Since there are no regulatory requirements for internal audit, the nature of internal audit work can vary substantially between different entities, depending on their size and structure, the nature of their business, the extent of regulation within their industry and markets, the extent of computerisation of the entity's main operational systems, the attitude of senior management to risk management, the nature and scale of the perceived control risks, and so on.

Internal auditing activities will usually include one or more of the following:

- **Monitoring of internal control**. The establishment of an adequate internal control system is a responsibility of management and is an important aspect of good corporate governance. Because the internal control system needs to be monitored on a continuous basis, large companies are likely to establish an internal audit function to assist management in this role. Internal audit is therefore usually given specific responsibility by management for reviewing internal controls, monitoring their operation and recommending improvements via a report to the directors.
- **Examination of financial and operating information**. This may include review of the means used to identify, measure, classify and report such information or specific inquiry into individual items including detailed testing of transactions, balances and procedures.
- **Review of the economy, efficiency and effectiveness of operations**. This could include a review of non-financial controls.
- **Review of compliance** with laws, regulations and other external requirements and with internal requirements such as management policies and directives.
- **Special investigations** into particular areas such as suspected fraud.

The majority of these activities will be classed as **operational internal audit assignments.** However, internal audit could also be asked to perform **other assignments** such as value for money audits.

The range of audit and investigation work that may be performed by internal auditors can be listed more specifically as follows:

- Carrying out audits into the adequacy of financial controls in specific areas of the accounting system
- Carrying out audits into the adequacy of operational controls in specific areas of the operational systems of the entity
- Auditing the adequacy of controls in the entity's IT systems

- Reviewing the economy, efficiency and effectiveness of particular operations or activities: these reviews are called value for money (VFM) audits
- Carrying out checks into compliance with key aspects of legal or regulatory requirements to which the entity is subject. For example a bank may use internal auditors to check compliance by the bank with regulations for the prevention or detection of money laundering. Similarly an oil company may use internal auditors to check into compliance with health and safety regulations at its operating sites.
- Examination and review of financial information produced by the entity.
- Special investigations, such as investigations into suspected cases of fraud within the entity.

Benefits of internal audit

Internal audit work costs money and should therefore provide benefits to justify the costs. The justification for internal audit may come from:

- Improvements in financial controls or operational controls within the entity
- Improvements in compliance with key laws and regulations, thereby reducing the risk of legal action or action by the regulators against the entity
- Improvements in the economy, efficiency or effectiveness of operations

There may be other benefits of internal audit.

- If the internal auditors carry out checks into the effectiveness of financial controls within the entity, the external auditors may decide that they can rely to some extent on the work done by internal audit. This would save time and effort when carrying out their own audit work. If the external auditors do rely to some extent on the work of internal audit, there may be a reduction in the external audit fee.
- The existence of an internal audit department may enhance the reputation of the entity for sound corporate governance in the opinion of customers and investors.

Independence of the internal auditors and other problems with internal audit

Auditors should be independent. However internal auditors cannot achieve the same **degree of independence** as that required of the external auditor. Full-time internal auditors are employed by the entity and rely on the entity for their job and salary. Even external firms that carry out internal audit work for a client entity may lack independence, because the audit work is not a regulatory requirement and the firm therefore relies on the client's attitude for their future fee income.

Methods of trying to ensure independence

For full-time internal auditors, one of the biggest problems with independence is that the auditors must report to someone within the entity, and both the independence and the status of the chief internal auditor will depend on who he reports to within the management hierarchy.

- In order to achieve as much independence as possible it is important that the internal auditor report to the highest level of management, or to the audit committee if there is one.
- However, even if the chief internal auditor reports to the finance director, there is a threat to his independence, because much of the work of the internal auditors will involve investigations into activities and controls for which the finance director is responsible.

Various measures can be taken to try to protect the independence of the internal auditors

- **Reporting lines**. The chief internal auditor may report to the audit committee and not to the finance director or chief accountant.
- **Deciding the scope of internal audit work**. The scope of work carried out by the internal auditors should not be decided by the finance director or line management responsible for the operations that might be subjected to audit. This is to avoid the risk that the internal auditors might be assigned to investigations of non-contentious areas of the business. The scope of internal audit work should be decided by the chief internal auditor or by the audit committee.

- **Rotation of internal audit staff**. Internal auditors should not be allowed to become too familiar with the operations that they audit or the management responsible for them. To reduce the familiarity threat, internal auditors should be rotated regularly, say every three to five years, and at the end of this time they should be assigned to other jobs within the entity.
- **Appointment of the chief internal auditor**. The chief internal auditor should not be appointed by a senior executive who may have some self-interest in wishing to appoint a 'yes man' who will not 'cause trouble'. Instead, the audit committee should be responsible for appointing a new chief internal auditor, subject perhaps to approval by the board of directors.
- **Designing internal controls**. The internal auditors should not be responsible for the design of internal controls within the entity. If they did, they would be required to audit their own work, which is unacceptable. Senior management in accounting and finance or line management should have responsibility for the design and implementation of internal controls, taking advice where appropriate from the external auditors when control weaknesses are identified during the external audit.

Weaknesses and limitations of internal audit

Since internal audit is not a regulatory requirement, there is no requirement for internal auditors to be professionally qualified for the work they do (although there may be a professional institute or association of internal auditors).

It is therefore a matter for the entity setting up the internal audit function what **qualifications or experience** it requires of the members of its internal audit team.

In contrast, the external auditor has to comply with regulations set by government and his professional body covering technical and professional standards and qualifications. However an internal auditor who is a member of a professional body (such as ICAP) will need to comply with the requirements of that body in any work that they do.

Arguments against having an internal audit department, referred to already, include:

- the cost of having one
- the problems that may arise with ensuring the independence of the internal auditors.

Comparison of external and internal audit

Internal and external auditors often carry out their work using similar procedures. This is something to bear in mind when answering 'practical' questions on auditing in an examination.

However, there are a number of fundamental differences between the two audit roles. These are summarised in the following table:

	External Audit	Internal Audit
Role and work	To express an opinion on the truth and fairness of the annual financial statements. The external auditor will therefore carry out whatever work he deems necessary to reach that opinion.	To examine systems and controls and assess risks in order to make recommendations to management for improvement. The internal auditor's work programme will therefore to a large extent be dictated by management.
Qualification to act	Set out by statute. This ensures that the external auditor is independent of the entity and suitably qualified	No statutory requirements – management select a suitably competent person to act as internal auditor. It is therefore possible that the internal auditor may not be as competent as the external auditor, depending on management's recruitment criteria.
Appointed by	The shareholders. This ensures independence.	Management. In order to give as much independence as possible the internal auditor should therefore report to the highest level of management.

	External Audit	Internal Audit
Duties set out by	Statute. (See above under role and work).	Management (See above under role and work).
Report to	The shareholders. (See above, under appointed by).	Management. (See above under appointed by).

You should also bear in mind that the external auditor has no specific responsibility for fraud and error, other than to report whether or not the financial statements give a true and fair view; the external auditor will be concerned that there has been no **material** undetected fraud or error during the period.

The internal auditor may be given specific responsibility for investigating suspected fraud or error by management, and he is likely to have much lower materiality thresholds.

1.2 Introduction to ISA 610 (Revised)

Relationship between ISAs 315 and 610 (Revised)

ISA 315 (Revised) Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment addresses how the knowledge and experience of the internal audit function can inform the external auditor's understanding of the entity and its environment and identification and assessment of risks of material misstatement. ISA 315 (Revised) also explains how effective communication between the internal and external auditors also creates an environment in which the external auditor can be informed of significant matters that may affect the external auditor's work.

ISA 315 (Revised) requires that when planning the audit the external auditor must assess the effectiveness of the internal audit function and determine whether they wish to use the work of the audit client's internal audit function. Even where the internal audit function is deemed ineffective, it may still be useful to be aware of the internal audit conclusions. 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.

ISA 610 (Revised) *Using the work of internal auditors* deals specifically with the external auditor's responsibilities when choosing to use the work of internal auditors. This includes:

- using the work of the internal audit function in obtaining audit evidence; and
- using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.

Definition: Direct assistance

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

ISA 610 (Revised) does not apply if the entity does not have an internal audit function and where an internal audit department exists but both their responsibilities and activities are not relevant to the audit or the external auditor does not expect to use the work of the function in obtaining audit evidence. Furthermore, the requirements relating to direct assistance do not apply if the external auditor does not plan to use internal auditors to provide direct assistance.

Note that in some jurisdictions (e.g. UK and Ireland) the external auditor may be prohibited or restricted to some extent, by law or regulation, from using the work of the internal audit function or using internal auditors to provide direct assistance. However, no such restrictions apply in Pakistan.

When ISA 610 (Revised) is applied the **objectives** of the external 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 and having made that determination:

- if using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit; and
- if using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.

1.3 Evaluating internal audit function

To determine whether the internal auditor's work is adequate for his purposes, the external auditor is **required** to **evaluate** the internal audit function and its procedures. A decision can then be taken as to whether the work of the internal auditors can be used as part of the evidence on which the external audit opinion will be based.

The table below summarises the criteria against which the internal audit function will be assessed.

Criterion	Comment
Objectivity	■ What is the status of the internal audit function within the entity? ■ To whom does it report? Does it have access to those charged with governance? ■ Is it free of any conflicting responsibilities (e.g. any operational responsibilities)? ■ Do those charged with governance oversee employment decisions re the internal audit function? ■ Are there any restrictions placed on the internal audit function? ■ Do management act on the recommendations of the internal audit function?
Competence	■ Are the internal auditors members of relevant professional bodies? ■ Do they have adequate technical training and proficiency? ■ Are there established policies for hiring and training internal auditors? ■ Do the internal auditors possess the required knowledge of financial reporting?
Systematic and disciplined approach	■ Is internal audit work properly planned, supervised, reviewed and documented? ■ Does the function have appropriate quality control procedures, audit manuals, work programmes and other relevant documents?

If any of the above factors regarding objectivity, competence and systematic and disciplined approach are lacking, ISA 610 (Revised) states that the external auditor shall not use the work of the internal audit function.

1.4 Using the work of internal auditors

Examples of work of the internal audit function that can be used by the external auditor include:

- Testing of the operating effectiveness of controls;
- Substantive procedures involving limited judgment;
- Observations of inventory counts;
- Tracing transactions through the information system relevant to financial reporting;
- Testing of compliance with regulatory requirements;
- In some circumstances, audits or reviews of the financial information of subsidiaries that are not significant components to the group (where this does not conflict with the requirements of ISA 600).

In addition to the **general** assessment of the internal audit function, ISA 610 also requires the external auditor to **evaluate each specific piece of work** performed by internal audit before it is used as external audit evidence.

As a basis for determining the areas and extent to which work of the internal audit function can be used, the external auditor shall consider the nature and scope of the work that has been performed and its relevance to the external auditor's overall audit strategy and audit plan.

The external auditor is **required** to evaluate whether:

- the work was properly planned, performed, supervised, reviewed and documented;
- sufficient, appropriate evidence was obtained to enable auditors to draw reasonable conclusions;
- appropriate conclusions were reached, consistent with any reports prepared;
- any exceptions or unusual matters were properly resolved.

Agreeing certain matters in advance should make it more likely that the external auditor will be able to rely on the work of internal audit. It may therefore be useful for the external auditor to agree the following in advance with internal audit:

- the timing of such work
- the nature of the work performed
- the extent of audit coverage
- materiality and performance materiality
- methods of item selection and sample sizes
- documentation of work performed
- review and reporting procedures.

Having evaluated the internal auditor's specific areas of work, the external auditor will then perform further procedures on some (or all) of the specific areas. Procedures may include:

- making inquiries of appropriate individuals within the internal audit function;
- observing procedures performed by internal audit;
- reviewing the internal audit function's work program and working papers;
- reperforming a sample of the internal audit function's procedures to validate conclusions reached by the internal audit function.

The exact nature, timing and extent of testing of specific work of the internal audit function will depend upon:

- the external auditor's judgement of the risk and materiality of each area concerned;
- the preliminary assessment of the internal audit function; and
- the evaluation of specific work of the internal audit function.

Communication with those charged with governance

ISA 610 (Revised) requires the external auditor to communicate the planned use of the work of the internal audit function to those charged with governance for their understanding of the proposed audit approach.

Documentation

The external auditor is **required** to **document** his conclusions about the adequacy of the internal audit function and its work, and the audit procedures performed by him on that work.

1.5 Direct assistance

Considering the use of internal auditors to provide direct assistance

If the external auditor plans to use internal auditors to provide direct assistance on the audit (and is not prohibited from doing so by law or regulation) they must evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance. This evaluation must include inquiry of the internal auditors regarding interests and relationships that may create a threat to their objectivity.

Internal auditors may not provide direct assistance if:

- there are significant threats to the objectivity of the internal auditor; or
- the internal auditor lacks sufficient competence to perform the proposed work.

When determining the nature and extent of direct assistance work to be assigned to internal audit, the external auditor shall consider:

- the amount of judgement involved;
- the assessed risk of material misstatement;
- the external auditor's evaluation of the existence of threats to the objectivity and level of competence of the internal auditors who will be providing such assistance;
- whether, in aggregate, using internal auditors to provide direct assistance to the extent planned, together with the planned use of the work of the internal audit function, would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

ISA 610 (Revised) precludes the use of internal audit to perform direct assistance procedures that:

- involve making significant judgements in the audit;
- relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited;
- relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or
- relate to decisions the external auditor makes in accordance with ISA 610 (Revised) regarding the internal audit function and the use of its work or direct assistance.

Communication with those charged with governance

ISA 610 (Revised) requires the external auditor to communicate the planned use of internal audit in providing direct assistance to those charged with governance.

Using internal auditors to provide direct assistance

Prior to using internal auditors to provide direct assistance, the external auditor shall:

- Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and
- Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with *ISA 220 Quality Control for an Audit of Financial Statements.* In so doing:

- The nature, timing and extent of direction, supervision, and review shall recognize that the internal auditors are not independent of the entity and be responsive to the outcome of the evaluation of the amount of judgement involved, the assessed risk of material misstatement and the evaluation of the existence and significance of threats to the objectivity and level of competence of the internal auditors providing direct assistance; and
- The review procedures shall include the external auditor checking back to the underlying audit evidence for some of the work performed by the internal auditors.

The direction, supervision and review by the external auditor of the work performed by the internal auditors must be sufficient in order for the external auditor to be satisfied that the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work.

In directing, supervising and reviewing the work performed by internal auditors, the external auditor shall remain alert for indications that the external auditor's evaluations of the existence and significance of threats to the objectivity and level of competence of the internal auditors providing direct assistance are no longer appropriate.

Documentation

The external auditor is **required** to **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 to provide direct assistance;
- The basis for the decision regarding the nature and extent of the work performed by the internal auditors;
- Who reviewed the work performed and the date and extent of that review in accordance with ISA 230;
- The written agreements obtained from an authorized representative of the entity and the internal auditors; and
- The working papers prepared by the internal auditors who provided direct assistance on the audit engagement.

2 USING THE WORK OF AN AUDITOR'S EXPERT: ISA 620

Section overview

- Introduction
- Assessing the need for an expert
- Assessing the work of an expert

2.1 Introduction

The term 'expert' is used here in the sense of an individual or an organisation that possesses skills, knowledge and experience **in fields other than accounting or auditing**.

The auditor may use the work of an expert to provide knowledge relevant to the audit, which the audit firm itself does not possess. ISA 620 *Using the work of an auditor's expert* gives a number of examples where experts may be used by an auditor. These include:

- legal opinions
- specialist valuation areas, such as property or pension liabilities
- the analysis of complex or unusual tax compliance issues.

Note that the ISA covers the work of **the auditor's** expert – the expert is employed by the auditor, not by the entity. The situation where management use the work of an expert is covered by ISA 500.

The **objective** of ISA 620 is to allow the auditor to:

- decide whether to use the work of an expert, and
- assess whether that work is adequate.

2.2 Assessing the need for an expert

There is a cost attached to the use of an expert by the auditors. The expert will charge a fee for the professional service he provides. The use of an expert should therefore be evaluated on a cost/benefit basis.

When deciding whether he needs to use an expert to assist him in obtaining sufficient appropriate evidence, the auditor should consider such factors as:

- the nature, significance and complexity of the matter
- the risk of material misstatement
- the availability of alternative sources of audit evidence.

2.3 Assessing the work of an expert

ISA 620 **requires** the auditor to apply the procedures set out below when using the work of an expert. The auditor should:

- assess the competence, capabilities and objectivity of the expert in one or more of the following ways:
  - Personal experience with previous work of that expert.
  - Discussions with that expert.
  - Discussions with other auditors or others who are familiar with that expert's work.
  - Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
  - Published papers or books written by that expert.

- obtain an understanding of the expert's field of expertise, sufficient to allow the auditor to determine the nature, scope and objectives of the expert's work and evaluate the adequacy of that work
- agree terms of engagement with the expert, including:
  - the nature, scope and objectives of the expert's work
  - the respective responsibilities of the expert and the auditor
  - the form of the expert's report
  - confidentiality requirements
- evaluate the adequacy of the expert's work, including the:
  - reasonableness of the expert's conclusions
  - consistency of those conclusions with other audit evidence
  - reasonableness of significant assumptions and methods used
  - relevance, completeness and accuracy of source data.

Generally, the auditor is assessing whether the expert's work constitutes sufficient and appropriate audit evidence.

If the auditor decides that the work of the expert is not adequate he is **required** to:

- agree additional work with the expert, or
- perform other appropriate additional audit procedures.

The auditor has sole responsibility for the audit opinion issued and this is not reduced in any way by his use of an expert. Therefore **he should not refer in his report to the use of an expert,** unless that is required by law or regulation. Even then, or if the auditor refers to the expert's work in his report because it is relevant to an understanding of a modified opinion, then he must make it clear that such a reference does not reduce his responsibility for that opinion in any way.

This approach reinforces the point made earlier, that the auditor remains fully responsible for the report produced, even if evidence on which it is based was produced by others. The auditor therefore cannot simply accept work performed by experts. That work must be evaluated in the same way as any other audit evidence is evaluated.

3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Differentiate between internal and external audit
- Explain what is involved when the external auditors seek to place reliance on the work of the internal auditor in accordance with ISA 610 (Revised)
- Discuss how the external auditor uses the work of an auditor's expert in compliance with ISA 620

CHAPTER 14

Professional ethics and codes of conduct

Contents

1 Fundamental principles
2 Conceptual Framework Approach
3 Chapter review

INTRODUCTION

Learning outcomes

The overall objective of the syllabus is acquiring knowledge of theory, skill and techniques of auditing and to enable the students to understand International Standards on Auditing, Assurance and Ethics.

Professional ethics

LO 5	**Respond on audit matters in the light of fundamental principles given in the Code of Ethics**

Fundamental principles (sections 100 to 150 of the Code of Ethics for Chartered Accountants)

LO 5.1.1	Describe with simple examples the fundamental principles of professional ethics of integrity, objectivity, professional competence and due care, confidentiality and professional behavior
LO 5.1.2	Apply the conceptual framework to identify, evaluate and address threats to compliance with fundamental principles
LO 5.1.3	Understand the threats and circumstances that cause threats of self-interest, self-review, advocacy, familiarity, and intimidation
LO 5.1.4	Discuss the safeguards to offset the threats to compliance with the fundamental principles
LO 5.1.5	Discuss the concept of ethical conflict resolution

References to the ICAP Code of Ethics

References to section numbers of the ICAP Code of Ethics are for reference purpose.

1 FUNDAMENTAL PRINCIPLES

Section overview

- The application of professional ethics
- The fundamental principles
- Integrity
- Objectivity
- Professional Competence and Due Care
- Confidentiality
- Professional Behavior

1.1 The application of professional ethics

Company law regulates the requirement for external auditing, but internal auditing is not normally subject to statutory regulation.

However, all accountants who are members of a professional body such as ICAP are required to comply with the regulations of that professional body. Such professional regulations therefore apply to external auditors, assurance providers and internal auditors.

The reason for the wide reach of ethical guidelines is that the accountancy profession accepts that it has a responsibility to act in the public interest.

This section of the chapter describes the code of ethics of ICAP, which must be followed by all members whether they are operating as external auditors or assurance providers or internal auditors.

Although these rules apply to all members, the examination is primarily concerned with how the rules apply to chartered accountants in practice (e.g an external auditor or assurance provider). In providing a code of ethics, ICAP is complying with one of its regulatory functions, which is to ensure that statutory audits are performed only by fit and proper persons who act with professional integrity.

1.2 The fundamental principles [s100.5]

A chartered accountant shall comply with the following fundamental principles:

(a) Integrity - to be straightforward and honest in all professional and business relationships.

(b) Objectivity - to not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

(c) Professional Competence and Due Care - to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.

(d) Confidentiality - to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the chartered accountant or third parties.

(e) Professional Behavior - to comply with relevant laws and regulations and avoid any action that discredits the profession.

1.3 Integrity [s110]

110.1 The principle of integrity imposes an obligation on all chartered accountants to be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.

110.2 A chartered accountant shall not knowingly be associated with reports, returns, communications or other information where the chartered accountant believes that the information:

(a) Contains a materially false or misleading statement;

(b) Contains statements or information furnished recklessly; or

(c) Omits or obscures information required to be included where such omission or obscurity would be misleading.

When a chartered accountant becomes aware that the accountant has been associated with such information, the accountant shall take steps to be disassociated from that information.

110.3 A chartered accountant will be deemed not to be in breach of paragraph 110.2 if the chartered accountant provides a modified report in respect of a matter contained in paragraph 110.2.

1.4 Objectivity [s120]

120.1 The principle of objectivity imposes an obligation on all chartered accountants not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others.

120.2 A chartered accountant may be exposed to situations that may impair objectivity. It is impracticable to define and prescribe all such situations. A chartered accountant shall not perform a professional activity or service if a circumstance or relationship biases or unduly influences the accountant's professional judgment with respect to that service.

1.5 Professional Competence and Due Care [s130]

130.1 The principle of professional competence and due care imposes the following obligations on all chartered accountants:

(a) To maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional service; and

(b) To act diligently in accordance with applicable technical and professional standards when performing professional activities or providing professional services.

130.2 Competent professional service requires the exercise of sound judgment in applying professional knowledge and skill in the performance of such service. Professional competence may be divided into two separate phases:

(a) Attainment of professional competence; and

(b) Maintenance of professional competence.

130.3 The maintenance of professional competence requires a continuing awareness and an understanding of relevant technical, professional and business developments. Continuing professional development enables a chartered accountant to develop and maintain the capabilities to perform competently within the professional environment.

130.4 Diligence encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

130.5 A chartered accountant shall take reasonable steps to ensure that those working under the chartered accountant's authority in a professional capacity have appropriate training and supervision.

130.6 Where appropriate, a chartered accountant shall make clients, employers or other users of the accountant's professional services aware of the limitations inherent in the services or activities.

1.6 Confidentiality [s140]

140.1 The principle of confidentiality imposes an obligation on all chartered accountants to refrain from:

(a) Disclosing outside the firm or employing organization confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose; and

(b) Using confidential information acquired as a result of professional and business relationships to their personal advantage or the advantage of third parties.

140.2 A chartered accountant shall maintain confidentiality, including in a social environment, being alert to the possibility of inadvertent disclosure, particularly to a close business associate or a close or immediate family member.

140.3 A chartered accountant shall maintain confidentiality of information disclosed by a prospective client or employer.

140.4 A chartered accountant shall maintain confidentiality of information within the firm or employing organization.

140.5 A chartered accountant shall take reasonable steps to ensure that staff under the chartered accountant's control and persons from whom advice and assistance is obtained respect the chartered accountant's duty of confidentiality.

140.6 The need to comply with the principle of confidentiality continues even after the end of relationships between a chartered accountant and a client or employer. When a chartered accountant changes employment or acquires a new client, the chartered accountant is entitled to use prior experience.

The chartered accountant shall not, however, use or disclose any confidential information either acquired or received as a result of a professional or business relationship.

140.7 The following are circumstances where chartered accountants are or may be required to disclose confidential information or when such disclosure may be appropriate:

(a) Disclosure is permitted by law and is authorized by the client or the employer;

(b) Disclosure is required by law, for example:

   (i) Production of documents or other provision of evidence in the course of legal proceedings; or

   (ii) Disclosure to the appropriate public authorities of infringements of the law that come to light; and

(c) There is a professional duty or right to disclose, when not prohibited by law:

   (i) To comply with the Quality Control Review (QCR) program of the Institute;

   (ii) To respond to an inquiry or investigation by a member body or regulatory body;

   (iii) To protect the professional interests of a chartered accountant in legal proceedings; or

   (iv) To comply with technical standards and ethics requirements.

140.8 In deciding whether to disclose confidential information, relevant factors to consider include:

- Whether the interests of all parties, including third parties whose interests may be affected, could be harmed if the client or employer consents to the disclosure of information by the chartered accountant.
- Whether all the relevant information is known and substantiated, to the extent it is practicable; when the situation involves unsubstantiated facts, incomplete information or unsubstantiated conclusions, professional judgment shall be used in determining the type of disclosure to be made, if any.
- The type of communication that is expected and to whom it is addressed.
- Whether the parties to whom the communication is addressed are appropriate recipients.

1.7 Professional Behavior [s150]

150.1 The principle of professional behavior imposes an obligation on all chartered accountants to comply with relevant laws and regulations and avoid any action that the chartered accountant knows or should know may discredit the profession. This includes actions that a reasonable and informed third party, weighing all the specific facts and circumstances available to the chartered accountant at that time, would be likely to conclude adversely affects the good reputation of the profession.

2 CONCEPTUAL FRAMEWORK APPROACH APPLICABLE TO ALL CHARTERED ACCOUNTANTS

Section overview

- Introduction
- Threats and Safeguards
- Safeguards Created by the Profession, Legislation or Regulation
- Ethical Conflict Resolution
- Communicating with Those Charged with Governance

2.1 Introduction

100.6 The circumstances in which chartered accountants operate may create specific threats to compliance with the fundamental principles. It is impossible to define every situation that creates threats to compliance with the fundamental principles and specify the appropriate action. In addition, the nature of engagements and work assignments may differ and, consequently, different threats may be created, requiring the application of different safeguards.

Therefore, this Code establishes a conceptual framework that requires a chartered accountant to identify, evaluate, and address threats to compliance with the fundamental principles. The conceptual framework approach assists chartered accountants in complying with the ethical requirements of this Code and meeting their responsibility to act in the public interest. It accommodates many variations in circumstances that create threats to compliance with the fundamental principles and can deter a chartered accountant from concluding that a situation is permitted if it is not specifically prohibited.

100.7 When a chartered accountant identifies threats to compliance with the fundamental principles and, based on an evaluation of those threats, determines that they are not at an acceptable level, the chartered accountant shall determine whether appropriate safeguards are available and can be applied to eliminate the threats or reduce them to an acceptable level. In making that determination, the chartered accountant shall exercise professional judgment and take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances available to the chartered accountant at the time, would be likely to conclude that the threats would be eliminated or reduced to an acceptable level by the application of the safeguards, such that compliance with the fundamental principles is not compromised.

100.8 A chartered accountant shall evaluate any threats to compliance with the fundamental principles when the chartered accountant knows, or could reasonably be expected to know, of circumstances or relationships that may compromise compliance with the fundamental principles.

100.9 A chartered accountant shall take qualitative as well as quantitative factors into account when evaluating the significance of a threat. When applying the conceptual framework, a chartered accountant may encounter situations in which threats cannot be eliminated or reduced to an acceptable level, either because the threat is too significant or because appropriate safeguards are not available or cannot be applied. In such situations, the chartered accountant shall decline or discontinue the specific professional activity or service involved or, when necessary, resigns from the engagement (in the case of a chartered accountant in practice) or the employing organization (in the case of a chartered accountant in business).

100.10 Sections 290 and 291 contain provisions with which a chartered accountant shall comply if the chartered accountant identifies a breach of an independence provision of the Code. If a chartered accountant identifies a breach of any other provision of this Code, the chartered accountant shall evaluate the significance of the breach and its impact on the accountant's ability to comply with the fundamental principles. The accountant shall take whatever actions that may be available, as soon as possible, to satisfactorily address the consequences of the breach. The accountant shall determine whether to report the breach, for example, to those who may have been affected by the breach, a member body, relevant regulator or oversight authority.

100.11 When a chartered accountant encounters unusual circumstances in which the application of a specific requirement of the Code would result in a disproportionate outcome or an outcome that may not be in the public interest, it is recommended that the chartered accountant consult with a member body or the relevant regulator.

2.2 Threats and Safeguards

100.12 Threats may be created by a broad range of relationships and circumstances. When a relationship or circumstance creates a threat, such a threat could compromise, or could be perceived to compromise, a chartered accountant's compliance with the fundamental principles. A circumstance or relationship may create more than one threat, and a threat may affect compliance with more than one fundamental principle. Threats fall into one or more of the following categories:

(a) Self-interest threat - the threat that a financial or other interest will inappropriately influence the chartered accountant's judgment or behavior;

(b) Self-review threat - the threat that a chartered accountant will not appropriately evaluate the results of a previous judgment made or activity or service performed by the chartered accountant, or by another individual within the chartered accountant's firm or employing organization, on which the accountant will rely when forming a judgment as part of providing a current service;

(c) Advocacy threat - the threat that a chartered accountant will promote a client's or employer's position to the point that the chartered accountant's objectivity is compromised;

(d) Familiarity threat - the threat that due to a long or close relationship with a client or employer, a chartered accountant will be too sympathetic to their interests or too accepting of their work; and

(e) Intimidation threat - the threat that a chartered accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the chartered accountant.

200.4 Examples of circumstances that create self-interest threats for a chartered accountant in practice include:

- A member of the assurance team having a direct financial interest in the assurance client.
- A firm having undue dependence on total fees from a client.
- A member of the assurance team having a significant close business relationship with an assurance client.
- A firm being concerned about the possibility of losing a significant client.
- A member of the audit team entering into employment negotiations with the audit client.
- A firm entering into a contingent fee arrangement relating to an assurance engagement.
- A chartered accountant discovering a significant error when evaluating the results of a previous professional service performed by a member of the chartered accountant's firm.

200.5 Examples of circumstances that create self-review threats for a chartered accountant in practice include:

- A firm issuing an assurance report on the effectiveness of the operation of financial systems after designing or implementing the systems.
- A firm having prepared the original data used to generate records that are the subject matter of the assurance engagement.
- A member of the assurance team being, or having recently been, a director or officer of the client.

- A member of the assurance team being, or having recently been, employed by the client in a position to exert significant influence over the subject matter of the engagement.
- The firm performing a service for an assurance client that directly affects the subject matter information of the assurance engagement.

200.6 Examples of circumstances that create advocacy threats for a chartered accountant in practice include:

- The firm promoting shares in an audit client.
- A chartered accountant acting as an advocate on behalf of an audit client in litigation or disputes with third parties.

200.7 Examples of circumstances that create familiarity threats for a chartered accountant in practice include:

- A member of the engagement team having a close or immediate family member who is a director or officer of the client.
- A member of the engagement team having a close or immediate family member who is an employee of the client who is in a position to exert significant influence over the subject matter of the engagement.
- A director or officer of the client or an employee in a position to exert significant influence over the subject matter of the engagement having recently served as the engagement partner.
- A chartered accountant accepting gifts or preferential treatment from a client, unless the value is trivial or inconsequential.
- Senior personnel having a long association with the assurance client.

200.8 Examples of circumstances that create intimidation threats for a chartered accountant in practice include:

- A firm being threatened with dismissal from a client engagement.
- An audit client indicating that it will not award a planned non- assurance contract to the firm if the firm continues to disagree with the client's accounting treatment for a particular transaction.
- A firm being threatened with litigation by the client.
- A firm being pressured to reduce inappropriately the extent of work performed in order to reduce fees.
- A chartered accountant feeling pressured to agree with the judgment of a client employee because the employee has more expertise on the matter in question.
- A chartered accountant being informed by a partner of the firm that a planned promotion will not occur unless the accountant agrees with an audit client's inappropriate accounting treatment.

Example:

Your assurance firm is auditor of Happy Goods. The audit manager has just become engaged to the managing director's daughter, who he met through a mutual friend. The managing director (MD) owns 51% of the shares in Happy Goods.

Required

List the threats to independence which might arise as a result of the above, explaining clearly why these are threats.

Answer

An **intimidation threat** might arise because the MD could exert influence over the audit manager via any influence he might have over his daughter. Alternatively, as the relationship between the audit manager and his future father-in-law develops direct intimation might be possible.

A **familiarity threat** might arise, again, as the relationship between the audit manager and the MD develops. The audit manager may become less critical of the reporting or operational practices at this client.

A **self-interest threat** might arise because the MD owns a majority shareholding in Happy Goods and his daughter (who may well inherit the shares at some point in the future) therefore has a vested interest in the performance of the organisation – as will her husband (i.e. this threat is probably greater once the marriage has taken place.)

100.13 Safeguards are actions or other measures that may eliminate threats or reduce them to an acceptable level. They fall into two broad categories:

a) Safeguards created by the profession, legislation or regulation; and

b) Safeguards in the work environment.

2.3 Safeguards Created by the Profession, Legislation or Regulation

100.14 Safeguards created by the profession, legislation or regulation include:

- Educational, training and experience requirements for entry into the profession.
- Continuing professional development requirements.
- Corporate governance regulations.
- Professional standards.
- Professional or regulatory monitoring and disciplinary procedures.
- External review by a legally empowered third party of the reports, returns, communications or information produced by a chartered accountant.

100.16 Certain safeguards may increase the likelihood of identifying or deterring unethical behavior. Such safeguards, which may be created by the accounting profession, legislation, regulation, or an employing organization, include:

- Effective, well-publicized complaint systems operated by the employing organization, the profession or a regulator, which enable colleagues, employers and members of the public to draw attention to unprofessional or unethical behavior.
- An explicitly stated duty to report breaches of ethical requirements.

Example of Safeguards

A chartered accountant in practice shall exercise judgment to determine how best to deal with threats that are not at an acceptable level, whether by applying safeguards to eliminate the threat or reduce it to an acceptable level or by terminating or declining the relevant engagement. In exercising this judgment, a chartered accountant in practice shall consider whether a reasonable and informed third party, weighing all the specific facts and circumstances available to the chartered accountant at that time, would be likely to conclude that the threats would be eliminated or reduced to an acceptable level by the application of safeguards, such that compliance with the fundamental principles is not compromised. This consideration will be affected by matters such as the significance of the threat, the nature of the engagement and the structure of the firm.

Safeguards in the work environment

200.11 In the work environment, the relevant safeguards will vary depending on the circumstances. Work environment safeguards comprise firm-wide safeguards and engagement-specific safeguards.

200.12 Examples of firm-wide safeguards in the work environment include:

- Leadership of the firm that stresses the importance of compliance with the fundamental principles.
- Leadership of the firm that establishes the expectation that members of an assurance team will act in the public interest.
- Policies and procedures to implement and monitor quality control of engagements.
- Documented policies regarding the need to identify threats to compliance with the fundamental principles, evaluate the significance of those threats, and apply safeguards to eliminate or reduce the threats to an acceptable level or, when appropriate safeguards are not available or cannot be applied, terminate or decline the relevant engagement.
- Documented internal policies and procedures requiring compliance with the fundamental principles.
- Policies and procedures that will enable the identification of interests or relationships between the firm or members of engagement teams and clients.
- Policies and procedures to monitor and, if necessary, manage the reliance on revenue received from a single client.
- Using different partners and engagement teams with separate reporting lines for the provision of non-assurance services to an assurance client.
- Policies and procedures to prohibit individuals who are not members of an engagement team from inappropriately influencing the outcome of the engagement.
- Timely communication of a firm's policies and procedures, including any changes to them, to all partners and professional staff, and appropriate training and education on such policies and procedures.
- Designating a member of senior management to be responsible for overseeing the adequate functioning of the firm's quality control system.
- Advising partners and professional staff of assurance clients and related entities from which independence is required.
- A disciplinary mechanism to promote compliance with policies and procedures.
- Published policies and procedures to encourage and empower staff to communicate to senior levels within the firm any issue relating to compliance with the fundamental principles that concerns them.

200.13 Examples of **engagement-specific safeguards** in the work environment include:

- Having a chartered accountant who was not involved with the non-assurance service review the non-assurance work performed or otherwise advise as necessary.
- Having a chartered accountant who was not a member of the assurance team review the assurance work performed or otherwise advise as necessary.
- Consulting an independent third party, such as a committee of independent directors, a professional regulatory body or another chartered accountant.
- Discussing ethical issues with those charged with governance of the client.
- Disclosing to those charged with governance of the client the nature of services provided and extent of fees charged.
- Involving another firm to perform or re-perform part of the engagement.
- Rotating senior assurance team personnel.

200.14 Depending on the nature of the engagement, a chartered accountant in practice may also be able to rely on safeguards that the client has implemented. However, it is not possible to rely solely on such safeguards to reduce threats to an acceptable level.

200.15 Examples of safeguards within the **client's systems and procedures** include:

- The client requires persons other than management to ratify or approve the appointment of a firm to perform an engagement.
- The client has competent employees with experience and seniority to make managerial decisions.
- The client has implemented internal procedures that ensure objective choices in commissioning non-assurance engagements.
- The client has a corporate governance structure that provides appropriate oversight and communications regarding the firm's services.

Example:

Following on from the previous example suggest specific, appropriate safeguards which could be put in place to mitigate the identified threats.

Answer

The most appropriate safeguards would be to:

- ❑ **remove the manager from the audit of Happy Goods Ltd, and**
- ❑ **ensure that he has no significant influence over the audit team (for example, by ensuring that the members of the audit team are not close friends of his).**

Failing that, the following safeguards could be implemented:

- ❑ **Confirm that the MD's daughter is not dependent on him in any way (financially or otherwise).**
- ❑ **Review the manager's work on the audit.**
- ❑ **Ensure that the manager is aware of the requirement for independence.**
- ❑ **Discuss the potential ethical issue with the client and request that the manager has no involvement with the MD during the course of the audit (he is more likely to deal with the FD). (Though this will not help if the relationship between the manager and the MD is already developing (as they may meet outside the audit environment) or if the MD has significant influence over his fellow-directors. However, it may be that no such close relationship is forming, especially if the daughter is not close to her father and is not financially dependent on him.)**

2.4 Ethical Conflict Resolution

100.19 A chartered accountant may be required to resolve a conflict in complying with the fundamental principles.

100.20 When initiating either a formal or informal conflict resolution process, the following factors, either individually or together with other factors, may be relevant to the resolution process:

a) Relevant facts;

b) Ethical issues involved;

c) Fundamental principles related to the matter in question;

d) Established internal procedures; and

e) Alternative courses of action.

Having considered the relevant factors, a chartered accountant shall determine the appropriate course of action, weighing the consequences of each possible course of action. If the matter remains unresolved, the chartered accountant may wish to consult with other appropriate persons within the firm or employing organization for help in obtaining resolution.

100.21 Where a matter involves a conflict with, or within, an organization, a chartered accountant shall determine whether to consult with those charged with governance of the organization, such as the board of directors or the audit committee.

100.22 It may be in the best interests of the chartered accountant to document the substance of the issue, the details of any discussions held, and the decisions made concerning that issue.

100.23 If a significant conflict cannot be resolved, a chartered accountant may consider obtaining professional advice from the relevant professional body or from legal advisors. The chartered accountant generally can obtain guidance on ethical issues without breaching the fundamental principle of confidentiality if the matter is discussed with the relevant professional body on an anonymous basis or with a legal advisor under the protection of legal privilege. Instances in which the chartered accountant may consider obtaining legal advice vary. For example, a chartered accountant may have encountered a fraud, the reporting of which could breach the chartered accountant's responsibility to respect confidentiality. The chartered accountant may consider obtaining legal advice in that instance to determine whether there is a requirement to report.

100.24 If, after exhausting all relevant possibilities, the ethical conflict remains unresolved, a chartered accountant shall, where possible, refuse to remain associated with the matter creating the conflict. The chartered accountant shall determine whether, in the circumstances, it is appropriate to withdraw from the engagement team or specific assignment, or to resign altogether from the engagement, the firm or the employing organization.

2.5 Communicating with Those Charged with Governance

100.25 When communicating with those charged with governance in accordance with the provisions of this Code, the chartered accountant or firm shall determine, having regard to the nature and importance of the particular circumstances and matter to be communicated, the appropriate person (s) within the entity's governance structure with whom to communicate. If the chartered accountant or firm communicates with a subgroup of those charged with governance, for example, an audit committee or an individual, the chartered accountant or firm shall determine whether communication with all of those charged with governance is also necessary so that they are adequately informed.

4 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Describe the fundamental principles of the ICAP Code of Ethics
- Apply the conceptual framework to identify threats to the fundamental principles and suggest appropriate safeguards across a range of common scenarios

CHAPTER 15

Audit finalisation and reporting

Contents

1 Subsequent events: ISA 560
2 Written representations: ISA 580
3 Overall review of the financial statements
4 Purpose of the audit report
5 The unmodified audit report: ISA 700
6 Communicating Key Audit Matters in Audit report: ISA 701
7 Audit reporting and the Companies Act, 2017
8 Modification to audit opinion: ISA 705
9 Emphasis of matter paragraphs and other matter paragraphs: ISA 706
10 Going concern basis and the audit report: ISA 570
11 Chapter review

INTRODUCTION

Learning outcomes

The overall objective of the syllabus is acquiring knowledge of theory, skill and techniques of auditing and to enable the students to understand International Standards on Auditing, Assurance and Ethics.

Performance of audit and reporting

LO 1	**On the successful completion of this paper, candidates will be able to demonstrate knowledge of general concepts governing an audit**
LO 1.6.6	Discuss the additional matters to be included in the auditor's report
LO 2	**On the successful completion of this paper, candidates will be able to demonstrate working knowledge in respect of performance of simple audit procedures and understand the audit report requirement under the Companies Act, 2017**

Audit Opinion and form of audit report under International Standards on Auditing under the Companies Act, 2017 and Going Concern (ISA 570 revised)

LO 2.10.1	Understand modified and unmodified audit opinion
LO 2.10.2	Explain qualified opinion, disclaimer of opinion and adverse opinion
LO 2.10.3	Explain emphasis of matter and other matter in the auditor report
LO 2.10.4	List the circumstances under which an external auditor uses an emphasis of matter and other matter paragraph in the auditor's report
LO 2.10.5	Discuss the modification of audit opinion and audit report in different situations including when entity is not a going concern and related concepts
LO2.10.6:	Drafting of opinion paragraph
LO2.10.7:	Key Audit matters and other related concepts as per ISA 701.
LO 2.10.8	Briefly state the contents of the auditor's report under International Standards on Auditing and under the Companies Act, 2017
LO 2.10.9	Explain the differences between auditor's report under International Standards on Auditing and under the Companies Act, 2017
LO 2.10.10	State the penalty for non-compliance with provisions related to the audit report
LO 3	**Understand the requirement and application guidelines relating to some of the specific areas of audit procedures including external confirmation, review of subsequent event etc.**

Subsequent Events (ISA 560)

LO 3.2.1 Explain subsequent events and its relevance with the following critical dates

a) Date of the financial statements

b) Date of approval of the financial statements

c) Date of the auditor's report

d) Date the financial statements are issued

LO 3.2.2 Explain the subsequent events review procedure

LO 3.2.3 Discuss the classification of subsequent events into adjusting and non-adjusting events

LO 3.2.4 Describe the auditor's responsibility in respect of following situations.

a) Events occurring between the date of the financial statements and the date of the auditor's report

b) Facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued

c) Facts which become known to the auditor after the financial statements have been issued

LO 3.2.5 Identify the subsequent events and explain the auditor responses

Written representation (ISA 580)

LO 3.3.1 Discuss the nature of written representations as audit evidence

LO 3.3.2 Discuss the circumstances where written representations are necessary and the matters on which representations are commonly obtained

LO 3.3.3 Discuss the form and content of written representations

LO 3.3.4 Explain the various types of written representations

LO 3.3.5 Discuss the auditor's course of action if management refuses to provide requested written representation

LO 3.3.6 Discuss the auditor's course of action when there is doubt as to the reliability of written representation provided by the management

1 SUBSEQUENT EVENTS: ISA 560

Section overview

- IAS 10 and ISA 560
- Events occurring up to the date of the audit report
- Facts discovered after the date of the audit report

1.1 IAS 10 and ISA 560

It is not possible to prepare financial statements that present a true and fair view by considering only those events and transactions that take place before the date at which the balance sheet is prepared. Material events that occur after the reporting period should also be considered when preparing the financial statements for the year.

Purpose of IAS 10

IAS 10 Events after the reporting period has two main objectives:

- to specify when an entity should adjust its financial statements for events that occur after the reporting period, but before the financial statements are authorised for issue, and
- to specify the disclosures that should be given about events that have occurred after the reporting period but before the financial statements were authorised for issue.

Events after the reporting period are defined in IAS 10 as ‘those events, 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 events after the reporting period:

- **Adjusting events**. These are events that provide evidence of **conditions that already existed** at the end of the reporting period.
- **Non-adjusting events.** These are events that have occurred due to conditions arising after the reporting period.

The role of the auditor: ISA 560

The work of the external auditor in this area is covered by ISA 560 Subsequent events.

The **objectives** of the auditor, as stated in ISA 560 are as follows:

- The auditor should obtain sufficient, appropriate evidence about whether events occurring between the date of the financial statements and the date of the audit report are appropriately reflected in those financial statements.
- The auditor should also respond appropriately to facts that become known to him after the date of the audit report that, had they been known to him at that date, may have caused him to amend his report.

This means that audit procedures must be planned and performed so as to consider all significant transactions occurring after the reporting period. This means that the audit work does not stop with events only up to the end of the reporting period. There are two key dates after the end of the reporting period: the date of the audit report and the date that the financial statements are issued:

- **Before the issue of the audit report**, the auditor should actively look for significant subsequent events. This is sometimes referred to as an **active review.**
- **After the issue of the audit report** (and up to the time that the financial statements are issued), the auditor has to consider the impact of any significant subsequent events that come to his attention. However, he does not have to look for these events actively. This is sometimes referred to as a **passive review.**

1.2 Events occurring up to the date of the audit report

Between the end of the reporting period and the date of the audit report, the auditor is required to obtain sufficient appropriate evidence that all events that require adjustment of or disclosure in the financial statements:

- **have been identified, and**
- **are suitably reported in the financial statements.**

Normal audit verification work

The auditor may find sufficient evidence of subsequent events in the course of his normal audit verification work. Where this is the case he is not required to perform additional audit procedures. Such normal audit verification work might include the following:

- The audit of receivables will consider whether receivables at the end of the reporting period are collectable. Cash receipts after the year-end may indicate a significant non-payment, suggesting the need to write off a debt as irrecoverable.
- The audit of inventory includes a review of the net realisable value of inventory. Sales of inventory after the year-end may indicate that some inventory in the balance sheet is over-valued (because subsequent events have shown that its NRV was less than cost).
- A search for unrecorded liabilities may discover the existence of some unrecorded liabilities, from invoices received after the reporting period but relating to the period covered by the financial statements.
- A review of the entity's cash position at the end of the reporting period may find that a cheque from a customer, recorded as part of the bank balances, was dishonoured after the reporting period.

Procedures aimed specifically at identifying subsequent events

The auditor should also actively look for 'subsequent events', up to the time that he prepares the audit report. Taking into account his risk assessment of this area, he should:

- obtain an understanding of management's procedures for identifying subsequent events
- inquire of management as to whether any subsequent events have occurred which might affect the financial statements
- read the entity's latest subsequent financial statements
- read minutes of shareholders' meetings, meetings of the board of directors and senior management meetings held after the date of the financial statements and inquire about matters discussed at any such meetings where minutes are not yet available
- obtain written representations in respect of subsequent events (covered in a later section).

1.3 Facts discovered after the date of the audit report

Even after the date on which the audit report is signed, the auditor retains some degree of responsibility for **events of which he becomes aware**, up to the time that the financial statements are issued. He is not required, during this period, to actively look for subsequent events. His level of responsibility is therefore much reduced compared with the period before the signing of the audit report.

Between the date of the audit report and the issue of the financial statements

The auditor has no obligation to perform any audit procedures after the date of his audit report. However, if he becomes aware of a fact that had it been known to him at the date of his report, may have caused him to amend his report then he is **required** to:

- discuss the matter with management
- determine whether the financial statements need amending, and
- inquire how management intend to address the matter in the financial statements.

If the financial statements are amended, the auditor is required to:

- carry out the necessary audit procedures on the amendment
- extend his review of subsequent events up to the date of the new audit report.

If management do not amend the financial statements for the subsequent event, but the auditor feels that an amendment should be made, the auditor is **required** to take the following action:

- If the audit report has not yet been provided to the entity, modify his opinion as appropriate.
- If the audit report has been provided to the entity:
  - instruct management not to issue the financial statements before the necessary amendments have been made
  - if they do so, take appropriate action to prevent reliance on the audit report, after taking legal advice.

Facts discovered after the financial statements have been issued

As above, the auditor has no obligation to perform any audit procedures after the financial statements have been issued. However, if he becomes aware of a fact that had it been known to him at the date of his report, may have caused him to amend his report then he is **required** to:

- discuss the matter with management
- determine whether the financial statements need amending, and
- inquire how management intend to address the matter in the financial statements.

If the financial statements are amended, the auditor is **required** to:

- carry out the necessary audit procedures on the amendment
- review the steps taken by management to inform anyone who received the original financial statements and audit report of the situation
- extend his review of subsequent events up to the date of the new audit report
- issue a new audit report, containing an **emphasis of matter paragraph** or **other matter paragraph**. This should refer to a note in the revised financial statements that explains in more detail the reason for the re-issue of the financial statements.

As usual, in the real exam, you are likely to be asked to **apply** your knowledge to a given scenario.

Example:

You are the auditor in charge of the audit of Hindsight, which has a 30 June year end. The subsequent events review for the year ended 30 June Year 5 revealed that, on 1 August Year 5, a receiver was appointed at a major customer. At 30 June Year 5 that customer owed Rs 200,000 and goods costing Rs 300,000 made to that customer's specification were held in inventory. Both these amounts are material.

Required

List the matters to which you would direct your attention in respect of the above in relation to the audit for the year ended 30 June Year 5, if the audit report on the financial statements has not yet been written

Answer

- Check that the directors are willing to adjust the financial statements for this adjusting event after the reporting period.
- Establish whether any cash has been received from this customer since the year end.
- Review any correspondence from the receiver to establish to what extent the outstanding debt will be recovered.
- Consider whether the goods held in inventory are now valued at the lower of cost and NRV, given that these goods were made to the customer's specification. This may depend on whether or not those goods can be sold to a different customer.
- In the light of the above, consider whether any write downs proposed by the directors to receivables and/or inventory are reasonable.
- If they are not, or if the directors refuse to adjust the financial statements, consider the impact on the audit report.

Note

If the event occurs after the date of the audit report but before the financial statements are issued, the auditor should discuss the matter with the directors of the client entity and ask what they propose to do.

- If the directors intend to amend the financial statements to include or report the event, the auditor should re-write the audit report accordingly and give it a new date.
- If the directors say that they do not intend to amend the financial statements, the auditor must consider the most appropriate course of action. If it is too late to re-write the audit report the auditor should consider communicating with the shareholders in another way; for example by asking to speak at the annual general meeting of the entity (which is the auditor's right).
- In the longer term, the auditor should also consider resigning from the audit, but this would not be appropriate as an immediate response to the problem. The immediate requirement is to convey the auditor's opinion to the shareholders.

2 WRITTEN REPRESENTATIONS: ISA 580

Section overview

- Definition and objectives
- Written representations as audit evidence
- Written representations about management's responsibilities
- Form and contents of the letter of representation
- Refusal to provide requested written representations

2.1 Definition and objectives

Definition: Written representation

A written statement by management provided to confirm certain matters or to support other audit evidence. It does not include financial statements, assertions, or supporting books and records.

The **objectives** of the auditor in this area, per ISA 580, are to:

- obtain written representations from management that it has fulfilled its responsibilities in respect of the financial statements and the audit
- obtain written representations as appropriate to support other audit evidence
- respond appropriately to written representations provided by management or if management refuse to provide the written representations requested.

ISA 580 requires appropriate written representations from management (often referred to as "**management representations**") to be in the form of a **letter of representation**, addressed to the auditor.

These written representations may be an important source of audit evidence.

2.2 Written representations as audit evidence

If the auditor considers that written representations are needed **to support other audit evidence** he is **required** to request such other written representations.

During the course of the audit, management will make many representations to the auditor. Some of these will be unsolicited but some will be given in response to specific enquiries from the auditor. The auditor will have recorded such verbal discussions with management in the audit working papers. However, verbal evidence is not strong audit evidence. In order to improve the quality of this evidence, the auditor will ask for any significant discussions to be confirmed in writing.

Such representations are likely to be needed:

- to support the auditor's understanding of management's intention or judgment (for example, in respect of future plans for the business or a specific matter such as the net realisable value of inventory), or
- in respect of the completeness of a specific item (for example, that all liabilities have been provided for).

However, although such written representations provide necessary audit evidence, **they do not provide sufficient appropriate evidence on their own**.

If a representation by management is contradicted by other audit evidence, the auditor should:

- consider whether his risk assessment of that area is still appropriate
- consider whether additional audit procedures are needed
- if he has concerns about the integrity of management, document those concerns and consider withdrawing from the audit.

The auditor is also **required by specific other ISAs** to request certain other written representations. These requirements are illustrated in the example letter set out below.

2.3 Written representations about management's responsibilities

The auditor is also **required** by ISA 580 to obtain certain other specific written representations from management. In these representations management acknowledges that:

- it has fulfilled its responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework
- it has provided the auditor with all relevant information and access
- all transactions have been recorded and are reflected in the financial statements.

Again, these points are illustrated in the example letter set out below.

2.4 Form and contents of the letter of representation

The letter of representation is:

- usually drafted by the auditor (since he knows the areas on which he requires written representations)
- addressed to the auditor
- dated as near as practicable (but not after) the date of the audit report.

A written representation letter may include the following statements.

- The written representation letter relates to the audit of the client company.
- The management of the entity has fulfilled their responsibilities for the preparation of the financial statements, and the financial statements give a true and fair view and are free from material misstatement.
- The assumptions made by management to make accounting estimates and reach fair values are reasonable.
- Related party relationships and transactions have been disclosed.
- All events after the reporting period have been either adjusted or disclosed.
- The effect of any uncorrected misstatements (a list of which should be attached to the letter) is immaterial.
- The auditors have been provided with all relevant material, including the books of account, and unrestricted access to individuals within the entity.
- All transactions have been recorded and are included in the financial statements.
- Management has disclosed to the auditors all information that is relevant to fraud or suspected fraud.
- Management has disclosed all known instances of non-compliance with laws or regulations that are relevant to the preparation of the financial statements.
- Representations may also be included that refer to specific assertions in the financial statements, if the auditors require that such assertions should be made.

Examples

The following example of a letter of representation shows the minimum contents of such a letter. However, remember that the auditor may also need to request management to provide written representations about specific assertions in the financial statements.

Example of a letter of representation

(Entity Letterhead)

(To Auditor) (Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Ltd for the year ended 31 December 31 20X1 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*):

Financial statements

We have fulfilled our responsibilities for the preparation and presentation of the financial statements as set out in the terms of the audit engagement dated….. and, in particular, the financial statements are fairly presented (or *give a true and fair view*) in accordance with International Financial Reporting Standards.

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)

Information provided

We have provided you with:

- all information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements
- additional information that you have requested from us; and
- unrestricted access to those within the entity.

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)

2.5 Refusal to provide requested written representations

If management refuses to provide requested written representations the auditor is **required** to:

- discuss the matter with management
- re-evaluate the integrity of management and reconsider the impact on other representations and audit evidence
- take appropriate action, including considering the effect on the audit report.

Example:

The following points have arisen during the audit for the year ended 30 June 20X6 of Compo, a nationwide dealer in used cars.

1. During the year, five of Compo's properties were revalued by an independent surveyor.
2. One property was sold during the year to the marketing director.
3. The directors have refused to make provision against a bad debt.

Required

Explain whether or not each of the above would be referred to in the letter of representation for the year ended 30 June 20X6.

Answer

1. No – other evidence should be available (the independent surveyor's report).
2. Yes – to support the completeness of disclosure of loans and other transactions with directors.
3. No – the impact on the audit report will need to be considered. (And if the directors have refused, and the auditor is sure the debt is bad, the directors are not going to provide evidence to support this view in the letter of representation.)

3 OVERALL REVIEW OF THE FINANCIAL STATEMENTS

Section overview

- General review
- Specific review

After the detailed audit work has been completed, the auditor will carry out an overall review of the financial statements. By this stage of the audit, the financial statements should be in their final draft form.

This review will normally be carried out by a senior member of the audit team, often the manager or partner.

3.1 General review

At a general level, the review will check that a clear conclusion has been reached and documented on each of the financial statement areas. Analytical procedures may be used as a final check that the information contained in the draft financial statements 'makes sense'.

3.2 Specific review

More specifically, the overall review will cover the following matters:

- Compliance by the client with the relevant accounting framework (national legislation and relevant accounting standards).
- A review of the accounting policies adopted by the entity, to assess whether they are acceptable (and comply with accounting standards and industry practice).
- A review of the financial statements for adequate disclosure of relevant information.
- An assessment of whether the information contained in the financial statements is consistent with known business facts.

4 PURPOSE OF THE AUDIT REPORT

Section overview

- Introduction
- The expectation gap

4.1 Introduction

The audit report is the end-product of the external audit process. It is the document in which the auditor expresses his professional judgement on whether the financial statements present a 'true and fair view'.

The contents of the audit report are likely to be regulated by national legislation. In addition, the external auditor is governed by:

- ISA 700 Forming an opinion and reporting on financial statements
- ISA 705 Modifications to the opinion in the independent auditor's report
- ISA 706 Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report

4.2 The expectation gap

The audit report is the only direct means of communication between the auditor and the users of the financial statements (who are mainly, but not exclusively, the shareholders). In recent years, auditing has suffered from an 'expectation gap' as the role of the auditor in law does not match what the users of financial statements expect from an auditor.

The term 'expectation gap' refers to the fact that the public perception of the role and responsibilities of the external auditor is different from his statutory role and responsibilities. The expectations of the public are often set at a level higher than that at which the external auditor actually operates.

Some examples of the misunderstandings inherent in the public's expectations are as follows:

- The public believes that the audit opinion in the audit report amounts to a 'certificate' that the financial statements are correct and can be relied upon for all decision-making purposes, including decisions about takeovers.
- The public also believes that the auditor has a duty to prevent and detect fraud and that this is one reason for an audit.
- The public assumes that, in carrying out his audit work, the auditor tests 100% of the transactions undertaken during the accounting period.

One consequence of these misunderstandings has been an increasing tendency in some countries to undertake legal action against the auditors, sometimes on a 'frivolous' basis, in the belief that the auditor should have prevented misstatements in the financial statements or should have prevented fraud.

Responses to the problem of the expectation gap have varied between countries. In some countries, corporate governance codes have been changed to strengthen the role and responsibilities of directors for good internal control and accounting systems.

In addition, the standard format of the audit report has been expanded in recent years in an attempt to clarify what is involved in an audit and the relative responsibilities of the directors and the auditors.

Critics argue that these moves are not likely to be effective as those groups in society who are promoting the expectation gap may not understand these attempts that have been made to remedy the problem.

5 THE UNMODIFIED AUDIT REPORT: ISA 700

Section overview

- Definition of an unmodified audit report
- Reaching the audit opinion
- Core elements of the audit report
- Audit report prescribed by law or regulation
- Unaudited supplementary information presented with the audited financial statements

5.1 Definition of an unmodified audit report

An **unmodified audit report** is an audit report containing an audit opinion not modified in any way – either by changing the unmodified opinion (to a qualified opinion, an adverse opinion or a disclaimer of opinion) or by adding an extra paragraph such as an 'emphasis of matter' or 'other matters' paragraph after the opinion paragraph.

ISA 700 **requires** the auditor to give an unmodified opinion when he concludes that the financial statements have been prepared, in all material respects, **in accordance with the applicable financial reporting framework**.

If that framework is a "fair presentation framework" then the report will give an opinion stating whether or not the financial statements "give a true and fair view" or "present fairly" the position and results of the entity.

An unmodified opinion provides a high level of assurance that a professional, independent examination of the financial statements has not revealed any material misstatements in those financial statements.

5.2 Reaching the audit opinion

In reaching his audit opinion, the auditor is **required** to evaluate whether:

- ❑ he has obtained sufficient appropriate audit evidence as to whether the financial statements are free from material misstatement
- ❑ uncorrected misstatements are material, individually or in aggregate
- ❑ the financial statements have been prepared in accordance with the requirements of the applicable financial reporting framework (which for a "fair presentation framework" will include evaluating whether the financial statements give a true and fair view)

and, in particular, whether:

- ❑ the financial statements adequately refer to or describe the applicable financial reporting framework
- ❑ the financial statements adequately disclose the entity's significant accounting policies
- ❑ the significant accounting policies are appropriate and consistent with the applicable financial reporting framework
- ❑ accounting estimates are reasonable
- ❑ the information in the financial statements is relevant, reliable, comparable and understandable
- ❑ the financial statements provide adequate disclosures
- ❑ the terminology used in the financial statements is appropriate.

5.3 Core elements of the audit report

The basic elements of an unmodified audit report, as given in ISA 700, are as follows:

1 Title
2 Addressee
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These elements are designed to achieve the **objectives** of ISA 700, which are for the auditor to:

- form an opinion on the financial statements, based on the conclusions drawn from his audit evidence, and
- express that opinion clearly through a written report that also describes the basis for that opinion.

Title

The auditor's report should have a title that clearly indicates that it is the report of an independent auditor. This is to distinguish this type of auditor's report from other reports that might be issued by other auditors (who may not have to abide by the same ethical requirements and requirement for independence as the independent auditor - for example, internal auditors).

Addressee

The report should be appropriately addressed, as required by national law and the circumstances of the engagement. The report is usually addressed to either:

- the shareholders of the entity whose financial statements are being audited, or
- the board of directors of the entity.

Auditor's opinion

The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion". The Opinion section of the auditor's report shall also:

- identify the entity whose financial statements have been audited
- state that the financial statements have been audited
- identify the title of each of statement that makes up the complete set of financial statements (e.g. statement of comprehensive income, statement of financial position, and so on)
- refer to notes, including the summary of significant accounting policies and other explanatory information
- specify the date or period covered by each statement.

When the financial statements have been prepared in accordance with a **"fair presentation" framework** an unmodified opinion should be expressed when the auditor concludes that the financial statements **give a true and fair view** or are **presented fairly, in all material respects**, in accordance with the applicable financial reporting framework.

When the financial statements have been prepared in accordance with a **"compliance" framework** an unmodified opinion should be expressed when the auditor concludes that the financial statements **have been prepared**, in all material respects, in accordance with the applicable financial reporting framework.

This can lead to a two-fold opinion. For example an opinion will be expressed on whether the financial statements:

- conform with approved accounting standards as applicable in Pakistan(IFRS)and
- give the information required by the Companies Act, 2017

in the manner so required and respectively give a true and fair view of the state of the Company's affairs

Where IFRSs are not used as the financial reporting framework, the reference to the financial reporting framework in the wording of the opinion should identify the jurisdiction of the financial reporting framework

Basis for opinion

This section shall be placed immediately after the "opinion" section of the auditor's report. This section:

- States that the audit was conducted in accordance with International Standards on Auditing;
- Refers to the section of the auditor's report that describes the auditor's responsibilities under the ISAs;
- Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.

The statement shall identify the jurisdiction of origin of the relevant ethical requirements or refer to the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code); and

- States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Going Concern

- The auditor shall report in accordance with ISA 570(Revised), where applicable. This section has been explained in a later portion of this chapter.

Key Audit Matters

For audits of listed entities and other prescribed or selected entities, auditor shall communicate "Key Audit Matters" in auditor's report. This section has been explained in a later portion of this chapter.

Other Information

The auditor shall report in accordance with ISA 720(revised), where applicable. ISA 720 (Revised) shall be discussed in your later studies at CFAP level examination.

Responsibilities for the financial statements

This section of the report should describe the responsibilities of those responsible for the preparation and presentation of the financial statements. It should include an explanation that management is responsible for:

- the preparation of the financial statements in accordance with the applicable financial reporting framework, and

- for such internal controls as deemed necessary to enable the preparation of financial statements which are free from material misstatement.
- assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern.

This section shall also identify those responsible for the oversight of the financial reporting process, when those responsible for such oversight are different from the management.

Auditor's responsibility

This section of the report shall:

- state that the 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; and
  - issue an auditor's report that includes the auditor's opinion.
- state that 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; and
- state that misstatements can arise from fraud or error, and either:
  - describe that they 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; or
  - provide a definition or description of materiality in accordance with the applicable financial reporting framework.

The Auditor's Responsibilities section of the auditor's report shall further:

- state that the auditor exercises professional judgment and maintains professional skepticism throughout the audit; and
- describe an audit by stating that the auditor's responsibilities are:
  - to identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error
  - to 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 entity's internal control
  - to evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
  - to conclude on the appropriateness of management's use of the going concern basis of accounting

(*see illustration at the end of this unit for exact wording suggested by ISA 700)

This section of the auditor's report also shall:

- state that the auditor communicates 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 the auditor identifies during the audit;
- for audits of financial statements of listed entities, state that the auditor provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards; and

- where "Key Audit Matters" are communicated, state that, from the matters communicated with those charged with governance, the auditor determines 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.

The description of the auditor's responsibilities **shall be included**:

- within the body of the auditor's report;
- within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix; or
- by a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority

Other reporting responsibilities

In some countries, the auditor may have additional reporting responsibilities. For example, he may be required by local legislation to report certain matters if they come to his attention during the course of the audit, or he may be required to report on specific matters such as the adequacy of accounting records.

Such other reporting responsibilities may be addressed in a separate section of the report sub-titled "Report on Other Legal and Regulatory Requirements. In this case the auditor's report would be having two separate sections.

- "Report on Audit of the financial statements" encompassing the auditor's opinion, basis for opinion, key audit matters, management's responsibilities and auditor's responsibilities areas; and
- "Report on other legal and regulatory requirements" covering the specific requirements of that particular area.

Name of the engagement partner

The name of the engagement partner shall be included in the auditor's report for audits of complete sets of general purpose financial statements of **listed entities**

However, if in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security, threat the auditor should not include the name as such and shall also discuss the severity with those charges with governance.

Auditor's signature

The report should be signed:

- in the name of the audit firm, or
- in the personal name of the auditor, or
- both.

The report is usually signed in the name of the firm because the firm assumes responsibility for the audit.

Auditor's address

The report should give a specific location for the auditor. This will usually be the city where the office responsible for the audit is located.

Date of the auditor's report

The report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base his opinion on the financial statements.

This will not be earlier than the date on which the financial statements are signed or approved by the directors/management of the client company.

The date of the report informs the reader that the auditor has considered the effect on the financial statements (and on his audit report) of subsequent events which occurred after the reporting period and up to that date.

Example:

An example of an unmodified audit report, of a **listed entity** prepared in accordance with **fair presentation framework**, is set out below.

INDEPENDENT AUDITOR'S REPORT

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

Report on the Audit of the Financial Statements[1]

Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 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.*]

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[2], 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.

[1] The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable

[2] Where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards, and for such ..."

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.

[3][As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism 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.[4]
- 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 t outweigh the public interest benefits of such communication.]

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[3] Paragraph 40(b) of this ISA explains that the shaded material can be located in an Appendix to the auditor's report. Paragraph 40(c) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities.

[4] This sentence would be modified, as appropriate, in circumstances when the auditor also has a responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements

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 (i.e., 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*]

Example:

An example of an unmodified audit report, of an **entity other than listed entity** prepared in accordance with **compliance framework**, is set out below.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement 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 of the Company are prepared, in all material respects, in accordance with XYZ Law of Jurisdiction X.

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 ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Responsibilities of Management and Those Charged with Governance for the Financial Statements[5]

Management is responsible for the preparation of the financial statements in accordance with XYZ Law of Jurisdiction X[6] 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.

[5] Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

[6] Where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards, and for such …"

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.

[7][As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism 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.

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.]

[*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]

[7] Paragraph 40(b) of this ISA explains that the shaded material can be located in an Appendix to the auditor's report. Paragraph 40(c) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities.

5.4 Audit report prescribed by law or regulation

If the auditor is required by law or regulation (e.g. a national auditing standard) to use a specific layout or wording of the audit report, rather than the wording in ISA 700, then the audit report may only refer to ISAs if it includes, as a minimum, the following elements:

- A title.
- An appropriate addressee
- An Opinion section and a reference to the applicable financial reporting framework used to prepare the financial statements
- An identification of the entity's financial statements that have been audited.
- A statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.
- A section that addresses, and is not inconsistent with, the reporting requirements of ISA 570-Revised (where applicable).
- Basis for modification paragraph (where applicable).
- A section that includes "Key Audit Matters" or additional information about the audit that is prescribed by law or regulation (where applicable),
- A description of management's responsibilities for the preparation of the financial statements
- A reference to ISA and the law or regulation, and a description of the auditor's responsibilities for an audit of the financial statements
- Name of the engagement partner (for audits of listed entities).
- Auditor's signature.
- Auditor's address.
- Date of the auditor's report.

These elements correspond with those specified by ISA 700 as elements to be included in an unmodified audit report.

5.5 Unaudited supplementary information presented with the audited financial statements

The report and accounts issued by a company often contain supplementary information that is not covered by the auditor's opinion, such as a chairman's statement, employment report or business review.

The auditor should be satisfied that any unaudited supplementary information that is presented together with the audited financial statements is clearly differentiated from the audited financial statements. This is because unaudited items are not covered by the auditor's opinion.

If the auditor concludes that the unaudited information is **not** clearly differentiated, then he should ask management to change how that information is presented. If management refuse to do so then the auditor should explain in his report that the supplementary information has not been audited.

The auditor's responsibilities in respect of unaudited supplementary information are covered by ISA 720 (which is outside the scope of this syllabus).

6 COMMUNICATING KEY AUDIT MATTERS IN AN AUDIT REPORT: ISA 701

Section overview

- Scope of the ISA 701
- Determining Key Audit Matters
- Communicating Key Audit Matters
- Description of Individual Key Audit Matters
- Communication with those charges with governance

6.1 Scope of the ISA 701

This International Standard on Auditing (ISA) deals with the auditor's responsibility to communicate key audit matters in the auditor's report. The purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed.

Definition: 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.

Auditor shall communicate key audit matters in the auditor's report for audits of

- Listed entities
- Entities other than listed entities, if required by law or regulation of any area
- Other entities decided by the auditor using his professional judgment, including those that may be of significant public interest, for example because they have a large number and wide range of stakeholders and considering the nature and size of the business (E.g. banks, insurance companies, and charities etc).

Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.

6.2 Determining Key Audit Matters

The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

- Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised)
- Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
- The effect on the audit of significant events or transactions that occurred during the period.

For example, the auditor may have had extensive discussions with management and those charged with governance at various stages throughout the audit about the effect on the financial statements of significant transactions with related parties or significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.

Note: Auditor's procedures regarding the related parties have been discussed in an earlier chapter.

Determining the relative significance of a matter

Other considerations that may be relevant to determining the relative significance of a matter communicated with those charged with governance and whether such a matter is a key audit matter include:

- The importance of the matter to intended users' understanding.
- The complexity or subjectivity involved in management's selection of an appropriate policy compared to other entities within its industry.
- The nature and materiality (quantitatively or qualitatively) of the misstatements due to fraud or error related to the matter, if any.
- The nature and extent of audit effort needed to address the matter, including:
  - The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any.
  - The nature of consultations outside the engagement team regarding the matter.
- The severity of any control deficiencies identified relevant to the matter.

6.3 Communicating Key Audit Matters

The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters,"

The introductory language in this section of the auditor's report shall state that:

- Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements [of the current period]; and
- These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.

No key audit matters to communicate

If the auditor determines, depending on the facts and circumstances of the entity and the audit, that there are no key audit matters to communicate, the auditor shall include a statement to this effect in a separate section of the auditor's report under the heading "Key Audit Matters."

In such a case the suggested wording to be included in "Key Audit Matters" portion would be as illustrated

Illustration:

Key Audit Matters

[Except for the matter described in the Basis for Qualified (Adverse) Opinion section or Material Uncertainty Related to Going Concern section,] We have determined that there are no [other] key audit matters to communicate in our report.

Note: 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 respect of that matter, in accordance with ISA 705 (Revised).

6.4 Descriptions of Individual Key Audit Matters

The description of each key audit matter in the Key Audit Matters section of the auditor's report shall

- Include a reference to the related disclosure(s), if any, in the financial statements;
- State that why the matter was considered to be one of most significance in the audit; and
- Specify how the matter was addressed in the audit
  - A brief overview of procedures performed;

- An indication of the outcome of the auditor's procedures; or
- Key observations with respect to the matter,

The description may also make reference to the principal considerations that led the auditor, in the circumstances of the audit, to determine the matter to be one of most significance, for example:

- ❑ New or emerging accounting policies, for example entity-specific or industry-specific matters on which the engagement team consulted within the firm.
- ❑ Changes in the entity's strategy or business model that had a material effect on the financial statements.

Reference to the related disclosure(s)

Management or those charged with governance may decide to include new or enhanced disclosures in the financial statements or elsewhere in the annual report relating to a key audit matter in light of the fact that the matter will be communicated in the auditor's report.

A reference to any related disclosures enables the intended users to further understand how management has addressed the matter in preparing the financial statements. Auditor may also draw attention to key aspects of them.

6.5 Communication with those charged with governance

Communication with those charged with governance enables them to be made aware of the key audit matters that the auditor intends to communicate in the auditor's report, and provides them with an opportunity to obtain further clarification where necessary.

The auditor shall communicate with those charged with governance:

- ❑ Those matters the auditor has determined to be the key audit matters; or
- ❑ If applicable, depending on the facts and circumstances of the entity and the audit, the auditor's determination that there are no key audit matters to communicate in the auditor's report.

7 AUDIT REPORTING AND THE COMPANIES ACT, 2017

Section overview

- Reporting requirements of the Companies Act, 2017
- Other audit-related matters
- Penalty for non-compliance with the Companies Act, 2017
- Comparison of report under form 35A and under ISA 700 (Revised)

7.1 Reporting requirements of the Companies Act, 2017 (s249 CA17)

The Companies Act requires that the auditor make a report to the members of the company on the accounts and books of accounts of the company and on every financial statements and on every other document forming part of the statements including notes, statements or schedules appended thereto, which are laid before the company in a general meeting and the report shall state:

- whether or not they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purposes of the audit and if not, the details and the effect of such information on the financial statements;
- whether or not in their opinion proper books of accounts as required by the Act have been kept by the company;
- whether or not in their opinion the statement of financial position and profit and loss account and other comprehensive income or the income and expenditure account and the cash flows have been drawn up in conformity with the requirements of accounting and reporting standards as notified under the Act and are in agreement with the books of accounts and returns;
- whether or not in their opinion and to the best of their information and according to the explanations given to them the said accounts give the information required by the Act in the manner so required and give a true and fair view—
  - in the case of the statement of financial position, of the state of affairs of the company as at the end of the financial year;
  - in the case of the profit and loss account and other comprehensive income or the income and expenditure account, of the profit or loss and other comprehensive income or surplus or deficit as the case may be, for its financial year; and
  - in the case of the statement of cash flows, of the generation and utilization of the cash and cash equivalents of the company for its financial year;
- whether or not in their opinion-
  - investments made, expenditure incurred and guarantees extended during the year were for the purpose of the company's business; and
  - zakat deductible at source under the Zakat and Usher Ordinance, 1980 (XVIII of 1980), was deducted by the company and deposited in the Central Zakat Fund established under section 7 of that Act.

Where the auditor's report contains a reference to any other report, statement or remarks which they have made on the financial statements examined by them, such statement or remarks shall be annexed to the auditor's report and shall be deemed to be a part of the auditor's report.

Where any of the matter referred above is answered in negative or with a qualification, the report shall state the reason for such answer along with the factual position to the best of the auditor's information.

The auditor shall express unmodified or modified opinion in his report in compliance with the requirements of International Standards on Auditing as adopted by the Institute of Chartered Accountants of Pakistan.

Illustration: Auditors' report to the members – Form 35A Companies Rules, 1985 (Rule 17A)

Note for students: The audit report format under the Companies Act, 2017 will be applicable by way of Companies Regulations, which have not been issued at the time of publication of this study text. Therefore, under section 509(2b) ('Repeal and savings') of the Companies Act, 2017 the audit report under the Companies Rules, 1985 shall be in effect till the time the regulations are issued.

Auditors' report to the members

Report on the Financial Statements

We have audited the accompanying financial statements (or revised financial statements)(if applicable) of ____________________, which comprise the balance sheet as at __________________, and the profit and loss account, the statement of comprehensive income (if applicable), the statement of changes in equity (if applicable) and the cash flow statement (if applicable) for the year then ended and a summary of significant accounting policies and other explanatory notes and we state that we have obtained all the information and explanations which, to the best of our knowledge and belief, were necessary for the purposes of our audit.

Management's Responsibility

Management is responsible for the preparation of these financial statements that give a true and fair view in accordance with the approved accounting standards as applicable in Pakistan and the requirements of the Companies Ordinance, 1984. This responsibility includes designing, implementing and maintaining 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.

Auditors' Responsibility

Our responsibility is to express an opinion on these statements based on our audit. We conducted our audit in accordance with the International Standards on Auditing as applicable in Pakistan. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that gives a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on effectiveness of entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.
We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Opinion

In our opinion and to the best of our information and according to the explanations given to us, the financial statements conform with approved accounting standards as applicable in Pakistan, and, give the information required by the Companies Ordinance, 1984, in the manner so required and respectively give a true and fair view of the state of the company's affairs as at ____________________ and of the profit/loss, the comprehensive income (if applicable), the changes in equity (if applicable) and its cash flows (if applicable) for the year then ended.

Report on Other Matters required by the Companies Ordinance, 1984

Based on our audit, we further report that in our opinion:

(a) Proper books of accounts have been kept by the company as required by the Companies Ordinance, 2017;

(b) the balance sheet and profit and loss account together with the notes thereon have been drawn up in conformity with the Companies Ordinance, 1984 and are in agreement with the books of accounts and are further in accordance with accounting policies consistently applied except for the change(s) as stated in note(s)____________ with which we concur;

(c) the expenditure incurred during the year was for the purpose of the company's business;

(d) the business conducted, investments made and the expenditure incurred during the year were in accordance with the objects of the company; and

(e) Zakat deductible at source under the Zakat and Ushr Ordinance, 1980 (XVIII of 1980), was deducted by the company and deposited in the Central Zakat Fund established under section 7 of that Ordinance.

Audit firm's signature

Name of the engagement partner

Place of signing and date of the auditors' report

7.2 Other audit-related matters

Additional matters (s246 of CA17)

The Commission may be general or special order direct that:

- in the case of all companies generally or such class or description of companies as may be specified in the order, the auditor's report shall also include a statement of such additional matters as may be so specified.
- the statement of compliance shall be reviewed by the auditor who shall issue a review report to the members on the format specified by the Commission.

Auditor's access to books & records (s248 of CA17)

An auditor of a company has a right:

- of access at all times to the company's books, accounts and vouchers(in whatever form they are held); and
- of access to such copies of, an extracts from, the books and accounts of the branch as have been transmitted to the principle office of the company;
- to require any of the following persons to provide him with such information or explanations as he thinks necessary for the performance of his duties as auditors:
  - any director, officer or employee of the company;
  - any person holding or accountable for any of the company's books, accounts or vouchers;
  - any subsidiary undertaking of the company; and
  - any officer, employee or auditor of any such subsidiary undertaking of the company or any person holding or accountable for any books, accounts or vouchers of any such subsidiary undertaking of the company.

Attendance at general meetings (s249.8 CA17)

The auditor of a company shall be entitled to attend any general meeting of the company, and to receive all notices of, and any communications relating to, any general meeting which any member of the company is entitled to receive, and to be heard at any general meeting which he attends on any part of the business which concerns him as auditor:

Provided that, in the case of a listed company, the auditor or a person authorized by him in writing shall be present in the general meeting in which the financial statements and the auditor's report are to be considered.

Audit report signature (s251 CA17)

The auditor's report must state the name of the auditor, engagement partner, be signed, dated and indicate the place at which it is signed.

Where the auditor is an individual, the report must be signed by him.

Where the auditor is a firm, the report must be signed by the partnership firm with the name of the engagement partner.

7.3 Penalty for non-compliance with the Companies Act, 2017

Company default (s252 CA17)

If a company defaults on complying with the requirements of sections 246, 247, 248 and 250 , it shall be liable to a penalty of offense of level 3 on the standard scale, i.e, upto Rs. 100 million and upto Rs. 500,000 per day if the default continues.

Auditor default (s253 CA17)

If any auditor's report or review report is made, or any document of the company is signed or authenticated otherwise than in conformity with the requirements of (sections 131, 249 and 251 of the Act), or is otherwise untrue or fails to bring out material facts about the affairs of the company or matters to which it purports to relate, the auditor concerned and the person, if any, other than the auditor who signs the report or signs or authenticates the document, and in the case of a firm all partners of the firm, shall be punishable to a penalty of level 2 on the standard scale i.e, upto Rs. 500,000 and upto Rs. 1,000 per day if the default continues.

If the auditor's report is made with the intent to profit the auditor or any other person or to put another person to a disadvantage or loss or for a material consideration, the auditor shall, in addition to the penalty provided above, be punishable with **imprisonment** for a term which may extend **two years** and with a penalty which may extend to **one million rupees**.

7.4 Comparison of report under form 35A and under ISA 700 (Revised)

Note for students: The comparison of the audit report as per ISA 700 has been made with the audit report format given in the Companies Ordinance, 1984.

The Companies Act, 2017 will be applicable by way of Companies Regulations, which have not been issued at the time of publication of this study text. Therefore, under section 509(2b) ('Repeal and savings') of the Companies Act, 2017 the audit report under the Companies Rules, 1985 shall be in effect till the time the regulations are issued.

Report under Form 35A	Illustration 1 of the appendix to ISA 700 (Revised)	Comments
AUDITORS' REPORT TO THE MEMBERS	**INDEPENDENT AUDITOR'S REPORT** To the Shareholders of ABC Company [or Other Appropriate Addressee]	1. Report under ISA 700 have appropriate headings according to nature and objectives of paragraphs of 'Independent Auditor's Report' 2. In case of listed companies, report under ISA 700 is also addressed to shareholders just like Form 35 A. However in case of other entities ISA 700 uses the term appropriate addressee.

Report under Form 35A	Illustration 1 of the appendix to ISA 700 (Revised)	Comments
Report on the Financial Statements We have audited the accompanying financial statements (or revised financial statements)(if applicable) of ___________________, which comprise the balance sheet as at _________________, and the profit and loss account, the statement of comprehensive income (if applicable), the statement of changes in equity (if applicable) and the cash flow statement (if applicable) for the year then ended and a summary of significant accounting policies and other explanatory notes and we state that we have obtained all the information and explanations which, to the best of our knowledge and belief, were necessary for the purposes of our audit.	**Report on the Audit of the Financial Statements**[8] We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 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.	1. Wordings of report under ISA 700 slightly differ from of Form 35A 2. Terms of 'statement of financial position' and 'statement of comprehensive income' are used instead of 'balance sheet' and 'related profit and loss account' respectively in report under ISA 700 3. Fact regarding the obtaining of necessary information and explanation is clearly mentioned in this paragraph of report under Form 35A
Management's Responsibility Management is responsible for the preparation of these financial statements that give a true and fair view in accordance with the approved accounting standards as applicable in Pakistan and the requirements of the Companies Ordinance, 1984. This responsibility includes designing, implementing and maintaining 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.	**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[9], 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.	1. Heading is used in report under ISA 700 2. More elaborated wordings in report under ISA 700 as compared to Form 35A 3. Objective of internal control for preparation of financial statements is clearly mentioned Report under ISA 700 4. Compliance with requirements of the Companies Ordinance, 1984 for preparation of financial statements is described in Form 35A 5. Responsibility of those charged with governance for overseeing decribed in ISA 700.
Auditors' Responsibility Our responsibility is to express an opinion on these statements based on our audit. We conducted our audit in accordance with the International Standards on Auditing as applicable in Pakistan. Those standards require that we comply with ethical requirements and plan	**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	1. Heading is used in Report under ISA 700 2. Reference to applicability of standards in Pakistan is mentioned in Form 35A 3. Reference to compliance with Ethical requirements is mentioned in report under ISA 700 4. Following are clearly mentioned in report under ISA 700 a. use of judgment in selection of audit procedure b. assessment of the risks of material

[9] The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable

[10] Where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards, and for such ..."

Report under Form 35A	Illustration 1 of the appendix to ISA 700 (Revised)	Comments
and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that gives a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on effectiveness of entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.	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. [10][As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism 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.[11] • 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	misstatement of the financial statements, whether due to fraud or error c. consideration internal control relevant to the entity's preparation and fair presentation of the financial statements for designing of audit procedures d. clear expression 'not for the purpose of expressing an opinion on the effectiveness of the entity's internal control' e. optional shaded area is used f. matters communicated to those charged with governance are discussed g. comprehensive elaboration of the auditor's responsibility is given in ISA 700.

[11] Paragraph 40(b) of this ISA explains that the shaded material can be located in an Appendix to the auditor's report. Paragraph 40(c) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities.

[12] This sentence would be modified, as appropriate, in circumstances when the auditor also has a responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements

Report under Form 35A	Illustration 1 of the appendix to ISA 700 (Revised)	Comments
	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 t outweigh the public interest benefits of such communication.]	
Opinion In our opinion and to the best of our information and according to the explanations given to us, the financial statements conform with approved accounting standards as applicable in Pakistan, and, give the information required by the Companies Ordinance, 1984, in the manner so required and respectively give a true and fair view of the state of the company's affairs as at ____________________ and of the profit/loss, the comprehensive income (if applicable), the changes in equity (if applicable) and its cash flows (if applicable) for the year then ended.	Opinion In our opinion, the financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of ABC Company as 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.	1. Reference to applicability of standards in Pakistan is mentioned in Form 35A 2. Compliance with requirements of the Companies Ordinance, 1984 for preparation of financial statements is described in Form 35A 3. Wordings are slightly differ in Form 35A as compared to report under ISA 700
	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.	This portion is discussed in the auditor's responsibility portion in Form 35A.
	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	This portion is not covered in the Form 35A.

Report under Form 35A	Illustration 1 of the appendix to ISA 700 (Revised)	Comments
	on these matters. [*Description of each key audit matter in accordance with ISA 701.*]	
Report on Other Matters required by the Companies Ordinance, 1984 Based on our audit, we further report that in our opinion: (a) Proper books of accounts have been kept by the company as required by the Companies Ordinance, 1984; (b) the balance sheet and profit and loss account together with the notes thereon have been drawn up in conformity with the Companies Ordinance, 1984, and are in agreement with the books of accounts and are further in accordance with accounting policies consistently applied except for the change(s) as stated in note(s)____________ with which we concur; (c) the expenditure incurred during the year was for the purpose of the company's business; (d) the business conducted, investments made and the expenditure incurred during the year were in accordance with the objects of the company; and (e) Zakat deductible at source under the Zakat and Ushr Ordinance, 1980 (XVIII of 1980), was deducted by the company and deposited in the Central Zakat Fund established under section 7 of that Ordinance.	**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 (i.e., 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.*]	1. This is a provision in report under ISA 700 for opinion or reporting requirement under applicable legal framework, the Form 35A exactly specifies those other legal requirements.
Audit firm's signature Name of the engagement partner Place of signing and date of the auditors' report	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*]	1. order is different 2. name of engagement partner is also given in ISA 700 (where the entity is a listed entity)
		Overall there is major difference in placement, sequence and wordings of the portions given in both sort of reports. (ISA 700 and Form 35A)

8 Modification to audit opinion : ISA 705

Section overview

- When auditor modify the opinion
- Nature of material misstatements
- Nature of an inability to obtain audit evidence
- Determining the type of modification to opinion
- Management-imposed limitation after the auditor has accepted the engagement
- Form and content of the modified report
- Communication with those charged with governance
- Illustrations of auditors' reports with modifications to the opinion as provided in the appendix to ISA 705

Previous sections of the chapter discussed the unmodified audit report under ISA 700 and under the Companies Act, 2017. Amongst all the additional paragraphs, it simply states that the financial statements show a true and fair view. There are no 'ifs', 'buts' or 'additional information provided.'

The standard audit report provides a positive opinion with reasonable assurance that the financial statements give a true and fair view of the state of the company's affairs as on specific date and of profit/loss, its cash flows and changes in equity for the year then ended in accordance with the approved accounting standards as applicable in Pakistan.

In order to form an opinion on the financial statements the ISA 700 requires that the auditor should conclude as to whether reasonable assurance has been obtained whether the financial statements are free from material misstatement or not. If there is any uncorrected misstatement the auditor should consider and evaluate the effect of such misstatements on financial statements in accordance with ISAs.

8.1 When auditor modify the opinion

The ISA 705 states that the auditor shall modify the opinion in the auditor's report when:

- The auditor concludes that, based on the audit evidence obtained, 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.

8.2 Nature of material misstatements

ISA defines a misstatement as a difference between the amounts, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

A material misstatement of the financial statements may arise in relation to the following:

- The appropriateness of the selected accounting policies;
- The application of the selected accounting policies; or
- The appropriateness or adequacy of disclosures in the financial statements.

Appropriateness of the selected accounting policies

In relation to the appropriateness of the accounting policies that management has selected, material misstatements of the financial statements may arise when:

- The selected accounting policies are not consistent with the applicable financial reporting framework; or

- The financial statements, including the related notes, do not represent the underlying transactions and events in a manner that achieves fair presentation.

Financial reporting frameworks often contain requirements for the accounting for, and disclosure of, changes in accounting policies. Where the entity has changed its selection of significant accounting policies, a material misstatement of the financial statements may arise when the entity has not complied with these requirements.

Application of the selected accounting policies

In relation to the application of the selected accounting policies, material misstatements of the financial statements may arise:

- When management has not applied the selected accounting policies consistently with the financial reporting framework, including when management has not applied the selected accounting policies consistently between periods or to similar transactions and events (consistency in application); or
- Due to the method of application of the selected accounting policies (such as an unintentional error in application).

Appropriateness or adequacy of disclosures in the financial statements

In relation to the appropriateness or adequacy of disclosures in the financial statements, material misstatements of the financial statements may arise when:

- The financial statements do not include all of the disclosures required by the applicable financial reporting framework;
- The disclosures in the financial statements are not presented in accordance with the applicable financial reporting framework; or
- The financial statements do not provide the disclosures necessary to achieve fair presentation.

8.3 Nature of an inability to obtain audit evidence

The auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from:

- Circumstances beyond the control of the entity;
- Circumstances relating to the nature or timing of the auditor's work; or
- Limitations imposed by management.

Circumstances beyond the control of the entity

Examples of circumstances beyond the control of the entity include when:

- The entity's accounting records have been destroyed.
- The accounting records of a significant component have been seized indefinitely by governmental authorities.

Circumstances relating to the nature or timing of the auditor's work

Examples of circumstances relating to the nature or timing of the auditor's work include when:

- The timing of the auditor's appointment is such that the auditor is unable to observe the counting of the physical inventories.
- The auditor determines that performing substantive procedures alone is not sufficient, but the entity's controls are not effective.

Limitations imposed by management

Examples of an inability to obtain sufficient appropriate audit evidence arising from a limitation on the scope of the audit imposed by management include when:

- Management prevents the auditor from observing the counting of the physical inventory.

- Management prevents the auditor from requesting external confirmation of specific account balances.

An inability to perform a specific procedure does not constitute a limitation on the scope of the audit if the auditor is able to obtain sufficient appropriate audit evidence by performing alternative procedures. If this is not possible, the requirements of modification to audit opinion may apply as appropriate.

8.4 Determining the type of modification to opinion

ISA 705 provides guidance on following modifications to the opinion of the auditor:

- Qualified opinion
- Adverse opinion
- Disclaimer of opinion

Qualified opinion

ISA 705 states that the auditor shall express a qualified opinion when:

- The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
- The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Adverse opinion

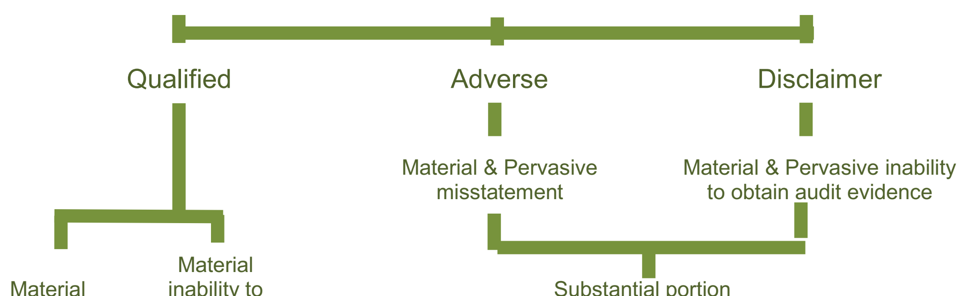
ISA 705 states that the auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Disclaimer of opinion

- ISA 705 states that the auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.
- ISA 705 states that the auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of 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.

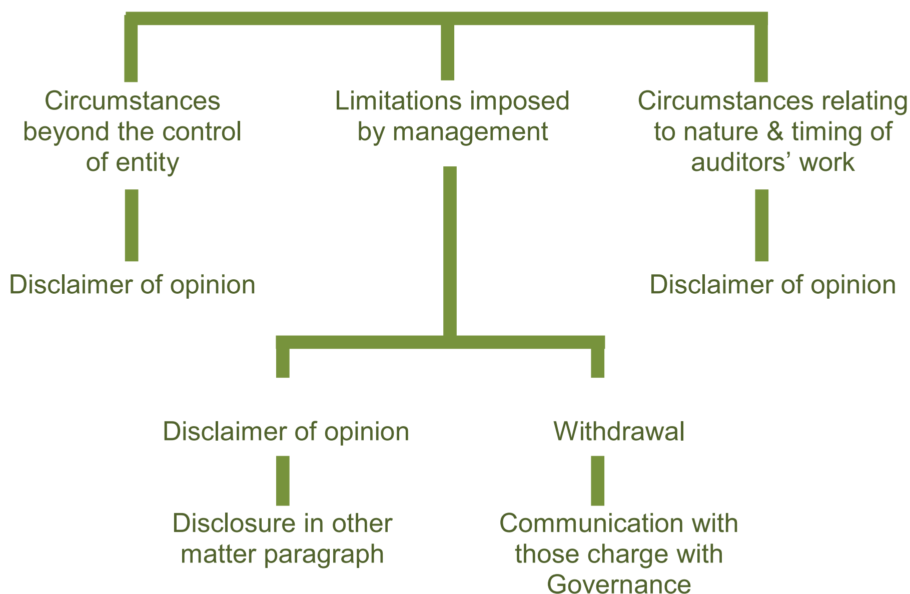
When the auditor considers it necessary to express an adverse opinion or disclaim an opinion on the financial statements as a whole, the auditor's report shall not also include an unmodified opinion with respect to the same financial reporting framework on a single financial statement or one or more specific elements, accounts or items of a financial statement. To include such an unmodified opinion in the same report in these circumstances would contradict the auditor's adverse opinion or disclaimer of opinion on the financial statements as a whole.

Types of modifications



Misstatement obtain audit evidence of financial statements (individual items / combination of items)

Materiality and pervasive on types of scope limitation



Following illustrative table is provided by the ISA 705 that shows how the auditor forms judgment about the nature of the matter giving rises to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed:

	Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
Nature of Matter Giving Rise to the Modification	***Material but Not Pervasive***	***Material and Pervasive***
Financial statements are materially misstated	**Qualified opinion**	**Adverse opinion**
Inability to obtain sufficient appropriate audit evidence	**Qualified opinion**	**Disclaimer of opinion**

Definition: Pervasive

A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment:

- Are not confined to specific elements, accounts or items of the financial statements;
- If so confined, represent or could represent a substantial proportion of the financial statements; or
- In relation to disclosures, are fundamental to users' understanding of the financial statements.

8.5 Management-imposed limitation after the auditor has accepted the engagement

If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to

express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

If management refuses to remove such limitation, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity, and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:

- If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or
- If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:
  - Withdraw from the audit, where practicable and possible under applicable law or regulation
  - If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.

But the practicality of withdrawing from the audit may depend on the stage of completion of the engagement at the time that management imposes the scope limitation. If the auditor has substantially completed the audit, the auditor may decide to complete the audit to the extent possible, disclaim an opinion and explain the scope limitation in the Basis for Disclaimer of Opinion paragraph prior to withdrawing.

Moreover, in certain circumstances withdrawal from the audit may not be possible if the auditor is required by law or regulation to continue the audit engagement. This may be the case for an auditor that is appointed to audit the financial statements of public sector entities. It may also be the case in jurisdictions where the auditor is appointed to audit the financial statements covering a specific period, or appointed for a specific period and is prohibited from withdrawing before the completion of the audit of those financial statements or before the end of that period, respectively. The auditor may also consider it necessary to include an Other Matter paragraph in the auditor's report.

If the auditor withdraws as contemplated by ISA 705, before withdrawing, the auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion.

Moreover, when the auditor concludes that withdrawal from the audit is necessary because of a scope limitation, there may be a professional, legal or regulatory requirement for the auditor to communicate matters relating to the withdrawal from the engagement to regulators or the entity's owners.

8.6 Form and content of the modified report

Consistency in the auditor's report helps to promote users' understanding and to identify unusual circumstances when they occur. Accordingly, although uniformity in the wording of a modified opinion and in the description of the basis for the modification may not be possible, consistency in both the form and content of the auditor's report is desirable.

Opinion paragraph

When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the opinion paragraph.

Inclusion of this paragraph heading makes it clear to the user that the auditor's opinion is modified and indicates the type of modification.

Qualified opinion

When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the auditor shall state in the opinion paragraph that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion paragraph:

- The financial statements present fairly, in all material respects (or give a true and fair view) in accordance with the applicable financial reporting framework when reporting in accordance with a fair presentation framework; or
- The financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework.

When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase "except for the possible effects of the matter(s) ..." for the modified opinion.

When the auditor expresses a qualified opinion, it would not be appropriate to use phrases such as "with the foregoing explanation" or "subject to" in the opinion paragraph as these are not sufficiently clear or forceful.

Adverse opinion

When the auditor expresses an adverse opinion, the auditor shall state in the opinion paragraph that, in the auditor's opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion paragraph:

- The financial statements do not present fairly (or give a true and fair view) in accordance with the applicable financial reporting framework when reporting in accordance with a fair presentation framework; or
- The financial statements have not been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework.

Disclaimer of opinion

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall state in the opinion paragraph that:

- The auditor does not express an opinion on the financial statements.
- Because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion; and, accordingly,
- Auditor was engaged to audit the financial statements.

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the opinion section of the auditor's report to state that the auditor was engaged to audit the financial statements. The auditor shall also amend the description of the auditor's responsibility and the description of the scope of the audit accordingly.

Basis for opinion

- When the auditor modifies the opinion on the financial statements, theauditor shall, in addition to the specific elements required by ISA 700 (Revised), amend the heading "Basis for Opinion" to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and
- within this section, include a description of the matter giving rise to the modification.

If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including quantitative disclosures in the notes to the financial statements), the auditor shall include in the basis for opinion section a description and quantification of the financial effects of the misstatement, unless impracticable. If it is not practicable to quantify the financial effects, the auditor shall so state in this section.

An example of the financial effects of material misstatements that the auditor may describe in the basis for modification paragraph in the auditor's report is the quantification of the effects on income tax, income before taxes, net income and equity if inventory is overstated.

If there is a material misstatement of the financial statements that relates to narrative disclosures, the auditor shall include in the basis for opinion section an explanation of how the disclosures are misstated.

If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall:

- Discuss the non-disclosure with those charged with governance;
- Describe in the basis for opinion section the nature of the omitted information; and
- Unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

Disclosing the omitted information in the basis for modification paragraph would not be practicable if:

- The disclosures have not been prepared by management or the disclosures are otherwise not readily available to the auditor; or
- In the auditor's judgment, the disclosures would be unduly voluminous in relation to the auditor's report.

If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the basis for opinion section the reasons for that inability.

An adverse opinion or a disclaimer of opinion relating to a specific matter described in the basis for opinion section does not justify the omission of a description of other identified matters that would have otherwise required a modification of the auditor's opinion. In such cases, the disclosure of such other matters of which the auditor is aware may be relevant to users of the financial statements.

Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor shall describe in the basis for opinion section the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof.

Description of auditor's responsibility when the auditor expresses a qualified or adverse opinion

When the auditor expresses a qualified or adverse opinion, the auditor shall amend the description of the auditor's responsibility to state that the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's modified audit opinion.

Effect of disclaimer of opinion on "Key Audit Matters"

Unless required by law or regulation, when the auditor disclaims an opinion on the financial statements, the auditor's report shall not include a Key Audit Matters section in accordance with ISA 701.

8.7 Communication with those charged with governance

When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the proposed wording of the modification.

The ISA 705 further explains that communicating with those charged with governance the circumstances that lead to an expected modification to the auditor's opinion and the proposed wording of the modification enables:

- The auditor to give notice to those charged with governance of the intended modification(s) and the reasons (or circumstances) for the modification(s);

- The auditor to seek the concurrence of those charged with governance regarding the facts of the matter(s) giving rise to the expected modification(s), or to confirm matters of disagreement with management as such; and
- Those charged with governance to have an opportunity, where appropriate, to provide the auditor with further information and explanations in respect of the matter(s) giving rise to the expected modification(s).

8.8 Illustrations of auditors' reports with modifications to the opinion as provided in the appendix to ISA 705

Illustration 1:

An auditor's report containing a qualified opinion due to a material misstatement of the financial statements.

Illustration 2:

An auditor's report containing an adverse opinion due to a material misstatement of the consolidated financial statements.

Illustration 3:

An auditor's report containing a qualified opinion due to the auditor's inability to obtain sufficient appropriate audit evidence regarding a foreign associate.

Illustration 4:

An auditor's report containing a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements.

Illustration 5:

An auditor's report containing a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about multiple elements of the financial statements.

Illustration 1:

Circumstances include the following:

- Audit of a complete set of financial statements of a listed entity using a fair presentation framework.
- The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in ISA 210.
- Inventories are misstated. The misstatement is deemed to be material but not pervasive to the financial statements (i.e., a qualified opinion is appropriate).
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with ISA 570 (Revised).
- Key audit matters have been communicated in accordance with ISA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

INDEPENDENT AUDITOR'S REPORT

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

Report on the Audit of the Financial Statements

Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 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 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 Qualified Opinion

The Company's inventories are carried in the statement of financial position at xxx. Management has not stated the inventories at the lower of cost and net realizable 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 realizable value, an amount of xxx would have been required to write the inventories down to their net realizable 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.

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 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. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified 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. In addition to the matter described in the *Basis for Qualified Opinion* 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.]

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

[Reporting in accordance with ISA 700 (Revised).]

Auditor's Responsibilities for the Audit of the Financial Statements

[Reporting in accordance with ISA 700 (Revised).]

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with ISA 700 (Revised).]

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*]

Illustration 2:

Circumstances include the following:

- Audit of a complete set of consolidated financial statements of a listed entity using a fair presentation framework. The audit is a group audit of an entity with subsidiaries (i.e., ISA 600 applies).
- The consolidated financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the consolidated financial statements in ISA 210.
- The consolidated financial statements are materially misstated due to the non-consolidation of a subsidiary. The material misstatement is deemed to be pervasive to the consolidated financial statements. The effects of the misstatement on the consolidated financial statements have not been determined because it was not practicable to do so (i.e., an adverse opinion is appropriate).
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with ISA 570 (Revised).
- ISA 701 applies; however, the auditor has determined that there are no key audit matters other than the matter described in the Basis for Adverse Opinion section.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under local law

INDEPENDENT AUDITOR'S REPORT

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

Report on the Audit of the Consolidated Financial Statements

Adverse Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated 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 consolidated financial statements do not present fairly (or *do not give a true and fair view of*) the consolidated financial position of the Group as at December 31, 20X1, and (*of*) its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for Adverse Opinion

As explained in Note X, the Group has not consolidated subsidiary XYZ Company that the Group acquired during 20X1 because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under IFRSs, the Company should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

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 Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

Key Audit Matters

Except for the matter described in the *Basis for Adverse Opinion* section, we have determined that there are no other key audit matters to communicate in our report.

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

[*Reporting in accordance with ISA 700 (Revised).*]

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

[*Reporting in accordance with ISA 700 (Revised).*]

Report on Other Legal and Regulatory Requirements

[*Reporting in accordance with ISA 700 (Revised).*]

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]

Illustration 3:

Circumstances include the following:

- Audit of a complete set of consolidated financial statements of a listed entity using a fair presentation framework. The audit is a group audit of an entity with subsidiaries (i.e., ISA 600 applies).
- The consolidated financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the consolidated financial statements in ISA 210.
- The auditor was unable to obtain sufficient appropriate audit evidence regarding an investment in a foreign associate. The possible effects of the inability to obtain sufficient appropriate audit evidence are deemed to be material but not pervasive to the consolidated financial statements (i.e., a qualified opinion is appropriate).
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's

ability to continue as a going concern in accordance with ISA 570 (Revised).

- Key audit matters have been communicated in accordance with ISA 701.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under local law.

INDEPENDENT AUDITOR'S REPORT

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

Report on the Audit of the Consolidated Financial Statements

Qualified Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated 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 consolidated financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Group as at December 31, 20X1, and (*of*) its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for Qualified Opinion

The Group's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at xxx on the consolidated statement of financial position as at December 31, 20X1, and ABC's share of XYZ's net income of xxx is included in ABC's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC's investment in XYZ as at December 31, 20X1 and ABC's share of XYZ's net income for the year because we were denied access to the financial information, management, and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

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 Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated 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 *Basis for Qualified Opinion* 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.]

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

[*Reporting in accordance with ISA 700 (Revised).*]

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

[*Reporting in accordance with ISA 700 (Revised).*]

Report on Other Legal and Regulatory Requirements

[*Reporting in accordance with ISA 700 (Revised).*]

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*]

Illustration 4:

Circumstances include the following:

- Audit of a complete set of consolidated financial statements of an entity other than a listed entity using a fair presentation framework. The audit is a group audit of an entity with subsidiaries (i.e., ISA 600 applies).
- The consolidated financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the consolidated financial statements in ISA 210.
- The auditor was unable to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements. That is, the auditor was also unable to obtain audit evidence about the financial information of a joint venture investment that represents over 90% of the entity's net assets. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the consolidated financial statements (i.e., a disclaimer of opinion is appropriate).
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- A more limited description of the auditor's responsibilities section is required.
- In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under local law.

INDEPENDENT AUDITOR'S REPORT

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

Report on the Audit of the Consolidated Financial Statements

Disclaimer of Opinion

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

We do not express an opinion on the accompanying consolidated financial statements of the Group. Because of the significance of the matter 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 consolidated financial statements.

Basis for Disclaimer of Opinion

The Group's investment in its joint venture XYZ Company is carried at xxx on the Group's consolidated statement of financial position, which represents over 90% of the Group's net assets as at December 31, 20X1. We were not allowed access to the management and the auditors of XYZ Company, including XYZ Company's auditors' audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the Group's proportional share of XYZ Company's assets that it controls jointly, its proportional share of XYZ Company's liabilities for which it is jointly responsible, its proportional share of XYZ's income and expenses for the year, and the elements making up the consolidated

statement of changes in equity and the consolidated cash flow statement.

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

[*Reporting in accordance with ISA 700 (Revised).]*

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our responsibility is to conduct an audit of the Group's consolidated financial statements in accordance with International Standards on Auditing and to issue an auditor's report. However, because of the matter described in the *Basis for Disclaimer of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements.

We are independent of the Group in accordance 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.

Report on Other Legal and Regulatory Requirements

[*Reporting in accordance with ISA 700 (Revised).*]

[*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*]

Illustration 5:

Circumstances include the following:

- Audit of a complete set of financial statements of an entity other than a listed entity using a fair presentation framework.
- The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in ISA 210.
- The auditor was unable to obtain sufficient appropriate audit evidence about multiple elements of the financial statements, that is, the auditor was also unable to obtain audit evidence about the entity's inventories and accounts receivable. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the financial statements.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- A more limited description of the auditor's responsibilities section is required.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

INDEPENDENT AUDITOR'S REPORT

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

Report on the Audit of the Financial Statements

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 December 31, 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 of the Company. 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 December 31, 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at December 31, 20X0 and 20X1, which are stated in the statements of financial position at xxx and xxx, respectively. In addition, the introduction of a new computerized accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the statement of financial position at a total amount of xxx as at December 31, 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the statement of comprehensive income, statement of changes in equity and statement of cash flows.

Responsibilities of Management and Those Charged with Governance for the Financial Statements22

[*Reporting in accordance with ISA 700 (Revised).*]

Auditor's Responsibilities for the Audit of the Financial Statements

Our responsibility is to conduct an audit of the Company's financial statements in accordance with International Standards on Auditing and to issue an auditor's report. However, because of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

We are independent of the Company in accordance 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.

Report on Other Legal and Regulatory Requirements

[*Reporting in accordance with ISA 700 (Revised).*]

[*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*]

9 Emphasis of matter paragraphs and other matter paragraphs: ISA 706

Section overview

- Emphasis of matter paragraphs
- Other matter paragraphs
- Placement of emphasis of matter or other matter paragraph in auditor's report
- Communication with those charged with governance

ISA 706 requires that there may be additional communication in the auditor's report when the auditor considers it is necessary to have these additional communications. ISA 706 describes such type of communication as 'Emphasis of Matter Paragraphs' and 'Other Matter Paragraphs.

9.1 Emphasis of matter paragraphs

Definition: Emphasis of matter paragraphs

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 judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

When the auditor considers it is necessary to draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements the emphasis of matter paragraph shall be included in the auditor's report.

The matter highlighted must not be a matter:

- requiring modification of opinion as per ISA 705; or
- determined to be a key audit matter to be communicated in the auditor's report

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

- Include it as a separate section in the auditor's report;
- Use any appropriate heading including the term "Emphasis of Matter,";
- Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements; and
- Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

The inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion. An Emphasis of Matter paragraph is not a substitute for either:

- The auditor expressing a modified opinion as per ISA 705 (Revised); or
- Disclosures in the financial statements that the applicable financial reporting framework requires management to make.
- Reporting in accordance with ISA 570 (Revised) when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern

Circumstances in which an emphasis of matter paragraph may be necessary

Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- Early application (where permitted) of a new accounting standard that has a pervasive effect on the financial statements.

- A major disaster having, a significant effect on the entity's financial position.

A widespread use of Emphasis of Matter paragraphs may diminish the effectiveness of the auditor's communication about such matters.

9.2 Other matter paragraphs

Definition: Other matter paragraphs

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 judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

When the auditor considers it is necessary to draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, the other matter paragraph shall be included in the auditor's report as a separate section with the heading of "other matters" or any other appropriate heading.

Auditor is allowed to use "other matter" paragraph where:

- this is not prohibited by law or regulation; and
- the matter has not been determined to be a key audit matter to be communicated in the auditor's report (ISA 701)

The content of an Other Matter paragraph reflects clearly that such other matter is not required to be presented and disclosed in the financial statements. An Other Matter paragraph does not include information that the auditor is prohibited from providing by law, regulation or other professional standards, for example, ethical standards relating to confidentiality of information. An Other Matter paragraph also does not include information that is required to be provided by management.

Circumstances where auditor may include other matter paragraph in report

- **Relevant to Users' Understanding of the Audit:** In the rare circumstance where the auditor is unable to withdraw from an engagement even though the possible effect of an inability to obtain sufficient appropriate audit evidence due to a limitation on the scope of the audit imposed by management is pervasive, the auditor may consider it necessary to include an Other Matter paragraph in the auditor's report to explain why it is not possible for the auditor to withdraw from the engagement.

  Also there may be a situation where law or regulation require the auditor to communicate about planning and scoping matters in the auditor's report, or the auditor may consider it necessary to communicate about such matters in an Other Matter paragraph.

- **Relevant to Users' Understanding of the Auditor's Responsibilities or the Auditor's Report:** Law, regulation or generally accepted practice in a jurisdiction may require or permit the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon. Where relevant, one or more sub-headings may be used that describe the content of the Other Matter paragraph.

An Other Matter paragraph does not deal with circumstances where the auditor has other reporting responsibilities that are in addition to the auditor's responsibility under the ISAs, or where the auditor has been asked to perform and report on additional specified procedures, or to express an opinion on specific matters.

- **Reporting on more than one set of financial statements:** An entity may prepare one set of financial statements in accordance with a general purpose framework (e.g., the national framework) and another set of financial statements in accordance with another general purpose framework (e.g. , International Financial Reporting Standards), and engage the auditor to report on both sets of financial statements. If the auditor has determined that the frameworks are acceptable in the respective circumstances, the auditor may include an Other Matter paragraph in the auditor's report, referring to the fact that another set of financial statements has been prepared by the same entity in accordance with another

general purpose framework and that the auditor has issued a report on those financial statements.

- **Restriction on distribution or use of the auditor's report:** Financial statements prepared for a specific purpose may be prepared in accordance with a general purpose framework because the intended users have determined that such general purpose financial statements meet their financial information needs. Since the auditor's report is intended for specific users, the auditor may consider it necessary in the circumstances to include an Other Matter paragraph, stating that the auditor's report is intended solely for the intended users, and should not be distributed to or used by other parties.

9.3 Placement of emphasis of matter or other matter paragraph in auditor's report

The placement of an Emphasis of Matter paragraph or Other Matter paragraph depends on the nature of the information to be communicated and the auditor's judgment of the relative significance of such information to intended users..

Emphasis of matter paragraph

When the Emphasis of Matter paragraph relates to the applicable financial reporting framework, the auditor may consider it necessary to place the paragraph immediately following the Basis of Opinion section to provide appropriate context to the auditor's opinion.

When a Key Audit Matters section is presented in the auditor's report, an Emphasis of Matter paragraph may be presented either directly before or after the Key Audit Matters section, based on the auditor's judgment as to the relative significance of the information included in the Emphasis of Matter paragraph. The auditor may also add further context to the heading "Emphasis of Matter", such as "Emphasis of Matter – Subsequent Event", to differentiate the Emphasis of Matter paragraph from the individual matters described in the Key Audit Matters section.

Other Matter Paragraphs

When a Key Audit Matters section is presented in the auditor's report and an Other Matter paragraph is also considered necessary, the auditor may add further context to the heading "Other Matter", such as "Other Matter – Scope of the Audit", to differentiate the Other Matter paragraph from the individual matters described in the Key Audit Matters section.

9.4 Communication with those charged with governance

If the auditor expects to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the auditor shall communicate with those charged with governance regarding this expectation and the proposed wording of this paragraph.

Such communication enables those charged with governance to be made aware of the nature of any specific matters that the auditor intends to highlight in the auditor's report, and provides them with an opportunity to obtain further clarification from the auditor where necessary. Where the inclusion of an Other Matter paragraph on a particular matter in the auditor's report recurs on each successive engagement, the auditor may determine that it is unnecessary to repeat the communication on each engagement

Illustration of an Auditor's Report that Includes a Key Audit Matters Section, an Emphasis of Matter Paragraph, and an Other Matter Paragraph

Circumstances include the following:

- Audit of a complete set of general purpose financial statements prepared by management of the entity in accordance with International Financial Reporting Standards.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in ISA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty

does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with ISA 570 (Revised).

- Between the date of the financial statements and the date of the auditor's report, there was a fire in the entity's production facilities, which was disclosed by the entity as a subsequent event. In the auditor's judgment, the matter is of such importance that it is fundamental to users' understanding of the financial statements. The matter did not require significant auditor attention in the audit of the financial statements in the current period.
- Key audit matters have been communicated in accordance with ISA 701.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

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 December 31, 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 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. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

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.

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 Matter

The financial statements of ABC Company for the year ended December 31, 20X0, were audited by another auditor who expressed an unmodified opinion on those statements on March 31, 20X1.

Responsibilities of Management and Those Charged with Governance for the Financial Statements4

[*Reporting in accordance with ISA 700 (Revised).*]

Auditor's Responsibilities for the Audit of the Financial Statements

[*Reporting in accordance with ISA 700 (Revised).*]

Report on Other Legal and Regulatory Requirements

[*Reporting in accordance with ISA 700 (Revised).*]

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*]

Illustration of an Auditor's Report Containing a Qualified Opinion Due to a Departure from the Applicable Financial Reporting Framework and that Includes an Emphasis of Matter Paragraph

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using a fair presentation framework.
- The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in ISA 210.
- A departure from the applicable financial reporting framework resulted in a qualified opinion.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with ISA 570 (Revised).
- Between the date of the financial statements and the date of the auditor's report, there was a fire in the entity's production facilities, which was disclosed by the entity as a subsequent event. In the auditor's judgment, the matter is of such importance that it is fundamental to users' understanding of the financial statements. The matter did not require significant auditor attention in the audit of the financial statements in the current period.
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with ISA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

INDEPENDENT AUDITOR'S REPORT

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

Report on the Audit of the Financial Statements

Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 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 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 Qualified Opinion

The Company's short-term marketable securities are carried in the statement of financial position at xxx. Management has not marked these securities to market but has instead stated them at cost, which constitutes a departure from IFRSs. The Company's records indicate that had management marked the marketable securities to market, the Company would have recognized an unrealized loss of xxx in the statement of comprehensive income for the year. The carrying amount of the securities in the statement of financial position would have been

reduced by the same amount at December 31, 20X1, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

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 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. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Emphasis of Matter – Effects of a Fire

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.

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

[*Reporting in accordance with ISA 700 (Revised).*]

Auditor's Responsibilities for the Audit of the Financial Statements

[*Reporting in accordance with ISA 700 (Revised).*]

Report on Other Legal and Regulatory Requirements

[*Reporting in accordance with ISA 700 (Revised).*]

[*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*]

10 GOING CONCERN BASIS AND THE AUDIT REPORT: ISA 570

Section overview

- Going concern basis and the financial statements
- Risk assessment procedures and the related activities
- Additional procedures when events or conditions are identified
- Implications for the audit report
- Communication with those charged with governance

10.1 Going concern basis and the Financial Statements

As discussed in the previous studies, the financial statements of the entity are normally prepared on a going concern basis. In the going concern basis it is assumed that the entity will continue to be in existence for foreseeable future (at least 12 months as per IAS 1).

IAS 1 requires management to make an assessment of the entity's ability to continue as a going concern. If management has some significant concerns about the entity's ability to continue as a going concern due to some material uncertainties, the uncertainties must be disclosed in a note to the financial statements.

If management concludes that the entity is not a going concern, the financial statements should not be prepared on a going concern basis.

10.2 Risk Assessment Procedures and the Related Activities

Auditor shall consider whether events or conditions exist that may cast significant doubt on entity's ability to continue as going concern.

Examples of such events or conditions

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 long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows (indicated by historical or prospective financial statements)
- Adverse key financial ratios.
- Substantial operating losses or deterioration in 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 transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

- Management intentions to liquidate entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- 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 entity that may result in claims that entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured disasters when they occur.

Auditor shall also determine whether management has already performed a preliminary assessment of continuance as going concern:

- If such assessment has been performed, auditor shall discuss with management and determine whether management has identified such events or conditions and, if so, what are the plans to address those.
- If such assessment has not yet been performed, auditor shall discuss with management basis for the intended use of the going concern basis of accounting, and inquire whether events or conditions exist that may cast significant doubt on going concern

10.3 Additional Procedures When Events or Conditions are Identified

Auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on going concern through additional audit procedures, including following factors

- Analyzing and discussing the cash flow, profit and other relevant forecasts with the management.
- Analyzing and discussing latest available interim financial statements
- Reading the terms of debentures and loan agreements
- Reading minutes of the meetings of shareholders, TCWG and relevant committees for reference to financing difficulties.
- Inquiring entity's legal counsel regarding existence of litigation and claims and reasonableness of management's assessments of their outcome and estimate of their financial implications.
- Performing audit procedures regarding subsequent events
- Confirming existence, terms and adequacy of the borrowing facilities
- Obtaining and reviewing reports of regulatory actions.

Requesting written representations from management and those charged with governance regarding their plans for the future actions and feasibility of those plans.

10.4 Implications for the Auditor's Report

Scenario	Implication
Going Concern Basis is Inappropriate	Adverse opinion
Going Concern Basis Is Appropriate but a Material Uncertainty Exists - Adequate Disclosure is made in the financial statements	Unmodified opinion with an Emphasis of Matter referring to the disclosure(s) of material uncertainty.
Going Concern Basis Is Appropriate but a Material Uncertainty Exists - Adequate Disclosure is not given in the financial statements	Qualified Opinion or Adverse Opinion

Scenario	Implication
Management Unwilling to Make or Extend Its Assessment	Qualified or Disclaimer

10.5 Communication with Those Charged with Governance

Auditor shall communicate with those charged with governance about the events or conditions identified that may cast significant doubt on going concern. Such communication shall include

- Whether events or conditions constitute a material uncertainty;
- Whether use of going concern basis is appropriate
- Adequacy of related disclosures in the financial statements
- Implications for the auditor's report.

Significant Delay in the Approval of F/S

If there is significant delay in approval of the financial statements by management or those charged with governance after the date of financial statements, auditor shall inquire the reasons for the delay. If the auditor believes that the delay could be related to events or conditions relating to the going concern assessment, the auditor shall perform necessary additional audit procedures.

11 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Describe what is involved in performing the subsequent events review in accordance with ISA 560
- Explain what a written representation is and discuss the instances in when they would be used
- Describe what is involved in the final review prior to signing the audit report
- Explain the contents of an unmodified auditor's report both in terms of the requirements of ISA 700 and the Companies Act, 2017
- Explain modification in auditor's opinion and report according to circumstances

CHAPTER 16

International standards on review engagements

Contents

1 Review engagements (ISRE 2400)
2 Chapter review

INTRODUCTION

Learning outcomes

The overall objective of the syllabus is acquiring knowledge of theory, skill and techniques of auditing and to enable the students to understand International Standards on Auditing, Assurance and Ethics.

Performance of audit and reporting

LO 3	**Understand the requirement and application guidelines relating to some of the specific areas of audit procedures including external confirmation, review of subsequent event etc.**

Engagement to review financial statements 2400

LO 3.6.1	Explain the objective of a review engagement of financial statements and how it differs from audit
LO 3.6.2	State the terms of engagement which may be included in the engagement letter
LO 3.6.3	Explain assurance and non-assurance engagement with examples
LO 3.6.4	Describe the procedures generally adopted by the practitioner to obtain evidence in review engagements
LO 3.6.5	Discuss and explain the report issued under engagement to review financial statements

1 REVIEW ENGAGEMENTS (ISRE 2400)

Section overview

- The distinction between audit and audit-related services
- Objective of review financial information
- Engagement and performance
- Forming the Practitioner's conclusion on the Financial Statements

1.1 The distinction between audit and audit-related services

An **audit** is a form of **assurance engagement**. The objective of an audit is to enable the auditor to form an opinion as to whether the financial statements of an entity give a 'true and fair view'.

An audit is designed to provide a high level of assurance to the users of the financial statements.

In contrast, **audit-related services** do not provide the same high level of assurance, and in some cases do not provide any assurance. Audit-related services are performed by **practitioner** and include engagements such as:

- **Reviews of data**. Reviews of data are checks carried out on information prepared by another person. They provide a **moderate** level of assurance that the information under review is free of material misstatement.
- **Agreed-upon procedures**. This is an engagement where the party hiring the practitioner specifies the procedures that the practitioner should follow when performing the assignment.
- **Compilations**. The practitioner is engaged to prepare information, rather than to audit information prepared by someone else. For example, an accountancy firm may be engaged to prepare a tax computation for a client.

1.2 Objective of review financial information

Review of financial information is done to (a) obtain limited assurance, primarily by performing inquiry and analytical procedures in accordance with applicable financial reporting framework (b) Report on the financial statements.

1.3 Engagement and performance

The practitioner shall agree the terms of the engagement with management or those charged with governance that shall include:

(a) The intended use and distribution of the financial statements,

(b) Identification of the applicable financial reporting framework;

(c) The objective and scope of the review engagement;

(d) The responsibilities of the practitioner;

(e) The responsibilities of management.

(f) A statement that the engagement is not an audit, and that the practitioner will not express an audit opinion on the financial statements; and

(g) Reference to the expected form and content of the report to be issued by the practitioner

Performing the Engagement

The practitioner shall determine and apply materiality for the financial statements as a whole. The practitioner shall obtain an understanding of the entity and its environment.

In obtaining sufficient appropriate evidence the practitioner shall design and perform inquiry and analytical procedures

Inquiry

Inquiries of management and others within the entity shall include inquiries relating to:

(a) Significant accounting estimates.

(b) The identification of related parties and related party transactions and their purpose

(c) Whether there are significant, unusual or complex transactions, events or matters including significant changes in the entity's business activity or operations, significant adjustments, significant transactions occurring near the end of the reporting period, the existence of any frauds or illegal acts or non-compliance, subsequent events, going concern, material commitments etc.

If the practitioner identifies significant transactions outside the entity's normal course of business, the practitioner shall inquire of management about:

(a) The nature of those transactions:

(b) Whether related parties could be involved; and

(c) The business rationale (or lack thereof) of those transactions.

Going concern

A review of financial statements includes consideration of the entity's ability to continue as a going concern. In this consideration, the practitioner shall cover the same period as that used by management

Use of work performed by others

If the practitioner uses work performed by another practitioner or an expert in the course of performing the review, the practitioner shall take appropriate steps to be satisfied that the work performed is adequate for the practitioner's purposes.

Subsequent Events

If the practitioner becomes aware of subsequent events that require adjustment of, or disclosure in. the financial statements the practitioner shall request management to correct those misstatements.

Written Representations

The practitioner shall request management to provide a written representation that management has fulfilled its responsibilities described in the agreed terms of engagement.

The practitioner shall also request management’s written representations that management has disclosed to the practitioner entity's related parties and related party transactions, significant facts relating to any frauds, known non-compliance, all information relevant to going concern assumption, subsequent events, material commitments and material non-monetary transactions

1.4 Forming the Practitioner’s conclusion on the Financial Statements

In forming the conclusion on the financial statements, the practitioner shall:

(a) Evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework

(b) Consider whether in the context of the requirements of the applicable financial reporting framework and the results of procedures performed:

(i) The terminology used in the financial statements including the title of each financial statement is appropriate:

(ii) The financial statements adequately disclose the significant accounting policies selected and applied:

(iii) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

(iv) Accounting estimates made by management appear reasonable;

(v) The information presented in the financial statements appears relevant, reliable, comparable, and understandable; and

(vi) The financial statements provide adequate disclosures.

Unmodified Conclusion

The practitioner shall express an unmodified conclusion in the practitioner's report on the financial statements as a whole when the practitioner has obtained limited assurance to be able to conclude that nothing has come to the practitioner's attention that causes the practitioner to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework.

Modified Conclusion

The practitioner shall express a modified conclusion in the practitioner's report on the financial statements as a whole when:

(a) The practitioner determines, that the financial statements are materially misstated; or

(b) The practitioner is unable to obtain sufficient appropriate evidence.

When the practitioner modifies the conclusion expressed on the financial statements, the practitioner shall:

(a) Use the heading "Qualified Conclusion," "Adverse Conclusion" or

"Disclaimer of Conclusion," as appropriate, for the conclusion paragraph in the practitioner's report; and

(b) Provide a description of the matter giving rise to the modification.

Financial statements are materially misstated

If the practitioner determines that the financial statements are materially misstated, the practitioner shall express:

(a) A qualified conclusion, when the practitioner concludes that the effects of the matter(s) giving rise to the modification are material, but not pervasive to the financial statements; or

(b) An adverse conclusion., when the effects of the matter(s) giving rise to the modification are both material and pervasive to the financial statements.

In the basis for conclusion paragraph, in relation to material misstatements that give rise to either a qualified conclusion or an adverse conclusion, the practitioner shall:

(a) Describe and quantify the financial effects of the misstatement if the material misstatement relates to specific accounts in the financial statements (including quantitative disclosures) unless impracticable, in which case the practitioner shall also state:

i. Explain how disclosures are misstated; or

ii. Describe the nature of omitted information.

Inability to obtain sufficient appropriate evidence

If the practitioner is unable to form a conclusion on the financial statements due to inability to obtain sufficient appropriate evidence the practitioner shall:

(a) Express a qualified conclusion if the practitioner concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive:; or

(b) Disclaim a conclusion if the practitioner concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

The practitioner shall disclaim a conclusion on the financial statements, or withdraw from the engagement, if:

(a) The practitioner concludes that there is sufficient doubt about the integrity of management; or

(b) Management does not provide the representations that are the preconditions for accepting an engagement.

When the practitioner disclaims a conclusion, the practitioner shall include the reason(s) for the inability to obtain sufficient appropriate evidence.

The Practitioner's Report

The practitioner's report for the review engagement shall be in writing, and shall contain the following elements:

(a) A title of report

(b) The addressee(s),

(c) An introductory paragraph that:

- i. Identifies the financial statements reviewed, including identification of the title of each of the statements contained;
- ii. Refers to the summary of significant accounting policies and other explanatory information; and
- iii. States that the financial statements have been reviewed;

(d) A description of the responsibility of management for the preparation of the financial statements.

(e) A description of the practitioner's responsibility to express a conclusion on the financial statements including reference to this ISRE and, where relevant, applicable law or regulation;

(f) A description of a review of financial statements and its limitations, and the following statements:

- i. A review engagement under this ISRE is a limited assurance engagement;
- ii. The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained; and
- iii. The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with International Standards on Auditing (ISAs), and, accordingly, the practitioner does not express an audit option on the financial statements;

(g) A paragraph under the heading "Conclusion" that contains:

- i. The practitioner conclusion on the financial statements as a whole
- ii. A reference to the applicable financial reporting framework used to prepare the financial statements,
- iii. When the practitioner's conclusion on the financial statements is modified:

(h) A paragraph under the appropriate heading that contains the practitioner's modified conclusion

(i) A paragraph, under an appropriate heading, that provides a description of the matter(s) giving rise to the modification

(j) A reference to the practitioner's obligation under this ISRE to comply with relevant ethical requirements;

   i. The date of the practitioner's report;

   ii. The practitioner's signature; and

   iii. The location in the jurisdiction where the practitioner practices.

Emphasis of Matter Paragraphs

The practitioner may consider it necessary to draw users' attention to a matter presented or disclosed in the financial statements. In such cases, the practitioner shall include an Emphasis of Matter paragraph in the practitioner's report.

2 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Distinguish between audit and audit-related services such as reviews
- Explain the requirements of ISRE 2400 Engagements to review financial information

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