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Paper Introduction
How to Use the Materials

These Kaplan Publishing learning materials have been carefully designed to make your learning experience as easy as possible and to give you the best chances of success in your examinations.

The product range contains a number of features to help you in the study process. They include:

(1) Detailed study guide and syllabus objectives
(2) Description of the examination
(3) Study skills and revision guidance
(4) Complete text or essential text
(5) Question practice

The sections on the study guide, the syllabus objectives, the examination and study skills should all be read before you commence your studies. They are designed to familiarise you with the nature and content of the examination and give you tips on how to best to approach your learning.

The complete text or essential text comprises the main learning materials and gives guidance as to the importance of topics and where other related resources can be found. Each chapter includes:

• The learning objectives contained in each chapter, which have been carefully mapped to the examining body’s own syllabus learning objectives or outcomes. You should use these to check you have a clear understanding of all the topics on which you might be assessed in the examination.

• The chapter diagram provides a visual reference for the content in the chapter, giving an overview of the topics and how they link together.

• The content for each topic area commences with a brief explanation or definition to put the topic into context before covering the topic in detail. You should follow your studying of the content with a review of the illustration/s. These are worked examples which will help you to understand better how to apply the content for the topic.
• **Test your understanding** sections provide an opportunity to assess your understanding of the key topics by applying what you have learned to short questions. Answers can be found at the back of each chapter.

• **Summary diagrams** complete each chapter to show the important links between topics and the overall content of the paper. These diagrams should be used to check that you have covered and understood the core topics before moving on.

• **Question practice** is provided at the back of each text.

**Icon Explanations**

**Definition** - Key definitions that you will need to learn from the core content.

**Key Point** - Identifies topics that are key to success and are often examined.

**Expandable Text** - Expandable text provides you with additional information about a topic area and may help you gain a better understanding of the core content. Essential text users can access this additional content on-line (read it where you need further guidance or skip over when you are happy with the topic).

**Illustration** - Worked examples help you understand the core content better.

**Test Your Understanding** - Exercises for you to complete to ensure that you have understood the topics just learned.

**Tricky topic** - When reviewing these areas care should be taken and all illustrations and test your understanding exercises should be completed to ensure that the topic is understood.

For more details about the syllabus and the format of your exam please see our Complete Text or go online.

**On-line subscribers**

**Paper background**

**Objectives of the syllabus**

**Core areas of the syllabus**
Syllabus objectives and chapter references

Syllabus learning objective

The Examination

Examination format

Paper-based examination tips

Study skills and revision guidance

Preparing to study

Effective studying

Further reading

You can find further reading and technical articles under the student section of ACCA’s website.
What is assurance?

Chapter learning objectives

Upon completion of this chapter you will be able to:

• state the objectives and principal activities of statutory audit and assess its value (e.g. in assisting management to reduce risk and improve performance)
• describe the limitations of statutory audits
• explain the level of assurance provided by audit assignments
• explain the level of assurance provided by other review assignments
• explain reporting as a means of communication to different stakeholders
• explain the nature and development of audit and other assurance engagements
• discuss the concept of stewardship
• discuss the concept of accountability
• discuss the concept of agency
• identify and describe the objective and general principles of external audit engagements
• explain the concept of materiality
• explain the concept of true and fair
• presentation and reasonable assurance.
1 Why we need assurance

What is assurance?

WHAT ARE ASSURANCE ENGAGEMENTS?

REASONABLE ASSURANCE

LIMITED ASSURANCE

STATUTORY AUDITS

REVIEW ENGAGEMENTS

FREE FROM MATERIAL MISSTATEMENTS

TRUE AND FAIR

ASSURANCE SERVICES

INCREASE CONFIDENCE

REDUCE RISK

FOR THE CLIENT
The purpose of assurance services is to:

- increase the confidence
- reduce the risk

of the user of those services.

2 How does assurance work?

Consider almost any purchase you have made, of almost anything – certainly anything which is important to you.

You will probably ask someone else’s opinion before you buy.

- Do I look OK in these clothes?
- What does it taste like?

If the purchase is for something more expensive:

- a new computer
- a new car

you may well do some research in computer or motoring magazines first.

If the purchase was a new house, you would almost certainly get a surveyor to look at it to give you some confidence that it was structurally sound before you committed yourself to buy it.

All of these transactions have similar elements. The most obvious ones are:

- you – the potential user of the thing you want to buy
- the thing you want to buy – the subject matter of the transaction
- your friend, the magazine or the surveyor who tells you what they think – in a formal assurance context known as the practitioner.
However, there are at least two other elements to the transaction:

- the person supplying the goods or services – the **responsible party**
- your expectations – the **criteria** against which you will decide whether your purchase is worthwhile.

There **may** be one more thing:

- it is possible that the subject matter cannot be examined directly – with a house or a car you can normally go and look, but to judge a property in an overseas country or the performance of a company over a year, you will be dependent on information about the subject matter – the real estate agent’s details of the property or some financial statements – known as **subject matter information**.

**Note** that there are three parties involved – the **tripartite engagement**:

- the user
- the responsible party
- the practitioner.

**Note also** that because the practitioner is offering a professional service (there is rather more to it than the “is this OK?” question above for which he or she expects to be paid a number of other issues arise:

- the need for competence
- the need for objectivity and independence
- the need for work to be carried out to expected standards.

All of these issues will be considered in the chapters which follow.
3 Assurance engagements

The engagement process usually involves:

- agreeing the terms of the engagement in an engagement letter
- deciding on a methodology for evidence gathering, and evaluation and measurement to support a conclusion
- agreeing the type of report to be produced at the end of the engagement.

### Types of assurance services

- an audit of financial statements
- a review of financial statements
- risk assessment reports
- performance measurement reports
- systems reliability reports
reports on social and environmental issues (e.g. to validate an employer’s claims about being an equal opportunities employer or a company’s claims about how ‘green’ it is)

• reviews of internal control
• best value/value for money work in private/public sector organisations.

4 Types of assurance engagement

The Framework permits only two types of assurance engagement to be performed:

• a reasonable assurance engagement
• a limited assurance engagement.

Reasonable assurance engagements

In a reasonable assurance engagement, the practitioner

• gathers sufficient appropriate evidence

We will look at this in detail in the chapters on audit evidence and audit procedures, but for now let us accept that it means that the practitioner has to do enough work to be able to draw rational conclusions

• concludes that the subject matter conforms in all material respects with identified suitable criteria
Materiality is another concept which we will consider in detail later. The important point for you to understand is that the practitioner is not saying that everything is absolutely correct, but that, broadly speaking, the information given is reliable

- gives his report in the form of **positive assurance.**

### Illustration 2 – Types of assurance engagement

<table>
<thead>
<tr>
<th>This means that the report states that in the practitioner’s opinion e.g.:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• financial statements <strong>have been prepared</strong> in accordance with applicable legislation and accounting standards</td>
</tr>
<tr>
<td>• the company’s employment policy in respect of disabled people <strong>is</strong> in accordance with applicable legislation or guidance</td>
</tr>
<tr>
<td>• the volume of greenhouse gasses emitting from the company’s factories <strong>is</strong> within targets set by government.</td>
</tr>
</tbody>
</table>

Compare this **positive assurance** report with the example of **negative assurance** in the section dealing with limited assurance engagements below.

A reasonable assurance engagement requires that:

- the subject matter is the responsibility of another party
- the subject matter is
  - identifiable and
  - in a form that can be subjected to evidence gathering procedures
  - the practitioner is not aware of any reason for believing that a conclusion expressing a reasonable level of assurance about the subject matter based on suitable criteria cannot be expressed.

### Limited assurance engagement

The practitioner:

- gathers sufficient appropriate evidence to be satisfied that the subject matter is plausible in the circumstances
- gives his report in the form of **negative assurance.**
A negative assurance report takes the form:

‘nothing has come to our attention that causes us to believe that the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework’.

**Not absolute assurance**

It is not possible to give an absolute level of assurance because of:

- the lack of precision often associated with the subject matter – e.g. financial statements are often subject to estimation and judgement
- the nature, timing and extent of procedures
- the fact that evidence is usually persuasive rather than conclusive
- the fact that evidence is gathered on a test basis
- even if everything reported on was examined and found to be satisfactory, there may be other items which should have been included – the *completeness* problem.

**Illustration – reasonable assurance engagement**

The most common example of a reasonable assurance engagement is an external audit. Using the terminology of the earlier paragraphs in this section, we can identify the elements of an audit engagement and the elements of an audit report.

The elements of an audit engagement are:

- a three party relationship between
  - a professional accountant (the auditor)
  - a responsible party (the board of directors of the company being audited)
  - intended users (the readers of the financial statements)
- a subject matter (the performance of the company)
- subject matter information (the annual financial statements)
- suitable criteria (the applicable financial reporting framework, e.g. national or international accounting standards and relevant law)
- sufficient appropriate evidence (the results of the tests that the auditor carries out to reach his conclusion)
- a written report (the audit report that is contained within the published financial statements).
External, statutory audit is the subject of the majority of the rest of this chapter, and, indeed, the majority of the syllabus and will therefore be dealt with in depth in the chapters that follow.

**Illustration – limited assurance engagement**

A review engagement

Agree terms of engagement

Review financial statements

Analytical procedures

Make enquiries

Negative assurance report

An example of a limited assurance engagement is an engagement to review financial statements.

**Characteristics of a review engagement**

A review engagement has all the attributes of any assurance engagement:

- the **practitioner** who conducts the work
- the **user** who commissioned the work
- a **responsible party**
- the **subject matter**
- the **subject matter information**
What is assurance?

- criteria
- sufficient appropriate evidence which needs to be documented
- a report.

However, there are important differences between a review engagement and an audit.

- The practitioner is not carrying out an audit
- For an audit the user will always be the company’s shareholders. Whereas for review engagement, the user could be whoever commissions the work e.g.:
  - a bank wanting to know whether to maintain existing or extend further credit facilities
  - the directors of the predator company in a takeover situation.

The level of assurance

The framework states that the level of assurance given by a reasonable assurance engagement is high, whereas a limited assurance engagement gives a moderate level of assurance.

There is no precise definition of what is meant by high or moderate in this context.

What is clear is that the confidence inspired in the user by the report produced after a reasonable assurance engagement is designed to be greater than the outcome of a limited assurance engagement.

It follows therefore that

- the procedures carried out will be more intensive
- the evidence gathered needs to be of higher quality

for a reasonable assurance engagement and this is reflected in the nature of the opinion given.

5 Reporting the outcome of assurance engagements
Who are the stakeholders of a company?

The stakeholders of a company are all those who are influenced by, or can influence, the company’s decisions and actions. Examples of stakeholder groups are:

- shareholders
- management, i.e. the directors or other senior officials with an executive role
- other employees
- those charged with governance, i.e. those whose role is to supervise management to ensure that they operate the business in the interests of the shareholders and other stakeholders and not, purely in their own, personal interests. This will be dealt with in more depth in chapter 3.
- customers
- suppliers
- the government
- lenders of funds
- community organisations, especially in the local neighbourhood.
Incorporation and the relationship between the owners and managers of a business

In most countries it is possible for businesses to be operated through companies – a process known as incorporation.

Incorporation may have two implications:

• the creation of a distinction between the owners of the business and the business itself, which may in turn lead to the business being run by managers who are distinct from its owners

• the granting of limited liability status so that, if the business fails, the owners only stand to lose a specific amount of money – hence the term ‘limited’. It is possible to have companies without limited liability status, but they are uncommon.

A legal framework was therefore needed for how companies should be operated

• to protect business owners from unscrupulous managers

• to protect the business world and the public at large from owners taking unfair advantage of limited liability status.

This in turn had two results:

• the legal requirement for accounts to be produced by management on a regular basis to account to the shareholders for their stewardship of the business
In most countries, therefore, companies generally require an audit. However, small or owner-managed companies are often exempt.

- the recognition of the need for these accounts to be checked in some way by someone independent of the managers – the auditor.

Stewardship is the responsibility to take good care of resources. A steward is a person entrusted with management of another person’s property, for example, when one person is paid to look after another person’s house while the owner goes abroad on holiday.

This relationship, where one person has a duty of care towards someone else is known as a ‘Fiduciary relationship’.

The steward is accountable for the way he carries out his role.

A fiduciary relationship is a relationship of ‘good faith’ such as that between the directors of a company and the shareholders of the company. There is a ‘separation of ownership and control’ in the sense that the shareholders own the company, while the directors take the decisions at the company. The directors must take their decisions in the interests of the shareholders rather than in their own selfish personal interests.

Accountability means that people in positions of power can be held to account for their actions, ie they can be compelled to explain their decisions and can be criticised or punished if they have abused their position.

In a company this works as follows:

- It is the shareholders of the company who own the shares in the company and thus indirectly own the assets of the company.
- The directors are accountable to the shareholders and to society at large for:
  - making decisions on behalf of the company’s owners (the shareholders)
  - using the assets of the company efficiently and effectively.
- The shareholders in turn have the right to remove the directors by voting in a general meeting and are likely to do this if they are dissatisfied with the decisions taken.
- Additionally, if the directors have acted illegally while running the company, they can be fined or even sent to jail.

Accountability is thus central to the concept of good corporate governance – the process of ensuring that companies are well run – which we will look at in more detail in Chapter 3.
**The concept of agency**

**Agency relationships** occur when one party, the **principal**, employs another party, the **agent**, to perform a task on their behalf.

Modern organisational theory views an organisation as comprising various interest groups often called **stakeholders** (see above). The relationships between the various stakeholders in a company are often described in terms of **agency theory**. For example, directors can be seen as the agents of shareholders, employees as the agents of directors and external auditors as agents of shareholders.

Each principal needs to recognise that, although he is employing the agent, the agent will have interests of his own to protect and thus may not fully carry out the requirements of the principal – a conflict of interests may arise.

**Illustration 3 – Agency theory considerations**

For example, the directors have a duty of stewardship of the company’s assets. However, they are also interested in their level of remuneration and, if this increases, the assets of the company go down. The decision to award directors pay increases may be in the hands of the directors themselves.

**The role of the auditor**

[Diagram showing the relationship between shareholders, ownership and finance, independent audit, control operations, directors (management), and company]

- **SHAREHOLDERS**
- **OWNERSHIP & FINANCE**
- **INDEPENDENT AUDIT**
- **CONTROL OPERATIONS**
- **DIRECTORS (MANAGEMENT)**
- **COMPANY**
- **FINANCIAL (AND OTHER) REPORTING**
The concepts of:

- stewardship
- fiduciary duty
- accountability

are all very well.

The requirement for a company’s management to produce financial statements giving an account of their stewardship of the company at regular intervals, certainly helps with the accountability concept.

But what if the financial statements contain errors, or worse, are fraudulent?

Clearly there was a need for some kind of independent validation of the financial statements – there was a need for independent audit.

There is a problem, however, in getting the balance right. If the auditors are expected to verify that the financial statements are correct, this:

- may prove to be very expensive because of the amount of work required
- may prove to be unduly disruptive to the operation of the business.

Over time, therefore, the role of the auditor has been established as forming an independent opinion about:

- the truth and fairness of the financial statements (see below about true and fair)
- their compliance with legal and regulatory requirements.

In other words the audit

- has all the characteristics of an assurance engagement
- cannot provide absolute assurance.

The statutory audit is going through a period of criticism and change. Part of this is due to the perceived failure of auditors to notice companies about to collapse, often due to massive frauds and accounting irregularities – the obvious examples in the past decade are Barings Bank, Enron, WorldCom and Parmalat. Linked in to this, is the growing belief that many firms of auditors are unable to make objective judgements, because they are too close to the companies they audit. As objectivity is vitally important to any opinion which the auditor gives on the ‘truth and fairness’ of the financial statements, this is extremely important and will be looked at in depth in Chapter 5 Ethics.
The contrast between the objective of the audit as a reasonable assurance engagement and the expectation that it should lead to the discovery of all errors and fraud is a phenomenon known as the ‘expectation gap’.

Test your understanding 1

(1) When buying a house, it is common for the purchaser to obtain a number of reports to give assurance that the property is sound and worth the money that is being offered. Describe three such reports and explain the assurance that is being sought.

(2) A common example of a limited assurance engagement is when an accountant is engaged to review a set of accounts. Identify and briefly describe the six elements of a review engagement to give limited assurance on whether a set of financial statements complies with Generally Accepted Accounting Practice.

(3) Complete all the boxes in the table below.

<table>
<thead>
<tr>
<th>Nature of engagement</th>
<th>Audit</th>
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<td></td>
<td></td>
</tr>
<tr>
<td>Type of report provided</td>
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</tbody>
</table>

(4) How can stakeholders other than the shareholders gain access to a company’s annual financial statements and audit report?

(5) Why might it be beneficial for management of a company to commission a report from its auditors on the company’s employment practices?

(6) What implications might the acceptance of such an engagement have for the audit firm?

(7) How does an external audit contribute to the accountability of the directors of a company?

(8) How does an external audit contribute to checking whether the directors of a company have exercised good stewardship of the company’s assets?

(9) Fill in the gaps below using any of the following words: ‘shareholders’, ‘directors’, ‘external auditors’, ‘government’. You can use words multiple times or not at all.
Directors act as the agents of the …

External auditors act as the agents of the …

Internal auditors act as the agents of the …

Employees act as the agents of the …

(10) An audit is one sort of assurance engagement. True or false?

7 Audit engagements

Audit objectives ➔ True and fair? Properly prepared?

General principles ➔ Ethics

Auditing standards

Professional scepticism

External audit

In most developed countries, all publicly quoted companies and all large companies are required by law to produce annual financial statements and have them audited by an external auditor. The majority of the syllabus is designed around this process.

Other organisations (e.g. small private companies, partnerships, etc.) may choose to be audited even if there is no legal requirement.

Objective of an external audit

The objective of an external audit engagement is to enable the auditor to express an opinion on whether the financial statements

• give a true and fair view (or present fairly in all material respects)
• are prepared, in all material respects, in accordance with an applicable financial reporting framework.

The financial reporting framework to be applied will vary from country to country.
General principles to be followed

The auditor should follow certain general principles in the conduct of an external audit.

- Compliance with applicable ethical principles, ie the IFAC Code of Ethics for Professional Accountants and the ethical pronouncements of the auditor’s professional body (e.g. the ACCA’s Rules of Professional Conduct) (See Chapter 5).
- Compliance with applicable auditing standards, ie the International Auditing and Assurance Standards Board’s (IAASB’s) International Standards on Auditing (ISAs).
- Planning and performing the audit with an attitude of professional scepticism that recognises that the financial statements being audited may be materially misstated. For example, the auditor should not simply accept an explanation about a matter given by management. The auditor should seek further evidence about the matter that confirms or contradicts management’s explanation.

8 Key concepts in the process of auditing

As stated earlier in this chapter, an audit is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement and give a true and fair view.

The purpose of this section is to investigate the meaning of ‘material misstatement’ and ‘true and fair view’. These are vitally important concepts, both in practice and for the purposes of the exam.
Materiality

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

**IAASB Glossary of Terms**

You have already seen that it is impossible for anyone to state that financial statements are precisely and absolutely correct. By stating that the accounts are free from material misstatement the auditor is saying that there are no alterations required that could alter the way in which someone might view/read the accounts (in other words, they are close enough to the truth!).

**True and fair**

In most countries the directors have a statutory duty to produce financial statements which give a true and fair view, and the auditors are required by law to report whether, in their opinion, the financial statements give a true and fair view. However, there is no official definition in the IAASB Glossary of Terms or in any individual ISA of the meaning of ‘true and fair’.

‘**Truth**’ in accounting terms can be taken to mean not factually incorrect.

The word **fair** can have the following meanings:

- on the one hand clear, distinct and plain,
- and on the other impartial/unbiased, just and equitable.

Both can be considered relevant when fair is used in an accounting context.

Auditors should attempt to ensure that the financial statements which are the subject of the audit, present clearly and equitably the financial state of affairs of the enterprise. This suggests that in order to achieve the statutory true and fair view, it is necessary:

- to present certain information impartially
- that this data is shown in such a way that it is clearly understood by the user.
Does the external auditor report on whether the published financial statements are correct or not?

You are auditing the financial statements of AB Ltd and discover that a car has been double-counted in the fixed assets at the balance sheet date. The car has a net book value of $5,000, non current assets are stated at $400,000 and the profit before tax for the year is $100,000. What should you do?

If you are deciding whether a particular accounting policy produces figures that give a true and fair view, state four sources of information that you might compare the policy with.
9 Chapter summary

What are assurance engagements?

Reasonable assurance

Statutory audits

Free from material misstatements

True and fair

Tripartite
- User
- Responsible party
- Practitioner

Elements
- Subject matter
- Subject matter information
- Criteria

Limited assurance

Review engagements
### Test your understanding 1

1. When buying a house, it is common for the purchaser to obtain a number of reports to give assurance that the property is sound and worth the money that is being offered. Describe three such reports and explain the assurance that is being sought.

   - **The purchaser might pay for the following reports:**
     - a surveyor’s report – a chartered surveyor will inspect the fabric of the property and give assurance that the walls and roof are soundly constructed. The surveyor will also give an estimated value for the property that a bank or building society will use as assurance that any loan they advance will be properly secured.
     - an electrician’s report – an electrician can assure whether the wiring in the property is safe and complies with relevant building regulations.
     - a roofer’s report – if the roof looks unsound, or the surveyor raises queries on its quality, a roofer can report on how much it would cost to mend or replace the roof. This cost can be incorporated into the discussions on purchase price between the seller and the purchaser of the property.

2. A common example of a limited assurance engagement is when an accountant is engaged to review a set of accounts. Identify and briefly describe the six elements of a review engagement to give limited assurance on whether a set of financial statements complies with UK Generally Accepted Accounting Practice.

   - The elements of a review engagement are:
     - a three party relationship between:
       - a professional accountant (the firm employed to carry out the review)
       - a responsible party (the board of directors of the company whose financial statements are being reviewed).
intended users (the readers of the financial statements with the accompanying review report)
• a subject matter (the performance of the company)
• subject matter information (the financial statements being reviewed)
• suitable criteria (UK GAAP)
• sufficient appropriate evidence (the results of the procedures that the reviewer carries out)
• a written report (the review report that is issued. Note that, because this is only a limited assurance engagement, the report will be worded to offer negative assurance only: "Nothing has come to our attention that causes us to believe that the financial statements do not comply with UK GAAP . . .")

3. Comparison of audit and review engagements.

<table>
<thead>
<tr>
<th>Nature of engagement</th>
<th>Audit</th>
<th>Review</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of work done decided by whom</td>
<td>Auditor, as much as he deems necessary to give positive opinion</td>
<td>Reviewer, as much as he deems necessary to give negative opinion</td>
</tr>
<tr>
<td>Type of assurance engagements</td>
<td>Reasonable, (but not absolute) assurance</td>
<td>Limited assurance</td>
</tr>
<tr>
<td>Level of assurance provided</td>
<td>High</td>
<td>Moderate</td>
</tr>
<tr>
<td>Type of report provided</td>
<td>Positive assurance</td>
<td>Negative assurance</td>
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<td><strong>4. How can stakeholders other than the shareholders gain access to a company’s annual financial statements and audit report?</strong></td>
<td>In most countries, every company must lodge a copy of their Annual Report and Accounts (including the financial statements and audit report) with a central government agency each year. Anyone can go to the agency’s website and (for a modest fee) inspect and print out a copy of any company’s accounts. Alternatively, most larger companies post a copy of their accounts on their own website where they can be inspected and printed out for free.</td>
<td></td>
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<tr>
<td><strong>5. Why might it be beneficial for management of a company to commission a report from its auditors on the company’s employment practices?</strong></td>
<td>Management might well hope that, because of the involvement of the auditors, the report would have greater credibility with employee groups than if it had been simply issued directly by management.</td>
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</tr>
<tr>
<td><strong>6. What implications might the acceptance of such an engagement have for the audit firm?</strong></td>
<td>The acceptance of an engagement other than an audit, might call into question the firm’s independence and objectivity when it was time to carry out the next audit.</td>
<td></td>
</tr>
<tr>
<td><strong>7. How does an external audit contribute to the accountability of the directors of a company?</strong></td>
<td>The directors are responsible for preparing draft financial statements that are submitted to the auditors for their audit. It is the directors who select the accounting policies and must make accounting estimates that are reasonable in the circumstances. The auditors will inspect the various decisions and judgements that the directors have made. Only if the auditors agree will they report that the accounts do give a true and fair view. Thus the directors are held accountable for their decisions and judgements, since the reputation of the company and the directors may suffer if the auditors reported that the accounts did not give a true and fair view.</td>
<td></td>
</tr>
</tbody>
</table>
8. How does an external audit contribute to checking whether the directors of a company have exercised good stewardship of the company’s assets?

The published financial statements will disclose the financial performance (i.e., profit or loss, and cash inflow or outflow) that the directors have achieved over the year, and the auditors will confirm whether or not these statements give a true and fair view. If the company has suffered a large loss during a period when its competitors have reported profits, then it appears that the directors have exercised poor stewardship of the assets under their control. The role of the auditors is to ensure that the directors are motivated to present accurate financial statements. If the directors try to hide the losses that have been incurred by unacceptable creative accounting, then the auditors will step in to persuade the directors to adopt proper accounting policies if they want the audit report to state that the accounts give a true and fair view.

9. Fill in the gaps below using any of the following words: ‘shareholders’, ‘directors’, ‘external auditors’, ‘government’. You can use words multiple times or not at all.

Directors act as the agents of the shareholder
External auditors act as the agents of the shareholders
Internal auditors act as the agents of the directors
Employees act as the agents of the directors

10. An audit is one sort of assurance engagement. True or false?

True. The fact that financial statements have been audited by an independent professional accountant gives assurance to readers of those statements that they can be relied upon to present a true and fair view.
1. Does the external auditor report on whether the published financial statements are correct or not?

No. The external auditor reports on whether the published financial statements give a true and fair view, or not (or give a fair presentation in all material respects, or not). This is different from certifying whether they are correct or not. For example, the financial statements may contain a figure (such as the valuation of a property) that is an estimate and where it is impossible to say precisely what the correct figure is. As long the auditor agrees that the estimate is reasonable, then the auditor can report that the financial statements give a true and fair view. He would be unable to give an opinion on whether the figures are 'correct' because absolute precision is impossible for many accounting values, e.g. the lives of non-current assets, the amounts necessary to write damaged inventories down to their net realisable value, possible losses from lawsuits in progress, etc.

2. You are auditing the financial statements of AB Ltd and discover that a car has been double counted in the fixed assets at the balance sheet date. The car has a net book value of £5,000, fixed assets are stated at £400,000 and the profit before tax for the year is £100,000. What should you do?

First you should bring this matter to the attention of management and ask them to correct the financial statements for this error. It is very likely that they will do so. If they refuse, then you must decide whether this (together with all of the other errors that you are aware of) means that the financial statements are materially mis-stated. If this is the only error you know of, on the basis of the figures provided it is unlikely to be considered to be a material misstatement.
3. If you are deciding whether a particular accounting policy produces figures that give a true and fair view, state four sources of accounting practices that you might compare the policy with.

You might compare the policy against:

- relevant accounting standards (e.g., IASs and IFRSs)
- the accounting standards of specific countries (e.g., US standards or UK standards) if there is no international standard that deals with the topic
- relevant company law
- the accounting policy used in previous years (if the audit report last year thought that the policy gave a true and fair view, then it probably still does)
What is assurance?
The rules and who sets them

Chapter learning objectives

Upon completion of this chapter you will be able to:

• describe the regulatory environment within which statutory audits take place
• explain the development and status of International Standards on Auditing
• explain the relationship between International Standards on Auditing and national auditing standards
• discuss the reasons and mechanisms for the regulation of auditors
• explain the statutory regulations governing the appointment, removal and resignation of auditors
• explain what is meant by supervisory and qualifying bodies and the ACCA’s role.
1 Conduct of audit

The conduct of audits is governed by three sets of rules:

- Codes of ethics
- Auditing Standards (ISAs)
- Company law.

In addition, Governments have increasingly tried to ensure that audits are conducted by people who are suitably qualified and whose work is of satisfactory quality – a process known as Audit Regulation.

2 Setting auditing standards
The International Federation of Accountants (IFAC) is the global organisation for the accountancy profession. It was formed in 1977 and is based in New York. IFAC has more than 160 member bodies of accountants (including the ACCA), representing 2.5 million accountants from 120 separate countries.

IFAC’s overall mission is to serve the public interest, strengthen the worldwide accountancy profession, and contribute to the development of strong international economies by establishing and promoting adherence to high-quality professional standards.

International standards on auditing (ISAs)

- Set by: International Auditing and Assurance Standards Board (IAASB).
- IAASB is a subsidiary of the International Federation of Accountants (IFAC).
- There are more than 30 ISAs

All audits carried out under the laws of member states of the EU have had to be conducted under ISAs for all accounting periods beginning on or after 1 January 2005

Other IFAC and IAASB activities

- IFAC publishes a code of ethics governing all assurance engagements carried out under IAASB standards.
- IAASB publishes International Standard on Quality Control 1 (ISQC1) setting out quality control principles for all assurance engagements (including audits) conducted under its standards.
- IAASB sets standards for other types of assurance engagements in addition to audits.

The relationship between international and national standards and regulation

Because IFAC is simply a grouping of accountancy bodies, it has no legal standing in individual countries. Countries therefore need to have arrangements in place for:

- regulating the audit profession
- implementing auditing standards.
National Regulatory bodies:

- enforce the implementation of auditing standards
- have disciplinary powers to enforce quality of audit work.
- Have rights to inspect audit files to monitor audit quality.

There are two possible schemes for regulation at the national level:

- Self regulation by the audit/accountancy profession.
- Regulation by government or by some independent body set up by government for the purpose.

National standard setters

- May set their own auditing standards.
- May adopt and implement ISAs, possibly after modifying them to suit national needs.

Following the decision by the EU to implement ISAs in all member states for all accounting periods beginning on or after 1 January 2005, countries with their own standard setting bodies such as the UK had to decide whether to:

- modify their own standards to bring them into line with ISAs
- adopt ISAs and modify them to suit national requirements.

In the UK the national standard setter – The Auditing Practices Board – decided to adopt and modify ISAs.

Test your understanding 1

(1) What is the role of the IFAC?
(2) Who originally issues ISAs?
(3) Describe how ISAs and national auditing standards influence each other.

3 The Law

Who needs an audit and why?

In most countries it is possible for businesses to be operated through companies – a process known as incorporation.
In most countries, companies generally require an audit. However, small or owner managed companies are often exempt (e.g. in UK, companies with annual turnover < £5.6 million).

**Audit exemption**

The main reasons for exempting small companies are:

- for owner-managed companies, those receiving the audit report are those running the company (and hence preparing the accounts!)
- the advice/value which accountants can add to a small company is more likely to concern other services, such as accounting and tax, rather than audit and which may also give rise to a conflict of interest under the ethics rules
- the impact of misstatements in the accounts of small companies is unlikely to be material to the wider economy
- given the above points, the audit fee and related disruption are seen as too great a cost for any benefits the audit might bring.

**The auditor's duties**

Fundamental duties are to:

- form an opinion on whether the financial statements give a true and fair view and are prepared in accordance with applicable reporting framework
- issue an audit report.

Matters implicit in the audit report and which the auditors therefore have a duty to check are as follows.

- Proper **R**eturns received from branches not visited by the auditor.
- The company's financial statements agree with the underlying **A**ccounting records.
- Proper **A**ccounting records have been kept.
- All necessary **I**nformation and explanations have been obtained.
- Information issued with the financial statements is consistent with the financial statements.
• Other information required by law, if not included in the financial statements, is included in the auditors’ report.

For example, in Britain this includes information about directors’ pay and benefits and any amounts owed by the directors to the company.

The above are often called **exception reporting**.

### 4 Who may act as auditor?

**To be eligible to act as auditor, a person must be:**

- a member of a Recognised Supervisory Body (RSB), e.g. ACCA

and

- allowed by the rules of that body to be an auditor

or

- someone directly authorised by the state.

**Individuals who are authorised to conduct audit work may be:**

- sole practitioners
- partners in a partnership
- members of an LLP
- directors of an audit company.

**To be eligible to act as auditor, a firm must be:**

- controlled by members of a suitably authorised supervisory body

or

- a firm directly authorised by the state.

**NB** In some countries only individuals can be authorised to act as auditor and need to be directly authorised by the state.
5 Who may not act as auditor?

Excluded by law

The law in most countries excludes those involved with managing the company and those who have business or personal connections with them.

For example, in Britain the following are excluded by company law:

• an officer (Director or secretary) of the company
• an employee of the company
• a business partner or employee of the above.

Excluded by the ethics rules (See Chapter 5 for more detail)

The IFAC and ACCA ethics rules and the APB Ethics Standards require Auditors to consider whether their objectivity and independence might be questioned by external parties because of:

• business relationships
• personal relationships
• long association with the client
• fee dependency
• non audit services provided.
Who may and who may not be the auditor – some examples

- Mr Blue is a very experienced accountant and business consultant. He has a degree but no professional qualifications. He is not allowed to act as an auditor.
- Ms Green is a qualified ACCA but has always worked in the accounting and finance departments of large companies. She is not allowed to act as an auditor.
- Mr Red, FCCA is a partner in an accounting practice and is authorised by the ACCA to conduct audits. He may be allowed to act as an auditor.
- Mr Red’s brother runs a successful company in the town and asks Mr Red to become his auditor. Mr Red must refuse because the relationship with his brother would bring his independence into question.
- Mr Red is also a non-executive director of a large local company Euphonium Ltd. Neither he, his firm, his partners, nor any members of his staff, may act as auditor for Euphonium Ltd.
6 How are auditors appointed and removed?

Who appoints the auditor?

In most jurisdictions:

- the members (shareholders) of the company
- directors can appoint the first auditor and fill a ‘casual vacancy’

**but**

- needs members’ approval at next Annual General Meeting (AGM).

However, in some countries the auditors may be appointed by the directors as a matter of course.

How long for?

- Appointment runs from the end of the Annual General Meeting (AGM) until the end of the next AGM.
- For a private company they will no longer have to hold an annual general meeting if an elective resolution is made.
- Where no AGM – automatic annual reappointment unless a shareholder objects (small companies can elect to dispense with the requirement for an AGM).

Removing the auditor

Arrangements for removing the auditor have to be structured in such a way that:

- the auditor has sufficiently secure tenure of office, to maintain independence of management
- incumbent auditors can be removed if there are doubts about their continuing abilities to carry out their duties effectively.

To enable this balance to be maintained, the removal of auditors can usually be achieved by a simple majority at a general meeting of the company, but with some safeguards such as a specified notice period, to prevent the resolution to remove the auditors being ‘sprung’ on the meeting.

In practice, if the auditors and management find it difficult to work together, the auditors will usually resign.

To prevent the circumstances of the resignation being hidden from the company’s members, the auditors have to submit a statement of the circumstances surrounding their resignation.
The details which follow about the appointment and removal of the auditors are taken from UK law and practice, but give an example of the way these things are usually handled.

**The auditor’s responsibilities on appointment and removal**

**On appointment**

- Obtain clearance from the client to write to the existing auditor (if denied, appointment should be declined).
- Write to the existing auditor asking if there are any reasons why the appointment should not be accepted.

**On removal/resignation**

- Deposit at the company’s registered office a statement of the circumstances connected with the removal/resignation or a statement that there are no such circumstances.
- Deal promptly with requests for clearance from new auditors.

**7 The auditor’s rights**

**During the audit/continued appointment**

- Access to the company’s books and records.
- To receive information and explanations necessary for the audit.
- To receive notice of and attend any general meeting of members of the company.
- To be heard at such meetings on matters of concern to the auditor.

**On resignation**

- To request an Extraordinary General Meeting (EGM) of the company to explain the circumstances of the resignation.
- To require the company to circulate the notice of circumstances relating to the resignation.
Test your understanding 2

1. What are the statutory duties of the auditor?
2. Who may act as auditor of a company?
3. Who may not act as the auditor of a company?
4. Who may appoint the first auditors of a company?
5. What action should a company take if the auditor resigns prior to completion of his term of office?
## Test your understanding answers

### Test your understanding 1

<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. What is the role of the IFAC?</td>
<td>IFAC is a federation of accountancy bodies throughout the world. Through its boards and committees it aims to encourage best practice by the members of its constituent bodies. It has developed a code of ethics for its members and through the IAASB it sets standards for audit and other assurance engagements.</td>
</tr>
<tr>
<td>2. Who originally issues ISAs?</td>
<td>The IAASB</td>
</tr>
<tr>
<td>3. Describe how ISAs and national auditing standards influence each other.</td>
<td>National standard-setters may adopt ISAs if they choose to do so, except that all audits in the EU must be conducted under ISAs. National standard-setters may choose to modify ISAs in order to make them more stringent or to suit national requirements.</td>
</tr>
<tr>
<td>Question</td>
<td>Answer</td>
</tr>
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<td>------------------------------------------------------------------------</td>
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</tr>
<tr>
<td>(1) What are the statutory duties of the auditor?</td>
<td>To form an opinion on the financial statements of the company&lt;br&gt;To issue an audit report&lt;br&gt;Other duties imposed by law,&lt;br&gt;e.g. to report if:&lt;br&gt;• returns from branches have not been received&lt;br&gt;• accounting records are inconsistent with the financial statements&lt;br&gt;• information or explanations have not been received&lt;br&gt;• proper accounting records have not been kept&lt;br&gt;• disclosures regarding directors’ pay and balances with the company have not been made&lt;br&gt;• other information issued with the financial statements conflicts with those statements.</td>
</tr>
<tr>
<td>(2) Who may act as auditor of a company?</td>
<td>An individual authorised by the state to be an auditor&lt;br&gt;or&lt;br&gt;the members of a professional body authorised by the state.</td>
</tr>
<tr>
<td>(3) Who may not act as the auditor of a company?</td>
<td>Those who are unable to comply with ethics rules with respect to independence, objectivity and competence to act as auditor for any particular client.&lt;br&gt;Those who are prohibited by law from acting as auditor for particular clients:&lt;br&gt;e.g. officers and employees of the company being audited and those closely associated with them – business partners, close relatives, etc.</td>
</tr>
<tr>
<td>(4) Who may appoint the first auditors of a company?</td>
<td>The directors or the members.</td>
</tr>
</tbody>
</table>
| (5) What action should a company take if the auditor resigns prior to completion of his term of office? | Hold an EGM if so requested by the auditor  
Circulate the auditors’ notice of the circumstances surrounding the resignation. |
Corporate governance and internal audit

Chapter learning objectives

Upon completion of this chapter you will be able to:

• discuss the objective, relevance and importance of corporate governance
• discuss the provisions of international codes of corporate governance (the OECD Principles) that are most relevant to auditors
• describe good corporate governance requirements relating to directors’ responsibilities and reporting responsibilities of auditors
• analyse the structure and roles of audit committees and discuss their drawbacks and limitations
• explain the importance of internal control and risk management
• discuss the factors to be taken into account when assessing the need for internal audit
• discuss the elements of best practice in the structure and operations of internal audit with reference to appropriate international Codes of Corporate Governance
• discuss the scope of internal audit and the limitations of the internal audit function
• explain the advantages and disadvantages of outsourcing internal audit.
• discuss the nature and purpose of internal audit assignments including
  – value for money
  – IT
  – best value
  – financial
• discuss the nature and purpose of operational internal audit assignments including
  – procurement
  – marketing
  – treasury
  – human resources management
• explain the types of audit report provided in internal audit assignments.
1 Introduction

What is corporate governance?

Corporate governance is the means by which a company is operated and controlled.

It concerns such matters as:

- the responsibilities of directors
- the appropriate composition of the board of directors
- the necessity for good internal control - the necessity for an audit committee
- relationships with the external auditors.

Corporate governance is about ensuring that companies are run well in the interests of their shareholders and the wider community.

- The need to improve corporate governance came to prominence in the UK in the 1980s, following the high profile collapses of a number of large companies (Maxwell, Polly Peck, BCCI, etc).
- Poor standards of corporate governance had led to insufficient controls being in place to prevent wrongdoing in the US in the 1990s, as demonstrated by the collapses at Enron and WorldCom.
The authorities internationally have now been working for a number of years to tighten up standards of corporate governance. (See the section on OECD Principles below.)

Good corporate governance is particularly important for publicly traded companies because large amounts of money are invested in them, either by ‘small’ shareholders, or from pension schemes and other financial institutions.

The well publicised scandals mentioned above are examples of abuse of the trust placed in the management of publicly traded companies by investors. This abuse of trust usually takes one of two forms (although both can happen at the same time in the same company):
– the direct extraction from the company of excessive benefits by management, e.g. large salaries, pension entitlements, share options, use of company assets (jets, apartments etc)
– manipulation of the share price by misrepresenting the company’s profitability, usually so that shares in the company can be sold or options ‘cashed in’.

The key to good corporate governance

The key to good and effective corporate governance is to ensure that talented individuals are rewarded at appropriate levels for their effort and skill, whilst ensuring that they act in the best interests of the company and its stakeholders.

Responsibilities

• Maintaining satisfactory standards of corporate governance is the responsibility of those operating a company – its management and those appointed for the purpose of ensuring that it is well managed.

•Whilst the external auditors do not have responsibility for standards of corporate governance at audit clients, they do have an interest in a company’s attitude and approach to the subject because:
  – they are concerned with the risk that a company’s financial statements might be misstated – we will consider the technical meaning of assurance and audit risk later, but for now let us accept that it simply means the likelihood that a company’s financial statements will contain errors.
  – if a company has good standards of corporate governance and is well managed, the risk of errors in the financial statements is reduced.

Auditors responsibility for reporting on corporate governance

• Listed companies following the Combined Code in the UK, or other applicable guidance in respect of corporate governance, must include a corporate governance statement in the annual report.
• The auditors are not required to ‘audit’ this statement but must review it for inconsistencies with other information contained within the annual report.

• If inconsistencies are found, there may be an impact on the audit report in two ways:
  – if the inconsistency highlights an error in the financial statements and the directors refuse to amend the error, the auditor will issue a qualified report
  – if the inconsistency highlights an error or misleading information in the corporate governance statement, the auditor will add an emphasis of matter paragraph to their report. This is not a qualification. It is included to bring the reader’s attention to the matter.

• In the US, the requirements are more stringent. Sarbanes Oxley states that the auditors must attest as to whether the company has complied with corporate governance requirements. Therefore, they must give an opinion as to the effectiveness of the company’s internal control system amongst other things. Therefore there is significantly more risk involved with auditing US listed companies who are covered by Sarbanes Oxley.
Although there have always been well run companies as well as those where scandals have occurred, the fact that scandals do occur has led to the development of codes of practice for good corporate governance.

Often this is done by pressures exerted by stock exchanges on the companies whose shares are traded. In 1999 the Organisation for Economic Co-operation and Development, OECD, took a hand.

The OECD Principles of Corporate Governance are intended to:

- assist Member and non-Member governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries
- to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance.
There are six Principles, each backed up by a number of sub principles. The Principles are reproduced below. Sub-principles relevant to the auditor are considered in section 'The OECD Principles and the audit' below.

The OECD principles of corporate governance were first published in 1999 and were revised in 2004. Their focus is on publicly traded companies. However, to the extent they are deemed applicable, they are a useful tool to improve corporate governance in non-traded companies.

### 3 How companies are run

**Boards of directors**

Fundamentally corporate governance is about how a company is run by its management.
There are two basic models of board structure:

- The two tier board
- The unitary board.

**Two tier board**

In continental Europe, the ‘two tier’ board is common. This is made up of:

- the executive board which takes day to day decisions in the running of the company.
- the supervisory board, which oversees the executive board and is made up of representatives of employees, investors and others. Major decisions are referred to the supervisory board for approval and which acts as a check on the actions of the executive board.

**Disadvantage of this structure:**

- The structure can be cumbersome and difficult to administer.
- The supervisory board may not have access to the information it needs on a sufficiently timely basis.
- It has been suggested that investors and some of the other stakeholders represented are reluctant to discuss many key issues in the presence of employees’ representatives.

**Unitary board**

The structure of boards of directors is different in the UK and many other English-speaking countries.

The main points to note are:

- Single board of directors (‘unitary’ board).
- Distinction between executive and non-executive directors. (Executive directors are often referred to as ‘management’.)
- Oversight of management’s actions is by non-executive directors and by sub-committees, e.g. audit committee, remuneration committee.
Non-executive directors

Non-executive directors are usually employed on a part-time basis and do not take part in the routine executive management of the company.

Their role is as follows.

- Participation at board meetings.
- To provide experience and business contacts which strengthen the board.
- Membership of sub-committees, e.g. audit committee, which should be by independent and knowledgeable non-executive directors.

Almost all listed companies in the UK and USA now have audit and remuneration committees as they are effectively a requirement of stock exchanges.

Advantages of participation by non-executive directors

- Oversight of the whole board.
- Often act as a ‘corporate conscience’.
- They bring external expertise to the company.

Disadvantages

- They, and the sub-committees, may not be sufficiently well-informed or technically competent.
- They are subject to the accusation that they are staffed by an ‘old boy’ network and may fail to report significant problems and approve unjustified pay rises.

Enron provides a cautionary note as its audit committee proved incapable of preventing the wrongdoing of the executive directors.
**4 Corporate governance in action**

**Challenges for companies**

Some companies are struggling more than others to deal with an increasingly demanding corporate governance environment. For example:

- the need for an ongoing mechanism for managing risks presents challenges for the organisation
- no longer is it enough to send a checklist around once a year to meet corporate governance requirements, there must be evidence of an appropriate control culture and evidence of ongoing review
- this has resulted in increased importance of Audit Committees and the need for greater information to be made available to the Board and to the Audit Committee.

We will now look at four aspects of corporate governance in action which are regarded as crucial if public companies are to be well run.

- Segregation between the roles of chairman and chief executive officer (CEO).
- Audit Committees.
- Other Committees, e.g. nominations and remuneration.
- Risk management.
- Internal audit.

**Segregation of roles**

Best practice and strongly recommended under corporate governance codes in many jurisdictions (e.g. the ‘Combined Code’ governing listed companies in the UK) is that the roles of:

- Chairman of the board and
- Chief executive officer.

should be held by different individuals.

**The chairman’s role**

- Non executive.
- Ensures full information and full discussion at board meetings.
- Ensures satisfactory channels of communication with the external auditors.
- Runs the board of directors
- Ensures the effective operation of sub-committees of the board.

**The Chief executive’s role**

- Ensures the effective operational functioning of the company.
- It is important that there is a distinction between the chief executive and chairman as effectively one person assuming both roles is a conflict of interests. The chief executive heads up the executive directors and the chairman heads up the non executives.
- Not only that, but having one person in both roles means there is a lot of power vested in that one person. They would be able to sway the decisions taken by the board. Those decisions may not be made in the best interests of the shareholders but in the best interests of the directors.
An audit committee is a committee consisting of non-executive directors which is able to view a company’s affairs in a detached and independent way and liaise effectively between the main board of directors and the external auditors.

**Best practice for listed companies:**

- The company should have an audit committee of at least three non-executive directors (or, in the case of smaller companies, two).
- At least one member of the audit committee should have recent and relevant financial experience.

**The objectives of the audit committee**

- Increasing public confidence in the credibility and objectivity of published financial information (including unaudited interim statements).
- Assisting directors (particularly executive directors) in meeting their responsibilities in respect of financial reporting.
The function of the audit committee

• Monitoring the integrity of the financial statements.
• Reviewing the company’s internal financial controls.
• Monitoring and reviewing the effectiveness of the internal audit function.
• Making recommendations in relation to the appointment and removal of the external auditor and their remuneration.
• Reviewing and monitoring the external auditor’s independence and objectivity and the effectiveness of the audit process.
• Developing and implementing policy on the engagement of the external auditor to supply non-audit services.
• Reviewing arrangements for confidential reporting by employees and investigation of possible improprieties (‘Whistleblowing’).

Advantages

In addition to meeting the objectives stated above, audit committees have the following advantages.

• It may improve the quality of management accounting, as it is well placed to criticise internal functions.
• It should lead to better communication between the directors, external auditors and management.

Disadvantages

Audit committees may lead to:

• fear that their purpose is to catch management out
• non-executive directors being over-burdened with detail
• a ‘two-tier’ board of directors
• additional cost in terms, at least, of time involved.

The audit committee and internal audit

Clearly, the functions of the audit committee are quite wide-reaching, therefore, it may be necessary to establish an internal audit function in order to help them fulfil their responsibilities.
Best practice is that the audit committee should:

- Ensure that the internal auditor has direct access to the board chairman and to the audit committee and is accountable to the audit committee.
- Review and assess the annual internal audit work plan.
- Receive periodic reports on the results of internal audit work.
- Review and monitor management’s responsiveness to the internal auditor’s findings and recommendations.
- Meet with the head of internal audit at least once a year without the presence of management.
- Monitor and assess the effectiveness of internal audit in the overall context of the company’s risk management system.

Other committees

For completeness you should understand something about:

- The nomination committee.
- The remuneration committee.

Both of these committees have a crucial role in corporate governance because they determine who will run the company and how much they will be paid.

The intention is to introduce a measure of independence into the whole process.

There is an argument, however, that as the community of non-executive directors, even on a global basis, is a comparatively small one, it may happen that a non-executive director of company A may be the chief executive of company B, whose non-executive directors may include the CEO of company A. Hence the accusation that the community of non-executive directors is something of an ‘old boys club’.

The nomination committee

The function of the nomination committee is to suggest suitable candidates for appointment to the board and other senior posts.

The nomination committee should ensure that the best person is chosen for the job. If there was not such a committee in place and the decision was down to one person, an inappropriate appointment could be made. It could be just that the person is not the most suitable. However, it could be that appointment is made of someone who will back up the person making the appointment in board decisions and it could be a way of fixing board votes.
The remuneration committee

The function of the remuneration committee is to determine fair rates of pay and other compensation – pension rights, share options etc – for management and other senior employees.

- The remuneration committee should ensure that directors are not paid excessive amounts.
- They should be paid enough to attract good people to the role but not too much.
- We have all seen stories in the newspaper where chief executives are paying themselves $10m salary per year and we might assume that to be excessive. However, if they could move to another company and be paid the same or more, the company is going to have to pay that amount of money to retain them.
- However, it is now deemed beneficial to pay people for good performance. Therefore many directors now receive a much lower salary, maybe $2m (how do they survive!), which is topped up with a performance related bonus, which usually brings them back up to their $10m.

Again, it is beneficial to use a committee to set salaries so that the decision does not rest with one person. That person could take bribes from other directors for giving undeserved payrises.

5 Risk management

Business risk

All companies face risks of many kinds.

- The risk that products may become technologically obsolete.
Companies therefore need to:

• identify potential risks and
• decide on appropriate ways to minimise those risks.

**Risk management in practice**

The following are practical ways a company may address the issue:

• Identify the risks a company faces and maintain a risk register.
• Risks can be of many types – e.g. operational, financial, legal.
• The company should then assess the relative importance of each risk by scoring it on a combination of its likelihood and potential impact. This could take the form of a ‘risk map’.

![](image)

Ways of reducing risk include:

• insurance
• implementing better procedures, e.g. health and safety provisions outsourcing
• discontinuing especially risky activities
• improving staff training.
Sometimes the company may be forced to accept the risk as an inevitable part of its operations.

**Internal controls and risk management**

One way of minimising risk is to incorporate internal controls into a company’s systems and procedures.

We will look at internal controls in detail in Chapter 8. Here it is sufficient for you to know that internal controls are any mechanisms built into a company’s systems and procedures to reduce the risk of error or fraud.

Examples might be as follows.

- One person checking another person’s work.
- Locking important documents in a safe.
- Restricting access to places with security systems.
- Restricting access to information and systems held on computers through passwords etc.
- An internal audit department which checks that procedures and systems are operating as they should.

In other words, internal controls are a means of minimising risk. They may not be able to:

- prevent an earthquake destroying a factory
- prevent a competitor coming up with a product which makes your product obsolete.

But they may be able to:

- reduce the risk that financial statements contain material errors
- reduce the risk of theft of the company’s assets
- reduce the risk that your business secrets might be handed over to a competitor.
Test your understanding 1

(1) What is meant by corporate governance?
(2) Why are external auditors interested in corporate governance?
(3) What are the key things the OECD principles are intended to deliver?
(4) Explain the difference between a unitary board of directors and a two-tier board.
(5) Who should make up a typical audit committee?
(6) What is the committee’s role?
(7) Why would a company need an audit committee if it has a good relationship with its external auditors?
(8) A company has identified one of its major risks as loss of key staff. Explain:
   (a) what they should do as a result of this
   (b) how they might reduce or even eliminate the risk
   (c) why the auditor is interested in this, given that it is not a direct financial risk.

6 Internal audit and corporate governance

What do internal auditors do?

We have seen in Chapter 1 that the function of auditors is to provide assurance, usually about financial information.

Internal auditors provide assurance to the company’s management that:

• systems are operating effectively
• internal controls are effective
• laid down procedures are being followed
• financial and other information being produced is sound and reliable.
Internal auditors do this by:

- carrying out assignments and
- producing reports of their findings.

If the internal audit department is to be effective in providing assurance it needs to be:

- Sufficiently resourced in terms of budgets and people.
- Well organised so that it has:
  - well developed work practices
  - competent staff who receive high quality training.
- Independent and objective.

This last point needs some explanation. Because internal auditors:

- are employed by the company about which they are reporting (although see below about outsourcing the internal audit function).
- are often managed as part of the finance function
- will often have to report on the effectiveness of financial systems

Care needs to be taken to ensure that their reports are independent and objective.

**Limitations of the internal audit function**

The main limitations of internal audit are:

- **Independence** (or lack of) – can internal audit be truly independent of the organisation of which it is a part?
- **Variation of standards** – not uniform across the profession. Compare this with external auditors who, on a global basis, have ISAs against which their performance can be measured.
• **Relatively new profession** – still evolving.

• **Expectations gap** – problem of what the internal auditor’s role is perceived to be.

• **Understanding of internal audit** – negative view by some – perhaps seen as ‘checking up’ on other employees on behalf of ‘the bosses’.

---

**Consideration of outsourcing the internal audit function**

In common with other areas of a company’s operations, the directors may consider that outsourcing the internal audit function represents better value than an in-house provision. Local government authorities are under particular pressure to ensure that all their services represent ‘best value’ and this may prompt them to decide to adopt a competitive tender approach.

**Advantages**

• Greater focus on cost and efficiency of the internal audit function.

• Staff may be drawn from a broader range of expertise.

• Risk of staff turnover is passed to the outsourcing firm.

• Specialist skills may be more readily available.

• Costs of employing permanent staff are avoided.

• May improve independence.

• Access to new market place technologies, e.g. audit methodology software without associated costs.

• Reduced management time in administering an in-house department.

**Disadvantages**

• Possible conflict of interest if provided by the external auditors (In some jurisdictions – e.g. the UK, the ethics rules specifically prohibit the external auditors from providing internal audit services).

• Pressure on the independence of the outsourced function due to, e.g. threat by management not to renew contract.

• Risk of lack of knowledge and understanding of the organisation’s objectives, culture or business.

• The decision may be based on cost with the effectiveness of the function being reduced.

• Flexibility and availability may not be as high as with an in-house function.
Minimising these risks

Some general procedures to minimise risks associated with outsourcing the internal audit function will include:

• Controls over acceptance of internal audit contracts to ensure no impact on independence or ethical issues.
• Regular reviews of the quality of audit work performed.
• Separate departments covering internal and external audit.
• Clearly agreed scope, responsibilities and reporting lines.

Performance measures, management information and risk reporting

• Procedure manuals for internal audit.

7 Internal audit assignments

We consider below examples of Internal Audit assignments.

In this section we look at generic types of assignment:

• Value for money/best value assignments.
• Assignments dealing with IT.
• Project auditing.
• Financial audit.

In the next section we will consider operational assignments – those which examine particular aspects of a business’ operations.
**Value for money**

Value for money (VFM) is concerned with obtaining the best possible combination of services for the least resources. It is therefore the pursuit of ‘Economy’, ‘Efficiency’ and ‘Effectiveness’ – often referred to as the 3Es.

- **Economy** – least cost. Accomplishes objectives and goals at a cost commensurate with the risk.
- **Efficiency** – best use of resources. Accomplishes goals and objectives in an accurate and timely fashion with minimal use of resources.
- **Effectiveness** – best results. Providing assurance that the organisation objectives will be achieved.

Comparisons of value for money achieved by different organisations (or branches of the same organisation) are often made using performance indicators that provide a measure of economy, efficiency or effectiveness.
Examples of local government indicators are given below:

- **Economy** – cost of waste collection per local taxpayer.
- **Efficiency** – number of households (premises) covered per waste collector.
- **Effectiveness** – % of waste recycled measured against target for the year.

### The 4Cs

- **Challenge** – review internally the different options for providing services and question the status quo.
- **Compare** – compare with other service providers to review options for improving performance.
- **Consult** – consult all users of services and those affected by services.
- **Compete** – demonstrate through performance management and continuous improvement that the most efficient and effective service is being provided.

Best value is a requirement for local authorities to demonstrate achievement of the ‘4C’ principles, as well as demonstrating service delivery and meeting customer needs through effective performance management systems.

### Audit of information technology

In Chapter 8 we consider the different strengths and weaknesses of manual and IT based systems.

We do this mainly from the external auditor’s point of view, which is to ascertain whether or not the company’s systems provide a reliable basis for the preparation of financial statements, and whether there are internal controls – mechanisms built into the systems – which are effective in reducing the risk of misstatement.
The internal audit approach to IT will cover all of this but with some additional objectives.

- Does the system represent value for money/best value.
- Were the controls over awarding contracts for IT installations effective?

**Project auditing**

Best value and IT assignments are really about looking at processes within the organisation and asking:

- were things done well?
- did the organisation achieve value for money?

Project auditing is about looking at a specific project:

- commissioning a new factory
- implementing new IT systems

and asking whether these were done well. So the focus is different and has more to do with:

- were the objectives achieved?
- was the project implemented efficiently.
- what lessons can be learned from any mistakes made?

A number of projects when taken together can become a programme.

**Financial internal audit**

Financial auditing was traditionally the main area of work for the internal audit department. It embraces

- the conventional tasks of examining records and evidence to support financial and management reporting in order to detect errors and prevent fraud
- analysing information, identifying trends and potentially significant variations from the norm.
8 Operational and internal audit assignments

Operational auditing covers:

- Examination and review of a business operation.
- The effectiveness of controls.
- Identification of areas for improvement in efficiency and performance including improving operational economy, efficiency and effectiveness – the three Es of value for money auditing.

We will now look at operational internal audit in practice, considering four of the main areas where such an approach is commonly used

- procurement
- marketing
- treasury
- human resources.
In all cases, the audit work should be based on an approach which starts by identifying the objectives of the audit. These should focus on:

- the identification of the principal business risks involved which may prevent the organisation achieving its objectives
- the assessment of the extent to which controls are in place and are operating effectively in order to manage these risks.

The outcome of each assignment should be a report to management which appraises the control systems which are currently in place and which makes appropriate recommendations for improvement. This reporting aspect is dealt with later.
9 Internal audit reports

Key principles

Who is the report for?

With any report the most important person in the process is the reader not the writer.

- If the report does not address the objective of the assignment.
- If the recipient of the report cannot understand its recommendations and the reasoning behind them, then the report might as well never have been written.

The report should be customer focused, meeting organisational needs. The internal auditor should always be conscious of the organisational philosophy, management styles and reporting objectives.

Purpose and structure of the report

Although it is possible to set out a format for reports which represents good practice (see below), the purpose of any report is to summarise the results of the work undertaken, so that lessons can be learned and appropriate action taken.

The content of any report will be determined by the nature of the assignment. (See the section on Internal Audit assignments above)

Short and sweet

Clear, concise, easy to read format will mean it is more likely to be read and understood.

Measurable/quantifiable outcomes

It is easy to recommend in a report that something should be improved, but without:

- clear recommendations about how this is to be done
- some way of measuring whether the recommendations have been successfully implemented

it is less likely that improvements will actually happen.
Prioritisation

The important content needs to be readily accessible, not buried in the back of an appendix somewhere.

Avoid surprises

Discuss with management as points arise. This will mean less argument over facts or detail when the draft report is issued and will allow management to take steps promptly.

Fairness

Balanced and constructive reporting will be welcomed by management and the organisation. For example, recognising where controls are good and how they could be used elsewhere within the organisation.

Ensure consistency across reports, particularly where ‘ratings’ are used. If management feel unfairly treated or criticised, they will respond negatively to the report.

Test your understanding 2

(1) **What is the role of internal audit in maintaining standards of corporate governance?**

(2) **List the types of activities normally carried out by internal audit departments.**

(3) **List and explain the limitations of internal audit.**

(4) **What would an internal audit assignment into a company’s treasury operations focus on?**

(5) **What are the three types of internal audit report?**

(6) **What are the key headings in a formal report?**
10 Chapter summary

Corporate governance

- OECD Principles
- Shareholders’ interest
  - Two-tier
  - Unitary
  - Audit committee

Board

- Risk management
  - Internal audit
- Assignments
  - VFM(3Es)
    - IT
    - Financial
    - Operational
  - Procurement
    - HR
    - Treasury
    - Marketing
- Reports
  - Cover
  - Exec summary
  - Recommendations
  - Findings
  - Appendices
### Test your understanding 1

<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) What is meant by corporate governance?</td>
<td>The term corporate governance refers to the means by which a company is managed in the interests of all stakeholders. It will include consideration of:</td>
</tr>
<tr>
<td></td>
<td>(1) directors’ responsibilities</td>
</tr>
<tr>
<td></td>
<td>(2) composition of the board of directors</td>
</tr>
<tr>
<td></td>
<td>(3) audit requirements (internal and external)</td>
</tr>
<tr>
<td>(2) Why are the external auditors interested in corporate governance?</td>
<td>Corporate governance is the responsibility of the company’s management and not its external auditors. However, it is the responsibility of the external auditors to form an opinion on the truth and fairness of the company’s financial statements. If a company has good standards of corporate governance and is therefore managed well in the interests of all stakeholders, the auditors are likely to conclude that the risk of material misstatement in the financial statements is reduced. As a result of this they may well be able to reduce the extent of the audit procedures they carry out.</td>
</tr>
<tr>
<td>(3) What are the key things the Combined Code is intended to deliver?</td>
<td>A framework so that companies are governed well which should be beneficial to financial markets.</td>
</tr>
<tr>
<td></td>
<td>Fair treatment of all shareholders</td>
</tr>
<tr>
<td></td>
<td>Companies to be run in the interests of all stakeholders.</td>
</tr>
<tr>
<td></td>
<td>Transparency of disclosure about the company’s performance and state of affairs.</td>
</tr>
<tr>
<td></td>
<td>The management of the company should carry out its role in the interest of all stakeholders.</td>
</tr>
<tr>
<td>(4) Explain the difference between a unitary board of directors and a two-tier board?</td>
<td><strong>Unitary board</strong></td>
</tr>
<tr>
<td></td>
<td>Single board of directors. Monitored by sub-committees and non-executive directors.</td>
</tr>
<tr>
<td></td>
<td><strong>Two-tier board</strong></td>
</tr>
<tr>
<td></td>
<td>Two boards: Executive board (decision-makers) Monitored by supervisory board consisting of employees, investors etc.</td>
</tr>
<tr>
<td>(5) Who should make up a typical audit committee?</td>
<td>The audit committee should be made up of non-executive directors and include someone with relevant financial experience.</td>
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</tr>
<tr>
<td>(6) What is the committee’s role?</td>
<td>The audit committee provides a channel of communication between the internal workings of the company and the external auditor. It also provides a channel of communication for employees who have concerns about the way the company is run.</td>
</tr>
<tr>
<td>(7) Why would a company need an audit committee if it has a good relationship with its external auditors?</td>
<td>A good relationship with external auditors is of immense help and support to an entity in complying with regulations, optimising controls and generally ensuring good corporate governance. However, the existence of an audit committee will enhance the company’s corporate governance profile by:</td>
</tr>
</tbody>
</table>
| | 1 improving public confidence  
| | 2 providing further support to directors  
| | 3 strengthening the independence of the external auditor  
| | 4 improving internal procedures e.g. management accounting, & communication generally. |
| (8) A company has identified one of its major risks as loss of key staff. Explain what they should do as a result of this, how they might reduce or even eliminate the risk, why the auditor is interested in this, given that it is not a direct financial risk. | The risk committee should discuss the issue and assess its seriousness in relation to its likelihood and potential impact. They should then decide what action is appropriate in order to manage the risk. This risk might be reduced by: |
| | 1 ensuring favourable employment packages for such individuals  
| | 2 ensuring training for other staff assists in case of succession issues  
| | 3 ensure key tasks are not carried out by just one person. |
| | The auditor must consider the possible impact of all significant risks as any of these could ultimately have financial consequences or going concern issues, hence impacting on the audit opinion. |
1. What is the role of internal audit in maintaining standards of corporate governance?

Internal audit is part of the organisational control of a business; it is one of the methods used by management to ensure the orderly and efficient running of the business as a whole and is part of the overall control environment.

A properly functioning internal audit department is part of good corporate governance, as recognised by national and international codes on corporate governance.

One of the objects of good corporate governance is to ensure that the needs of all stakeholders are met as far as possible and internal audit procedures meet the needs of the owners of the business, its employees, and the business community at large, as well as the needs of management. The main way in which internal audit exercises its functions is by enabling management to perform proper risk assessments in relation to corporate objectives by means of properly understanding the strengths and weaknesses in all of the control systems in the business. The role of internal audit has expanded considerably in recent years and the scope of internal audit is no longer routine or low level; internal audit is involved at all levels of management and internal audit includes non-routine matters such as assisting in setting corporate objectives and assessing performance against them.

2. List the types of activities normally carried out by internal audit departments.

The review of management, organisational, operational, accounting, internal control and other business systems.

Making recommendations in relation to the improvement of systems and monitoring the performance of systems against targets.

Performing value for money (economy, efficiency and effectiveness), best value and similar audits.

Compliance work involving the review of compliance with legislation, regulations and codes of practices.

The detailed examination of financial and operating data.

Special investigations, such as fraud investigations.
3. List and explain the limitations of internal audit

- May not be independent.
- There are no recognised standards for internal audit work.
- There is an expectation gap in that internal audit cannot uncover every fraud or solve every problem, even though others in the organisation may wish it could.
- Internal audit may be regarded as management’s private police force, and as a result may not receive full co-operation from those whose work is being examined.

4. What would an internal audit assignment into a company’s treasury operations focus on?

- Are the organisation’s laid-down procedures designed to reduce risk being complied with?
- Are those procedures appropriate?
- Could other, more effective procedures be implemented?
- Is the department operated efficiently?
- Could the department deliver better value for money?

5. What are the three types of internal audit report?

- Formal report.
- Shorter memorandum reports.
- Presentations.

6. What are the key sections in a formal report?

- Cover.
- Executive summary.
- Key findings and recommendations.
- Detailed findings and agreed action
- Appendices.
Responsibilities

Chapter learning objectives

Upon completion of this chapter you will be able to:

• discuss the need for auditors to communicate with those charged with governance
• compare the responsibilities of management and auditors for the design and operation of systems and controls
• discuss the responsibilities of internal and external auditors for the prevention and detection of fraud and error
• compare and contrast the role of external and internal audit regarding audit planning
• compare and contrast the role of external and internal audit regarding the collection of audit evidence
• compare and contrast the types of report provided by internal and external audit
• explain the importance of internal control and risk management.
1 Introduction

The distinction between the responsibilities of a company’s management and its external auditors is reasonably clear cut.

However, as we have seen in chapter 1, misconceptions, particularly about the role of audit, in the minds of the public, can lead to a phenomenon known as the 'expectation gap'.
2 Control structure within the organisation

Corporate governance

As we have seen in chapter 3, a company’s board of directors is responsible for operating the company in the interests of shareholders and other stakeholders.

To do this it needs to ensure that all the mechanisms for good corporate governance are in place.

Financial reporting

Management is responsible for preparing financial statements which give a true and fair view of the company’s results for the period under review and its financial position at the year end.

In order to do this the directors are required to:

• Select suitable accounting policies and apply them consistently.
• Make judgements and estimates that are reasonable and prudent.
• Design and implement internal controls relevant to the preparation of financial statements and to prevent and detect fraud or error.

3 Responsibilities of the external auditors

The legal requirements for audit are set out in chapter 2.
The audit opinion

The auditors’ main responsibility is to form an opinion on whether the company’s financial statements give a true and fair view.

In some jurisdictions the external auditors have further reporting responsibilities, e.g.

• The auditors of listed companies in the UK report on certain aspects of the disclosures of directors’ remuneration.
• Auditors in the Republic of Ireland report on certain aspects of the adequacy of a company’s capital.

What the auditors are not responsible for

They are not responsible for:

• Preparing the financial statements.
• Choosing accounting policies.
• Implementing systems and controls.
• Establishing the mechanisms for ensuring that good standards of corporate governance are maintained.

Other responsibilities and consequences

As we shall see in the chapters which follow, the external auditors are responsible for:

• planning their work
• gathering sufficient appropriate audit evidence

so that the risk that they may come to the wrong conclusion is reduced to an appropriately low level.

As a consequence they are interested in:

• the quality of accounting systems from which the financial statements are produced
• the internal controls operated by the company to ensure that its financial information is as complete and accurate as possible
• the standards of corporate governance including the effectiveness of the internal audit function

because all of these factors will reduce the risk of misstatement in the financial statements.

But the establishment and maintenance of these things is the responsibility of the company and its management, not its auditors.
The ISAs and in particular ISA 260 Communication of audit matters with those charged with governance, places some further responsibilities on the external auditors.

The main forms of formal communication are:

- the letter of engagement (see chapter 5)
- the management letter – sent at the end of the audit.

There may also be ad hoc needs to communicate particular matters at other times.

Also, communication generally should be two-way and ongoing, with either party keeping the other informed about relevant matters throughout the year.

**Summary of responsibilities**

‘Audit matters of governance’ include:

- Effects of significant accounting policies.
- Potential financial effect of risks/uncertainties.
• Material audit adjustments.
• Disagreements with management concerning the financial statements.
• Expected modifications to the audit report.
• Internal control weaknesses including fraud.

Timing of communications

<table>
<thead>
<tr>
<th>Stage of audit</th>
<th>Communication required</th>
</tr>
</thead>
<tbody>
<tr>
<td>During the audit</td>
<td>If any situation occurs and it would not be appropriate to delay communication until the audit is concluded.</td>
</tr>
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</table>

5 Responsibilities of internal auditors

As we have seen in Chapter 3, the internal auditors are either:

• employees of the organisation they are auditing or
• contracted to provide internal audit services through an outsourcing arrangement.

It therefore follows that the precise responsibilities of internal auditors will be defined by whoever determines the objectives of the assignments they conduct.

ISA 610 Considering the work of Internal Audit gives the main activities of the internal audit function as:

• monitoring of internal control
• examination of financial and operating information
• review of the economy, efficiency and effectiveness of operations including non-financial controls of an entity
• review of compliance with laws, regulations and other external requirements and management policies and directives and other internal requirements
• special investigations into particular areas, for example, suspected fraud.

As assurance professionals, internal auditors are responsible for conducting their work bearing in mind the requirements for:

• independence
• objectivity
• compliance with the ethics rules of any professional body to which they belong.

6 Systems and controls

Directors need to establish suitable systems and controls to:

• safeguard the company’s assets
• enable financial statements which give a true and fair view to be produced
• prevent and detect fraud.

External auditors need to review systems and controls to:

• Assess whether the systems are such that the risk of material misstatement in the financial statements is reduced.
• If they are to rely on the operation of controls in a system so that the extent of the procedures which they carry out will be reduced, they will need to test those controls and document their findings.
• If the external auditors discover weaknesses in systems and controls, they will report their findings to those charged with governance in their management letter.

Internal auditors

• May be given an assignment to review systems and controls and to report to management about their effectiveness.
• The nature of the work carried out by internal audit in these circumstances will be very similar to that performed by the external auditors and is covered in detail in chapter 8.
7 Fraud and error

What is fraud and error?

Major scandals that have affected the accounting profession in recent times have usually been as a result of fraud. Therefore, in order to maintain confidence in the profession it is important for the auditors and the directors to understand their role in the prevention and detection of fraud.

ISA 240 The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements gives the definition of:

**Fraud** – ‘an intentional act involving the use of deception to obtain an unjust or illegal advantage’.

**Error** – ‘an unintentional mistake’ and could include accidental misapplication of accounting policies, oversights or misinterpretation of the facts.

Both affect the accuracy of the financial statements and as such are a concern for the external auditor.

Fraud can be further split into two types:

- fraudulent financial reporting – deliberately misstating the accounts to make the company look better/worse than it actually is
- misappropriation of assets – the theft of the company’s assets such as cash or inventory.

The external auditor’s responsibilities

As we have seen, the external auditor is responsible for identifying material misstatements in the financial statements in order to ensure that they give a true and fair view. By definition then, the external auditor is responsible for detecting any material fraud that may have occurred as this will lead to a material misstatement.

However, they have no specific responsibility with regard to immaterial fraud. As with immaterial errors, if they identify them they will be reported to those charged with governance, but there is no duty to identify them.

The auditor cannot guarantee that the financial statements are free of all fraud and error because of the inherent limitations of the audit, for example the use of sampling. The risks in respect of fraud are higher than those for error because of the possibility of concealment and collusion between staff.

In order to have a chance of detecting fraud the auditor must maintain an attitude of professional scepticism when performing their work which involves keeping an open mind to the possibility of fraud occurring (see Chapter 6).
Under ISA 240, the auditors are required to consider the risks of material misstatement in the financial statements due to fraud when planning and performing their audit. If their work confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditors need to consider the implications for their audit.

**Reporting of fraud**

The external auditor needs to be careful of their duty of confidentiality to their client, therefore before reporting to any external party, it is advisable to seek legal advice unless there is a legal requirement to report e.g. money laundering regulations.

If fraud is identified the auditor should report it to:

- the audit committee, if one exists, or
- to the highest level of management, or
- the shareholders if the fraud is being committed by the highest level of management and no audit committee is in place.

**The directors’ responsibilities**

The **directors** are primarily responsible for the prevention and detection of fraud.

As we have seen the directors are responsible for:

- safeguarding the company’s assets and
- implementing an effective system of internal control.

If they have been effective in meeting these responsibilities fraud and error should not occur.

The directors should be aware of the potential for fraud and this should feature as an element of the risk assessment and corporate governance procedures. The audit committee should review these procedures to ensure that they are in place and working effectively. This will normally be done in conjunction with the internal auditors.

**Internal auditors** may be given an assignment:

- to assess the likelihood of fraud, or if a fraud has been discovered,
- to assess its consequences and
- to make recommendations for prevention in the future.
Responsibilities

Test your understanding 1

Whose responsibility are the following:

- Preparation of accounts.
- Undertaking the risk assessment exercise.
- Detection of fraud.
- Reporting on controls.

Test your understanding 2

What matters should be communicated to those charged with governance following the conclusion of the audit?
## Test your understanding answers

### Test your understanding 1

- Directors.
- Directors/management/outsourced/internal auditors.
- Directors.
- External/internal auditor.

### Test your understanding 2

The auditor will include in his post-audit communication to those charged with governance:

- Significant audit findings.
- Whether the audit report is likely to be modified.
- Control weaknesses (with explanations of their potential impact).
- Uncorrected misstatements – unless trivial.
- His views on the qualitative aspects of the entity’s accounting practices and financial reporting.
- Final draft of letter of representation.
- Any other matters of governance interest/issues required by other ISAs.
Ethics and acceptance of appointment

Chapter learning objectives

When you complete this chapter you will be able to:

• define and apply the fundamental principles of professional ethics of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour
• define and apply the conceptual framework
• discuss the sources of, and enforcement mechanisms associated with, ACCA’s Code of Ethics and Conduct
• discuss the requirements of professional ethics and other requirements in relation to the acceptance of new audit engagements
• discuss the process by which an auditor obtains an audit engagement
• explain the importance and state their contents of engagement letters.
Ethics and acceptance of appointment

IFAC CODE OF ETHICS

ACCA CODE OF ETHICS AND CONDUCT

PROFESSIONAL BEHAVIOR

FUNDAMENTAL PRINCIPLES

THREATS

SAFEGUARDS

OBTAINING AUDIT WORK

ENGAGEMENT LETTER
1 Introduction – the need for professional ethics

We have seen in chapter 1 that the purpose of assurance engagements is to increase the confidence of end users by reducing their level of risk.

It follows from this that the user needs to trust the professional.

In the light of the various corporate scandals which have occurred in the past decade – Enron, Worldcom etc. – but which have happened for decades, even centuries, there is a need for a basis for this level of trust.

- The **user** needs to believe that assurance practitioners act in accordance with a code of ethics, and
- the **practitioner** needs a code of ethics to make sure that he or she is worthy of that level of trust.

In order to be trusted the auditor needs to be **independent** of their client. Independence is defined in APB Ethical Standard 1 as ‘freedom from situations and relationships which make it probable that a reasonable and informed third party would conclude that objectivity either is impaired or could be impaired.’
2 The IFAC and ACCA codes and the conceptual framework

IFAC has also issued a code of ethics, as has the ACCA. The ACCA Code of Ethics is covered in this chapter however, both the IFAC and ACCA codes have the same roots and are, to all intents and purposes identical.

Both follow a conceptual framework which identifies:

- fundamental principles of ethical behaviour
- potential threats to ethical behaviour
- possible safeguards which can be implemented to counter the threats.

A conceptual framework relies on a principles rather than a rules based approach. That means that the spirit of the code is followed rather than a strict set of rules. It is guidance so the actual application will depend on the individual circumstances of a specific situation.

You should remember that sometimes the only viable safeguard is not to accept an assurance engagement, or to resign from it.

**Giving the framework some teeth**

The framework and principles would be of little use if they could not be enforced.

Professional bodies like the ACCA therefore reserve the right to discipline members who infringe the rules through a process of:
Disciplinary hearings which can result in:
– fines
– suspension of membership
– withdrawal of membership.

3 The fundamental principles

The formal definitions of the fundamental principles are as follows:

- **Integrity**: Members should be straightforward and honest in all professional and business relationships.

- **Objectivity**: Members should not allow bias, conflicts of interest or undue influence of others to override professional or business judgements.

- **Professional competence and due care**: Members have a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. Members should act diligently and in accordance with applicable technical and professional standards when providing professional services.

- **Confidentiality**: Members should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority or unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of members or third parties.

- **Professional behaviour**: Members should comply with relevant laws and regulations and should avoid any action that discredits the profession.
Some examples of the fundamental principles in action might be:

**Integrity**

You find out that one of your listed audit clients is shortly to be taken over, or has access to technological advances which will give it a fantastic competitive advantage. You might be tempted to buy some shares or encourage your friends to do so.

**Objectivity**

The owners of a private company have the opportunity to sell their shareholdings to a large listed company and have asked for your advice. It looks like an excellent deal, but which will almost certainly mean that your firm will lose the audit to a larger competitor. Your advice might not be impartial - you may be tempted to advise against the deal in order to keep the client.

**Professional competence and due care**

A client is starting to expand into areas where there are complex tax issues. You have no direct experience of this area, but you know that a larger firm in the town does have a number of specialists in this field. You might be tempted to think that you can ‘get yourself up to speed’ quite quickly.

**Confidentiality**

You are tempted to share your knowledge of the takeover or technical advances mentioned above, or even of the level of directors’ salaries, with your friends on a night out on the town.

**Professional behaviour**

This is possibly the most difficult principle to illustrate. Clearly you, as a professional, would not indulge in illegal behaviour. But does it matter what you do in the evenings or on your lunch break?
4 Threats and safeguards

Principles rather than rules based

Both the IFAC and ACCA codes have developed a ‘principles approach’ rather than a ‘rules based’ approach to ethical professional behaviour.

This has taken the form of identifying five potential threats to ethical behaviour and the suggestion of a number of safeguards which might be appropriate, including the possibility of ceasing to act for the client.

Throughout, the consideration is not simply the practitioner’s view as to whether his or her integrity is under real threat, but how the situation might appear to a third party.

The practitioner needs to:

‘behave and be seen to behave’ in an ethical, professional manner.

The threats

The identified threats are:

- self-interest
Identifying the threats

In order to guard against the threats or perceived threats the firm needs procedures to enable it to:

- identify possible threats
- evaluate the risk arising from the threat
- evaluate whether the necessary safeguards are in place
- take corrective action if necessary.

Usually this will be done through the use of checklists and the issues need to be considered.

- On acceptance of a new client.
- At the planning stage of any audit.
- At the completion stage of any audit.
- Whenever additional, non audit services are provided to an audit client.
- If any event, or change in circumstances occurs which may mean that the firm’s independence may be threatened.

The procedures operated by the firm will normally consist of the following.

- ‘Fit and proper’ or ‘independence’ forms to be completed by all staff on a regular, usually annual basis disclosing financial interests and other relevant factors.
- A checklist of procedures to be filled in when a new appointment is accepted covering such issues as:
  - proof of the client’s identity
  - consideration of relationships with the firm, its staff, other clients etc.

See the section below on accepting new appointments.
• Consideration of independence issues when files are reviewed as part of the firm's quality control process.
• Appointment of a senior partner with responsibility for ethical issues.

Possible safeguards

General safeguards

• **Safeguards created by the profession** (these might include education, training and experience requirements for entry into the profession, professional development requirements, corporate governance regulations, professional standards, monitoring, external review of work and reports).
• **Safeguards in the work environment** (such as oversight structures, ethics and conduct programmes, good recruitment procedures, strong internal controls, disciplinary procedures, strong ethical leadership, policies and procedures to promote quality control, culture of strong ethics in the organisation).
• **Safeguards created by individuals** (complying with professional development requirements, keeping records of contentious issues, keeping a broader perspective, using a mentor, keeping in contact with professional bodies).

Threats and there safeguards

**APB Ethical standards - General Threats to objectivity**

General threats to objectivity

• Self-interest
• Self review
• Familiarity
• Advocacy
• Intimidation
• Management
## Specific threats to objectivity

### Self-interest threats

<table>
<thead>
<tr>
<th>Threat</th>
<th>Safeguard</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dependence on client</td>
<td>• Should not audit if the client provides a large proportion of regular/RECURRING income to the audit firm&lt;br&gt;• Total gross recurring fees should be no more than:&lt;br&gt;  - Listed Co’s - 10% of the Firms total fees (review at 5%)&lt;br&gt;  - Other CO’s - 15% of the Firms total fees (review at 10%)</td>
</tr>
<tr>
<td>Lowballing</td>
<td>• Setting audit fee low to try and get more lucrative work&lt;br&gt;• Fee must be based on pre-determined level of work required</td>
</tr>
<tr>
<td>Loans, guarantees and overdue fees</td>
<td>• No loans or guarantees allowed to or from client, unless in normal course of business&lt;br&gt;• Significant overdue fees are deemed a loan, hence not allowed</td>
</tr>
<tr>
<td>Hospitality or other benefits</td>
<td>• Benefits should not be accepted unless modest&lt;br&gt;• Modest - means available to all the company’s staff at same terms&lt;br&gt;• The assurance firm should establish policies on gifts and hospitality and should be communicated</td>
</tr>
<tr>
<td>Contingent fees</td>
<td>• Assurance work should not be conducted on a contingent basis (i.e. where you receive a commission, or a % of fees is payable upon a specific event occurring)&lt;br&gt;• No safeguard - fee must be based on pre-determined amount</td>
</tr>
<tr>
<td>Financial/business interest CAN ALSO LEAD TO INTIMIDATION THREAT</td>
<td>• Close business, family or personal relationship should be avoided between the client and the assurance firm&lt;br&gt;• i.e. seeking to gain employment with an assurance client&lt;br&gt;• i.e. entering a Joint venture / arrangement with client</td>
</tr>
</tbody>
</table>
### Financial interest in shares etc

- Anyone involved with assurance must **NOT** have direct or indirect interest in a client i.e. holding shares
- Rules apply to
  - Assurance firm
  - Any partner in the firm
  - Person in a position to influence engagement
  - IMMEDIATE family member of above

### SAFEGUARDS:
- Dispose of interest
- Remove individual from the team
- Independent partner review
- Internal QC procedures in place (i.e. Prohibited shareholding list)

### Cross selling

- Assurance team should not be remunerated on their success in selling other services to the client

### Self-review threats

(Providing other services to the client and then also doing the Statutory Audit)

<table>
<thead>
<tr>
<th>Accounting services</th>
<th>Should not do for LISTED companies, unless it is an emergency</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>For non-listed clients - permitted as long as safeguards in place (applicable to all self-review threats)</td>
</tr>
<tr>
<td></td>
<td>No management decisions are made; client to prepare judgemental area</td>
</tr>
<tr>
<td></td>
<td>Separate personnel / terms / partners</td>
</tr>
<tr>
<td></td>
<td>Independent partner review</td>
</tr>
</tbody>
</table>

| IT                   | Should not design, provide or implement IT systems which are important to a significant part of the accounting system or undertake the role of management |

| Valuation services   | Should not provide valuation services if they involve degree of judgement and have a material effect on the FS being audited |
### Ethics and acceptance of appointment

<table>
<thead>
<tr>
<th>Tax services</th>
<th>Should not be undertaken if audit firm seen to be taking on management role or if they are likely to have a material effect on the FS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate finance services</td>
<td>Acceptable, as long as not making decisions</td>
</tr>
<tr>
<td></td>
<td>Allowed to assist client raising finance/developing corporate strategies</td>
</tr>
<tr>
<td>Internal Audit Services (Session 9)</td>
<td>Should not be undertaken where significant reliance will be placed on the IA work by the auditors from same firm</td>
</tr>
<tr>
<td>Former employee of client joining assurance firm</td>
<td>The employee cannot be involved with the audit until 2 years have elapsed</td>
</tr>
</tbody>
</table>

### Familiarity

<table>
<thead>
<tr>
<th>Participation in client affairs/family and personal relationships</th>
<th>Cannot be director, employee or a business partner if you are going to audit a client</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Must not take part in audit if have been officer / employee in that period, or in the last 2 yrs</td>
</tr>
<tr>
<td></td>
<td>If the director / employee or business partner is an immediate family member of someone on the audit team, that audit team member must be removed</td>
</tr>
<tr>
<td></td>
<td>May be extended to other close relationships within the firm (not just those on the team)</td>
</tr>
<tr>
<td>Audit partners leaving to join the client</td>
<td>Can join the client, but must sever all links with the assurance firm (e.g. pension)</td>
</tr>
<tr>
<td></td>
<td>Audit partner has to inform the audit firm immediately and is then removed from audit team as soon as decision to join client is made</td>
</tr>
<tr>
<td></td>
<td>If partner becomes director or key management and has worked as partner on the audit in prior 2 years the audit firm must resign as auditors</td>
</tr>
<tr>
<td></td>
<td>2 year period must then elapse before the firm can be re-appointed as auditors</td>
</tr>
</tbody>
</table>
### Advocacy

<table>
<thead>
<tr>
<th>Legal services</th>
<th>Should not offer legal services to a client and defend them in dispute or litigation which is material to the FS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate finance services</td>
<td>Should not advise on debt restructuring as part of Corporate finance - don't enter negotiations with bank on clients’ behalf</td>
</tr>
<tr>
<td>Contingent fees</td>
<td>See SELF-INTEREST THREAT</td>
</tr>
<tr>
<td>Dealing in clients shares</td>
<td>This could be seen as signal to other investors if dealing in clients shares</td>
</tr>
</tbody>
</table>

### Intimidation

<table>
<thead>
<tr>
<th>Close business, family and personal relationships</th>
<th>Also see SELF-INTEREST</th>
</tr>
</thead>
<tbody>
<tr>
<td>Litigation</td>
<td>If there is actual or threatened litigation between client and assurance firm, the firm should not continue to act</td>
</tr>
<tr>
<td>Assurance staff move to join clients</td>
<td>See SELF-REVIEW</td>
</tr>
</tbody>
</table>
Management

Undertaking any work which involves making judgements and taking decisions that are responsibility of management

- An engagement partner or employee of the assurance firm should not serve on the board of directors as they would be involved with decision making
- Performing other services is also a management threat - See SELF-REVIEW
- Safeguards; Informed management

Test your understanding 1

What are the fundamental principles of the ACCA and IFAC Codes of Ethics?

Test your understanding 2

(1) Adhering to the ACCA Code of Ethics and Conduct is an essential part of membership.
   - True □
   - False □

(2) Failure to adhere to the ACCA Code of Ethics and Conduct can result in the member being fined.
   - True □
   - False □

Test your understanding 3

Offcon Ltd, a private company, is a major audit client of your firm. Recurring annual fee income from Offcon amounts to 12% of annual fee income for the firm. Offcon is currently considering taking over another company. It has asked your firm to carry out investigation work in respect of this potential takeover.
The takeover would constitute a purchase of shares, so Offcon would be acquiring a new subsidiary. If the takeover proceeds, you would be invited to be the auditors for the subsidiary company. Related annual fee income for the audit would be 2% of the annual fee income and for tax services, advice and projects would be another 2% annually. The fee for the investigation work would represent 0.2% of annual fee income for the firm. In addition, the directors of Offcon have intimated that if they proceed to buy the company on the basis of the investigation report, they will increase the fee for the investigation work by a bonus 10%.

(1) **As recurring fees from Offcon already amount to 12% of total annual firm income, the firm is in breach of the ethical code.**
   - True ☐
   - False ☐

(2) **The firm should:**
   - Accept the investigation work because it will not cause the firm to breach the fee percentage guidelines in the ethical code. ☐
   - Not accept the investigation work because the contingent fee associated with it makes it unacceptable. ☐
   - Only accept the investigation work if the directors remove the option of the contingent fee and make the fee fixed. ☐
   - Not accept the investigation work because there is a self-interest threat caused by the fact that the firm has been offered the audit of the new subsidiary if the takeover goes through. ☐

(3) **Explain the matters the audit firm should consider if the takeover goes through and it is offered the work relating to the new subsidiary.**

**Other proposals to improve independence**

- Compulsory rotation of audit firms (already happens in some countries).
- A ban on the provision of certain (maybe all) other services.
- A State Auditing Board to audit all major companies.
- Government to appoint auditors of listed companies.
**Other issues**

**Lowballing**

Firms may be tempted to quote a very low audit fee in order to win a new client. They would then seek to make their money back by either raising future fees, or by doing lucrative other services for the client.

There is no outright ban on this process, but it is dangerous. A firm may win a client but then see no way of getting its money back other than reducing the quantity (and probably therefore the quality) of its audit procedures.

**Opinion Shopping**

Whilst shareholders appoint auditors, the Directors typically seek out a potential firm for the shareholders to vote on. The Board might be tempted to interview several firms until it found one that accepted its accounting methods.

Any firm of auditors aware that a potential client is engaged in this process should not accept nomination.

**Confidentiality**

External auditors are in a unique position of having a legal right of access to all information about their clients. It goes without saying that the client must be able to trust the auditor not to disclose anything about their business to anyone as it could be detrimental to their operations. As a basic rule, members of an audit team should not disclose any information to those outside of the audit team, whether or not they work for the same firm. There is little point using different teams for different work assignments if staff from different teams are disclosing information to each other!

Information should only be disclosed under certain circumstances.

- If the client has given their consent.
- If there is an obligation to disclose, e.g. if the client is suspected of money laundering, terrorism, drug trafficking.
- If it is required by a regulatory body, e.g. financial services legislation.
- If a court order has been obtained.
- If a member has to defend himself in court or at a disciplinary hearing.
- If it is in the public interest.

This latter point is difficult to prove and the audit must proceed with caution if thinking of disclosing information for this reason. Such examples could include fraud, environmental pollution, or simply companies acting against the public good.
Legal advice should be sought beforehand to avoid the risk of being sued. Matters to consider before disclosing information in the public interest are whether that matter is likely to be repeated and how serious the effects of the client’s actions are.

Where an auditor feels the need to disclose information, they should consider disclosing to the company’s Audit Committee (or Board of Directors, if there is no Audit Committee).

In certain circumstances auditors may be required by law to disclose information. For example, where money laundering is suspected, UK auditors must disclose their suspicions to the Serious Organised Crime Agency (SOCA).

On some occasions, auditors may come under pressure to disclose information (e.g. to customers, suppliers, tax authorities). There is no duty for the auditor to disclose to these parties therefore should only do so if a court order has been obtained.

**Conflicts of interest**

Members should place their clients’ interests before their own and should not accept or continue engagements which threaten to give rise to conflicts of interest between the firm and the client. Any advice given should be in the best interests of the client. Where clients’ interests conflict (for example, clients in the same line of business), the firm’s work should be arranged to avoid the interests of one being adversely affected by those of another.

The steps to be taken by the auditor are:

- once a conflict is noted, you should advise both clients of the situation
- reassure the client that adequate safeguards will be implemented, e.g. separate engagement leaders for each, separate teams, ‘Chinese walls’ to prevent the transfer of client information between teams and a second partner review
- suggest they seek additional independent advice
- if adequate safeguards can’t be implemented, the auditor should resign.

Safeguards can help to avoid or manage a problem situation, but problems are often hard to foresee as the auditor may have no knowledge that two clients are related in some way until a problem comes to light.
5 Accepting new audit engagements

If offered an audit role, the auditor should:

- ask the client for permission to contact the outgoing auditor (reject role if client refuses)
- contact the outgoing auditor, asking for any professional reasons why they should not accept appointment (if the client has caused problems, you may wish to say no to the appointment). If a reply is not received, the prospective auditor should always try and contact the outgoing auditor by other means e.g. by telephone or in person. Even if there are professional reasons or if a reply is still not received, the prospective auditor may still choose to accept but must proceed with care and be alert to increased risk
- ensure that the legal requirements in relation to the removal of the previous auditors and the appointment of the firm have been met (these were covered in Chapter 2)
- carry out checks to ensure the firm can be independent, is competent to do this audit and has the necessary resources
- assess whether this work is suitably low risk (a sound knowledge of the client will be required in order to make this assessment, see below)
- assess the integrity of the company’s directors
• as a commercial organisation, the firm should also ensure that this client is one it wants (e.g. right industry, suitable profit margin available, etc)

• not accept the appointment, where it is known in advance a limitation will be placed on the scope of their audit (likewise, if a restriction is imposed during an audit, resignation should be considered). In general, the question of what constitutes a reason for not accepting nomination is one of judgement for the prospective auditor and will primarily depend on the level of risk willing to be accepted.

Auditors are required to adopt more rigorous client identification procedures as a result of the money laundering regulations.

Test your understanding 4

The Chairman of Foley International, a large public trading company with extensive overseas interests, has asked you to accept the nomination to replace the present auditor at the next annual general meeting of the company.

Before acceptance of any new audit assignment, there are a number of reasons for non-acceptance that have to be considered. List the circumstances in which acceptance of the nomination would be inappropriate under the following headings:

(a) legal
(b) ethical
(c) practical.

6 Obtaining new audit work

The most common way of obtaining an audit engagement is by recommendation. It is not uncommon for up to 90% of a firm’s new business to come from its existing client base.

However, the second most common way of obtaining new work is by submitting a successful tender, after being invited to participate in what is frequently referred to as a ‘beauty parade’.
‘Tendering’ is the process of quoting a fee for work before the work is carried out.

**Risks associated with the tender process**

In addition to the risk associated with any other new client the specific risks of being involved with the tender include:

- wasted time – if the audit tender is not accepted
- setting an uncommercially low fee in order to win the contract (lowballing, discussed above)
- making unrealistic claims or promises in order to win the contract.

### 7 Engagement letters

- **ENGAGEMENT LETTER**
- **AUDITOR/CLIENT CONTRACT**
  - **SCOPE**
  - **STANDARDS**
  - **NOT ABSOLUTE ASSURANCE**
  - **MANAGEMENT LETTER**
  - **FEES**
**Engagement letters – main considerations**

- The engagement letter will be sent before the audit.
- It specifies the nature of the contract between the audit firm and the client.
- It minimises the risk of any misunderstanding of the auditor’s role.
- It should be reviewed every year to ensure that it is up to date but does not need to be reissued every year unless there are changes to the terms of the engagement.
- The auditor **must** issue a new engagement letter if the scope or context of the assignment changes after initial appointment.
- Many firms of auditors choose to send a new letter every year, to emphasise its importance to clients.

**The contents of the engagement letter**

The contents of a letter of engagement for audit services will include the following.

- Objective of the audit.
- Management’s responsibility for the financial statements.
- The scope of the audit including reference to legislation and professional standards.
- A description of audit procedures including their inherent limitations (e.g. for the discovery of fraud and irregularities)
- The form of reports to be issued.
- Use of the work of internal audit.
- Risk assessment matters.
- The auditor’s use of specialists.
- Deadlines.
- Access to information.
- Communications between the auditor and the client (e.g. form of audit report, management representations, letter of weakness, etc.).
- A reference to other services (normally covered in a separate letter).
- The basis of fees.
- Complaints procedures and jurisdiction.
- The need for co-operation and agreement of terms.
Engagement letters are important because they form a contract between the audit firm and the client.

Test your understanding 5

Engagement letters are important because they form a contract between the audit firm and the client.

True ☐
False ☐

Test your understanding 6

Which of the following is least likely to be included in an engagement letter?

A. The names of the staff involved in the assignment.
B. An outline of management's responsibility with regard to the financial statements.
C. The basis for setting the audit fee.
D. An outline of the scope of the audit.
8 Chapter summary

IFAC CODE OF ETHICS

ACCA CODE OF ETHICS AND CONDUCT

PROFESSIONAL BEHAVIOUR

FUNDAMENTAL PRINCIPLES

THREATS

SAFEGUARDS

OBTAINING AUDIT WORK

ENGAGEMENT LETTER
Ethics and acceptance of appointment

Risk analysis
- May not want to accept client if risk deemed too high.
- Management integrity: obtain references.
- Past performance of business?
- Internal controls: environment: Good/bad.
- Complexity of transactions.
- Unusual transactions.
- Money laundering risks; client due diligence.

Ethical issues
- If changing auditor: need to ask permission to get in contact with existing auditor; then wait for clearance.
- If no response consider the new appointment carefully.

Legal issues Appointment
- Directors: casual basis; first appointment.
- Ordinary resolution (21 days) AGM.
- Secretary of State: rare; when no auditor appointed at appropriate time.

Removal
- Ordinary resolution + special notice (28 days).

Resignation
- Ordinary resolution + special notice (28 days).

Duties of outgoing auditor
- Must submit a statement of circumstances.
- May: written representation to be circulated to members; speak at/make meetings.

Must
- written notice to company; statement of circumstances.
- Must present statement to members; Attend EGM (extraordinary general meeting).

When accepted engagement?
- Engagement letter.
Test your understanding answers

Test your understanding 1

**Integrity**: Members should be straightforward and honest in all professional and business relationships.

**Objectivity**: Members should not allow bias, conflicts of interest or undue influence of others to override professional or business judgements.

**Professional competence and due care**: Members have a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. Members should act diligently and in accordance with applicable technical and professional standards when providing professional services.

**Confidentiality**: Members should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third-parties without proper and specific authority or unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of members or third parties.

**Professional behaviour**: Members should comply with relevant laws and regulations and should avoid any action that discredits the profession.

Test your understanding 2

1 True.

2 True.
(1) False. The limit in the ethical code is 15% as Offcon Co is not listed and there is no indication that it is public interest (in which case, the limit would be 10% and the firm would be in breach). However, as recurring fees relating to Offcon are 12%, the firm should have monitoring procedures in place to ensure that the 15% rule is not breached.

(2) First and foremost, the firm should only accept the investigation work if there is no contingent fee associated with it. Therefore, if they decide to accept the work they should ensure that the fee is fixed.

However, in effect the firm appears to have been promised additional work if the takeover goes through, there is a self-interest threat arising in relation to this assurance work and the firm should probably consider not accepting it. It would be difficult to persuade a third party bystander that the audit firm’s report on the suitability of the company for takeover was not affected by the fact that if it was, they served to gain more ongoing work for the future.

(3) If the takeover goes ahead and the firm is offered additional work in relation to the subsidiary, the following factors should be considered:

The need not to breach the 15% guideline from one client (who would be the Offcon group) in respect of recurring fees.

Whether the additional 4% annual fee income predicted (which would in total take them over the 15%) is actually all annual and recurring or whether in practice it is inflated in the first year by virtue of the upheaval of the takeover, in which case it might be appropriate to accept it all with safeguards, as the 15% rule relates to recurring work.

Whether the firm would rather accept this work than risk losing the work relating to Offcon altogether.

How it would be possible to accept the work without breaching the 15% rule – for example, quoting a lower price for the subsidiary work, or seeking to boost other fee income in the firm, perhaps following up leads or inviting another partner with contacts to join the firm to increase overall fee income that way.

Ensure that the firm has adequate resources to perform both audits.
(a) Legal

Officers or servants of the company, or partners or employees of an officer or servant of the company, are prohibited from accepting the position of auditor to the company.

The auditor must be a member of a recognised supervisory body (RSB) and eligible under the rules of that body. An RSB must only deem appropriately qualified persons eligible for appointment or a member of a firm controlled by a qualified person.

(b) Ethical

If the fees from this appointment would exceed 10% of the gross fees of the practice then the appointment should not be accepted.

Any personal relationship (kinship, friendship or mutual business interest) with an officer or employee of the company would be considered unethical.

Any financial involvement with the company (such as a shareholding or a loan to or from the company) would also be regarded as unethical.

Finally, any conflict of interest should be avoided, such as advising two clients who were in dispute with each other.

(c) Practical

It may be impossible for the appointment to be accepted because the practice is not sufficiently large to audit the company satisfactorily or is heavily engaged in other audits at the time the client would need the audit to be carried out.

Also, the firm may not have the necessary expertise, for example in computing or international trade, to provide a satisfactory service to the client.

Finally, it may be that the level of fees is not considered sufficient, particularly if the client is considered high risk. In all situations, an appointment should be declined if there is no way in which the problem can be safeguarded.

Test your understanding 5

True.
The engagement letter may be in place for more than one year if there are no significant changes relating to the assignment, so it is unlikely to give details of staff involved with the assignment.
Planning

Chapter learning objectives

When you have completed this chapter you will be able to:

• identify and explain the need for planning an audit
• identify and describe the contents of the overall audit strategy and the audit plan
• explain the difference between interim and final audit
• discuss the effect of fraud and misstatements on the audit strategy and extent of audit work
• explain and describe the relationship between the overall audit strategy and the audit plan
• explain how auditors obtain an initial understanding of the entity and knowledge of its business environment
• define and explain the concepts of materiality and tolerable error
• compute indicative materiality levels from financial information
• develop and document an audit plan
• describe and explain the nature and purpose of analytical procedures in planning.
1 Why plan?

The auditor should plan the audit so that the engagement will be performed in an effective manner.

ISA 300 para 2

An audit is:

- an expensive process
- a potentially complex project which needs to be managed effectively.

Although it is tempting to assume that it is simply a question of following a tried and tested programme and that the important thing is to ‘get busy’, the extra time spent planning the engagement properly will repay itself by:

- Ensuring the right team is selected for the assignment.
- Ensuring that staff are employed effectively rather than simply ‘given something to do’.
- Ensuring the work is properly focused on material areas of risk.
- Identifying potential problem areas.
- Ensuring that the nature and quantity of the work done addresses the risks and problem areas.
• Ensuring the work can be fully completed in time for the review process.
• Enabling deadlines to be met so that there is time for due consideration of the important issues.

The purpose of all this is to ensure that the risk that the financial statements may be misstated is reduced to an acceptable level.

2 The planning process

The planning process consists of a number of phases and activities:

• assessing risk
• developing the audit strategy
• selecting the audit team
• assessing materiality
• selecting appropriate audit procedures.

3 Assessing risk

It's all about risk

The whole of the next chapter of these materials is devoted to the concept of risk, but it is vital that you understand that it is the auditor's assessment of risk which underpins the whole audit.

It is the assessment of risk which determines:

• the audit strategy
• who should be on the audit team
• the potential impact of fraud
• the nature of the procedures to be carried out
• how much evidence needs to be gathered

so everything in the planning process is about the auditor’s response to assessed risk.
How do you assess risk?

There are two sources of information from which it is possible to assess risk:

- Knowledge of the business (KOB) which we will consider later in this chapter.
- Analytical procedures which we will consider in the chapter on evidence.

Risk and materiality

It follows that there is a relationship between risk and materiality in that:

- the greater the risk of material misstatement
- the lower the level of materiality.

4 The audit strategy
The audit strategy sets the overall approach of the audit and covers:

- the scope
- the timing
- the direction

of the audit.

**Scope**

What is the financial reporting framework for the financial statements?

- National GAAP?
- International Accounting standards?

Are there industry specific or other special reporting requirements?

- Listed companies.
- Charities.
- Other regulated businesses such as banks and insurance companies.

Are there other factors which influence the overall approach to the audit?

- Multiple locations.
- Group audits.

**Timing**

Deadlines for:

- final reporting
- any interim report
- reports to management
- reports to those charged with governance.

The timing of:

- interim and
- final audit visits

to enable these deadlines to be met.
It is always good, when managing a project (even an audit) to start with the completion date and work backwards.

If there is to be an interim as well as a final audit the timing has to be:

- Early enough:
  - not to interfere with year-end procedures at the client and
  - to give adequate warning of specific problems.
- Late enough:
  - to enable sufficient work to be done to ease the pressure on the final audit.

**Interim v Final audits**

The interim audit will normally focus on:

- documenting systems
- evaluating controls
- some tests of details – usually tests of income and expenditure and, perhaps, purchases and disposals of fixed assets.

It may be possible to:

- attend an interim inventory count or
- carry out an interim receivables circularisation,

providing the results can be satisfactorily ‘rolled forward’ to the balance sheet date. (A roll forward reconciles the movements between the date of the count or circularisation and the year end date.)

The final audit can then focus on:

- balance sheet areas
- finalisation of the financial statements and the audit report.

For an interim audit to be justified the client normally needs to be of a sufficient size, although, if reporting deadlines are very tight it may be possible to audit up to ‘Month 11’ and then ‘roll forward’ to the balance sheet date.
Direction

The ‘direction’ of the audit covers the overall approach and concerns such issues as:

- preliminary assessment of materiality
- preliminary identification of high risk areas
- preliminary identification of material components and account balances.

Component – A division, branch, subsidiary, joint venture, associated company or other entity whose financial information is included in financial statements audited by the principal auditor.

- Decisions about whether assurance is expected to be derived from reliance on controls or a fully substantive approach.
- The need for site visits and other logistical issues.
- The impact of recent developments at the client, in its industry, in regulatory or financial reporting requirements.

5 The impact of fraud on the audit strategy

6 Possible different strategies

- INTERIM OR FINAL?
- POSSIBLE STRATEGIES
- SUBSTANTIVE OR CONTROLS?
- ANALYTICAL REVIEW OR TESTS OF DETAILS?
- IT’S HORSES FOR COURSES TAILOR THE STRATEGY TO THE CLIENT

REMEMBER
Possible different strategies could be:

- Final audit only.
- Interim and final.
- Reliance on controls with reduced reliance on substantive procedures.
- Reliance on substantive procedures rather than on internal controls.
- Heavy reliance on analytical procedures rather than tests of details.

The nature of the client’s business and structure will have a huge impact on the appropriate strategy.

- Clients with multiple sites, such as retail chains or manufacturers with a number of factories, will require the planning of a programme of site visits, perhaps on a rotational basis.
- Finance companies where the confirmation of a bewildering number of bank balances is crucial to the audit.
- The need to use experts, e.g.
  - specialist inventory checkers in the restaurant and pub trade or for livestock
  - surveyors and valuers for property companies
  - actuaries for pension schemes.

NB. In the exam it is possible that you may be asked to come up with different strategies for a single client. More likely, however (as in real life) your understanding of this part of the syllabus will be tested by asking you to come up with an appropriate strategy for a particular client.

There is no point:

- Recommending a receivables circularisation for a client with cash sales.
- Suggesting an inventory count for a software company whose work in progress consists of the unamortised costs of developing its products.
7 The audit plan

Once the audit strategy has been decided upon, the next stage is to decide how it is going to be carried out – we need the **audit plan**.

We also need to distinguish between:

- The plan itself – what needs to be done and how.
- Documenting the planning process (dealt with in the last section of this chapter).

**The plan itself**

Based on the assessed:

- risk
- materiality.

It is possible to decide:

- **what** audit procedures are to be carried out
- **who** should do them
- **how much** work should be done (sample sizes, etc)
- **when** the work should be done.
The relationship between the audit strategy and the audit plan

Whilst the strategy sets the overall approach to the audit, the plan fills in the operational details of how the strategy is to be achieved.

8 Knowledge of the business (KOB)

The need for KOB

If the audit strategy and the plan depend on the assessed level of risk, the auditor’s ability to assess that risk will depend on an understanding of all aspects of the client’s business:

- what the client does
- the environment in which it does it
- its management, systems and governance
- who it interacts with (key customers, suppliers, etc).
What KOB does the auditor need?

The subheadings in the ‘operating environment’ box as well as ‘What they do’, ‘Management’ and ‘Accounting policies’ are dealt with more fully below.

Systems and controls and significant risks are dealt with in other chapters.
9 Sources of KOB

The sources

Information from your firm

Information from external sources

Partner
Manager
Industry experts
Last year’s team
Last year’s audit
working papers file

Industry surveys
Companies House
The internet
Trade Press
Credit reference
agencies

Past experience

Discussion
Observation
Website
Brochures

Information from you

Information from the client
Discussion among the engagement team

‘The members of the engagement team should discuss the susceptibility of the entity’s financial statements to material misstatements.’

ISA 315 para 14

This discussion – effectively a planning meeting – is required by ISA 315.

In order to demonstrate that it has taken place and that the standard has been complied with, there will need to be evidence, usually in the form of minutes of the discussion meeting.

Analytical procedures

Analytical procedures are usually carried out at three stages of the audit process. They are mandatory at the planning and final review stages. At the substantive testing stage, they are one of several methods for obtaining evidence, so may not be appropriate in some circumstances.

Analytical procedures comprise the evaluation of financial information by studying the relationship between this information and other financial and non-financial data. They include comparison of financial information with prior periods, budgets and forecasts and similar industries.

At the planning stage, analytical procedures are used for two main reasons:

• to help understand the client’s financial statements
• to help spot possible errors.

If errors look possible, the audit work will be directed towards those errors.

How this is done

Basic analytical procedures could involve simply looking at the client’s trial balance or draft financial statements to see if they appear in line with the auditor’s expectations. However, auditors will typically go further than this:

• monitoring statistical trends in key figures and ratios
• asking the client why certain balances appear out of line with expectations.

Computer programs are often used to select those balances that appear furthest from expectations.
10 Materiality

What is materiality?

We have already seen the definition of materiality:

‘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 para 3

So what really is materiality?

- A big amount of money (material by size).
- An amount which although not big:
  - triggers a threshold
  - indicates future developments or other significant events
  - whose disclosure is compulsory

(material by nature).

Why is materiality important?

- If financial statements contain a material misstatement they cannot show a true and fair view.
- Auditors therefore must design their audit procedures to reduce the risk of material misstatement to an acceptable level.
- This means that auditors must decide on what they mean by ‘material’ before they design their procedures – hence its place in this chapter.

What are the implications for the work the auditors do?

Auditors will:

- Need to examine all items in the financial statements which are material

BUT

- they will also need to design tests to give assurance that material amounts have not been omitted from the financial statements
AND

• they will need to allow for the fact that a number of immaterial errors could together add up to a material misstatement.

Calculating materiality

Firms typically have a standard method for calculating a baseline materiality figure as part of the planning process.

Common measures are:

• ½ – 1% of turnover
• 5 – 10% of results
• 1 – 2% of assets

but these are up to the judgment of the auditor.

As a result, different firms use different measures.

Any calculation done is very flexible, and may have to be reassessed during the audit (if for example many large errors are found).

Exam focus

Materiality is quite a difficult concept to explain.

Be familiar with the definition from ISA 320 quoted above remembering a phrase like ‘influence the economic decisions of users’.

Take some time to think about why materiality is important, as indicated above.

11 Tolerable error

What is tolerable error?

The maximum error in a population that the auditor is willing to accept.

ISA 530 para 12

This means that in the case of tests of control, the auditors will accept a certain number of instances of a failure to apply a control procedure and will still conclude that the procedure is operating properly.
Tolerable error is considered during the planning stage, and for substantive procedures, is related to the auditor's judgement about materiality.

**The difference between materiality and tolerable error**

- **Materiality** concerns the financial statements as a whole.
- **Tolerable error** only concerns the population being tested.

**12 Documenting the planning process**
This chapter has considered all aspects of the planning process. ISAs require that all the elements of the audit should be documented, and so it is clearly necessary to produce a record of the audit strategy and plan, which can be referred to as the audit progresses and can be used in the completion stages to ensure that everything has been done which ought to have done.

Most firms will use ‘audit packs’ – pre-printed or computerised documents and checklists to ensure that the requirements of ISAs have been followed.

**The stages of the plan**

The plan usually consists of nine stages:

1. **Gather/confirm knowledge of the business**
   - Nature of the business
   - Management
   - Key staff
   - Those charged with governance
   - Accounting systems
   - Internal controls
   - KOB discussion
2. **Preliminary analytical review**
3. **Risk assessment**
   - Overall
   - By area
   - Significant risks
4. **Materiality calculation**
5. **Tolerable error calculations for material areas**
6. **The audit approach to be adopted for all areas**
7. **Assessment of auditor’s independence – See Chapter 5 Ethics**
8. **Budget and staffing**
9. **Timetable and deadlines**
Variations on the theme

- For large audits much of the KOB information may be kept on a permanent file and the audit plan may contain a summary or simply cross refer to the permanent file.
- Increasingly KOB is being summarised in a planning memorandum which is updated each year.
- With computerised audit systems where all background documents may be scanned in, the distinction between current and permanent audit files is being eroded.
- For large audits, the planning may be so complex that it needs to be summarised in a separate memorandum.
- For small audits the summary may be all that is necessary.

Permanent file – a file of information which is relevant for more than one year’s audit, e.g.

- Names of management, those charged with governance, shareholders.
- Systems information.
- Background to the industry and the client’s business.
- Title deeds.
- Directors’ service agreements
- Copies of contract and agreements.

Current file – a file containing the documentation and evidence for the current audit.
Give 6 issues to be considered as part of the planning process for an audit.

State 5 things which need to be done during the planning process.

State the 2 sources of information which enable the auditor to assess risk.

What are the main elements of an audit strategy?

What is the difference between the audit strategy and the audit plan?

State 8 aspects of the client’s business which need to be explained in the audit plan.

State 8 possible sources of knowledge of the business.

Define materiality.

Why might calculated materiality for a property company be weighted towards different elements in the financial statements from a manufacturing company?

Define tolerable error?

What is the difference between materiality and tolerable error?

State the 9 stages of the audit plan.

Why is it important for the auditor to plan?
## Test your understanding answers

### Test your understanding 1

<p>| | |</p>
<table>
<thead>
<tr>
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</thead>
</table>
| **1. Give six issues to be considered as part of the planning process for an audit.** | **People** – Who should make up the audit team?  
**Timing** – What are the deadlines?  
**Focus** – What are the key aspects of the audit?  
**Problem areas** – What issues are likely to cause difficulties and how should they be addressed?  
**Nature of work** – What audit approach should be used and what types of procedures are appropriate?  
**Amount of work** – Sample sizes, number of tests etc. all driven by assessment of risk and materiality. |
| **2. State five things which need to be done during the planning process.** | Assess risk.  
Develop the audit strategy.  
Select the audit team.  
Assess materiality.  
Select appropriate audit procedures. |
| **3. State the two sources of information which enable the auditor to assess risk.** | Knowledge of the business.  
Analytical review. |
| **4. What are the main elements of an audit strategy?** | Scope.  
Timing.  
Direction. |
| **5. What is the difference between the audit strategy and the audit plan?** | Whilst the strategy sets the overall approach to the audit, the plan fills in the operational details of how the strategy is to be achieved. |
6. State eight aspects of the client’s business which need to be explained in the audit plan.

<table>
<thead>
<tr>
<th>Choose from:</th>
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<tbody>
<tr>
<td>The industry</td>
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<tr>
<td>The competition</td>
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<tr>
<td>Technology</td>
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<tr>
<td>Laws and regulations</td>
</tr>
<tr>
<td>Stakeholders</td>
</tr>
<tr>
<td>Acquisitions</td>
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<tr>
<td>Disposals</td>
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<tr>
<td>Financing</td>
</tr>
<tr>
<td>Trading partners</td>
</tr>
<tr>
<td>Related parties</td>
</tr>
<tr>
<td>What the client does</td>
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<tr>
<td>Management</td>
</tr>
<tr>
<td>Systems</td>
</tr>
<tr>
<td>Controls</td>
</tr>
<tr>
<td>Significant risks</td>
</tr>
<tr>
<td>Accounting policies</td>
</tr>
</tbody>
</table>

7. State eight possible sources of knowledge of the business.

<table>
<thead>
<tr>
<th>Choose from:</th>
</tr>
</thead>
<tbody>
<tr>
<td>The engagement partner</td>
</tr>
<tr>
<td>The engagement manager</td>
</tr>
<tr>
<td>Your firm’s industry experts</td>
</tr>
<tr>
<td>Last year’s audit team</td>
</tr>
<tr>
<td>Industry surveys</td>
</tr>
<tr>
<td>The company’s registry</td>
</tr>
<tr>
<td>The internet</td>
</tr>
<tr>
<td>Trade press</td>
</tr>
<tr>
<td>Credit reference agencies</td>
</tr>
<tr>
<td>Discussions with client’s staff</td>
</tr>
<tr>
<td>Observation of events and processes at the client’s premises</td>
</tr>
<tr>
<td>The client’s website</td>
</tr>
<tr>
<td>Brochures and other publicity material</td>
</tr>
</tbody>
</table>
8. Define materiality.  

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

9. Why might calculated materiality for a property company be weighted towards different elements in the financial statements from a manufacturing company?  

The property company’s balance sheet will probably contain items with a higher value in comparison with the figures in its profit and loss account, than the manufacturer, where the largest numbers are likely to be those for sales, purchases and payroll.

As a result calculated materiality for the property company will usually be weighted in favour of the items in its balance sheet – particularly the investment properties and any related borrowings – whereas materiality for the manufacturer is more likely to be weighted in favour of its sales figure.

10. Define tolerable error.  

‘The maximum error in a population that the auditor is willing to accept.’

11. What is the difference between Materiality and tolerable error?  

**Materiality** concerns the financial statements as a whole.

**Tolerable error** only concerns the population being tested.

12. State the nine stages of the audit plan.  

Knowledge of the business.

Preliminary analytical review.

Risk assessment.

Materiality.

Tolerable error.

Audit approach.

Independence.

Budget and staffing.

Timetable and deadlines.
<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>13. Why is it important for the auditor to plan?</td>
<td>To decide on the audit approach.</td>
</tr>
<tr>
<td></td>
<td>To decide how much work to do.</td>
</tr>
<tr>
<td></td>
<td>To decide what type of work to do.</td>
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<tr>
<td></td>
<td>To decide on the composition of the audit team.</td>
</tr>
<tr>
<td></td>
<td>To ensure that risk is reduced to an acceptable level.</td>
</tr>
</tbody>
</table>
Risk

Chapter learning objectives

Upon completion of this chapter you will be able to:

• identify and describe the need to plan and perform audits with an attitude of professional scepticism
• compare and contrast risk-based, procedural and other approaches to audit work
• discuss the importance of risk analysis
• describe the use of information technology in risk analysis
• identify and describe engagement risks affecting the audit of an entity
• explain the components of audit risk.
1 Risk-based and procedural approaches to auditing

When doing an audit, auditors can take one of two basic approaches:

- **procedural**
- **risk-based.**

**Procedural**

The auditor carries out a set of standard procedures and tests regardless of the particular nature of the client.
Risk-based

The auditor plans the audit around the risks that the client’s financial statements may contain misstatements, whether as a result of fraud or not. As such, each audit will involve different priorities, different tests, and will take different lengths of time.

Traditionally, auditors have followed a risk-based approach, as this should minimise the chance of them giving the wrong opinion. It also helps to ensure that audit work is carried out as efficiently as possible, as assurance is obtained using the most effective tests.

2 Risk assessment as part of the audit process

If the auditor needs to conduct the audit with an attitude of professional scepticism, he or she needs to ask the question:

- **So what could go wrong?**

**Professional scepticism – An attitude that includes a questioning mind and a critical assessment of evidence.**

3 The importance of risk analysis

Risk analysis is the most important stage of the audit. If auditors assess risk properly, they will:

- Identify main areas where errors or misstatements are likely early in the audit.
- Plan audit work that addresses these possible mistakes.
- Discover errors as early as possible in the audit process.
- Carry out the most efficient (and hence profitable) audit possible.
- Minimise the chance of issuing an incorrect audit opinion.
- Reduce the chance of getting sued (and losing!).
- Have a good understanding of the risks of fraud, money laundering etc.
- Be in the best position to assess whether the client is a going concern.

Although the key to risk assessment is to do it as part of the planning process, it is important to understand that:

- Risk can be uncovered at any stage of the audit.
- In the light of the work done the level of risk may be reappraised.
The review and completion phase of the audit has to confirm that the risk of material misstatement has been reduced to an acceptable level.

**The impact of ISA 315**

Audits conducted under ISAs must follow the risk-based approach

It is difficult to overstate how important this is. It affects:

- how audits are planned
- the sources of assurance
- the nature of audit evidence gathered by the auditor
- the nature of the procedures carried out by the auditor
- the amount of evidence gathered.

We consider all of these aspects in the chapters on planning, systems and controls, audit evidence and audit procedures.
Exam hint

It is also important for you and your approach to exam questions:

- Where there is a scenario given, you must adapt your answer to the facts of the scenario – the nature of the business, systems in operation, etc.

The major driver behind all this is ISA 315 Obtaining an Understanding of the Entity and its Environment and Assessing the Risks of Material Misstatement.

Put simply, it says when you do an audit you have to:

- Assess the risk.
- Address the risk.
- Review the results to make sure that the risk of material misstatement has been reduced to an acceptable level.

4 Audit risk

Audit risk defined

Audit risk is defined as:

‘The risk of that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.’

(typically, stating that the financial statements are true and fair, when in fact they are not).
Audit risk is further defined by way of a formula:

\[
\text{AUDIT RISK} = \text{INHERENT RISK} \times \text{CONTROL RISK} \times \text{DETECTION RISK}
\]

We will look at the components of audit risk below.

**Inherent risk**

The risk of errors or misstatements due to the nature of the company and its transactions.

Clearly this requires the audit team to have a good knowledge of how the client’s activities are likely to affect its financial statements, and the audit team should discuss these matters in a *planning meeting* before deciding on the detailed approach and audit work to be used.

Such a meeting is compulsory under ISA 315 and must be documented.

**At the account balance and assertion level**

As well as considering the entity as a whole, the auditor needs to assess whether individual headings in the financial statements or assertions about those items, carry increased levels of inherent risk.

Management makes a number of *assertions* about items in the financial statements – whether they exist, their value, whether all are included, whether they are recognised in the correct accounting period etc. which we will consider in detail in the chapter on audit evidence.

**Control risk**

Control risk is the risk of errors or misstatements because the company’s internal controls are not strong enough to prevent, detect and correct them.

We will consider internal control in depth in Chapter 8 Systems and controls.
Control risk increases due to the lack of suitable procedures implemented by the client. The implementation of such procedures will have a cost, e.g.:

- the installation of new equipment
- the employment of extra staff
- the time taken by additional administrative procedures.

The client therefore needs to make a judgement about whether the benefits of the control outweigh the costs of implementing it.

- How much 'shrinkage' (jargon for theft of goods from a retail store) would there need to be to make it worthwhile employing a store detective or installing electronic tags and detectors?

**Detection risk**

This is the risk that the auditor’s procedures do not pick up material misstatements.

**Sampling risk**

Detection risk includes sampling risk, which is defined as:

> The risk which ‘arises from the possibility that the auditor's conclusion, based on a sample may be different from the conclusion reached if the entire population were subjected to the same audit procedure’.

**ISA 530 Para 7**

In other words it is the risk that the sample may not be representative.

Any other risks that the auditor may come to the wrong conclusion, e.g.:

- by misinterpreting the results of a test
- by using inappropriate procedures
- by failing to investigate a particular balance or transaction
- because a member of the client’s staff misleads the auditor

is classified as **non-sampling risk**. Non-sampling risk is defined as arising from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample.
5 Assessing the risk

It can be seen that audit risk comprises three types of risk:

- inherent risk (IR)
- control risk (CR)
- detection risk (DR)

and that the formula mentioned below.

\[ AR = IR \times CR \times DR \]

means that it is possible to ‘score’ the level of risk.

The assessment does not need to be a mathematical one – the equation helps us to understand how the risks interact – but many firms use a mathematical approach.

This involves the various risks being assessed (often using a checklist of relevant questions) and being issued a ‘score’, a process that may be carried out using software.

Inherent risk and control risk cannot be directly influenced by the auditor, as they relate to the nature of the entity and its systems. (Together these two risks are known as the **Entity risk**.)

The only risk that the auditor can change is detection risk.

Therefore, once inherent and control risk have been assessed, and with a maximum overall audit risk ‘score’ in mind, detection risk becomes the balancing figure.

Detection risk will be a major variable in determining the extent of audit procedures, e.g. sample sizes for audit tests.

If control risk and inherent risk are deemed low because the entity is not particularly risky and the its controls are effective, the auditor will place reliance on these factors. Detection risk can be allowed to be higher and still give an acceptably low level of audit risk. If detection risk needs to be low because the client is inherently risky or controls are not effective, the auditor will increase the sample size and/or use more experienced staff.
<table>
<thead>
<tr>
<th>Factor/Identify</th>
<th>Audit risk</th>
<th>Work we need to perform/effect on the audit</th>
<th>Type of risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lack of physical controls</td>
<td>Employees are more likely to steal assets from the company or not look after them therefore get damaged and become impaired. Incorrect statement on Financial statements the asset position potentially over statement.</td>
<td>Physical checks of the assets required to determine completeness and value. Analytical review to see any unusual trends over excess ordering etc.....</td>
<td>Control risk</td>
</tr>
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<td></td>
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</tr>
<tr>
<td>Lack of IT based controls</td>
<td>Computer systems can be changed or modified without suitable authorisation. Changes are not recorded and or notified to responsible individuals.</td>
<td>Analytical procedures to be performed to see if any unusual trends are happening. Review the integrity of the staff. Assess the systems to see how easy changes will go undetected.</td>
<td>Control risk</td>
</tr>
<tr>
<td>Risk</td>
<td>Control</td>
<td>Inherent</td>
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<tr>
<td><strong>Lack of authorisation controls.</strong></td>
<td><strong>Unnecessary expenditure incurred or even non business expenditure</strong></td>
<td><strong>Assess the systems to determine the likelihood of this happening.</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Sales completed over the limits therefore potential for non payment.</strong></td>
<td><strong>Review the old balances and credit limited and see what other controls the company have in place.</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>New staff employed without authorisation that may not be necessary.</strong></td>
<td><strong>Review the organisation chart for reasonableness and understand the roles within the company.</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Lack of segregation of duties.</strong></td>
<td><strong>Not identifying errors and fraud as only one person doing the job therefore concealment easier to perform.</strong></td>
<td><strong>Increase the substantive testing to ensure that the statements are true and fair.</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Account balances for example Research and development and warranty provisions.</strong></td>
<td><strong>Due to the natures of these transactions a high degree of judgement or estimation is involved and is therefore open to manipulation or error.</strong></td>
<td><strong>Get a understating of the criteria that needs to met and obtain sufficient evidence to support the calculations.</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Client operates in a high tech or fashion industry</strong></td>
<td><strong>Stock may be obsolete</strong></td>
<td><strong>Review post balance sheets events to determine the net realisable value of stock</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Obsolete stock may be overstated in the financial statements</strong></td>
<td><strong>Use an independent valuer to value stock</strong></td>
<td></td>
</tr>
<tr>
<td>Client is based in multiple locations</td>
<td>Stock held at other locations may be omitted from year-end stock</td>
<td>Attend stock takes at all locations</td>
<td>Control risk + Detection risk</td>
</tr>
<tr>
<td>---------------------------------------</td>
<td>---------------------------------------------------------------</td>
<td>-----------------------------------</td>
<td>-----------------------------</td>
</tr>
<tr>
<td></td>
<td>Controls may be less effective</td>
<td>Review control procedures to ensure they are adequate</td>
<td>Consider using a substantive approach</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Bank is relying on the financial statements or Directors are paid a bonus based on profits</th>
<th>Risk management bias</th>
<th>Pay more attention</th>
<th>Inherent risk</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>• accounting estimates • cut-off</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Obtain independent estimates re valuation of year-end stock etc</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>It is cash-based business</th>
<th>Cash may be misappropriated, causing turnover to be understated</th>
<th>Consider the adequacy of internal controls over sales</th>
<th>Inherent risk + Potentially control risk</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>(possible limitation in scope if we cannot verify the completeness of sales and internal controls are inadequate)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>The company trades overseas</th>
<th>Transactions in foreign currency may not be translated at the correct rate</th>
<th>Ensure foreign currency is correctly accounted for</th>
<th>Inherent risk</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The company may make foreign exchange losses</td>
<td>Review procedures to mitigate exchange loss risk, e.g. hedging</td>
<td></td>
</tr>
<tr>
<td>New computer system in the year</td>
<td>Errors in transferring the data from one system to another</td>
<td></td>
<td></td>
</tr>
<tr>
<td>--------------------------------</td>
<td>-----------------------------------------------------------</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>There may be inherent errors in the new system that have not yet been discovered</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Review controls over the changeover:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• parallel run</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• check opening balances transferred properly</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Use test data on the system to ensure it operates correctly</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>New audit client</th>
<th>Lack of cumulative audit knowledge and experience may lead to increased detection risk</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Use an audit team that is experienced in the industry</td>
</tr>
<tr>
<td></td>
<td>Gather knowledge of the company</td>
</tr>
<tr>
<td></td>
<td>Check opening balances are correct</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tight audit deadline imposed by client</th>
<th>Staff working quickly to a tight deadline are more likely to make errors</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>There is a shorter post balance sheet period that we can use to help with our audit</td>
</tr>
<tr>
<td></td>
<td>Increase substantive testing</td>
</tr>
<tr>
<td></td>
<td>Perform an interim visit to complete some audit work before the end of the year</td>
</tr>
<tr>
<td></td>
<td>Agree a timetable re:</td>
</tr>
<tr>
<td></td>
<td>• reporting deadline</td>
</tr>
<tr>
<td></td>
<td>• client schedules to be available</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Temporary staff used during the year</th>
<th>Errors more likely as staff are not familiar with the client's systems</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Increase substantive testing</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>A client in a specialised industry</th>
<th>Errors more likely or fraud more likely to be missed because of the complexity of the work</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Ensure that the auditors understand the system, increase testing</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Why is professional scepticism important to the auditor?

Explain the difference between procedural and risk-based approaches to auditing.

Under ISAs is it acceptable to conduct an audit using a procedural approach?

Give five benefits to the audit process derived from assessing risk.

What is meant by a significant risk?

What are the three components of audit risk and how are they defined?

Which two components of audit risk constitute entity risk?
6 Chapter summary

- Independence/objectivity
- Professional scepticism
  - Procedural
  - Risk-based
- Audit approach
- Assess risk
- Risk-based required by ISA 315
- Audit risk
  - Entity risk
    - Inherent risk
  - Detection risk
    - Control risk
**Test your understanding answers**

<table>
<thead>
<tr>
<th>Test your understanding 1</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Why is professional scepticism important to the auditor?</strong></td>
<td>Because it means that the auditor is questioning the validity of the audit evidence gathered in an objective, independent fashion.</td>
</tr>
<tr>
<td><strong>2. Explain the difference between procedural and risk-based approaches to auditing.</strong></td>
<td>Procedural – following a predetermined set of procedures irrespective of the nature of the engagement or the client. Risk-based – adapting the nature and extent of audit procedures in response to the assessed risk of misstatement at the individual client.</td>
</tr>
<tr>
<td><strong>3. Under ISAs is it acceptable to conduct an audit using a procedural approach?</strong></td>
<td>No. ISA 315 states that the auditor must assess risk and design audit procedures in response to that risk.</td>
</tr>
</tbody>
</table>
| **4. Give five benefits to the audit process derived from assessing risk.** | Choose from:  
- Identify main areas where errors or misstatements are likely early in the audit  
- Plan audit work that addresses these possible mistakes  
- Discover errors as early as possible in the audit process  
- Carry out the most efficient (and hence profitable) audit possible  
- Minimise the chance of issuing an incorrect audit opinion  
- Reduce the chance of getting sued (and losing!)  
- Have a good understanding of the risks of fraud, money laundering, etc.  
- Be in the best position to assess whether the client is a going-concern. |
| **5. What is meant by a significant risk?** | A risk which requires special audit consideration. |
6. What are the three components of audit risk and how are they defined?

<table>
<thead>
<tr>
<th>Question</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inherent risk</td>
<td>the risk of errors or misstatements due to the nature of the company and its transactions.</td>
</tr>
<tr>
<td>Control risk</td>
<td>the risk of errors or misstatements because the company's internal controls are not strong enough to prevent, detect and correct them.</td>
</tr>
<tr>
<td>Detection risk</td>
<td>the risk that the auditor's substantive testing does not pick up errors and misstatements.</td>
</tr>
</tbody>
</table>

7. Which two components of audit risk constitute entity risk?

<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inherent risk</td>
<td></td>
</tr>
<tr>
<td>Control risk</td>
<td></td>
</tr>
</tbody>
</table>
Systems and controls

Chapter 8

Chapter learning objectives

Upon completion of this chapter you will be able to:

• explain why an auditor needs to obtain an understanding of internal control activities relevant to the audit
• describe and explain the key components of an internal control system
• discuss the difference between tests of control and substantive procedures
• identify and describe the important elements of internal controls, including the control environment and management control activities
• explain the importance of internal controls to auditors
• explain how auditors identify weaknesses in internal control systems and how those weaknesses limit the extent of auditors’ reliance on those systems
• explain and tabulate tests of control, suitable for inclusion in audit working papers, for
  – revenue
  – purchases
  – payrolls
  – revenue and capital expenditure
  – inventory
  – bank and cash
• provide examples of computer system controls and list examples of application controls and general IT controls
• analyse the limitations of internal control components in the context of fraud and error
• explain the need to modify the audit strategy and audit plan following the results of tests of control
• identify and explain management’s risk assessment process with reference to internal control components

• discuss and provide examples of how the reporting of internal control weaknesses and recommendations to overcome those weaknesses are provided to management.
1 Client's systems

Auditors need to understand the client’s systems so that they can:

- Assess their reliability for the preparation of financial statements.
- Design suitable audit procedures.

If the auditor is able to rely on the system it will be because it contains some of the components of internal control as set out in ISA 315.

This chapter takes you through:

- How systems operate.
- What internal control is.
- How auditors identify and test controls.
- What they should do when the controls fail or when there are other weaknesses in the system.

2 A word about systems

Why do companies have systems?

A company’s management has a number of obligations:

- To manage the business effectively.
- To produce timely, and accurate financial statements and management information (both for management and statutory purposes).
- To safeguard the business’ assets.
- To prevent and detect fraud.

These things do not happen at random – the company needs systems.

The purpose of a system is to enable the business to:

- collect data
- summarise data
- produce financial statements and management information.
3 What is internal control and how does it work?

Management’s view

Logically, the more reliable a system is the more accurate its output will be as more reliable information will lead to better decision making.

Therefore management should be pleased to have good systems because:

• financial information will be less prone to error
• good systems may play a part in fraud prevention and detection
• good systems will help with safeguarding the assets.

What about the auditors?

The auditor’s job is to form an opinion on the financial statements.

To do this the risk that the financial statements may be misstated, must be reduced to an acceptable level.

It really is all about risk.

So, from the auditor’s point of view:

The next question must be, therefore, how to judge whether a system is more or less reliable. The answer will depend on the strengths or weakness of internal control.
It follows, therefore, that to form a view about the extent to which internal control can be relied upon, the auditor will need to:

- understand how the system works
- understand the controls within the system
- test whether or not the controls are effective.

We will look at all of this later in this chapter.

First, we need to consider the nature of internal control.

**Internal control components**

ISA 315 states that there are five components of internal control:

1. The control environment.
2. The entity’s risk assessment process.
3. The information system including the related business processes, relevant to financial reporting and communication.
4. Control activities.
5. Monitoring of controls.

**The control environment**

The control environment is defined in ISA 315 as being made up of:

- communication and enforcement of ethical values
- commitment to competence
- participation by those charged with governance
- management’s philosophy and operating style
- organisational structure
- assignment of responsibility
- human resource policies and practices – staff training, recruitment procedures etc.

This sounds quite high-level, but it is really only saying that if a client complies with the principles of good corporate governance (see Chapter 3), the risk of misstatement will be lower.
The entity's risk assessment process

If the client has robust procedures for assessing the business risks it faces, the risk of misstatement will be lower.

The information system

We will examine the way controls operate for different transaction cycles later in this chapter. Here we need to stress that the consideration of systems is not optional.

ISA 315 states:

'The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting.'

NB – It says 'relevant to financial reporting' and we also know that the auditor is interested in whether or not there are material misstatements in the financial statements.

The standard therefore does not mean that:

• the auditor should look into every aspect of a client’s systems, or that
• immaterial areas need to be considered.

Exam hint

Understanding the system is compulsory and in nearly every sitting of the predecessor paper over the last two years or so at least one and sometimes several questions have demanded an understanding of systems specific to the scenario client.

• Usually these systems are computerised.
• Often they involve use of the internet or some aspect of e-commerce.
Control activities

Control activities are all around us. When we leave the train station and put our ticket through the barrier; when we leave a shop and set off an alarm; when our passport application has to be countersigned - all are examples of control activities.

ISA 315 refers to five types of control activity:

1. Authorisation
2. Performance reviews.
3. Information processing.
4. Physical controls.
5. Segregation of duties.

Examples of each might be:

- When a staff member feels the need to work overtime, their manager should **authorise** this in advance (as it will cost the company extra money, and may not be needed).
- The ACCA compare average marks from exam centres, to help spot potential cheating, or to identify if any centre might have been disrupted during the exam - **performance review**.

Performance review covers all sorts of analytical procedures that give management the opportunity to identify problems.

This could be the comparison of the results of different branches or the monitoring of the costs of a project against budget (or the time spent on an audit against the budgeted fee) usually referred to as a **budgetary control system**.

- **Information processing** – the reconciliation of control accounts, or ‘edit checks’ that ensure that inputs comply with pre-established criteria.
ISA 315 assumes that the vast majority of systems are IT based – see below about application controls and general controls in IT systems.

- Any company with valuable goods or assets is likely to employ security guards and use CCTV systems – a physical control.
- If one member of staff is responsible for preparing cheques and bankings and maintaining the cashbook or bank ledger account, someone else should perform the bank reconciliation – segregation of duties.

Monitoring of controls

Clearly if:

- a control is either ineffective, or
- simply does not function,

it might as well not be there.

Management must therefore monitor controls to be sure that they are effective.

Controls in IT systems

Computer based controls are normally divided into two categories:

- Application controls.
- General controls.
Application controls

Application controls are controls that are built into the system, e.g.

- arithmetic checks
- range checks
- validation checks.
- Quickbooks, the small business accounting package, for example, will not let you enter a sale until you have set up an ‘item’, which means you have to allocate the sale to a revenue account, set up the customer as a receivable, decide on VAT treatment, etc.
- Some systems will not let you reverse or delete entries so that all errors have to be corrected through the use of journals. This may be seen as a strength, because all entries must leave an ‘audit trail’, although the system can be so cumbersome to operate and correcting journals become so difficult to follow, that the operational difficulties created outweigh the benefits of the control.

The formal definition of application controls in the glossary to the ISAs is:

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

General controls

General IT – controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems, e.g. controls over:

- data centre and network operations
- system software acquisition
We gave the example above of an application control that will not allow errors to be corrected by simply deleting the offending entry and replacing it with a correct one. In the absence of a control such as this, there will need to be general controls which ensure that staff are properly trained, so that errors are minimised and that the deletion of entries only happens in appropriate circumstances and with proper authorisation.

4 What should the auditor do about internal control?

Why does the auditor carry out audit work?

To reduce the risk of issuing an inappropriate audit report to an acceptable level.

The auditor has two possible sources of assurance that the financial statements are not materially misstated:

- Internal controls.
- Substantive procedures.

Substantive procedures are those tests and other procedures (such as analytical review) that give direct assurance about the assertions in the financial statements – see the chapter on audit evidence for more about financial statement assertions.

So the audit opinion is supported by evidence gathered by the auditor, and if the auditor wishes to gain assurance from internal controls, it will be necessary to test those controls.
The double-headed arrow across the vertical line between controls and substantive procedures needs some explanation.

- The greater the assurance from controls, the less the assurance required from substantive procedures, so the less the level of testing.
- If it is more efficient to take all the necessary assurance from substantive procedures, then none will come from controls and therefore there is no requirement to test them.
- It is a requirement of ISA 500 that some substantive procedures (which may be analytical review) must be carried out for all material classes of transactions, account balances and disclosures.

With a Test of Controls, the auditor is interested in whether a control has operated correctly – the size of the transaction is irrelevant. In other words, the auditor is checking that the company has been trying to ensure that its Financial Statements are accurate.

For example, if, when auditing the ‘bank and cash’ figure, an auditor is told that the client performs bank reconciliations at the end of every month and the auditor looks for evidence that this reconciliation is indeed taking place every month, and is done properly, a test of control has been performed.
With a **Substantive Test**, the auditor is trying to gain assurance directly about the accuracy of a figure in the Financial Statements.

For example, in a company where no bank reconciliations are performed, the auditor may choose to perform one to gain assurance that the bank figure in the Financial Statements is accurate.

It can sometimes be difficult to tell the difference between a test of control and a substantive test. The key is to understand **why** the auditor is carrying out the test.

**5 The auditor and the system**

We have already seen that the auditor needs to understand the system:

- To assess its reliability as a basis for preparing financial statements.
- To assess the effectiveness of controls.
- To design suitable audit procedures.

It is also compulsory as stated in ISA 315:

> ‘The auditor should obtain an understanding of the information systems, including the related business processes, relevant to financial reporting.’

ISA 315 para 81

**Establishing the system**

Information about the system comes from:

- previous knowledge/experience
- client’s staff
- client’s system manuals
- walk-through tests (where transactions are traced through system to confirm our understanding).

**Documenting the system**

Possible ways of documenting the system and controls are:

- narrative notes (which can prove bulky if system is large or complex)
- flowcharts (which can make a complex system easier to follow)
- organisation charts – showing roles, responsibilities, and reporting lines
• Internal Control Questionnaire (ICQ)
• Internal Control Evaluation Questionnaire (ICE).

A word on questionnaires (ICQs)

ICQs

• An ICQ is a list of all possible controls for each area of the Financial Statements. The client’s staff are asked questions and systems documentation reviewed, to establish which controls exist.
• The system is then appraised – but this can be difficult. Different combinations of controls could achieve the same result.

ICEs

• ICE (sometimes referred to as ICEQ) does not attempt to record ALL controls like an ICQ.
• Instead, for each control objective, it asks for the controls which achieve that objective.
• As such, an ICE may not record the entire system – but it is far more use as an evaluation tool for the auditor, as its focus is on whether IC Objectives are being met.

Examples of ICQs and ICEs are given later in the chapter.

6 The limitations of internal control

Good, but not that good

We have seen that where internal control is strong, it may reduce the amount of evidence the auditor needs to gain from other sources.

Nevertheless ISA 315 insists that for material areas some substantive testing needs to be carried out.

The reason for this is that there are limitations to the reliance that can be placed on internal control because of:

• human error in the use of judgement
• simple processing errors and mistakes
• collusion of staff in circumventing controls
• responsible people abusing that responsibility to override controls.
Internal control and fraud

The last two items on the above list take us into fraud territory.

We know that:

- management is responsible for the prevention and detection of fraud
- the auditor is not.

However, as ISA 240 states:

‘In planning and performing the audit to reduce audit risk to an acceptably low level, the auditor should consider the risks of material misstatements in the financial statements due to fraud.’

7 What if the controls don’t work?

The possibilities

As we have seen, the auditor draws assurance from a number of sources, including internal controls.

The chart below shows the decisions to be taken which depend on the effectiveness of controls and the impact on the audit plan if they are found not to be effective.
• It may be more efficient and cost effective not to rely on controls at all as a source of assurance (but we need sufficient assurance from other sources).

• It is possible that, even though the controls are not as effective as we would like, and the risk of misstatement may be increased, it may still be at an acceptable level.

• If we do need to amend the plan, it is not simply a matter of increasing the number of items we test.
If we need to change the plan

As you can see from the diagram, there are two possibilities:

- Find an alternative source of assurance.
- Increase the extent of testing.

Alternative sources

Possibilities are:

- external confirmation
- analytical procedures
- management representations (be careful with this one – you cannot simply rely on what the client tells you, because your opinion has to be independent – but representations may add to the sum total of evidence).

Increasing the extent of testing

ISA 330 says:

- If the risk increases you would normally increase the extent of your audit procedures.

So, if controls are ineffective, increase your sample size.

BUT

- The evidence you gather must always be relevant to reducing the risk (simply looking at more incorrect invoices will not achieve anything).
- The increase in sample size may need to be substantial. (The original statistical studies – admittedly carried out when manual systems were the norm – indicated that sample sizes needed to be tripled to compensate for poor internal control.)

ISA 330 states:

‘Extent includes the quantity of a specific audit procedure to be performed, for example, a sample size or the number of observations of a control activity. The extent of an audit procedure is determined by the judgment of the auditor after considering the materiality, the assessed risk, and the degree of assurance the auditor plans to obtain.'
In particular, the auditor ordinarily increases the extent of audit procedures as the risk of material misstatement increases. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk; therefore, the nature of the audit procedure is the most important consideration.’

ISA 330 Para 18

8 The ‘nitty gritty’ of controls

Each major accounting system should have control objectives and control procedures. The auditor can then perform tests of control to ensure the controls are working.

- Control objectives – what objectives are the internal controls seeking to achieve
- Control procedures – the procedures that should be in place to ensure that the control objectives are achieved
- Tests of control – audit work performed to generate evidence as to whether the controls are operating

Sales cycle

Objectives of controls

The objectives of controls in the revenue cycle are to ensure that:

- sales are made to valid customers
- sales are recorded accurately
- all sales are recorded
- cash is collected within a reasonable period.

This is a summary of the sales cycle, showing the possible problems and the related controls:
The table shows the various stages of the revenue ‘cycle’, together with:

- the **risks** / (what could go wrong)
- **control procedures** (so that things **don’t** go wrong!).
<table>
<thead>
<tr>
<th>Stage</th>
<th>Risks</th>
<th>Control Objective</th>
<th>Control procedures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receive an Order</td>
<td>Orders may not be recorded accurately.</td>
<td>To ensure that order is raised accurately</td>
<td>Confirm order back to customer (or) get all orders in writing</td>
</tr>
<tr>
<td></td>
<td>Orders may be taken from customers that are unable to pay or unlikely to pay for a long time = financial loss</td>
<td>To ensure that the customer is creditworthy</td>
<td>All new customers subject to credit check</td>
</tr>
<tr>
<td></td>
<td>Orders cannot be fulfilled and therefore customer goodwill is lost (and possibly the customer)</td>
<td>To ensure that the order does not take customer over credit limit</td>
<td>Perform regular credit checks on existing customers</td>
</tr>
<tr>
<td>Goods are despatched to customer</td>
<td>Goods may not be despatched for orders made.</td>
<td>To ensure that all orders are sent to warehouse</td>
<td>Credit limit check before order is accepted</td>
</tr>
<tr>
<td></td>
<td>Incorrect goods may be sent to customers leading to loss of goodwill or goods may not be in stock.</td>
<td>To ensure that the right goods are in stock</td>
<td>Check stock system before issuing order</td>
</tr>
<tr>
<td></td>
<td></td>
<td>To ensure that the goods are sent to the right customer</td>
<td>Automatic re-ordering system linked to customer order system</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Use sequentially numbered customer order pads. Send a copy to the warehouse where they are filed numerically and sequence is checked to ensure that all are there (none missing)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Pick goods using a copy of the customer’s order.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Get the copy signed by the picker as correct.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>When GDN is raised check it matches with the customer order (staple together and file)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Get the customer to sign a copy of the GDN and return to the company</td>
</tr>
<tr>
<td>Systems and controls</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>----------------------</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Invoice is raised</strong></td>
<td>Use sequentially numbered GDNs, file a copy numerically and check that they are all there</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Invoices may be missed, incorrectly raised or sent to the wrong customer</td>
<td>Copy of sequentially numbered GDN sent to invoicing dept, stapled to copy of the invoice, checked all GDNs are there and having invoice to match</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To ensure invoice is raised for every delivery</td>
<td>On copy of the invoice sign as agreed to original order and GDN, signed as agreed to customer price list, signed as agreed it adds up properly</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To ensure that the invoice is raised for the correct amount</td>
<td>Review receivables ledger for credit balances (paid for goods but no debtor recorded)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Sale is recorded</strong></td>
<td>To ensure that all sales are recorded</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Invoiced sales may be inaccurately recorded, missed or recorded for the wrong customer</td>
<td>Perform a receivables ledger reconciliation (check info in individual ledger matches that in nominal)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To ensure that the sale is recorded at the correct amount</td>
<td>Computer controls</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To ensure that the sale is recorded in the right debtor’s ledger</td>
<td>Double check back to invoice</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Perform receivables ledger control account reconciliation</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Customer statements sent out (customers let you know if error)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash received</td>
<td>Incorrect amounts may be received</td>
<td>To ensure that the customer pays the correct amount</td>
<td>Agree cash receipt back to the invoice</td>
</tr>
<tr>
<td>--------------</td>
<td>---------------------------------</td>
<td>-----------------------------------------------</td>
<td>-----------------------------------</td>
</tr>
<tr>
<td>Customer may not pay for goods</td>
<td>Review receivables ledger for credit balances (customer overpaid)</td>
<td>Review aged debt listing and investigate (customer underpaid)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Review aged debt listing regularly, phone when overdue by 30 days, another letter at 45 days final letter threatening legal action at 60 days</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Refer receivable to solicitor</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Customer statements</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash recorded</td>
<td>Cash maybe incorrectly recorded or recorded against the wrong customer account</td>
<td>To ensure that all cash receipts are recorded</td>
<td>Perform a bank reconciliation</td>
</tr>
<tr>
<td></td>
<td>To ensure that cash is recorded at the correct amount</td>
<td></td>
<td>Customer statements</td>
</tr>
<tr>
<td></td>
<td>Regular banking/physical security over cash (i.e. a safe)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Reconciliation of banking to cash receipts records</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Segregation of duties</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To ensure all money received is banked promptly</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Notes**

- All documents should be pre-numbered in a sequence, so that completeness and validity are easy to verify.
- All documents should be cross-referenced, so that it is easy to trace from the original order through to the Accounts.
- The awarding of CREDIT is a particularly dangerous area, as the easiest way to hide stolen money is to give customers credit instead.
Common frauds

Money received is stolen by staff

- Stolen money is hidden by false entries to the Receivables Ledger.
- Receipt of money (whether by post, or by bank transfers) should be organised by different staff from those able to make entries to the Receivables Ledger.

In shops, money stolen by staff

- Cash, so more attractive/easy to steal.
- In McDonalds, staff have uniforms without pockets.
- Cash registers should need keys to open.
- These keys identify the member of staff.
- Cash registers require staff to enter PRODUCTS rather than amounts – to stop over charging (and then stealing the excess).
- Price lists should be easily accessible to customers, to avoid overcharging.
- Reconcile till record to cash therein.

Examples of ICQs and ICEs

As noted above, auditors need to establish what controls are in operation, document the system, and then test that controls are operating properly. We also saw that one method of documenting controls was to use some form of internal control questionnaire/checklist.

For sales, an Internal Control Questionnaire (ICQ) would be a checklist of questions to establish which controls were in operation, e.g.

ICQ – sales orders received

Q1. Are all new customers credit-checked before goods are sent on credit?

Q2. Are all sales orders received in writing on standard, pre-numbered forms?

If the auditor is using an Internal Control Evaluation (ICE), the layout would be slightly different:

ICEQ - SALES ORDER RECEIVED

Q1. Could the company send goods on credit to a customer who is unlikely to pay?

(important to auditors as it impacts on the need for a bad debt provision).
Answer – no, because of the following controls:

- all new customers are credit checked using an external reference agency
- customer is then given a credit limit, which is reassessed every three months.

**Examples of control tests:**

Tests of control should be designed to check that the control procedures are being applied and that objectives are being achieved. Tests may be appropriate under the following broad headings.

- Carry out sequence tests checks on invoices, credit notes, despatch notes and orders. Ensure that all items are included and that there are no omissions or duplications.
- Check the existence of evidence for authorisation in respect of:
  - acceptance of the order (the creditworthiness check) by reviewing the order file or doing a dummy order to see how it get’s processed
  - despatch of goods
  - raising of the invoice or credit note by reviewing the goods dispatch notes and ensuring the GDN has been attached to the customer order
  - pricing or discounts. Review the price list and follow the prices through the orders and check for authorisation if outside the list price or discount policy
  - write off of irrecoverable debts. Review the customer file for authorised bad debt write offs.

  Check both that the relevant signature exists and that the control has been applied.

- Seek evidence of checking of the arithmetical accuracy of:
  - invoices, including pricing and sales tax calculations
  - credit notes.

- This is often done by means of a “grid stamp” containing several signatures on the face of the document. Ensure that the control has been applied by checking the accuracy of such invoices and credit notes.
- Compare despatch notes and goods returned notes to ensure that they are matched with invoices and credit notes.
In all cases, test should be performed on a sample basis. Aspects of sampling are dealt with in chapter 9.

Test your understanding 1

Your firm is the auditor of Lenton Textiles and you have been asked to work on the sales system.

Lenton sells its goods to shops. Most sales are made on credit, but very small customers collect their purchases and pay in person. For these 'cash sales':

- The customer orders the items from the sales department, which inputs the order to the system and emails a copy of the order to the despatch department.
- The despatch department make up the order and give it to the customer with a copy of the order.
- The customer gives the order to the cashier, who prints out the sales invoice.
- The customer pays by cheque, credit card or cash.
- The cashier records and banks the cash.

For credit sales, cheques and cash are received by post. The post is opened by two people, who record cash and cheques received. The cheques and cash are given to the cashier who records them in the cash book and pays them into the bank. The cashier reports the cheques and cash received to the sales accounting department, which posts them to the sales ledger.

Credit notes must be authorised before being sent to customers and posted to the sales ledger.

(a) **What controls would you expect to be built into the 'cash sales' system, to ensure there are minimal weaknesses in it?**

(b) **Explain why it might be necessary for two people to open the post containing cash and cheques and what other controls could be implemented to make it unnecessary.**

(c) **List the reasons why credit notes may be issued and describe the audit work you would perform to ensure that all credit notes have been authorised for a valid reason.**
**Purchases cycle**

**Objectives of controls**

The objectives of controls in the purchases cycle are to ensure that:

- purchases are only made when there is a genuine need
- value for money is achieved
- goods/services delivered are what was ordered
- quality of goods/services delivered is satisfactory
- liabilities are recorded completely and accurately
- only valid liabilities are paid
- liabilities are paid in a sensible, commercial timescale.

This is a summary of the purchases cycle, showing the possible problems and the related controls:
The table shows the various stages of the purchases ‘cycle’, together with:

- the **risks** (what could go wrong)
- the **control procedures** (so that things *don’t* go wrong!).

<table>
<thead>
<tr>
<th>Stage</th>
<th>Risks</th>
<th>Control objective</th>
<th>Control procedures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Requisition raised</td>
<td>Unauthorised purchases may be made (i.e. for own personal use/fake suppliers entered onto payables ledger)</td>
<td>To ensure that requisition is for a valid business reason</td>
<td>All requisitions authorised by department manager</td>
</tr>
<tr>
<td></td>
<td></td>
<td>To ensure that it is cost effective</td>
<td>Central purchasing dept</td>
</tr>
<tr>
<td></td>
<td></td>
<td>To ensure items are actually needed</td>
<td>Preferred suppliers/agreed price lists/terms</td>
</tr>
<tr>
<td></td>
<td></td>
<td>To ensure items are actually recorded by supplier</td>
<td>Check stock levels first</td>
</tr>
<tr>
<td>Order is placed</td>
<td>Invalid or incorrect orders made or recorded</td>
<td>To ensure that order is raised for all requisitions</td>
<td>Have sequentially numbered requisition pads, copies filed numerically with copy of order stapled to it. Periodically check that all are there</td>
</tr>
<tr>
<td></td>
<td>The most favourable terms not obtained</td>
<td>To ensure orders are accurately recorded by supplier</td>
<td>Ask them to repeat the order back to you (on the phone)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>To ensure items are correctly costed</td>
<td>(or) send/confirm all orders in writing</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Check quoted price against supplier price list (discounts to contract)</td>
</tr>
<tr>
<td>Goods received</td>
<td>Goods may be misappropriated for own use or not received at all</td>
<td>To ensure goods received for all orders</td>
<td>Have one delivery area kept secure</td>
</tr>
<tr>
<td>----------------</td>
<td>---------------------------------------------------------------</td>
<td>---------------------------------------</td>
<td>-----------------------------------</td>
</tr>
<tr>
<td></td>
<td>Goods may be accepted that have not been ordered/wrong quantity/inferior quality</td>
<td>To ensure that the goods received are as ordered + correct quality</td>
<td>Stock records updated on a timely basis</td>
</tr>
<tr>
<td>Invoice received</td>
<td>Invoices may not be recorded resulting in non-payment and loss of supplier goodwill</td>
<td>To ensure that an invoice is received for all goods received</td>
<td>Copy of Purchase order sent to warehouse, sequentially numbered, filed, matched to GRN stapled, checked all there</td>
</tr>
<tr>
<td></td>
<td>Invoices may be logged for goods not received</td>
<td>To ensure that do not get invoices for things we have not received, and valid business purchases</td>
<td>Raise GRN and grid stamp it, signed as goods checked to PO and checked for quality</td>
</tr>
<tr>
<td></td>
<td>Invoices may contain errors</td>
<td>To ensure invoices are for right items, right price adds up</td>
<td>Copy of sequentially numbered GDNs sent to invoicing department, filed and matched to copy of invoice (stapled), checked to see if all there.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>As above - if no GRN ask supplier for proof of delivery + match to PO (authorised as mentioned above)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Grid stamp invoice signed as checked items to PO, GRN, agree price to supplier's price list</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Check invoice calculations</td>
</tr>
</tbody>
</table>
### Examples of ICQs and ICEs

For purchases, an Internal Control Questionnaire (ICQ) would be a checklist of questions to establish which controls were in operation, e.g.

<table>
<thead>
<tr>
<th>Purchase recorded</th>
<th>Some purchases may be missed or recorded incorrectly leading to loss of supplier goodwill</th>
</tr>
</thead>
<tbody>
<tr>
<td>To ensure that all purchases are recorded</td>
<td></td>
</tr>
<tr>
<td>To ensure that all invoices are recorded at the correct amount</td>
<td></td>
</tr>
<tr>
<td>To ensure recorded in right supplier ledger</td>
<td></td>
</tr>
<tr>
<td>Batch controls on input</td>
<td></td>
</tr>
<tr>
<td>Stamp the invoice to indicate recorded, check all filed invoices are stamped</td>
<td></td>
</tr>
<tr>
<td>Suppliers send in monthly statements, reconcile these to suppliers ledger account (may need to consider cash/goods in transit)</td>
<td></td>
</tr>
<tr>
<td>Grid stamp - signed</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash paid</th>
<th>Invoices may not be paid/the incorrect amount paid or may be paid twice</th>
</tr>
</thead>
<tbody>
<tr>
<td>To ensure all invoices paid (and only once)</td>
<td></td>
</tr>
<tr>
<td>To ensure paid correct amount</td>
<td></td>
</tr>
<tr>
<td>To ensure valid business expense</td>
<td></td>
</tr>
<tr>
<td>Batch controls on input</td>
<td></td>
</tr>
<tr>
<td>Stamp invoices when paid check all invoices stamped</td>
<td></td>
</tr>
<tr>
<td>Keep paid invoices separately from unpaid ones</td>
<td></td>
</tr>
<tr>
<td>Cheque signatory to check to invoice when signing cheque/authorising BACS</td>
<td></td>
</tr>
<tr>
<td>Have relevant bank authorised signatories (level £)</td>
<td></td>
</tr>
<tr>
<td>Get invoices signed as authorised by relevant manager</td>
<td></td>
</tr>
</tbody>
</table>

**Notes**

- All documents should be pre-numbered in a sequence, so that completeness and validity are easy to verify.
- All documents should be cross-referenced, so that it is easy to trace from the original order through to the Accounts.
- Quality is checked as goods arrive, and any problems fed back to suppliers.
ICQ – purchase orders placed

(1) Are all orders made from suppliers who have been checked for quality and price (preferred suppliers)?

(2) Are all purchase orders made in writing on standard, pre-numbered forms?

If the auditor is using an Internal Control Evaluation (ICE), the layout would be slightly different.

ICEQ – purchase order received

(1) Could the company buy poor quality goods?

(important to auditors as it impacts on stock valuation, and possibly on the need for a provision for warranty costs)

Answer – no, because of the following controls:

• all new suppliers are asked for samples before any agreement to purchase is made
• all new supply needs re put out to tender before a supplier is chosen
• quality is checked as goods arrive, and any problems fed back to suppliers

Examples of control tests

As already noted, tests of control should be designed to check that the control procedures are being applied and that objectives are being achieved. One suggested way to design tests of control for a particular situation is to list the documents in a transaction cycle and generate appropriate tests of control for each document. This approach is illustrated here in connection with the purchases cycle – note that a similar technique could be applied to other transaction cycles.

<table>
<thead>
<tr>
<th>Document</th>
<th>Actual tests that can be done:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase order</td>
<td>• Evidence of a sequence check.</td>
</tr>
<tr>
<td></td>
<td>• Evidence of approval.</td>
</tr>
<tr>
<td></td>
<td>• Adherence to authority limit.</td>
</tr>
<tr>
<td>Goods received note</td>
<td>• Evidence of a sequence check.</td>
</tr>
<tr>
<td>Goods returned note</td>
<td>• Evidence of a sequence check.</td>
</tr>
</tbody>
</table>
### Systems and controls

| Purchase invoice | • Serial numbering.  
|                 | • Evidence of a sequence check.  
|                 | • Evidence of matching purchase invoices with goods received notes and purchase orders.  
|                 | • Evidence of checking casts, extensions and tax treatment.  
|                 | • Evidence of account coding.  
|                 | • Initialling of invoice grid for work done.  
|                 | • Approval of purchase invoice for further processing.  
| Credit note     | • Evidence of matching credit notes to goods returned notes.  
| Payables ledger | • Evidence of authorisation of adjustments to payables ledger.  
| Payables ledger control account | • Evidence of review of reconciliation of purchase ledger listing.  
|                 | • Evidence of authorisation of adjustments to payables ledger control account.  

**Test your understanding 2**

You are carrying out the audit of the purchases system of Spondon Furniture. The company has a turnover of about $10 million and all the shares are owned by Mr and Mrs Fisher, who are non-executive directors and are not involved in the day-to-day running of the company.

The bookkeeper maintains all the accounting records and prepares the annual financial statements.

The company uses a standard computerised accounting package.

You have determined that the purchases system operates as follows:

- When materials are required for production, the production manager sends a handwritten note to the buying manager. For orders of other items, the department manager or managing director sends handwritten notes to the buying manager. The buying manager finds a suitable supplier and raises a purchase order. The purchase order is signed by the managing director. Purchase orders are not issued for all goods and services received by the company.

- Materials for production are received by the goods received department, who issue a goods received note (GRN), and send a copy to the bookkeeper. There is no system for recording receipt of other goods and services.
Mr and Mrs Fisher are aware that there may be weaknesses in the above system and have asked for advice.

**Identify the weaknesses in controls in Spondon’s purchases system and suggest improvements.**

### Payroll

**Objectives of controls**

The objectives of controls for the payroll cycle are to ensure that the company will:

- pay the right people
- at the right rate
- for valid work done.

And

- deal correctly with taxes and other deductions.
This is a summary of the payrolls cycle, showing the possible problems and the related controls:

1. **Stage**: Clock cards/timesheets submitted
   - **Risks**: Cards may be missed, bogus employees paid or employees paid for hours not worked
   - **Control objectives**: To ensure all cards received, To ensure that no bogus clock cards submitted, To ensure the hours noted have actually been worked
   - **Control procedures**: Check number of cards to number of employees, Keep all spare cards locked in cupboard, Get departmental managers to sign clock cards as authorised hours (and especially any overtime)

The table shows the various stages of the payroll 'cycle', together with:

- The **risks** (what could go wrong).
- **Control procedures** (so that things **don't** go wrong!).

<table>
<thead>
<tr>
<th>Stage</th>
<th>Risks</th>
<th>Control objectives</th>
<th>Control procedures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Clock cards/timesheets submitted</td>
<td>Cards may be missed, bogus employees paid or employees paid for hours not worked</td>
<td>To ensure all cards received, To ensure that no bogus clock cards submitted, To ensure the hours noted have actually been worked</td>
<td>Check number of cards to number of employees, Keep all spare cards locked in cupboard, Get departmental managers to sign clock cards as authorised hours (and especially any overtime)</td>
</tr>
<tr>
<td>Clock cards input into computer</td>
<td>Cards may not be recorded accurately</td>
<td>To ensure all clock cards entered</td>
<td>Batch total or hash total checks</td>
</tr>
<tr>
<td>---------------------------------</td>
<td>-------------------------------------</td>
<td>----------------------------------</td>
<td>----------------------------------</td>
</tr>
<tr>
<td></td>
<td></td>
<td>To ensure details input correctly</td>
<td>Range checks inputter signs clock card to say double checked details to screen</td>
</tr>
<tr>
<td></td>
<td></td>
<td>To ensure inputter doesn't input data twice/input bogus employees</td>
<td>Programme only allows input for each person once, can only input for employees held within standing data</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Hierarchical password control to payroll system</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Different person should be responsible for updating standing data, to those responsible for the monthly processing (segregation of duties)</td>
</tr>
<tr>
<td>Standing data input</td>
<td>Standing data could be compromised. Unprocessed updates may mean employees who have left are paid or joiners are missed</td>
<td>To ensure leavers are not paid after they have left/joiners are paid when they start</td>
<td>Managers should complete a leavers/joiners form noting date of departure/arrival and send promptly to Payroll dept</td>
</tr>
<tr>
<td></td>
<td>To ensure standing data input is accurate</td>
<td></td>
<td>Standing data files regularly printed out and sent to department managers for them to sign and return confirming all staff there</td>
</tr>
</tbody>
</table>
### Systems and controls

<table>
<thead>
<tr>
<th>Processing of data</th>
<th>Inaccurate processing of data could lead to wages and taxes being incorrectly calculated</th>
<th>To ensure correct wage is calculated</th>
<th>Sample of wages recalculated manually, print out signed as checked</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>To ensure correct tax is calculated</td>
<td></td>
<td>Exception report produced automatically for anyone paid over £xxx, or paid under £xxx</td>
</tr>
<tr>
<td></td>
<td>Sample of deductions (PAYE, NIC) recalculated manually print out signed as checked</td>
<td></td>
<td>Sample of deductions (PAYE, NIC) recalculated manually print out signed as checked</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Recording of payroll</th>
<th>Recorded payroll may not match actual payroll</th>
<th>To ensure correct wages, NIC, PAYE recorded</th>
<th>Nominal ledger clerk signs payroll print out to confirm entries double-checked to print</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Senior management review wages expenses for reasonableness</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Staff paid</th>
<th>Staff may not be paid</th>
<th>To ensure all staff are paid (employees will complain if not!!)</th>
<th>Have two people present where cash wages are paid. (See controls above over standing data)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Bogus staff could be paid</td>
<td>To ensure no bogus employees are paid</td>
<td>Responsible individual should review any BACS payroll summary prior to paying staff - sign to confirm reviewed</td>
</tr>
</tbody>
</table>

### Notes

- All documents should be pre-numbered in a sequence, so that completeness and validity are easy to verify.
- All documents should be cross-referenced.
The adjustments stage is crucial, as it is here that fake employees or pay rises may get into the system.

Examples of ICQs and ICEs

For payroll, an Internal Control Questionnaire (ICQ) would be a checklist of questions to establish which controls were in operation, e.g.

ICQ – leavers

Q1  Are all leavers required to provide a resignation letter (or fill in a leavers form) that is dated and signed?

Q2  Is the monthly pay list reviewed by department heads to ensure that leavers are removed?

Q3  Do personnel regularly reconcile the number of employees on the payroll to the number of ‘open’ employee files?

If the auditor is using an Internal Control Evaluation (ICE), the layout would be slightly different:

ICEQ – leavers

Q1  Could the company pay employees who have left? (important to auditors as it may indicate fraud)

Answer – no, because of the following controls:

•  leavers provide a resignation letter, which is dated and signed
•  department heads review pay list to ensure all leavers have been removed
•  personnel regularly reconcile number of employees on payroll to number of current employee files.

Examples of control tests

A suggested programme of tests of control is set out below. This would, of course, be modified to suit the particular circumstances of the client.

•  Test a sample of timesheets, clock cards or other records, for approval by a responsible official. Pay particular attention to the approval of overtime there relevant.
•  Test authority for payment of casual labour, particularly if in cash.
•  Observe wages distribution for adherence to procedures ensuring employees sign for wages, that unclaimed wages are rebanked, etc.
• Test authorisation for payroll amendments by reference to personnel records.
• Test controls over payroll amendments by reviewing changes and seeing whether they have been authorised. You could print off an exception report highlighting changes and follow those through. You could also do a dummy transaction to see how the system handles change.
• Examine evidence of checking of payroll calculations (e.g. a signature of the financial controller).
• Examine evidence of approval of payrolls by a responsible official.
• Examine evidence of independent checks of payrolls (e.g. by internal audit).
• Inspect payroll reconciliations done regularly, clearing wage control account, tying the PAYE liability up to the Inland Revenue records. Review the client working papers or observe the reconciliation process happening.
• Examine explanations for payroll expense variances.
• Test authorisation for payroll deductions by reviewing the employees records, looking at who is authorised to place through amendments, and observe the process.
• Test controls over unclaimed wages. You could do a dummy transaction to see how the system works, what happens to the wages unclaimed, are they place in a safe, if so tick the clients working to the amount in the safe.

Test your understanding 3

Bassoon Ltd runs a chain of shops selling electrical goods all of which are located within the same country.

It has a head office that deals with purchasing, distribution and administration. The payroll for the whole company is administered at head office.

There are 20 staff at head office and 200 staff in the company’s 20 shops located in high streets and shopping malls all over the country.

Head office staff (including directors) are all salaried and paid by direct transfer to their bank accounts.

The majority of the staff at the company’s shops are also paid through the central salary system, monthly in arrears. However, some students and part time staff are paid cash out of the till.
Recruitment of head office staff is initiated by the department needing the staff who generally conduct interviews and agree terms and conditions of employment. Bassoon has an HR manager who liaises with recruitment agencies, places job adverts and maintains staff files with contracts of employment, etc.

Shop managers recruit their own staff.

Shop staff receive a basic salary based on the hours worked and commission based on sales made.

The company has a fairly sophisticated EPOS till system at all shops that communicates directly with the head office accounting system.

All staff when making a sale have to log on with a swipe card which identifies them to the system, and means that the sales for which they are responsible are analysed by the system and commissions calculated.

Store managers have a few ‘guest cards’ for temporary and part time staff, who generally do not receive commissions.

Store managers and regional supervisors are paid commissions based on the performance of their store or region. Directors and other head office staff usually receive a bonus at Christmas, depending on the company’s performance. This is decided on by the board in consultation with departmental manages and put through the system by the payroll manager.

The payroll manager is responsible for adding joiners to the payroll and deleting leavers as well as for implementing changes in pay rates, tax coding and other deductions and for making sure that the list of monthly transfers is communicated to the bank.

The computerised payroll system is a standard proprietary system which is sophisticated enough to incorporate the commission calculations mentioned above which are fed in directly from the EPOS system.

The company employs an IT manager who is responsible for the maintenance of all IT systems and installing new hardware and software.

Comment on the strengths and weaknesses of the payroll system at Bassoon Ltd and recommend any changes which you think are appropriate.
Inventory

Objectives of controls

The objectives of controls in the inventory cycle are to ensure that:

- inventory levels are in keeping with the needs of:
  - production (raw materials and bought in components)
  - customer demand (finished goods)
- inventory levels are not:
  - excessive
  - too low (‘stockouts’).
- value for money is achieved
- goods/services delivered are what was ordered
- quality of goods/services delivered is satisfactory
- liabilities are recorded completely and accurately
- only valid liabilities are paid
- liabilities are paid in a sensible, commercial timescale.

The table shows the various stages of the inventory ‘cycle’, together with:

- the risks (what could go wrong)
- control procedures (so that things don’t go wrong!).

<table>
<thead>
<tr>
<th>Process</th>
<th>Risks</th>
<th>Possible control procedures</th>
</tr>
</thead>
</table>
| Inventory arrives because it has been purchased, or a sale has been returned | • Inventory stolen on arrival.  
• New purchases mixed up with returns.  
• Poor quality inventory accepted.  
• Inventory accepted that was never ordered.  
• No record is made of its arrival. | • All goods inward received at set locations and signed for/logged in by stores manager.  
• All returns sent to a returns department for checking.  
• See purchase cycle. |
| Inventory is stored until it is needed | • Poor storage conditions lead to damaged inventory. |
| | • Inventory items not used before their useful life ends. |
| | • Inventory stolen from storage areas. |
| Raw materials leave stores, to be used in production | • Materials over-ordered to enable theft. |
| Finished goods leave because they have been sold | • Wrong goods sent. |
| | • Goods being stolen (no real sale). |
| | • Poor quality sent. |
| | • Records not updated. |
| Goods leave because they are being returned to suppliers | • Returned goods actually being stolen. |
| | • Storage areas fitted with sprinklers, fire alarms, temperature monitors. |
| | • Inventory ‘rotated’ to ensure FIFO usage where relevant. |
| | • Valuable inventories locked away and inventory areas limited to a single exit (security guard?). |
| | • All requisitions from stores to have signed authorisation from production manager. |
| | • Use of standard quantity requirements. |
| | • See sales cycle. |
| | • See purchase returns. |
An inventory count is performed (may be annual, or more regular)

- Counting lacks accuracy.
- Staff lie about amounts counted to cover up their theft.
- Inventory records lost during count.
- Inventory wrongly counted because it is moved during count.
- All counted areas to be marked as completed.
- Managers to check by doing random second counts.
- Staff do not count areas that they are usually responsible for.
- Counting done in pairs.
- Inventory sheets sequenced and counters sign out (and in) the count sheets.
- All inventory movements during count authorised by management.
- Closure during inventory accounts to avoid problems.

**Notes**

- All documents should be pre-numbered in a sequence, so that completeness and validity are easy to verify.
- All documents should be cross-referenced.

**Examples of ICQs and ICES**

For inventory, an Internal Control Questionnaire (ICQ) would be a checklist of questions to establish which controls were in operation, e.g.

**ICQ – INVENTORY MOVEMENTS**

**Q1**  Are Goods Received Notes (GRNs) prepared for all goods inward?

**Q2**  Are all requisitions from stores authorised by the production manager?
If the auditor is using an Internal Control Evaluation (ICE), the layout would be slightly different:

**ICEQ – inventory movements**

**Q1** Could inventory arrive but not be recorded? (important to auditors as it may indicate inventory is understated)

Answer – no, because of the following controls:

- inventory arrives at a single goods in point
- inventory manager keeps sequenced GRNs
- inventory records are sequence-checked monthly to ensure complete entry of GRNs.

**Examples of control tests**

- Observe physical security of inventories and environment in which they are held.
- Test procedures for recording of inventory movements in and out of inventory.
- Test authorisation for adjustments to inventory records.
- Test authorisation for write off or scrapping of inventories.
- Test controls over recording of movements of inventory belonging to third parties.
- Test procedures for authorisation for inventory movements i.e. the use made of authorised goods received and despatch notes.
- Inspect reconciliations of inventory counts to inventory records (this gives overall comfort on the adequacy of controls over the recording of inventory).
- Check sequences of despatch and goods received notes for completeness.
- Assess adequacy of inventory counting procedures and attend the count to ensure that procedures are complied with.

**Capital and revenue expenditure**

This area looks at expenditure on items other than purchases. However, the controls are virtually identical to controls over purchases as seen above.
Some controls may vary, such as:

- Capital expenditure is often for substantial amounts. As such, most companies would require such items to be included in an annual budget and authorised by very senior level management.
- Regular revenue expense items may be monitored by simple variance analysis (i.e. actual versus budget) on a monthly basis.
- Capital items are likely to be stored on an asset register, which records details of supplier, price, insurance details, current location, responsible employee, etc.
- Just as inventories are counted, assets are likely to be checked against the register on a regular basis.
- When assets are sold second-hand, the items will be checked against similar items or price guides to ensure the company receives fair value.
- Ownership documents (title deeds, vehicle registration documents) will be safely stored.

**Bank and cash**

**Objectives of controls**

The objectives of controls over bank and cash are to ensure that:

- cash balances are safeguarded
- cash balances are kept to a minimum
- money can only be extracted from bank accounts for authorised purposes.
### Possible controls

<table>
<thead>
<tr>
<th>Objective</th>
<th>Possible control procedures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash balances are kept to a minimum.</td>
<td>Tills emptied regularly. Frequent bankings of cash and cheques received.</td>
</tr>
<tr>
<td>Money can only be extracted from bank accounts for authorised purposes.</td>
<td>Restricted list of cheque signatories. Dual signatures for large amounts. Similar controls over bank transfers and online banking, e.g. secure passwords and pin numbers. Cheque books and cheque stationery locked away. Regular bank reconciliations reviewed by person with suitable level of authority.</td>
</tr>
</tbody>
</table>

### Examples of control tests

Cash receipts:

- attend mail opening and ensure procedures are adhered to
- test independent check of cash receipts to bank lodgements
• test for evidence of a sequence check on any pre-numbered receipts for cash
• test authorisation of cash receipts
• test for evidence of arithmetical check on cash received records.

Cash payments:

• inspect current cheque books for:
  – sequential use of cheques
  – controlled custody of unused cheques
  – any signatures on blank cheques
• test (to avoid double payment) to ensure that paid invoices are marked “paid”
• test for evidence of arithmetical checks on cash payments records, including cashbook
• examine evidence of authority for current standing orders and direct debits.

Bank reconciliations:

• examine evidence of regular bank reconciliations, at least once per month, but in larger organisations this should be done daily or weekly
• examine evidence of independent checks of bank reconciliations (e.g. a signature)
• examine evidence of follow up of outstanding items on the bank reconciliation. Pay particular attention to old outstanding reconciling items that should be written back such as old, unpresented cheques.

Petty cash:

• Test petty cash vouchers for appropriate authorisation.
• Test cancellation of paid petty cash vouchers.
• Test for evidence of arithmetical checks on petty cash records.
• Test for evidence of independent checks on the petty cash balance.
• Perform a surprise petty cash count and reconcile to petty cash records.
9 Reporting to those charged with governance

Auditors should communicate material weaknesses in internal control in writing to ‘those charged with governance’ – the audit committee (if one exists) or management in general.

The form, timing and addressees of this communication should be agreed at the start of the audit, as part of the terms of the engagement.

This report has traditionally been known as a management letter or report to management and is usually sent at the end of the audit process.

Recent revision of audit standards has added other matters that should be communicated.

• For listed companies, a report on audit independence.
• A report at the planning stage, identifying key audit risks and the work to be performed.
• At the end of the audit, a report covering:
  – expected audit report
  – unadjusted errors and misstatements
  – comments on accounting practices and policies in use by the company any
  – other relevant matters.

However, this section of the Notes will concentrate on internal control issues.

Reporting on controls

Where the auditor is reporting weaknesses, it should be made clear that:

• the report is not a comprehensive list of weaknesses, but only those that have come to light during normal audit procedures
• the report is for the sole use of the company
• no disclosure should be made to a third party the without written agreement of the auditor
• no responsibility is assumed to any other parties.
The usual structure of the report is:

- covering letter (which will include the above list of points)
- appendix, noting the weaknesses, consequences, and recommendations (often with a space left for management to respond with their planned action).

**In the exam, an internal control question may require you to analyse controls and report weaknesses in the form of a management letter. If so, it is the appendix (see below) that you need to produce. A covering letter would be specifically requested by your examiner.**

The best structure is:

**Weakness**

Clear description of what is wrong.

**Consequence**

What could happen if the weakness is not corrected. Focus on what matters to the client – the risk of lost profits, stolen assets, extra costs, errors in the accounts.

**Recommendation**

This must deal with the specific weakness you have observed! It must also provide greater benefits than the cost of implementation.

Try to suggest who should carry out the control procedures, and when.

**Illustration**

<table>
<thead>
<tr>
<th>Weakness</th>
<th>Consequence</th>
<th>Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td>There appear to be purchase invoices missing from the sequentially numbered invoice file.</td>
<td>There is a possibility that purchases and liabilities are not completely recorded. Also, it would be difficult to provide proof of purchase where the invoice is missing. This may make it difficult to obtain refunds for faulty goods, leading to increased costs.</td>
<td>All invoices should be sequentially filed on receipt by the Accounts Department. Regular checks should be made to ensure a complete record, with any missing items investigated (and copies requested if necessary). As such, the accounts could be incomplete and items may have been purchased without control over quality, price, etc.</td>
</tr>
</tbody>
</table>
10 Chapter summary

Components
- Control environment
- Risk assessment
- Information system
- Control activity
- Monitoring

Control activities
- Authorisation
- Performance reviews
- Information processing
- Physical controls
- Segregation of duties

How controls operate
- Revenue
- Purchases
- Payrolls
- Inventory
- Cash & Bank
- IT/Manual

Testing controls

Reporting weaknesses
(a) ‘Cash sales’

All orders must be input to the system, so it should not be possible for customers to collect goods without their order being processed and held on the system.

Sales invoices produced by the system should be sequentially numbered and should derive from the order already input to the system. Otherwise it may be possible for the cashier to take payments in actual cash – notes and coin – and fail to issue an invoice. A check on unfulfilled orders would probably reveal this, unless the cashier is able to delete them from the system. The review should therefore be carried out by someone with sufficient authority, independent of the cashier, who would be able to delete orders which have genuinely never been fulfilled. Payments by cheque and credit card are probably less risky than those in actual cash, and the business might consider eliminating actual cash sales altogether unless they represent a substantial source of revenue.

Customers appear to be able to walk out without paying. Goods should either be released only once they have been paid for or there should be an electronic tagging system as seen in most clothes shops, with detectors at the exits.

Prices should be held on the system rather than being input by the cashier to reduce the possibility of errors or the cashier giving unofficial preferential prices to favoured customers.

Any takings in actual cash should be banked in tact, probably subject to there being a fixed cash float in the till. Bankings should take place sufficiently frequently to avoid unnecessarily large amounts being held on site and the system should be able to summarise the cash takings so that it is possible to reconcile the amounts banked to cash sales made. These reconciliations should be reviewed periodically by someone with sufficient authority who does not also handle the cash – the chief accountant or someone of similar standing.

(b) Mail

It is preferable for two people to open the mail because the process involves both the recording of a transaction, and custody of an asset. An individual would be able to pocket money and not record its arrival. Alternatively, they could carry out a teeming and lading fraud by lying about who had sent the money.
The benefit of using two staff members may be lost if they collude with each other, so mail-opening duties should ideally be rotated on a regular basis.

However, it is more sensible to discourage payment by actual cash altogether. Payment by cheque is better, but payment by credit card or direct transfer from the customer’s bank are better still because the transfer of funds becomes a pure bank to bank transaction and employees therefore have no opportunity to access cash.

If cheques are received in the post, there is a theoretical possibility that someone could alter the payee, or pay it into a bank account with a similar name set up for the purpose. As the risk of this happening is lower than the risk that actual cash may be stolen, it would probably be sufficient to make sure that the posting of receipts to the receivables account is done by someone other than the person responsible for opening the post and that overdue receivables are reviewed regularly by someone with suitable authority.

Segregation of duties between those opening the post and updating the receivables account should also reduce the risk of a teeming and lading fraud because the person opening the mail would not have the intimate knowledge of the receivables ledger to make the fraud work. There is still the theoretical possibility that such a fraud could be disguised by the person opening the post by misrecording the name of the customer making the payment.

There are circumstances when double staffing is vital – for example at charities either opening the post or opening collecting tins etc, because there can be no other controls over the amounts received.

(c) Credit notes

Main reasons for them being issued are:

- company was not able to fulfil the entire order
- mistakes on the invoice leading to overcharging
- faulty goods
- failure to give relevant discounts.

The main audit work to verify credit notes would be:

- select a sample of credit notes and agree amounts back to original invoice
- if goods were returned, look for evidence of a returns note, and checks having been done on the product.
- inspect credit note for evidence of authorisation by a senior official (i.e. a signature)
- review correspondence with the customer to check reason for credit
- if credit is due to pricing errors, check correct prices to price lists (or the order)
- check the credit note sequence to ensure it is complete, and free from additional unsequenced items.

---

**Test your understanding 2**

**Authorisation of expenditure**

The principle is that:

- goods and services should only be ordered if there is a genuine need and that prices paid should represent value for money for the company
- there needs to be a satisfactory balance between price and quality, and stock levels should be maintained at a suitable level to avoid both excessive holdings of stock and shortages which would prevent customer orders from being fulfilled
- the current system, whereby informal handwritten notes are used to initiate orders, makes it difficult to check on outstanding orders and may lead to errors.

Therefore:

- the ordering of production materials should be initiated by the production department after checks on stock levels
- orders should be authorised by someone with a suitable level of authority in the production department, probably the production manager
- there should either be a system of formal purchase requisitions duly authorised, numbered sequentially with a copy kept by the production department to enable outstanding orders to be followed up. (This could be a standardised paper form, or more likely a computerised record)
- as an alternative, particularly for small businesses, the requisition process may be quite informal, although stock checks are still necessary, but the purchase order to the supplier issued by the buying department should be authorised by the production manager
- a similar system of requisitions would also be appropriate for other departments, including the managing director’s own.
the buying department should issue formal purchase orders in all cases. Even if the order is placed by telephone or email, there should still be a formal record maintained by the buying department so that outstanding orders can be chased and details of the date of the order, quantities, prices, etc kept in case there is a dispute.

there should be a mechanism for ensuring the company receives value for money. This may consist of a tendering process for large contracts or a list of authorised suppliers for smaller, and more regular purchases. The performance of individual buyers needs to be appraised from time to time.

it is unlikely to be effective or economic for the managing director to authorise all purchases. He is unlikely to have the detailed knowledge necessary for this to be meaningful. What he should do is to review departments’ spending against budgets, and to review the margins achieved by the production department and other reports such as customer complaints, quality assurance reports, rejection reports, etc.

**Goods received notes (GRN)**

When goods arrive:

- ideally, their quantity and quality should be checked to the GRN before they are signed for. However, this is not always practical, but such checks should be carried out as soon as possible after the goods are received.
- the GRNs should be sequentially numbered, and signed by the stores manager.
- the GRN should be checked to the order.

**Authorisation and payment of invoices**

Currently this is dealt with by the bookkeeper and the managing director. This might enable the bookkeeper to pass fraudulent invoices through the system, because, as with the ordering system, it is unlikely that the authorisation of invoices by the managing director for both posting and payment represents a valid control.

Invoices should be authorised by the managers of the department initiating the purchase – usually by signing the invoice.

The authorised invoices scheduled for payment should be reviewed, together with the GRN and order or other supporting documentation, when the managing director signs the cheques.
The bookkeeper's role

If the bookkeeper is competent, experienced and well trained, he or she will be expected to post invoices to the correct accounts. It would appear that the bookkeeper is supervised by the managing director, who therefore needs sufficient knowledge of accounting to be able to interpret management accounts effectively.

If:

- the bookkeeper is not competent, experienced and well trained
- the managing director does not have the ability to interpret management accounts
- management accounts are not produced at regular and sufficiently frequent intervals

there is a recipe for chaos in the production of financial statements, even though the measures suggested above improve controls over purchases and payments.

If the managing director does not have the necessary accounting knowledge to be able to supervise the bookkeeper, it might be sensible to consider employing a suitably qualified financial controller, chief accountant or even finance director.

In any event, the company has no back-up during the absence or incapacity of the bookkeeper.

Posting to ledgers

The accounting package used should incorporate checks to ensure that:

- invoices input are arithmetically correct
- purchase ledger control account is maintained.

Once there are orders and GRNs for all items, invoices should always be checked to a signed GRN and order, confirming that the items were received, and that prices and terms are correct.

The account code analysis should be done before the managing director approves the invoice for posting.
Mr and Mrs Fisher

Whilst they are not (and presumably cannot be) involved in the day-to-day running of the company, they should review purchases against budgets on a regular basis (e.g. at monthly board meetings). It may be wise for them to approve very large items, or new suppliers for the most important areas.

Test your understanding 3

The principle

The objective is to ensure:

- the right amounts are paid to
- the right people for
- work carried out on the company’s business and
- payroll taxes and other deductions are accounted for properly.

Joiners and leavers

There appears to be very little control over the appointment of head office staff. For a company of this size new posts and filling vacancies would normally be approved at board level, as would pay rates, holiday entitlement and other terms and conditions of employment. It is usually sensible to standardise pay rates and terms of employment and for this to be supervised by the HR manager.

It is to be expected that shop staff will be appointed by shop managers, although they may receive support/ supervision from their regional managers and the HR manager. Again, the use of standardised employment contracts is advisable, and for those paid by the main system, they simply will not get paid unless details are communicated to head office.

There are control problems with the casual staff who are paid cash from the till.

- in most countries payroll tax rules mean that employers have to register all employees on their system; for example, in the UK a record has to be kept of the employee’s name, address and National Insurance number for all employees unless they are paid a really trivial amount (less than £5 a week), and all are theoretically subject to the deduction of tax and national insurance contributions
• if there are minimum wage requirements there may be no check on whether they are being infringed
• if the shop manager or other staff were to steal from the till it could simply be explained away as 'casual wages'.

As the company seems to have a relatively sophisticated payroll system, it would make sense to apply it to all employees, 'casuals' as well as 'regulars'.

There appears to be no system for notifying head office when someone leaves. Arguably store managers would not like to be charged with the costs of ex-employees as it would affect their commissions, but there should be a routine for this. It should also be possible for the system to report if an employee fails to use their swipe card within a given period.

**Hours worked**

It is not clear how the hours worked by shop employees are recorded. If they are contracted to work for a fixed period, their standard pay rate can reflect this, but if the number of hours they work is flexible, recording the hours worked may be a problem.

This could be overcome by the use of timesheets or similar returns made to head office on a weekly basis – but these would need to be input into the payroll system by the payroll manager as it is unlikely that employees in a busy shop would be able to take the time to submit the information digitally. An alternative might be for all employees to 'swipe in' when they start their shift and 'swipe out' when they finish.

**Pay rates**

Pay scales would normally be set by the board with advice from the HR manager.

**Swipe cards and commissions**

This system seems, on the whole, to represent a strength rather than a weakness. It is in a member of staff’s interest to swipe in when making a sale, otherwise commission may be lost.

The system should identify who was logged in to which till and when, making unauthorised opening of the tills (and therefore access to the cash drawer) difficult to conceal. There would need to be instructions to staff about safeguarding their card, but as, without it they will not get commission, and by using someone else’s card the other person would get commission to which they are not entitled, it would seem to be in every member of staff’s interest to look after their card.
The ‘guest’ cards could be used to gain unauthorised, untraceable access to the tills, so spare cards would need to be kept securely in a safe, and wherever possible all staff, even part-timers should have their own cards.

**The payroll manager**

The payroll manager would seem to have almost unfettered power within the system, with control over leavers, joiners, pay rates, tax codes and deductions. With responsibility for 220 staff being paid every month, he or she also controls large sums being paid out on a regular basis.

Controls would be improved by:

- the monthly payroll run (including the net amounts payable to employees) should be approved by the finance director or, possibly the personnel director
- there should be a reconciliation of the payroll from month to month. This might be difficult because of commission payments, but if the amount of commissions can be separately identified, not impossible. Alternatively, some statistics giving head count and average pay might be used. These should also be reviewed by the relevant director
- budgetary controls (performance reviews) would be really useful. The head of an individual department, a store manager or regional supervisor, would almost certainly notice fluctuations in the payroll charge being made on their department, even a single employee, even though this may not be noticeable across the company as a whole.

**The IT manager**

It is probable that the IT manager would have access to all aspects of all of the company’s IT systems.

Clearly access to different parts of the system should be restricted by the use of passwords, signing-on routines, etc to those who legitimately need them, but it is in the nature of the IT manager’s role that he or she would not be restricted in this way.

Even if the IT manager did not have authorisation to access the payroll routines, it is almost certain that he or she would be able to circumvent the restriction.
This makes the reviews and budgetary controls which increase the strengths in the system over the payroll manager’s access, even more important.

It is also important that changes to IT systems are approved by the board and subject to meaningful supervision at board level.
Chapter learning objectives

When you have completed this chapter you will be able to:

• explain the assertions contained in the financial statements
• explain the use of assertions in obtaining audit evidence
• explain the principles and objectives of testing transactions, account balances and disclosures
• discuss the sources and relative merits of the different types of evidence available
• define audit sampling and explain the need for sampling
• identify and discuss the differences between statistical and non-statistical sampling
• discuss and provide relevant examples of, the application of the basic principles of statistical sampling and other selective testing procedures
• discuss the results of statistical sampling, including consideration of whether additional testing is required
• describe why smaller entities may have different control environments
• describe the types of evidence likely to be available in smaller entities
• discuss the quality of evidence obtained
• explain the need for and the importance of audit documentation
• explain the procedures to ensure safe custody and retention of working papers.
1 Why does the auditor need evidence?

If the auditors are to:

• form an opinion which is worth something
• be paid good money for it

they will need to base their opinion on valid evidence.
2 Evidence about what exactly?

Financial statements are complex documents

They consist of:

- income statement
- balance sheet
- cash flow statement
- notes.

Each of which contains numbers of headings:

- revenue
- expenditure
- non-current assets
- inventories
- receivables
- payables, etc.

Management is responsible for the preparation of financial statements that give a true and fair view, but what does this really mean?

For each item in the financial statements, management is making **assertions**.

Assertions like:

- This factory is owned by the company.
- The receivables really do owe us this money and will pay fairly soon.
- The payroll expense was for the company’s genuine employees working on the company’s business.
The auditors therefore need evidence that these assertions are valid.

3 Financial statement assertions

**Occurrence** – did the transaction actually take place?

**Completeness** – are all transactions or balances that should be included in the financial statements, actually included?

**Accuracy** – are the amounts correct?

**Cut-off** – are transactions accounted for in the correct period?

**Classification** – are transactions recorded in the proper accounts?

**Existence** – do the assets or liabilities actually exist?

**Rights and obligations** – does the client own or have other rights over the assets and have a genuine obligation to pay liabilities?

**Valuation** – are assets or liabilities included at appropriate amounts?

**Allocation** – are account balances included in appropriate accounts?

**Classification and understandability** – are items in the financial statements disclosed under appropriate headings and in such a way that they can be readily understood by readers?

**Accuracy** – are the amounts disclosed in the financial statements appropriate?
The assertions are **important** because they have an impact on how the auditor gathers evidence.

There are 13 different types of assertion across the three headings although some of them repeat each other and this may seem to be rather daunting to remember.

Remember that the audit evidence required depends on both:

- the nature of the item being tested

**AND**

- the assertion being tested

and it can all be simplified down to four key questions that the auditor needs to answer.

1. Should it be in the accounts at all?
   - Occurrence.
   - Existence.
   - Rights and obligations.
   - Cut-off.
2. Is it included at the right value?
   - Accuracy.
   - Valuation.
3. Are there any more?
   - Completeness.
4. Is it disclosed properly?
   - Classification.
   - Allocation.
   - Understandability.
4 Why assertions matter to auditors

Assertions matter to auditors because:

- The auditor chooses suitable procedures based on the nature of the item in the financial statements being audited.
- The procedures will be refined further depending on which assertion about the item the auditor is testing.

**Different items – different approach**

The audit approach to testing receivables will be different from testing payroll.
e.g.

<table>
<thead>
<tr>
<th>Item</th>
<th>Audit tests e.g.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>Carry out third party confirmation.</td>
</tr>
<tr>
<td></td>
<td>Review correspondence and aged analysis for evidence of delinquent receivables.</td>
</tr>
<tr>
<td></td>
<td>Test subsequent receipt of cash from customers.</td>
</tr>
<tr>
<td>Payroll</td>
<td>Inspect timesheets.</td>
</tr>
<tr>
<td></td>
<td>Inspect authorised pay rates.</td>
</tr>
<tr>
<td></td>
<td>Verify employees are genuine through contracts of employment.</td>
</tr>
<tr>
<td></td>
<td>Check tax and other deductions.</td>
</tr>
</tbody>
</table>

**Different assertions – different approaches**

For a single item in the financial statements – e.g. freehold property, the auditor may need to use different approaches for different assertions

<table>
<thead>
<tr>
<th>Assertion</th>
<th>Audit tests e.g.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existence</td>
<td>Inspect the property concerned.</td>
</tr>
<tr>
<td>Valuation</td>
<td>Agree cost to purchase contract or subsequent revaluation to valuer’s report.</td>
</tr>
<tr>
<td></td>
<td>Re-perform depreciation calculation.</td>
</tr>
</tbody>
</table>
Rights and obligations: Inspect title deeds.

Cut-off: Inspect purchase contract to verify date of purchase.

Completeness: Review repairs account, correspondence with lawyers and property consultants for evidence that there are no additional properties.

**Note.** The completeness assertion tends to be the most difficult assertion to test. It is usually easier to verify items we know about than to think about what should be there, but is not.

**Test your understanding 1**

1. **Name the five assertions associated with transactions.**
2. **Name the four assertions associated with account balances.**
3. **Name the four assertions associated with disclosures in financial statements.**
4. **Why do assertions matter to auditors?**
5 How does the auditor test things?

- Audit Procedures
- Inspection of Records or Documents
- Inspection of Tangible Assets
- Observation
- Enquiry
  - Management Representations
- Confirmation
- Recalculation
- Reperformance
  - Planning
  - Substantive
  - Overall Review
- Analytical Procedures
Audit procedures

We have seen above, that:

- the nature of the transaction or balance being audited and
- the assertion being tested

demand different approaches from the auditor.

ISA 500 identifies eight types of procedures that the auditor can adopt to obtain audit evidence:

In Chapter 10 ‘Audit procedures’ we will look in detail at how these procedures are applied in specific circumstances as well as at some of the more detailed requirements of ISAs.

ISA 500 identifies eight procedures that the auditor can adopt to obtain audit evidence:

6 Inspection of records or documents

- Will usually give pretty conclusive evidence of existence!
- May give evidence of valuation, e.g. obvious evidence of impairment of inventory or non-current assets.
- Unlikely to give evidence of rights and obligations, e.g. a vehicle may be leased, inventory held on behalf of a third party, etc.

7 Inspection of tangible assets

- Will usually give pretty conclusive evidence of existence!
- May give evidence of valuation, e.g. obvious evidence of impairment of inventory or non-current assets.
- Unlikely to give evidence of rights and obligations, e.g. a vehicle may be leased, inventory held on behalf of a third party, etc.

3. Observation

- Involves looking at a process or procedure.
- May well provide evidence that a control is being operated, e.g. double staffing or a cheque signatory examining supporting documentation.
4. Enquiry

- Enquiry is a major source of audit evidence, however the results of enquiries will usually need to be corroborated in some way through other audit procedures.
- The answers to enquiries may themselves be corroborative evidence.

**Management representations**

Management representations are a sub-set of Enquiry.

The auditor obtains written representations from management to confirm oral enquiries where:

- the issue is material or
- where other sources of evidence cannot reasonably be expected to exist or
- where other evidence is of lower quality.

5. Confirmation

- A specific form of enquiry
- Examples of use:
  - circularisation of receivables
  - confirmation of bank balances
  - confirmation from legal advisers of actual or contingent liabilities arising from legal proceedings
  - confirmation of inventories held by third parties
  - confirmation of investment portfolios by investment managers.

6. Recalculation

- Checking the arithmetical accuracy of the client’s calculations.
7. Reperformance

• May be something relatively simple, e.g. test checking inventory counts.
• May be more sophisticated, e.g. using IT tools to check a receivables ageing.

8 Analytical procedures

• The consideration of the relationships between figures in the financial statements or between financial and non-financial information.

Test your understanding 2

(1) What are the eight types of audit procedure?

(2) What are the two purposes for which the auditor must use analytical procedures?

(3) What is the third use of analytical procedures available to the auditor?

(4) Why does the auditor need to obtain management representations?

(5) Give three examples where an auditor might use confirmations.

9 How much evidence does the auditor need?

WHAT TO DO? DEPENDS ON TRANSACTION OR BALANCE? WHICH ASSERTION(S)?

HOW MUCH TO DO? DEPENDS ON RISK PURPOSE OF THE PROCEDURE QUALITY OF AVAILABLE EVIDENCE
We have seen that the types of audit procedure the auditor can carry out:

- are quite limited – inspection, observation, enquiry, etc.
- are driven by the nature of the transaction or balance being audited and the assertion being tested.

We now need to consider how much evidence the auditor needs.

This is driven by:

- the risk of material misstatement
- the quality of the evidence obtained
- the purpose of the procedure (test of controls or substantive test).

These three factors – risk, purpose and quality – have a complex relationship, as we shall see. Although risk is the most important factor, as everything the auditor does on an audit is in response to the assessed level of risk, we will consider it after we have dealt with the quality and the purpose of audit evidence.

10 The quality of evidence – ‘Sufficient appropriate evidence’

‘The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.’

ISA 500 para 2
The key questions here are:

What do we mean by:

- sufficient?
- appropriate?

‘Appropriate’ breaks down into two qualities:

- reliable
- relevant

and ‘sufficient’, ‘reliable’ and ‘relevant’ are all interlinked.

Sufficient

There needs to be ‘enough’ evidence, and what is ‘enough’ is a matter of professional judgement.

Example 1

For the client’s bank balance, one confirmation letter from the bank (if the client has only one bank account) will be enough, and indeed is all there is available.

The bank letter will not, however, give the auditor all the information required. There will need to be consideration of the bank reconciliation as well.

So, 2 sources of evidence combining to be sufficient.

Example 2

To test purchases for a manufacturing client where there are literally thousands of transactions a year, the auditor may well decided to extract a statistical sample of purchase transactions to test to purchase orders, invoices, delivery notes, etc. But how many items should there be in the sample? Statistical sampling theory will give some help here – see below – but ultimately it is a question for the auditor’s professional judgement.
Reliable

**This is better**
- Independent external evidence.
- Internal evidence subject to effective controls.
- Evidence obtained directly by the auditor.
- Documentary.
- Original documents.

**This is worse**
- Internally generated evidence.
- Internal evidence not subject to such controls.
- Evidence obtained indirectly or by inference.
- Oral.
- Photocopies or facsimiles.

ISA 500 gives the above guidance.

**The link between sufficient and reliable**

Broadly speaking, the more reliable the evidence the less of it the auditor will need.

However, the relationship is quite subtle:

If the evidence is found to be unreliable, looking at a greater quantity of such evidence will never be sufficient.

**Expandable Text**

**Relevant**

As we have seen above the nature of the evidence the auditor wants depends on:

- the nature of the transaction or balance being tested

and

- the assertion being tested.
Persuasive not conclusive

Consider:

- The auditor gives an opinion about the financial statements not a certificate that the financial statements are correct.
- The audit report gives reasonable not absolute assurance about the financial statements.
- Audit procedures are designed to reduce the risk that the financial statements contain material misstatements not to eliminate all possibility of error.

The reason for all this lack of absolute, definitive certainty is the nature of audit evidence which is gathered by human beings in real live organisations.

- The auditor gathers evidence on a test basis (the sample may or may not be representative).
- People make mistakes (both client and auditor).
- Documents could be forged (increasingly easy with digital technology).
- The client’s personnel may not always tell the truth.

As a result, we have to say that audit evidence is persuasive rather than conclusive in nature.

This also means that the auditor will need to gather evidence from a variety of sources.

Expandable Text

11 Sampling
The need for sampling

It will usually be impossible to test every item in any accounting population because of the costs involved – remember the audit gives reasonable not absolute assurance. The audit evidence gathered, therefore, will be on a test basis – hence the need for the auditor to understand the implications and effective use of sampling.

However, it is important to understand that:

- there is no requirement to use sampling laid down in the ISAs
- 100% testing may be appropriate in certain circumstances – particularly where there is a small population of high-value items
- the use of analytical procedures – see section 7 above and the more detailed coverage in Chapter 10 – and a variation on analytical procedures ‘proof in total’, may be a more effective and efficient method of gathering audit evidence
- because analytical procedures are a requirement of ISA 520 at the planning and overall review stages of the audit, it is sensible to make best use of the work done.

In other circumstances some form of sampling will be used.

Definition

The definition of sampling set out in ISA 530 Audit sampling and other means of testing is:

‘Audit sampling’ (sampling) involves the application of audit procedures to less than 100% of items within a class of transactions or account balance such that all sampling units have a chance of selection. This will enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can use either a statistical or a non-statistical approach.

ISA 530

Statistical or non-statistical sampling

‘Statistical sampling’ means any approach to sampling that has the following characteristics:

- random selection of a sample, and
- use of probability theory to evaluate sample results, including measurement of sampling risk.
A sampling approach that does not have both these characteristics is considered non-statistical sampling.

Statistical sampling requires the following:

- **Random selection**, e.g. generating a random number to determine which item or $ in the population is the first in the sample and using a sampling interval, usually based on tolerable error, to select subsequent items.

**Judgmental or haphazard sampling** – picking say two invoices from each month, or focusing on a particular period do not usually count as statistical sampling because of the risk of bias in selecting the sample.

- **Evaluation of results** using probability theory, e.g. if a sample with a total value of $100,000 contains errors of $1,000, it may be possible to extrapolate and say that there may be an error of 1% in the population as a whole, i.e. $30,000 in a population of $3m or $100,000 in a population of $10m.

Clearly this will depend on how representative the sample is and the margin of error according to probability theory.

To be representative, a sample needs to be of sufficient size

– usually at least 30 items – and the larger the sample size, the greater the precision it will give.

If the results of the sample reveal potential errors which might be material, the auditor has to resolve the problem:

– by considering whether there were special circumstances surrounding the errors, e.g. the absence of a key member of the client’s staff and carrying out additional testing on items or the period likely to be affected

– by deciding whether, because the risk of misstatement has clearly increased, which will lead to an increase in the level of materiality, the new level of materiality is too high. If it is, it will be necessary to increase the level of testing. However, care needs to be taken over this – see the section on risk revisited below.
Test your understanding 3

1. What three qualities must audit evidence have?
2. Which type of evidence is more reliable – a faxed copy of a contract or the original contract?
3. Which is more reliable – the client’s bank statement or a confirmation letter from the bank direct to the auditor?
4. Give two reasons why audit evidence is likely to be persuasive rather than conclusive.
5. Give two examples where it would be appropriate to use statistical sampling.
12 Audit documentation

Why do we need working papers?

WORKING PAPERS

PRINCIPLES

IF IT’S NOT RECORDED... IT DIDN’T HAPPEN

IF IT CAN’T BE UNDERSTOOD (AND QUICKLY)... IT’S NOT RECORDED PROPERLY

CONTENTS

OBJECTIVE

FUNDAMENTALS

CLIENT

METHOD

PERIOD END

RESULTS

PREPARED BY/DATE

CONCLUSION

REVIEWED BY/DATE

SUBJECT

CROSS REFERENCE

KEY
The job of working papers is to:

- provide a record of the basis for the auditor’s report
- provide evidence that the audit was conducted in accordance with ISAs and legal and regulatory requirements.

To assist with the planning, performance, supervision and review of the audit.

To aid the auditors' defence if subsequently sued for negligence.

Principles

There are two major principles

- **If it's not recorded, it didn’t happen.**
  
  If there is nothing on file, there is no evidence that the necessary procedures were completed, so there can be no basis for the audit opinion.

- **If it can’t be understood, it might as well not have happened.**
  
  Clarity is important for two reasons

  Completeness – If the working papers are easy to understand it will be more obvious if anything has been omitted.

  Efficiency – Working papers need to be reviewed for quality control purposes and to ensure that the audit opinion is justified. The reviewer may be at a senior level in the firm and therefore time will be charged at an expensive rate. Clear working papers will keep the time spent and therefore the costs to a minimum.

Structure and layout

The file

There are two broad areas to the file.

- The control part consisting of:
  - the planning section
  - the completion and review section.

- The main working papers are divided into the relevant sections of the financial statements, e.g. non-current assets, inventories, receivables, etc.
Custody and retention of working papers

Who owns the working papers?
The auditor does. This is important because:

- Access to the working papers is controlled by the auditor, not the client, which is an element in preserving the auditor’s independence.
- In some circumstances care may need to be taken when copies of client generated schedules are incorporated into the file.

Security

Working papers must be kept secure.

- Audits are expensive exercises. If the files are lost or stolen, the evidence they contain will need to be recreated, so the work will need to be done again. The auditors may be able to recover the costs from their insurers, but otherwise it will simply represent a loss to the firm. Either way, prevention is better than cure.
- By its nature, audit evidence will comprise much sensitive information that is confidential. If the files are lost or stolen, the auditor’s duty of confidentiality will be compromised.
- There have been cases of unscrupulous clients altering auditors’ working papers to conceal frauds.
The implications of IT based audit systems are also far reaching.

- By their nature, laptops are susceptible to theft, even though the thief may have no interest in the contents of the audit file. Nevertheless, all the problems associated with re-performing the audit and breaches of confidentiality remain.
- It is more difficult to be certain who created or amended computer based files than manual files – handwriting, signatures and dates have their uses – and this makes it harder to detect whether the files have been tampered with.

This means that the following precautions need to be taken.

- If files are left unattended at clients’ premises – overnight or during lunch breaks – they should be securely locked away, or if this is impossible, taken home by the audit team.
- When files are left in a car, the same precautions should be taken as with any valuables.
- IT-based systems should be subject to passwords, encryption and backup procedures.

**Retention**

ISA 230 states that audit documentation should be retained for five years from completion of the audit. Many firms keep working papers for longer than this because information may still be required for tax purposes.

All of this means that firms need to make arrangements for:

- secure storage of recent files
- archiving older files
- archiving and backup of IT-based files.
13 Smaller entities

Smaller commercial entities will usually have the attributes above most of which are double edged in a good news/bad news kind of way:

- **Lower risk**: Smaller entities may well be engaged in activity that is relatively simple and therefore lower risk. However, this will not be true for small – often one person businesses – where there is a high level of expertise in a particular field, e.g. consultancy businesses, creative businesses, the financial sector.

- **Direct control by owner managers** is a strength because they can know what is going on and have the ability to exercise real control. They are also in a strong position to manipulate the figures or put private transactions ‘through the books’.

- **Simpler systems**: Smaller entities are less likely to have sophisticated IT systems, but pure, manual systems are becoming increasingly rare. This is good news in that many of the bookkeeping errors associated with smaller entities may now be less prevalent. However, a system is only as good as the person operating it.
Evidence implications

• The normal rules concerning the relationship between risk and the quality and quantity of evidence apply irrespective of the size of the entity.
• The quantity of evidence may well be less than for a larger organisation.
• It may be more efficient to carry out 100% testing in a smaller organisation.

Small not-for-profit organisations

Small not-for-profit organisations have all the attributes of other small entities. Arguably, however, the position is more difficult for the auditor because:

• While most small businesses are under the direct management of the owner, small not-for-profit organisations tend to be staffed by volunteers and the culture is more likely to be one of trust rather than accountability.
14 Chapter summary

- **Audit opinion**
  - About what?
  - Financial statements
- **Evidence**
  - About what?
  - Assertions
- **Sufficient**
  - Appropriate
  - Transactions balances disclosure
- **Reliable**
  - Relevant
  - Procedures
  - Documentation
  - Chapter 10 audit procedures
## Test your understanding answers

### Test your understanding 1

<table>
<thead>
<tr>
<th>Question</th>
<th>Assertions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Name the five assertions associated with transactions.</td>
<td>Occurrence, Completeness, Cut-off, Accuracy, Classification</td>
</tr>
<tr>
<td>2. Name the four assertions associated with account balances.</td>
<td>Existence, Rights and obligations, Completeness, Valuation and allocation</td>
</tr>
<tr>
<td>3. Name the four assertions associated with disclosures in financial statements.</td>
<td>Occurrence and rights and obligations, Completeness, Classification and understandability, Accuracy and valuation</td>
</tr>
<tr>
<td>4. Why do assertions matter to auditors?</td>
<td>The assertion being tested will have an influence over the nature of the audit procedure used</td>
</tr>
</tbody>
</table>
1. What are the eight types of audit procedure?

| Inspection of records or documents. |
| Inspection of assets. |
| Observation. |
| Enquiry. |
| Confirmation. |
| Recalculation. |
| Reperformance. |
| Analytical procedures. |

2. What are the two purposes for which the auditor must use analytical procedures?

| To assist with planning the audit. |
| At the review stage to make sure that the financial statements make sense. |

3. What is the third use of analytical procedures available to the auditor?

| As substantive procedures. |

4. Why does the auditor need to obtain management representations?

| Where the issue is material. |
| Where other sources of evidence cannot reasonably be expected to exist. |
| Where other evidence is of lower quality. |
| Where it is specifically required by an ISA. |

5. Give three examples where an auditor might use confirmations.

| Circularisation of debtors. |
| Confirmation of bank balances. |
| Confirmation from legal advisers of actual or contingent liabilities arising from legal proceedings. |
| Confirmation of stock held by third parties. |
| Confirmation of investment portfolios by investment managers. |
1. What three qualities must audit evidence have?

It must be:
- Sufficient.
- Relevant.
- Reliable.

2. Which type of evidence is more reliable – a faxed copy of a contract or the original contract?

The original contract – (but consider – how do you know it is original).

3. Which is more reliable – the client’s bank statement or a confirmation letter from the bank direct to the auditor?

The bank confirmation letter because it is independent third-party evidence.

(But beware, it has been known for fraudsters to type letters on paper stolen from a bank).

4. Give two reasons why audit evidence is likely to be persuasive rather than conclusive.

The auditor gathers evidence on a test basis (the sample may or may not be representative).
- People make mistakes (both client and auditor).
- Documents could be forged (increasingly easy with digital technology).
- The client’s personnel may not always tell the truth.

5. Give two examples where it would be appropriate to use statistical sampling.

Purchases transaction testing
Revenue transactions testing
Payroll transactions testing, etc.
Audit procedures

Chapter learning objectives

When you have completed this chapter you will be able to:

• explain the purpose of substantive procedures in relation to financial statements assertions
• explain the substantive procedures used in auditing each balance, and
• tabulate those substantive procedures in a work program, for the following areas:
  – inventories
  – receivables
  – payables
  – bank and cash
  – non current assets
  – non current liabilities
  – accounting estimates
• explain the use of computer assisted audit techniques in the context of an audit
• discuss and provide relevant examples of the use of test data and audit software for the transaction cycles and balance sheet items
• discuss the use of computers in relation to the administration of the audit
• discuss and provide examples of how analytical procedures are used as substantive procedures
• compute and interpret key ratios used in analytical procedures
• discuss the problems associated with the audit of accounting estimates
• discuss the extent to which auditors are able to rely on the work of experts and internal audit
• discuss the audit considerations relating to entities using service organizations
• discuss why auditors rely on the work of others
• explain the extent to which reference to the work of others can be made in audit reports.
1 General principles

A word of warning: Chapter 9 dealt with the principles of audit evidence. This chapter deals with how those principles are applied.

In the sections that follow, we will examine a number of specific audit areas and deal with how these are usually tested. You may be tempted to learn these by heart. Whatever you do,

**DO NOT DO THIS!!!!**

The audit of any item is based on:

- the risk of misstatement
- the nature of the item
- the assertion you are testing.

The examiner is not stupid. He or she knows that auditing is a matter of professional skill and judgement. If you can answer an exam question simply by learning a few pages of a book, it is not a very good test of whether you are a competent auditor.

So the questions may not ask about standard situations and you will have to apply your knowledge to the demands of the question.

**Things you always have to do**

Nevertheless, there are some things which, one way or another, will always apply (and which, if you mention them, will gain you marks):

- understand the system
- analytical procedures
- document your work.

**Things you will always have to consider**

**What are you being asked to test?**

- A transaction or event that took place during the year.
- An account balance at the period end.
- Presentation or disclosure.
What is the nature of the item you are testing?

- Asset
- Liability
- Revenue
- Expense

What assertion(s) are you testing?

- Existence
- Occurrence
- Valuation
- Cut-off, etc.

Things you may have to do

- If you rely on controls, you will have to test them.
- Management representations are required for some items by ISA 580 and by a number of other ISAs.
- If there are high volumes of transactions, consider using computer assisted audit techniques (CAATs).
2 Analytical procedures

Why do them?

Analytical Procedures as substantive evidence

ISA 520 states that analytical procedures must be used at the planning stage to identify risks, and at the completion stage of the audit as a final review of the FS.

They may also be used at the substantive stage when the auditor is auditing the draft financial statements.

Analytical procedures are not just the comparison of one year with another. AP’s can be used in the following ways:

• Ratio analysis
• Trend analysis
• Proof in total

Why? - Planning – Risk assessment – compulsory (ISA 520)
• Substantive – not compulsory per ISA 520, but usually an effective and efficient means of gathering evidence
• Review – Final check that the figures make sense – compulsory (ISA 520)
• Efficient
• Effective

How? - Set out the figures
• Calculate ratios/compute trends/proof in total/make comparisons
• Investigate anomalies
• Corroborate answers to enquiries
In order to use analytical procedures the following process should be followed:

- Create your own expectation of what you think the figure should be
- Compare your expectation to the actual figure
- Investigate any significant differences
  - Example 1 - create an expectation of payroll costs for the year by taking last year’s cost and inflating for payrise and change in staff numbers – proof in total.
  - Example 2 – calculate the receivables day ratio and compare it with prior year and credit terms given to customers. If the figure is higher than expected it may indicate overstatement of receivables – ratio analysis.
  - Example 3 – plot monthly sales data for the prior year and plot against the current year and investigate any unusual trends. You would expect the business to follow the same pattern month on month especially if they have a seasonal business – trend analysis.
  - Example 4 – using the client’s depreciation policy, re-compute the expected depreciation charge and compare it with the actual depreciation charge. If there is a significant difference it should be investigated – proof in total.
The ratios

- **PROFITABILITY**
  - GROSS PROFIT %
  - NET PROFIT %

- **EFFICIENCY**
  - RECEIVABLES DAYS
  - INVENTORY TURNOVER
  - PAYABLES DAYS

- **LIQUIDITY**
  - CURRENT RATIO
  - QUICK RATIO
  - GEARING

- **RETURN**
  - RETURN ON CAPITAL
  - EMPLOYED (ROCE)

**How are analytical procedures used?**

Calculating the ratios is just the start. Analytical procedures are audit procedures in their own right, designed to enable the auditor to reduce the risk of coming to the wrong opinion about the financial statements.

This means that the auditor needs to use analytical procedures to identify anomalies in the figures, which may indicate problems.

To do this, the auditor will make comparisons:

- between the current year and previous year(s)
- between actual figures and budgets, forecasts or client’s expectations
- with similar companies

**Analytical procedures as substantive procedures**

- ISA 520 states that the auditor may use analytical procedures as substantive procedures.
The suitability of this approach depends on four factors:

- The suitability of using substantive analytical procedures given the assertions.
- The reliability of the data.
- The degree of precision possible.
- The amount of variation which is acceptable.

Some examples.

(1) Suitability
   - Analytical procedures are clearly unsuitable for testing the existence of inventories – to do this you need to go and count the items on the shelves in the warehouse.
   - Analytical procedures may well be suitable for testing the value of labour carried forward in inventory – by comparing direct labour costs for the year with value in inventory, in the context of the costs of raw materials and overheads in inventory.

(2) Reliability
   - If controls over sales order processing are weak, it will probably be necessary to rely on tests of details rather than analytical procedures.

(3) Precision
   - There is likely to be greater consistency in gross margins over time than in discretionary expenditure like advertising or R&D.

(4) Acceptable variation
   - Variations in sales revenue, which may have a minor impact on the results for the year, will be regarded differently from receivables, which, if uncollectible will have a proportionately greater impact.
3 The audit of receivables

Receivables circularisation

**Purpose:**

- Direct third party confirmation to give evidence of existence and valuation.

**Advantages:**

- Independent evidence.
- External evidence.
- Relatively efficient (if successful).
**Disadvantage**

- Those circularised may not reply.

**Method**

- Select sample of receivables to be circularised.
- Inform client of intended list of those to be circularised.
- Consider implications if client objects to any of the accounts selected being circularised.
- Record names and amounts circularised.
- Record replies received and consider implications of any accounts not agreed.
- For non-replies perform alternative procedures (see below).

**Other evidence in relation to accounts receivable**

- Obtain a list of the individual balances from the receivables ledger, check the cast and agree the total to the trade receivables figure in the draft financial statements
- Ensure that balances have been correctly extracted from the receivables ledger
- Obtain a list of credit balances in the receivables ledger and obtain explanations from management
- Agree brought forward figures to last year’s audit file

**Recoverability/Provision for doubtful debts [Valuation]**

- Discuss the assumptions underlying the general provision with management to ensure reasonable
- Recalculate the provision based on management’s assumptions and agree to the figure in the financial statements
- Compare the prior year provision to the amounts actually written off as bad in the year to test how accurate management usually are in estimating possible bad debts
- Obtain a list of aged receivables and investigate the recoverability of any old balances
- Check whether receivables have paid after the year-end to ensure recoverability
• Where overdue receivables have not paid, trace the balances to the provision for doubtful debts. Where the balances are not included in the provision discuss with management the basis on which they believe the debtor to be recoverable

**Presentation and disclosure**

• Check that the figures disclosed in the financial statements agree to the audited figures

**Analytical review**

• Calculate the trade receivables collection period and compare to last year to assess reasonableness

**Cut-off**

• Select a sample of GDN’s immediately prior to the year-end and immediately after the year end and ensure that they have been recorded in the correct period.
• For prepayments review relevant invoices to check calculation of prepayment and ensure that payment has actually been made by agreeing it to the bank statements.

**Income statement entries related to accounts receivable**

Check postings and validity of:

• bad debt write offs
• movements on bad debt provision
• recoveries from receivables previously written off.

Ensure doubtful receivables and recoveries identified from other audit work are properly reflected in the income statement.
4 The audit of inventories

Overview

The audit of inventories is usually regarded as one of the higher risk areas of the audit:

- It is usually crucial to assurance about an entity’s profit.
- It may be complex.
- It is usually subject to a degree of estimation.

They can also be very varied, e.g.:

- sheep or cows on a farm
- jewellery
- the costs of developing a computer game
- cars
- food and drink
- chemicals
- petrol.

That’s probably enough to be going on with!

How are inventories valued?
Finished goods and raw materials

**FINISHED GOODS AND RAW MATERIALS**

- OBJECTS ON SHELVES, IN BINS, IN CUPBOARDS IN SHOPS, WAREHOUSES, ON LORRIES, ETC.
- THESE CAN BE COUNTED, MEASURED, WEIGHED, ETC.

**CONSIDERATIONS:**
- PRICING
- OBSOLESCENCE
- SALEABILITY
- DAMAGE
- NET REALISABLE VALUE
- MATERIALS CONTENT
- LABOUR CONTENT
- OVERHEAD CONTENT
Work in progress

- **Work in Progress**

- **Partly-Completed Objects at Workstations**
  - On the factory floor, or stored awaiting completion
  - These can be counted and estimates made of stage of completion

- **Partly-Completed Major Contracts**
  - Roads, buildings, ships, aircraft, etc.
  - These can be inspected and estimates made of stage of completion or expert opinions sought

- **Unamortised Costs of Developing Software, Books, Recorded Music**
  - Cannot be counted, but costs can be verified from invoices, timesheets, etc.

- **Considerations**
  - Stage of completion costs to completion
  - Net realisable value
  - Materials content
  - Labour content
  - Overhead content

**Considerations:**
- Saleability
- Amortisation policy
Assertions again

The inventory count

Principles

• The inventory count is a ‘one off’. It is a single opportunity to establish what is and what is not in inventory.

• Because of the crucial impact of inventory levels on the results for the year, it must be tested both for existence and completeness. (For most other areas the emphasis is likely to be on one or other of these assertions rather than both.)

• Inventory can consist of almost anything with different properties (see the list above). It can therefore be quite complex and so needs to be well organised by the client. The auditor needs to be equally well organised to ensure that sufficient, appropriate evidence is gathered.
• It is the client’s responsibility to establish the correct value of the inventory. The auditor’s job is to form an opinion as to whether that value is materially correct or not. It is therefore *not* the auditor’s responsibility to count the inventory, only to check that it has been done correctly.

**Procedures**

• Obtain clients’ instructions for the count and review them:
  – for obvious flaws
  – to ensure that the logistics for the audit team have been thought through
  – to obtain awareness of where the most material or otherwise risky inventory lines are to be found.

• Observe the count as it proceeds to ensure:
  – the client’s instructions are being followed
  – everything is counted and recorded
  – there is no risk of anything being included more than once
  – evidence of damaged or slow moving inventory is being recorded
  – cut-off is observed – no despatches or deliveries occur while the count is taking place, and there is no movement of inventory within the client’s premises which may confuse the count
  – inventory sheets (or whatever method is used to record the count – handheld devices, barcode readers, etc.) are properly controlled.

• Conduct test counts on a suitably random basis whilst gearing the tests towards material items:
  – **Existence** – it will be necessary to check from the client’s inventory records to your test data, so you need to ensure that you record sufficient details of the location and the items to be able to trace them later.
  – **Completeness** – you will need to be able to trace the items from your counts, into the client’s inventory records and will therefore need to record sufficient details to enable you to do this.

**Note.** These aspects of the count are crucial – the auditor needs to know in advance:

  – the details of the inventory
  – how the inventory will be recorded in the client’s system.

• **Record cut-off information:**
  – the last goods received record of the year
  – the last despatch record of the year.
Audit procedures at the final audit stage

- Obtain a list showing each individual line of inventories categorised between finished goods, WIP and raw materials. Cast and agree the total to the inventories figures in the financial statements.

Presentation and disclosure

- Check that the figures disclosed in the financial statements agree to the audited figures and that inventories have been correctly analysed between finished goods, raw materials and work in progress.

Valuation

- Trace some items of inventory in the inventory sheets back to original purchase invoices to agree the cost.
- Trace the same items of inventory to post-year-end sales to determine the net realisable value of inventory.
- For items that have not yet been sold trace to the provision for slow-moving inventory or discuss with management why these have not been provided for.
- Ensure that inventory is stated in the accounts at the lower of cost and net realisable value.

Analytical review

- Calculate inventory turnover and compare to last year to assess reasonableness.
- Calculate gross profit percentage and compare to prior year to assess reasonableness.

Cut-off

- Select a sample of GRN’s from immediately prior to the year end and included in year-end payables, and ensure that the goods are included in year-end inventories.
- Select a sample of GDN’s from immediately prior to the year end and included in year-end receivables, and ensure that the goods are not included in year-end inventories and that the invoice was raised in the correct period.

Year end counts and continuous inventory systems

The procedures suggested above apply to all inventory counts whether as a one-off year end exercise or where inventory is counted on a rolling basis throughout the year.
The objective is the same:

- To know what the client has in inventory at the time the count took place.

**Continuous inventory systems**

Where the client has a continuous inventory system, where a theoretical ‘book inventory figure’ is always known, there are both advantages and disadvantages for the auditor.

**Advantages**

- The auditor is less time constrained and can pick and choose particular locations and inventory lines at any time to ensure the system is working properly.
- Slow moving and damaged inventory should be identified and adjusted for in the clients' records on a continuous basis therefore the inventory valuation should be more reliable.

**Disadvantages**

- The auditor will need to gain sufficient evidence that the system operates correctly at all times, not just at the time of the count.
- Additional procedures will need to be devised to ensure that the year end inventory figure is reliable, even though it may not have been counted at that date.

**Inventory held at third parties**

- Where the client has inventory at locations not visited by the auditor, the auditor normally obtains confirmation of the quantities, value and condition from the holder. The auditor needs to consider whether the holder is sufficiently independent to be able to provide relevant, reliable evidence.
- As with confirmations from receivables, the auditor requests details from the party holding the inventory on behalf of the client to confirm its existence.
- The confirmation request will be sent by the client to those parties identified by the auditor.
- The reply should be sent directly to the auditor to prevent it being tampered with by the client.
- Problems can occur if the third party uses a different description to that of the client and as always, a response is not guaranteed.
Other audit evidence about inventory

• For specialised inventory – livestock, property, food in restaurants, significant work in progress – it will be necessary to obtain evidence from experts – see section 12 of this chapter.

• The auditor needs to obtain evidence of the value of the inventory.
  – Cost information can be obtained from invoices and price lists.
  – The costs of manufactured inventory can be obtained from invoices and costing records.
  – The opinion of independent experts may be obtained.

Test your understanding 1

(1) **State three things the auditor should consider when reviewing a client’s instructions for the inventory count.**

(2) **How would you test inventories for existence?**

(3) **How would you test inventories for completeness?**

(4) **Saxophone Ltd runs a petrol filling station. How would you test the quantities of petrol in inventory?**

(5) **Flute Ltd makes large machines out of very heavy lumps of steel. How would you assess its inventory of sheet and bar steel?**

(6) **Piccolo Ltd has a sheep farming business. How would you verify the number of animals it owns at the year end?**
The main thrust of the testing of payables is usually to test for completeness.

Testing for existence, valuation, etc. is still important, but the major consideration, is for the auditor to gain assurance that all liabilities which should be included, are included.

You therefore have to think of the best indicators that additional liabilities may exist. If as a result of this, none are revealed, the testing of the values, rights and obligations of the payables we know about is relatively straightforward.

Possible indicators of additional liabilities

Does the list of payables at the year end:

- include all the major suppliers the client dealt with during the year?
- include all significant suppliers from the equivalent list last year?
- include all expected accruals? Rent, utilities, telephone, etc.
- include expected sources of financing for non-current assets? leasing, hire purchase, mortgages, etc.
Supplier statement reconciliations

For those suppliers’ balances selected for testing:

• obtain supplier statements at the balance sheet date
• compare with balance according to the client’s records
• seek explanation for differences from client staff.

There are generally two main explanations for differences:

(1) **Timing differences:**
   – Invoices not yet received by the client.
   – Payments not yet received by the supplier.
   – Returns and credit notes not yet appearing on the supplier’s statement.

(2) **Errors**
   – Supplier errors that will remain as part of the reconciliation until the supplier corrects them.
   – Client errors, which the client needs to adjust.

**Note.** It is possible that there are administrative reasons at the client for some of the differences:

• **Goods received accrual** – invoices received but not yet processed – perhaps awaiting authorisation, or perhaps ‘Mary does the postings on Tuesdays’ which means that invoices arriving between Wednesday and Monday are known about but not yet entered on the system.

• **Goods received not invoiced** – the client accrues for all goods received but does not post to the purchase ledger until the invoice is received.
Suggested layout for a supplier’s statement reconciliation

<table>
<thead>
<tr>
<th>Supplier’s statement reconciliation</th>
<th>Year end date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supplier Limited</td>
<td>$  $</td>
</tr>
<tr>
<td>Balance per supplier statement</td>
<td>xxxx</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Returns/credit notes not yet credited</td>
<td>xx</td>
</tr>
<tr>
<td>Payments not yet received by supplier</td>
<td>xx</td>
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<tr>
<td></td>
<td>___</td>
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<tr>
<td></td>
<td>(xx)</td>
</tr>
<tr>
<td></td>
<td>___</td>
</tr>
<tr>
<td>Balance per purchase ledger</td>
<td>xxx</td>
</tr>
<tr>
<td>Invoices not yet posted</td>
<td>xxx</td>
</tr>
<tr>
<td>Goods received not invoiced</td>
<td>xxx</td>
</tr>
<tr>
<td></td>
<td>___</td>
</tr>
<tr>
<td>Reconciled balance</td>
<td>xxx</td>
</tr>
<tr>
<td></td>
<td>___</td>
</tr>
</tbody>
</table>

These figures should be the same!

Accounts payable and accruals – other evidence

- Obtain a list of the individual balances from the payables ledger, check the cast and agree the total to the trade payables figure in the draft financial statements
- Ensure that balances have been correctly extracted from the payables ledger
- Obtain a list of debit balances in the payables ledger and obtain explanations from management
- Agree brought forward figures to last year’s audit file
Presentation and disclosure

• Check that the figures disclosed in the financial statements agree to the audited figures

Existence

• Circularise a sample of trade payables to confirm the balance at the end of the year [this is not a usual audit test, and is more or less the same format as for receivables confirmations except that negative confirmations are more acceptable]

Completeness

• Investigate any supplier names that were shown on last year's payables listing but do not have a balance showing in this year's list of balances
• Review after date invoices and payments and ensure they have been provided for at the year-end as appropriate
• Analytical review
• Calculate the trade payables payment period and compare to last year to assess reasonableness

Cut-off

• Select a sample of GRN's immediately prior to the year end and included in year-end payables, and ensure that the goods are included in year-end inventories

Accruals

• Review relevant invoices when received after the balance sheet date. If none are received, compare with previous periods.
• Obtain the list of accruals from the client, cast it to confirm arithmetical accuracy.
• Agree the figure per the schedule to the general ledger and financial statements.
• Agree the calculation of the accrual by reference to supporting documentation e.g. previous period invoice

Tax balances

• Corporation/Profits taxes – agree computations.
• Payroll taxes – agree to payroll records.
**Overdrafts, loans, etc.**

- Agree to bank confirmations.

**Leases, hire purchase creditors**

- Agree details to underlying agreement.

**Income statement entries related to accounts payable**

- Accruals will have a direct impact on the income statement accounts they relate to – ensure the postings have been put through correctly and any opening accruals have been properly reversed.
- Some accruals may themselves lead to additional accruals, e.g. accrued bonuses payable to directors and staff, may lead to additional employer’s social security charges.
- For all interest bearing accounts, loans, overdrafts, etc., ensure the correct accrual is made for interest payable.

**6 The audit of bank and cash**
The bank letter (bank confirmation reports)

- Direct confirmation of bank balances gives the auditor independent, third-party evidence.
- The format of the letter is usually standard and agreed between the banking and auditing professions.
- Issues covered are:
  - the client’s name
  - the confirmation date
  - balances on all bank accounts held
  - any documents or other assets held for safekeeping
  - details of any security given
  - details of any contingent arrangements – guarantees, forward currency purchases or sales, letters of credit.
- The auditor needs the client to give the bank authorisation to disclose the necessary information. (In some jurisdictions such disclosures are illegal so bank letters cannot be used at all)
- Ensure that all banks that the client deals with are circularised.
- When items on the bank letter are dealt with, tick them off and cross-reference to the relevant working paper to make it easy to see that there are no outstanding items. The balances for each bank account should be agreed to the relevant bank reconciliation at the year end; interest charges should be agreed to the interest expense account in the general ledger; details of loans should be agreed to the disclosure in the balance sheet to ensure it is correctly classified into the current and non current elements.

Bank and cash – other evidence

- Obtain a list of all bank accounts, cash balances and bank loans and overdrafts and agree to totals to figures included in current assets and current liabilities in the financial statements
- Obtain a copy of the client’s bank reconciliation, cast and agree the balances to the cash book and bank letter
- Trace all outstanding lodgements and unpresented cheques to pre-year-end cash book and post-year-end bank statements
- Ensure all accounts in the bank certificate are included in the financial statements
- Ensure bank loans and overdrafts are not offset against positive bank balances in the financial statements
- Count the petty cash in the cash tin at the end of the year and agree the total to the balance included in the financial statements
• Note. It is vital for an auditor conducting a cash count to do so in the presence of a member of the client’s staff and to obtain a signature for the amounts handed back into the client’s custody.

• Where there are multiple cash balances – a number of tills in a department store, etc. – it is important to ensure amounts cannot be moved between tills and that proper cut-off procedures are in place.

Income statement and other account entries related to bank and cash

• Clearly, bank loans, overdrafts and bank deposits all have interest implications.

• The bank letter may reveal details of security, borrowings and contingent liabilities which need to be disclosed in the financial statements.
7 The audit of tangible non-current assets

**Existence**

- Select a sample of assets from the non-current asset register and physically inspect them.

**Completeness**

- Select a sample of assets visible at the client premises and inspect the asset register to ensure they are included.
- Examine the repairs and maintenance accounts in the general ledger for large and unusual items that may be capital in nature.
Valuation

• Reperform depreciation calculations by:
  – selecting a sample of assets from the register and recalculating the charge for the year
  – recasting the list of individual asset depreciation charges
  – agreeing the total charge to the financial statement.

• Alternatively, agree this year’s charge as reasonable by taking last year’s charge and amending it for additions, disposals, revaluations, changes in method or policy, etc. Compare the predicted charge for the year with the actual charge, and seek explanations for any material differences.

• Assess depreciation policies for reasonableness by:
  – comparing methods used with prior year
  – comparing methods used with similar companies
  – analysing the recent trend of profits and losses on asset disposals.

• If any assets have been revalued during the year:
  – agree new valuation to valuer’s report
  – verify that all similar assets have also been revalued
  – reperform depreciation calculation to verify that charge is based on new carrying value.

• When physically inspecting assets, take note of their condition and usage in case of impairment.

• For a sample of assets, agree cost to purchase invoice (or other relevant documentation) ensuring all relevant costs have been included.

• If any assets have been constructed by the company, obtain analysis of costs incurred and agree to supporting documentation (timesheets, materials invoices, etc.).

Rights and Obligations

• For a sample of recorded assets, obtain and inspect ownership documentation:
  – title deeds for properties
  – registration documents for vehicles
  – insurance documents may also help to verify ownership (and asset values).

• Where assets are leased, inspect the lease document to assess whether the lease is operating or finance (if the latter, the asset should be included on the company’s balance sheet).
Disclosure

- Agree opening balances with prior year financial statements.
- Compare depreciation rates in use with those disclosed.
- For revalued assets, ensure appropriate disclosures made (e.g. name of valuer, revaluation policy).
- Agree breakdown of assets between classes with the general ledger account totals.

8 The audit of non-current liabilities

Loan payables

- Agree loan balance to the loan statement.
- Agree interest payments to the loan agreement and the bank statements.
- Analyse relevant disclosures of interest rates, amounts due (e.g. between current and non-current payables) to ensure complete and accurate.
- Recalculate the interest accrual to ensure arithmetical accuracy.
Provisions and contingencies

Provisions are a form of payable where the amount or timing of payment is uncertain. As such they are harder to audit.

Where the likelihood of payment is only possible, rather than probable, no amounts will be entered in the accounts. However, the matter (contingent liability) must be adequately disclosed.

- Discuss the matter giving rise to the provision with the client to verify whether an obligation exists.
- Obtain confirmation from the clients lawyers as to the possible outcome and probability of having to make a payment.
- Review subsequent events. By the time the final audit is taking place the matter may have been settled.
- Obtain a letter of representation from the client as the matter is one of judgement and uncertainty. For more on representation letters see Chaper 11.

Test your understanding 2

(1) **How would you verify that all unpresented cheques are included on a client’s bank reconciliation?**

(2) **State two things that might be included on a bank letter besides the balances on a client’s accounts.**

(3) **How would you test the rights and obligations assertion for a freehold property?**

(4) **How would you test the completeness of a client’s hire purchase and leasing liabilities?**
9 Relying on the work of others

Why rely on the work of other people?

- Auditors may need to rely on the work of others. (The ISAs stress the need for auditors to consult with others in appropriate circumstances.)
- Auditors may choose to rely on the work of others because they find it effective and efficient to do so.

The need to consult others

Auditors do not need to be experts in all aspects of their clients’ business.

Where they are unable to form an opinion without expert help the auditors will need to consult. Examples are:

- property valuations
- construction work in progress
Choosing to consult others

Because of the circumstances at a particular client, it may be effective and efficient for the auditor to rely on the work of others. Examples are:

- internal audit (see below)
- confirmation from external holders of the client’s inventory
- another firm of auditors for assurance on an overseas branch or subsidiary
- service organisations (see below).

What attributes do these ‘other people’ need?

ISA 620 Using the Work of an Expert states that the auditor should obtain sufficient and appropriate evidence that the work of the expert is adequate for the purpose of the audit.

In making this assessment the external auditor must assess the expert’s:

- independence and objectivity
- competence – consider:
  - qualifications
  - experience.

For example, the auditor might inspect a valuation report to provide evidence of a revaluation of land and buildings. However, this report might be have been produced by a qualified valuer who is a close friend or relative of one of the directors.

The auditor will have to decide whether:

- the valuer is sufficiently independent
- the report provided is reliable or not.
**Relying on internal audit**

- Internal audit forms a part of the client’s system of internal control.
- It may well therefore reduce control risk.
- The auditor will take this into consideration when planning audit procedures and reduced levels of substantive testing may therefore be appropriate.

The auditor cannot devolve responsibility for the audit opinion onto the internal audit department.

ISA 610 Considering the Work of Internal Audit states that before relying on the work of internal audit, the external auditor must first assess the internal audit function with regard to:

- the objectivity and technical competence of the internal audit staff
- whether the internal audit function is carried out with due professional care
- the effect of any constraints or restrictions placed on the internal function by management or those charged with governance.

If the function is assessed and is found not to be sufficiently independent of the management structure or the staff are not suitably qualified and trained, there is no point in the external auditor going to the trouble of assessing the work that has been performed by the function during the year as it will not be considered reliable enough for external audit purposes.

However, if the internal audit function has been assessed as reliable, the specific work should be evaluated to ascertain its adequacy. The external auditor must consider whether:

- the work is properly supervised, reviewed and documented
- the persons performing the work have relevant experience and training
- sufficient and appropriate evidence has been obtained
- the conclusions drawn are valid given the results of the work performed
- recommendations made have been acted on by management.

If the auditor assesses both the function and the specific work to be reliable and adequate, the work will be relied on and reduced levels of testing will be performed.
Service organisations

The client may outsource certain functions to another company – a service organisation, e.g.

- payroll
- receivables collection
- the entire finance function
- internal audit.

Advantages from the auditor's point of view

- The independence of the service organisation may give increased reliability to the evidence obtained.
- Less detailed work may therefore be required.

Other considerations

- The auditor will need to be confident of the reliability and the independence of the service organisation.
- If the audit firm provides some of these services itself – e.g. bookkeeping or payroll services – it will need to ensure that it can maintain its own independence and objectivity as auditor.

Reference to the work of others in the audit report

It is the auditors' responsibility to obtain sufficient and appropriate audit evidence in order to arrive at the correct audit opinion.

Therefore, no reference should be made in the audit report to the use of others during the audit.

If the auditors cannot satisfy themselves that the work of others is sufficiently reliable then the auditor must find another means of obtaining the required level of comfort.

They cannot pass the blame onto another party.
10 Accounting estimates

Accounting estimates are of particular concern to the auditor as by their nature there may not be any physical evidence to support them. They are subjective and judgemental and therefore prone to management bias. If the directors wish to manipulate the accounts in any way, accounting estimates are the easy way for them to do this. The auditor must take care when auditing estimates to ensure this has not been the case.

Procedures used by the auditor in respect of estimates are:

- Discuss with management their process for calculating the estimate and assess whether this appears reasonable.
- For estimates such as provisions it may be possible to obtain an independent expert opinion for example correspondence from lawyers regarding a legal provision or a surveyor’s report for evidence of an environmental provision.
Review subsequent events, for example if there is a pending legal case with a legal provision at the balance sheet date, the case may have been settled by the time of the audit and therefore will provide evidence as to whether the provision was reasonably stated. An accrual can be compared with the actual invoice if the invoice has been received by the client by the time of the audit.

11 Computer assisted audit techniques (CAATs)

The use of a computer to either perform, be tested or to assist the auditors in carrying out their audit procedures.

With so many accounting systems now held on computer, the assurance provider may wish to make use of CAAT’s. There are two types of CAAT’s

(1) Audit software
(2) Test data
Auditing around the computer?

This term means that the ‘internal’ software of the computer is not documented or audited by the auditor, but the inputs to the computer are agreed to the expected outputs to the computer.

Audit outcome

Increase the AUDIT RISK Why?

The actual computer files and programs are NOT TESTED.
Therefore no DIRECT evidence that the programs are working as documented

Where errors are found it may be difficult or even impossible to determine why those errors have occurred.
If amendments cannot be made, there is an increased likelihood of audit qualifications.
Since controls are being tested, all discrepancies between predicted and actual results must be fully resolved and documented, irrespective of financial amounts involved.

Audit software

Description

This is software specifically designed for audit purposes, there are a number of off-the-shelf packages available, or the auditor could have a tailor-made system. It is used to process the client’s data in order to check that the figures themselves are correct. It can therefore carry out a whole range of substantive procedure, across all sorts of different data.

Examples of what audit software can do include:

• Extract a sample according to specified criteria
  – Random
  – Over a certain amount
  – Below a certain amount
  – At certain dates
• Calculate ratios and select those outside the criteria
Package programmes are generally designed to;

- read computer files
- select information
- perform calculations
- create data files, and
- print reports in a format specified by the auditor

**Test data**

The assurance provider supervises the process of running data through the clients system. To do this the auditor would have to

- Note controls in the clients system
- Decide upon the test data

It maybe processed during a normal production run ('live' test data) or during a special run at a point in time outside the normal cycle ('dead' test data), either with real data or dummy data.

- Run the test data
- Compare results with those expected
- Conclude on whether controls are operating properly

Through test data. This is data generated by the auditor in order to test the systems, processing logic, calculations and controls, to ensure that the controls within the system are operating properly.

An auditor would take a transaction through a system, testing the systems limits. So you would have ‘normal’ transactions and invalid transactions to test that the system work. If the results are positive that means the auditor can rely on the system and have more confidence that the output is accurate.
What are the benefits of CAAT’s?

<table>
<thead>
<tr>
<th>Benefits / Advantages</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>CAAT’s force the auditor to rely on programmed controls during the audit. Sometimes it may be the only way to test controls within a computer system, therefore enables the auditor to test program controls</td>
<td>Credit limits within a system can only be changed by the accountant. A computer assisted check will test that this is the case.</td>
</tr>
<tr>
<td>Using CAAT’s enables the auditors to comply with ISA of obtaining appropriate audit evidence increasing the overall confidence for the audit opinion</td>
<td>Checking the depreciation charged on each asset would be quicker with a computer assisted program than manually</td>
</tr>
<tr>
<td>Large number of items can be tested quickly and accurately</td>
<td>Actual wages will be tested instead of paper copies.</td>
</tr>
<tr>
<td>CAAT’s test original documentation instead of print outs, therefore the authenticity of the document is more valid this way.</td>
<td>Examples of use or audit tests</td>
</tr>
</tbody>
</table>
| After initial set up costs, using CAAT’s are likely to be cost effective, as the same audit software can be used each year as long as the system doesn’t changed | (1) Calculation checks  
(2) Reviewing lists of old or outstanding items and investing those specifically  
(3) Detecting for unreasonable items  
(4) Detecting violation of the system rules  
(5) New analysis  
(6) Completeness checks  
(7) Selects samples  
(8) Identifying exception reporting facilities |
| Allow the results from using using CAATs to be compared with ‘traditional’ testing,    | If the two sources of evidence agree then this too will increase the overall audit confidence |
### What are the weaknesses, or problems with CAAT’s, and how can they be resolved?

<table>
<thead>
<tr>
<th>Weaknesses / problems</th>
<th>Recommendations / resolve</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Limitations</strong></td>
<td>CAAT’s will be limited depending on how well the computer system is integrated.</td>
</tr>
<tr>
<td></td>
<td>The more integrated the better the use of CAAT’s. For example the invoices should be</td>
</tr>
<tr>
<td></td>
<td>computer generated and then processed through the accounts system to feed in to the</td>
</tr>
<tr>
<td></td>
<td>financial statements.</td>
</tr>
<tr>
<td></td>
<td>The existing system made do some of the functions of the CAAT, for example highlight old</td>
</tr>
<tr>
<td></td>
<td>balances or obsolete inventory</td>
</tr>
<tr>
<td></td>
<td>Ensure you understand the system to assess whether audit software will be relevant for</td>
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<td></td>
<td>the company.</td>
</tr>
<tr>
<td></td>
<td>Need to assess whether there is a need for the audit software.</td>
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<tr>
<td><strong>Reliability</strong></td>
<td>CAAT’s are only useful methods of testing if you can rely on the system, so the auditor</td>
</tr>
<tr>
<td></td>
<td>would have to assess the reliability first, before use.</td>
</tr>
<tr>
<td></td>
<td>Assess the reliability, document and then make a decision whether it’s relevant to use</td>
</tr>
<tr>
<td></td>
<td>audit software as part of the evidence collected.</td>
</tr>
<tr>
<td><strong>Cost</strong></td>
<td>It takes time to design CAAT’s tests therefore may not be cost effective if the auditor</td>
</tr>
<tr>
<td></td>
<td>is dealing with a bespoke system, as there maybe a lot of set up costs. The reason for</td>
</tr>
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<td></td>
<td>this is it takes time to write specific test data or to program the audit software to the</td>
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<td></td>
<td>needs of the client.</td>
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<td></td>
<td>A cost benefit analysis from the audit point of view should be carried out prior to</td>
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<tr>
<td></td>
<td>deciding to use the audit software.</td>
</tr>
<tr>
<td><strong>Lack of software documentation</strong></td>
<td>If the company you are auditing can not confirm all system documentation is available,</td>
</tr>
<tr>
<td></td>
<td>then the auditors will be unable to do the tests effectively due to lack of understanding</td>
</tr>
<tr>
<td></td>
<td>Shouldn’t use audit software until these have been identified. Hold until this point.</td>
</tr>
<tr>
<td><strong>Change to clients systems</strong></td>
<td>If there is a change in the accounting year or from the previous year then the audit</td>
</tr>
<tr>
<td></td>
<td>software will have to be reset and designed, therefore may be costly.</td>
</tr>
<tr>
<td></td>
<td>A cost benefit analysis from the audit point of view should be carried out prior to</td>
</tr>
<tr>
<td></td>
<td>deciding to use the audit software.</td>
</tr>
<tr>
<td></td>
<td>Or if you know there to be a change in the near future hold the audit software until</td>
</tr>
<tr>
<td></td>
<td>that year.</td>
</tr>
</tbody>
</table>
### Lack of direction and useless results

Audit tests may be done just because the auditors have the facility to do them, therefore the output of results will either be inconclusive or not required. Therefore having an inefficient and costly audit

### Use of copy files

Clients tend to provide the auditors with copies of the system notes and any other relevant information. The problem here is do we know if those are the actual files?

To ensure the files are genuine either the auditor should supervise the copying or use the originals in the first place.

### Test data - problems

#### Damage of computer system

Because we are testing the limits of the system the dummy process may damage the computer system.

Ensure as auditors we understand the system and have support if need be form software experts.

#### Need to reverse or remove dummy transactions

Ideally test data should be run ‘live’ if not possible then the ‘dead’ test data needs to be used under identical systems for it to be valid, and enough computer time should be provided. The transactions may be incorrectly or incompletely removed, leaving dummy data in a live system.

Ensure there is a process for ensuring all dummy transactions are cleared and the auditor has discussed when they can use the computer and for what test specifically.

### Examples of Test Data

<table>
<thead>
<tr>
<th>Tests</th>
<th>Reason for the Test</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td></td>
</tr>
<tr>
<td>Input an order into the clients system that would cause a customer to exceed their credit limit.</td>
<td>The order should not be accepted, or should raise a query whether you are sure you wish to proceed. If this happens then the auditors will have confidence the system is working properly.</td>
</tr>
<tr>
<td>Input a negative number of items on an order</td>
<td>Ensures only positive quantities are accepted.</td>
</tr>
<tr>
<td>Input incomplete customer details</td>
<td>The system should not process the order unless all information is completed.</td>
</tr>
<tr>
<td>Input an excessive amount</td>
<td>There are reasonable checks in the system to identify possible input errors. A warning should appear on the screen confirming the number</td>
</tr>
<tr>
<td>Input and invalid inventory code</td>
<td>Ensures that the computer detects the invalid code and presents an error message rather than taking the nearest code and accepting it</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>----------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Input of invalid details</td>
<td>Ensures that no errors are made for sipping and payment</td>
</tr>
<tr>
<td><strong>Purchases</strong></td>
<td></td>
</tr>
<tr>
<td>Raise an order from a supplier not on the preferred supplier list</td>
<td>A query should be raised as to whether you want to proceed with this transaction</td>
</tr>
<tr>
<td>Process an order with an unauthorised staff ID</td>
<td>The system should reject the process altogether or send the request through to an appropriate person for authorisation</td>
</tr>
<tr>
<td>Try and make changes to the supplier standing data using the ID of someone who is not authorised to do so</td>
<td>The system should reject the process altogether or send the request through to an appropriate person for authorisation</td>
</tr>
<tr>
<td><strong>Payroll</strong></td>
<td></td>
</tr>
<tr>
<td>Try and set up a new employee up on the payroll system using an unauthorised ID</td>
<td>The system should reject the process altogether or send the request through to an appropriate person for authorisation</td>
</tr>
<tr>
<td>Try and make employee changes of detail using an unauthorised ID</td>
<td>The system should reject the process altogether or send the request through to an appropriate person for authorisation</td>
</tr>
<tr>
<td>Make an excess change for example increase someone’s salary by $1,000,000 by someone authorised</td>
<td>The system should have parameters in place to question this amount, and maybe reject it due to it being outside the normal range</td>
</tr>
<tr>
<td><strong>Receivables</strong></td>
<td></td>
</tr>
<tr>
<td>Cast the receivables ledger to ensure it agrees with the total on the receivables control account</td>
<td>To ensure the completeness and accuracy of the items on the receivables control account</td>
</tr>
<tr>
<td>Compare the balances to the credit limits to ensure they haven’t been exceeded</td>
<td>To check or violation of the system rules</td>
</tr>
<tr>
<td>Review the balances to ensure they don’t exceed the total sales to that customer</td>
<td>To check for unreasonable items in the ledger</td>
</tr>
<tr>
<td>To review the receivable days on a monthly basis and compare to year</td>
<td>To obtain new / relevant statistical information</td>
</tr>
<tr>
<td>To form receivable balances to show all material items and select appropriate sampling for testing.</td>
<td>To select specific items for the audit test.</td>
</tr>
<tr>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>To produce an aged receivables analysis to assist with identification of irrecoverable receivables.</td>
<td>To assist in the receivables valuation testing.</td>
</tr>
</tbody>
</table>

### Test your understanding 3

Give examples of test using CAATs when dealing with orders received, goods despatched, and invoices raised?
12 Chapter summary

AUDIT PROCEDURES

WORKING PAPERS

RECEIVABLES

ANALYTICAL PROCEDURES

INVENTORIES

CAATs

PAYABLES

THE WORK OF OTHERS

BANK AND CASH

NON-CURRENT ASSETS

NON-CURRENT LIABILITIES

ACCOUNTING ESTIMATES
### Test your understanding answers

#### Test your understanding 1

<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
</tr>
</thead>
</table>
| 1. State three things the auditor should consider when reviewing a clients instructions for the stock count. | Are they flawed in any way?  
The impact on the logistics for the audit team attending the count.  
How to ensure that the most material/risky stock lines are included in the auditors' tests. |
| 2. How would you test stocks for existence?                              | Select items from the client's final stock listing and compare with the results of the auditor's test counts                           |
| 3. How would you test stocks for completeness?                           | Trace the items counted by the auditor into the client's final stock listing.                                                        |
| 4. Saxophone Ltd runs a petrol filling station. How would you test the quantities of petrol in stock? | If the tank has a gauge – read the results.  
The accuracy of the gauge can be tested by noting the reading just before and after a new delivery of fuel is made and comparing with the quantity delivered.  
If there is no gauge, it will be necessary to ‘dip the tank’ using a measuring stick. |
| 5. Flute Ltd makes large machines out of very heavy lumps of steel. How would you assess its stock of sheet and bar steel? | Test count bars sheets of steel.  
Assess average weights of bars and sheets from delivery/weighbridge records                                                      |
| 6. Piccolo Ltd has a sheep farming business. How would you verify the number of animals it owns at the year end? | Count them at dipping time or when they are herded together for some purpose.  
Or (preferably) use the report of a relevant expert.   |
1. How would you verify that all unpresented cheques are included on a client’s bank reconciliation?

- Review post-year-end bank statements to test that all cheques drawn before year end but clearing after the balance sheet date are included on the reconciliation.

2. State 2 things which might be included on a bank letter besides the balances on a client’s accounts.

- Deeds and other documents or assets held.
- Guarantees.
- Forward currency contracts
- Bills of exchange and letters of credit.

3. How would you test the rights and obligations assertion for a freehold property?

- Check title deeds and register of charges.

4. How would you test the completeness of a client’s hire purchase and leasing liabilities?

- For all assets acquired in the year review correspondence to ensure there are no hire purchase or leasing liabilities in relation to the asset.

**Test your understanding 3**

**Solution**

**Orders**

Place orders on the website using test data.

**Goods dispatched**

Programme audit software to select a sample of customer orders, obtain the GDN number from each order, and verify that each GDN number exists in the GDN file.

**Invoice**

Programme audit software to select a sample of GDNs, obtain the invoice numbers from each order and verify that each invoice number exists in the invoice file.

(GDN – goods despatch note)
Completion and review

Chapter learning objectives

Upon completion of this chapter you will be able to:

Subsequent events

• explain the purpose of a subsequent events review
• discuss the procedures to be undertaken in performing a subsequent events review.

Going concern

• define and discuss the significance of the concept of going concern
• explain the importance of and the need for going concern reviews
• explain the respective responsibilities of auditors and management regarding going concern
• discuss the procedures to be applied in performing going concern reviews
• discuss the disclosure requirements in relation to going concern issues
• discuss the reporting implications of the findings of going concern reviews.

Management representations

• explain the purpose of and procedures for obtaining management representations
• discuss the quality and reliability of management representations as audit evidence
• discuss the circumstances where management representations are necessary and the matters on which representations are commonly obtained.
Audit Finalisation and review

- discuss the overall review of evidence obtained
- explain the significance of unadjusted differences.
1 Introduction

This chapter deals with some of the procedures which happen at the completion stage of the audit.

It deals with:

• the significance of the partner’s file review
• what to do about errors
• subsequent events
• going concern
• management representations.

It does not deal with the technicalities of how to carry out a file review or some of the other issues which tend to arise at the completion stage. You will come across these later in your studies.

2 Overall review of evidence

What happens in the final review?

The overall review stage of the audit is the point at which the final decisions are taken:

• Do the financial statements comply with the relevant reporting framework?
  – Law.
  – Applicable accounting standards.
  – GAAP.
  – Other regulations (e.g. Stock Exchange listing requirements).
  – Does other information published with the financial statements (e.g. Directors’ report, Chairman’s review) conflict with them in any way?
The review is carried out by the engagement partner who has ultimate responsibility for committing the audit firm when signing the audit report.

From the above list you can probably gather that the review is a highly significant part in the whole audit process. This can best be summarised by stating that the overall review is the point where the decision is taken that:

- the firm’s procedures have been followed properly
- the quality of the work done is up to standard

and either the financial statements:

- give a true and fair view and
- comply with the applicable accounting framework or they do not.

• Does the evidence gathered in the course of the audit support the audit opinion?
  - Was the audit plan followed?
  - Has sufficient, appropriate audit evidence been gathered?
  - What issues arose? What errors were found?
  - Was the plan suitably modified to allow for changing circumstances?
  - Have necessary consultations taken place both within the firm and with outside experts?
  - Has the file been adequately reviewed at lower levels within the firm (e.g. by the senior and the manager)?
  - Have the necessary checklists been completed?

• Have the necessary completion procedures been carried out?
  - Final analytical review.
  - Consideration of the firm’s continued independence.
  - Second partner review (if appropriate). Subsequent events review.
  - Going concern review.
  - Management representations obtained.

The review is carried out by the engagement partner who has ultimate responsibility for committing the audit firm when signing the audit report.
Overall review – quality control

The three pillars of quality control

Review is one of the three pillars of quality control, the other two being planning and supervision.

The seven points

The role of review in quality control is set out in ISA 220 Quality Control for Audits of Historical Financial Information. The detail of ISA 220 is not examinable however you do need to understand the reasons why the overall file review takes place.
The reviewer needs to consider the following points:

- the work has been performed in accordance with professional standards and regulatory and legal requirements
- significant matters have been raised for further consideration
- appropriate consultations have taken place and the resulting conclusions have been documented and implemented
- there is a need to revise the nature, timing and extent of the work performed
- the work performed supports the conclusions reached and is appropriately documented
- the evidence obtained is sufficient and appropriate to support the auditor’s report
- the objectives of the engagement procedures have been achieved.

(1) Which of the following might be done as part of the final review?

(a) Read the proposed directors’ report and check for any inconsistencies with the financial statements.
(b) Assess whether the financial statements fully reflect the information and explanations received during the audit?
(c) Discuss material errors found during the audit that require adjustment.
(d) Substantive testing.
(e) Ensure all accounting standards relevant to the company and its activities have been considered, and disclosures made in the financial statements.

(2) Which of the following are true?

(a) Audit firms have quality control procedures because:
(b) It’s the law.
(c) Their success is largely dependent on reputation, which is influenced by quality.
(d) Poor quality may result in poor performance, potentially leading to damage to reputation.
(e) Quality improvements may result in cost savings.
During the course of the audit, the auditor will have identified errors within the account balances and transactions. How these differences are dealt with impacts on their significance to the financial statements.

- All identified errors should be recorded on a working paper set up for the purpose. Often referred to as:
  - errors summary
  - overs and unders
  - schedule scoresheet.

- Errors that are individually immaterial may in aggregate amount to a material difference.

- The auditor must persuade management to adjust the financial statements for material errors, otherwise a qualified audit report must be given.

- Errors identified through sampling need to be extrapolated so that the potential error in the population as a whole can be estimated. If such errors reveal a potentially material adjustment, the audit team should have carried out additional work to determine whether or not the error actually is material, before the assignment reaches the review stage.

- **ISA 260 Communication of audit matters with those charged with governance** states that the auditors would normally report:
  - material audit adjustments whether or not recorded by the entity and
  - aggregate uncorrected misstatements
to those charged with governance. ISA 260 allows for a threshold to be set to avoid the necessity for reporting errors which are clearly trivial, but this reinforces the need for the ‘errors schedule’ to be completed methodically as the audit progresses.

– Consideration of errors identified in the course of the audit will often provide useful input to the planning process for the following year’s audit.

**Test your understanding 2**

Give three examples of findings that could result in unadjusted differences (material or immaterial).

**4 Subsequent events reviews**

**Definitions**

**Subsequent events** are events occurring and facts discovered between the period end and the date the financial statements are authorised for issue.

Auditors must take steps to ensure that any such events are properly reflected in the financial statements.

To identify any such events, a **subsequent events review** is carried out.

There are two types of subsequent events:

- **Adjusting** – events providing additional evidence relating to conditions existing at the balance sheet date; they require **adjustments** in the financial statements.
• **Non-adjusting** – events concerning conditions which arose after the balance sheet date, but which may be of such materiality that their disclosure is required to ensure that the financial statements are not misleading.

**Subsequent events reviews – what auditors need to do**

**ENQUIRE**
- into management systems
- of directors
- about matters not yet minuted

**REVIEW**
- minutes
- accounting records
- correspondence with lawyers, customers and suppliers

**PERFORM**
- ‘normal’ post balance sheet work

**ENQUIRE**
- letter of representation

ISA 560 Subsequent Events details the responsibilities of the auditors with respect to subsequent events and the procedures they can use. As auditors are responsible for their audit work right up to the date that the financial statements are issued, they should perform subsequent event reviews until that date has passed.

However, the nature of their responsibility changes at the point the audit report is signed – see section 'Going concern reviews - the auditor's role' below.
Procedures undertaken in performing a subsequent events review might include any of the following:

- Enquiring into management procedures/systems for the identification of subsequent events.
- Reading minutes of members’ and directors’ meetings, and of audit and executive committee meetings, and enquiring about matters not yet minuted.
- Reviewing accounting records including budgets, forecasts and interim information.
- Making enquiries of directors to ask if they are aware of any subsequent events, adjusting or non-adjusting, that have not yet been included or disclosed in the financial statements.
- ‘Normal’ post balance sheet work performed in order to verify year-end balances:
  - checking after date receipts from receivables
  - verifying the value of accrued expenses by checking invoices when received
  - checking inventory valuations are at lower cost and net realisable value by testing to eventual selling prices.
- Obtaining, from management, a letter of representation.

Subsequent events review – changes triggered by the signing of the audit report

The stage of completion of the annual financial statements determines the procedures the auditor must undertake in performing subsequent event reviews.

Up to signing the audit report

- Auditors have an active duty to search for all material events between the balance sheet date and the date the audit report is signed.
Between signing the audit report and issuing the financial statements

- Auditors have a **passive duty**.
- Auditors only have to act if they are made aware of something – but once they are aware, they have a duty to take the necessary action.

<table>
<thead>
<tr>
<th>Illustration 1 – Subsequent events review</th>
</tr>
</thead>
<tbody>
<tr>
<td>A few days after signing an audit report, but before the client’s financial statements have been approved by the shareholders at the AGM, the auditors receive a phone call from a director indicating a material error in the financial statements.</td>
</tr>
<tr>
<td>In such circumstances, a number of things may happen.</td>
</tr>
<tr>
<td>- Client produces a revised set of financial statements.</td>
</tr>
<tr>
<td>Where this happens, the auditor needs to produce a new audit report, as the audit report must always be dated on or after the date that the financial statements are signed by the directors. The auditor will therefore need to extend ‘active duties’ on all other matters from the original date of the audit report to the new date.</td>
</tr>
<tr>
<td>- Client refuses to change the financial statements.</td>
</tr>
<tr>
<td>Now the financial statements are materially wrong, but the initial audit report said they were true and fair. The auditor should ask for the audit report back, so that a new qualified report can be issued. However, the client may refuse this as well.</td>
</tr>
<tr>
<td>In such circumstances, the auditor should obtain legal advice, consider resignation, and speak at the AGM to notify shareholders.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Test your understanding 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) <strong>Which of the following would be adjusting subsequent events?</strong></td>
</tr>
<tr>
<td>- Trade receivables may ‘go bad’, resulting in additional provisions or write-offs</td>
</tr>
<tr>
<td>- Final dividend is declared</td>
</tr>
<tr>
<td>- Inventory may be sold at less than cost</td>
</tr>
</tbody>
</table>
Until the point where the financial statements are approved by the shareholders, the auditors have an active duty to search for all material events after the balance sheet date.

(2) Give two examples of procedures that might be undertaken in performing a subsequent events review.

(3) True or false?

Until the point where the financial statements are approved by the shareholders, the auditors have an active duty to search for all material events after the balance sheet date.

5 Going concern

The going concern concept – definition

According to IAS1 financial statements should be prepared on the basis that the company is a going concern unless it is inappropriate to do so.

- The **going concern concept** is defined in IAS1 as the assumption that the enterprise will continue in operational existence for the foreseeable future.
- Any consideration involving the ‘foreseeable future’ involves making a judgement about future events, which are inherently uncertain.
- Uncertainty increases with time and judgements can only be made on the basis of information available at any point – subsequent events can overturn that judgement.
- Management (and auditors) should generally look ahead **at least one year** from the date of the directors’ approval of the financial statements, in assessing the validity of the going concern basis.
- There may be circumstances in which it is appropriate to look further ahead. This depends on the nature of the business and the associated risks.
The going concern concept – significance

Whether or not a company can be classed as a going concern affects how its financial statements are prepared.

• Financial statements are usually prepared on the basis that the reporting entity is a going concern.
• IAS1 state that ‘an entity should prepare its financial statements on a going concern basis, unless
  – the entity is being liquidated or has ceased trading, or
  – the directors have no realistic alternative but to liquidate the entity or to cease trading.’
• Where the assumption is made that the company will cease trading, the financial statements are prepared using the **break-up basis** under which:
  – assets are recorded at likely sale values
  – inventory and receivables are likely to require more provisions, and
  – additional liabilities may arise (severance costs for staff, the costs of closing down facilities, etc.).

**Going concern reviews – the auditor’s role**

Auditors are concerned with ensuring that financial statements give a ‘true and fair’ view, which includes being satisfied that they have been prepared using the correct basis.

• A set of financial statements is typically put together on the presumption that the company will continue trading for the foreseeable future (as a guide, at least one year).
Auditors may appear negligent if they issue a ‘clean’ audit report on a company’s financial statements that paint a positive picture, only for that company to quickly go out of business.

Hence it is important for auditors to be assured that the company is a going concern, to confirm that the correct basis of preparation has been used.

Auditors undertake ‘going concern reviews’ to obtain this assurance.

**Going concern – responsibilities**

- **Directors**: Assess the company’s ability to continue as a going concern
- **Auditors**: Satisfy themselves that the going concern assumption is reasonable, and disclosures made by directors are adequate
Going concern – what the auditor has to do

The procedures that the auditors undertake for their going concern review will depend on the risk that the company may not be a going concern.

- In a company where profits are high, cash flows are positive, finance is in place, and there is no obvious exposure to large losses, going concern procedures are likely to be minimal.
- Where any doubts regarding going concern exist, procedures are more extensive.
- When companies go out of business, it is more likely to be due to a lack of cash than a lack of profits. However, in the long term, profits are of course essential for survival.
- The auditor should remain alert for evidence of events or conditions which may cast significant doubt on the entity’s ability to continue as a going concern, both in the planning stage and throughout the audit.

Indicators of going concern problems

Typical indicators of going concern problems include the following:

- Net current liabilities (or net liabilities overall!).
- Borrowing facilities not agreed.
This is not an exhaustive list and you may identify other factors from the scenario given to you in the exam.

Actions an auditor can carry out to determine whether the entity is a going concern.

The auditors could do the following

- Review management’s plans for future actions based on its going concern basis.
- Gather additional sufficient and appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists regarding the going concern concept.
- Seek written representation from management regarding its plans for future action.
- Obtain information from company bankers regarding continuance of loan facilities.
- Review receivables ageing analysis to determine whether there is an increase in days – which may also indicate cash flow problems.
- Look at cash flow forecasts for the twelve months to identify if they have enough cash to trade.
- Review long term contracts for loss of business when the contracts come up for tender.
- Look at articles on and negative press, which would have an impact on the goodwill of the company and therefore potentially create a going concern issue.
- Review legislation that the company has to comply with and ensure they are complying.
Going concern – disclosure requirements

Where there is any doubt over the going concern status of a company, the directors should include disclosures in the financial statements explaining:

• the doubts
• the possible effect on the company.

Where the directors have been unable to assess going concern in the usual way (e.g. for less than one year beyond the date on which they sign the financial statements), this fact should be disclosed.

Where the financial statements are prepared on a basis other than the going concern basis, the basis used should be disclosed.
We will look at the detail of the contents of the auditor’s report in Chapter 12.

Here it is important for you to understand the following.

• Financial statements are normally prepared on the going concern basis.

• Where the going concern basis is used and is appropriate, the auditors do not need to mention the fact in their report.

• If the auditors believe that the going concern basis is inappropriate, or the disclosures given by management about the going concern issues are inadequate, but the directors do not, the audit report will need to be qualified, i.e. the auditors will be saying that the financial statements do not give a true and fair view.

• If the going concern basis is not appropriate and the directors prepare the financial statements on some other, appropriate basis, the auditors would normally refer to this in their report because it is a matter of extreme significance – this is called an ‘emphasis of matter paragraph’ for obvious reasons.
Which of the following are true?

(a) Auditors should generally look ahead at least five years from the date of the directors’ approval of the financial statements in assessing the validity of the going concern basis.

(b) Auditors should generally look ahead at least one year from the date of the directors’ approval of the financial statements in assessing the validity of the going concern basis.

(c) The going concern concept is defined in IAS 1.

(d) Subsequent events have no impact on the assessment of going concern at the balance sheet date.

If a company can no longer be considered a going concern, on what basis will its financial statements be prepared?

Why do auditors undertake going concern reviews?

Which of the following is true?

(a) Auditors are responsible for deciding whether a business is a going concern.

(b) Auditors are correct to assume that a business is a going concern if it was in the previous year.

(c) It is the directors’ responsibility to assess the company’s ability to continue as a going concern when they are preparing the financial statements.

(d) Directors do not need to disclose material uncertainties regarding going concern if they arise after the balance sheet date.

True or false?

(a) When companies go out of business, it is more likely to be due to a lack of cash than a lack of profits.

(b) Going concern procedures are likely to be extensive in a company where profits are high and cash flows are positive.

(c) The auditor should rely on the directors to inform them if there is any doubt over the entity’s ability to continue as a going concern.

Give three things that you think may indicate going concern problems within a company.

What disclosures must directors make in relation to going concern?
6 Management representations

What are management representations?

Management representations are a particular type of enquiry, whereby the auditor asks management to confirm, in writing, a number of issues covered by or surrounding the financial statements.

- These may be general matters such as:
  - the directors’ understanding that it is their responsibility to produce financial statements that show a true and fair view or
  - whether all information that the auditors need for the purpose of the audit has been communicated to the auditors.

- They may be specific to the client or this particular year’s financial statements such as:
  - confirmation of values where there is a significant degree of estimation or judgement involved, e.g. development expenditure on new products or the outcome of litigation
  - formal confirmation of the directors’ judgement on contentious issues, e.g. the recognition of revenue, or the value of assets where there is a risk of impairment.

How are management representations obtained?

As the audit progresses, the audit team will assemble a list of those items about which it is appropriate to seek management representations.

As part of the completion process the auditors will write to the client’s management stating the issues about which they are seeking representations.

The representations themselves may take any of the following forms.

- A letter from the client’s management to the auditors covering the necessary points. Usually the auditors will provide management with a draft of the letter for them to produce on the client’s letterhead and sign.
- A letter from the auditors to management setting out the necessary points, which management signs in acknowledgement and returns to the auditors.
- Minutes of the meeting at which representations were made orally which can be signed by management as a true record of what was discussed.
Why do auditors need management representations?

**MANAGEMENT REPRESENTATIONS – 3 REASONS**

1. **FORMAL CONFIRMATION BY MANAGEMENT**
2. **PERHAPS THE ONLY EVIDENCE AVAILABLE**
3. **REQUIRED BY ISA 580 AND OTHER ISAs**

You may think that as the auditor’s job is to form an independent opinion about whether or not the financial statements prepared by management give a true and fair view, the value of representations from management might be questionable.

However, there are three good reasons why management representations are necessary:

1. **Precisely because it is management’s responsibility to produce financial statements that show a true and fair view, the most obvious first source of audit evidence is to ask them whether or not they have done so.**

2. **There may be circumstances where no other sufficient, appropriate audit evidence may reasonably be expected to exist – the issues concerning estimation and judgement mentioned above are the most obvious examples.**

3. **ISA 580 Management representations and the requirements of a number of other ISAs make it compulsory for the auditors to obtain management representations on a number of specific issues.**

**The quality and reliability of management representations**

We have seen in Chapter 9 on audit evidence that the quality and reliability of audit evidence depends on a number of issues, in particular:

- its source (independent, external or auditor generated evidence is better than evidence generated internally by the client)
Clearly written management representations are documentary evidence obtained directly by the auditor which is the good news.

The bad news is that management representations are not independent.

The auditor will therefore have to make judgements about:

- management’s competence to make the representations
- management’s integrity
- whether circumstances are such that management’s behaviour may be expected to be different from how it has been in the past.

If, for example the client was:

- under increased financial pressure because of difficult trading conditions
- subject to being taken over, where the value of managements’ shareholdings could vary widely depending on the terms of the takeover

the auditors might revise their judgement about the reliability of management representations.

---

**Test your understanding 5**

1. **Give three reasons why auditors obtain management representations.**
2. **Give three methods for obtaining management representations.**
3. **Suggest five things about which management representations may be obtained.**
7 Chapter summary

COMPLETION AND REVIEW

FILE REVIEW
- QUALITY CONTROL
- ERRORS
- FINANCIAL STATEMENTS OK?
- AUDIT EVIDENCE OK?

SPECIFIC PROCEDURES
- SUBSEQUENT EVENTS
- GOING CONCERN
- MANAGEMENT REPRESENTATIONS
  - ADJUSTING NON-ADJUSTING
  - HORIZON
  - ISA 580

PROCEDURES
- ACTIVE/PASSIVE
- DISCLOSURE
  - QUALITY RELIABILITY
  - ISA 560
  - ISA 570
## Test your understanding answers

### Test your understanding 1

1. Which of the following might be done as part of the final review?

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>(a) Read the proposed directors’ report and check for any inconsistencies with the financial statements.</td>
<td>Yes.</td>
</tr>
<tr>
<td>(b) Assess whether the financial statements fully reflect the information and explanations received during the audit?</td>
<td>Yes.</td>
</tr>
<tr>
<td>(c) Discuss material errors found during the audit that require adjustment.</td>
<td>No – should have been done before the final review stage.</td>
</tr>
<tr>
<td>(d) Substantive testing.</td>
<td>No – should have been done during the main body of the audit.</td>
</tr>
<tr>
<td>(e) Ensure all accounting standards relevant to the company and its activities have been considered, and disclosures made in the financial statements.</td>
<td>Yes.</td>
</tr>
</tbody>
</table>

2. Which of the following are true? Audit have quality control procedures because:

<p>| | |</p>
<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) It’s the law.</td>
<td>Perhaps not strictly, but it is a requirement of ISAs and International Standard on Quality Control 1.</td>
</tr>
<tr>
<td>(b) Their success is largely dependent on reputation, which is influenced by quality.</td>
<td>Yes.</td>
</tr>
<tr>
<td>(c) Poor quality may result in poor performance, potentially leading to damage to reputation.</td>
<td>Yes.</td>
</tr>
<tr>
<td>(d) Quality improvements may result in cost savings.</td>
<td>Yes.</td>
</tr>
<tr>
<td><strong>Test your understanding 2</strong></td>
<td></td>
</tr>
<tr>
<td>--------------------------------</td>
<td></td>
</tr>
<tr>
<td>Give three examples of findings which could result in unadjusted differences (material or immaterial).</td>
<td></td>
</tr>
<tr>
<td>Lots of possibilities – some suggestions:</td>
<td></td>
</tr>
<tr>
<td>• year-end stock counted incorrectly</td>
<td></td>
</tr>
<tr>
<td>• trade debtors unrecoverable</td>
<td></td>
</tr>
<tr>
<td>• over-provisions</td>
<td></td>
</tr>
<tr>
<td>• under-provisions</td>
<td></td>
</tr>
<tr>
<td>• depreciation incorrectly calculated</td>
<td></td>
</tr>
<tr>
<td>• cash book/payables ledger/debtors ledger closed too early/late</td>
<td></td>
</tr>
<tr>
<td>• sales revenue cut-off incorrectly applied</td>
<td></td>
</tr>
<tr>
<td>• accruals and prepayments calculated incorrectly</td>
<td></td>
</tr>
<tr>
<td>• interest charge/income not recognised.</td>
<td></td>
</tr>
</tbody>
</table>
### Test your understanding 3

1. Which of the following would be adjusting subsequent events?

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Trade debtors may 'go bad', resulting in additional provisions or write-offs.</td>
<td>Adjusting.</td>
</tr>
<tr>
<td>(b) Final dividend is declared.</td>
<td>The declaration of dividends is not an adjusting event – recognition of the liability is in the period of declaration, not the period to which it relates.</td>
</tr>
<tr>
<td>(c) Stock may be sold at less than cost.</td>
<td>Adjusting.</td>
</tr>
<tr>
<td>(d) Company is bought by a large, multi-national group.</td>
<td>This would be a material non-adjusting event unless the price paid for the company suggested that it should have been valued on a break-up rather than a going concern basis at the year end.</td>
</tr>
<tr>
<td>(e) Sales revenue returns may indicate problems with year end stock holdings.</td>
<td>Adjusting.</td>
</tr>
</tbody>
</table>

2. Give three examples of procedures which might be undertaken in performing a subsequent events review.

Choose from:

- enquiring into management procedures/systems for the identification of subsequent events
- reading minutes of members’ and directors’ meetings, and of audit and executive committee meetings, and enquiring about matters not yet minuted
- reviewing accounting records including budgets, forecasts and interim information
• making enquiries of directors to ask if they are aware of any subsequent events, adjusting or non-adjusting, that have not yet been included or disclosed in the financial statements
• normal post balance sheet work performed in order to verify year-end balances
• obtaining, from management, a letter of representation.

3 True or false?

Until the point where the financial statements are approved by the shareholders, the auditors have an active duty to search for all material events after the balance sheet date.

False – auditors only have an active duty to search for all material events after the balance sheet date up to the point where the audit report is signed, thereafter the duty becomes a passive one.

Test your understanding 4

1. Which of the following are true?

(a) Auditors should generally look ahead at least five years from the date of the directors’ approval of the financial statements in assessing the validity of the going concern basis.

The usual 'horizon' is regarded as one year. However, auditors use their judgement at all times and if for example it looked probable that the company might collapse in, say one year and one month, from the date the directors signed the financial statements, the auditors would want the fact to be disclosed.

(b) Auditors should generally look ahead at least one year from the date of the directors’ approval of the financial statements in assessing the validity of the going concern basis.

Clearly the longer the 'horizon', the less the degree of certainty.
**Completion and review**

<table>
<thead>
<tr>
<th>(c) The going concern concept is defined in IAS1/FRS18.</th>
<th>True.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(d) Subsequent events have no impact on the assessment of going concern at the balance sheet date.</td>
<td>False. A non adjusting subsequent event might cause doubts about the going concern basis if it happened within the one-year horizon.</td>
</tr>
</tbody>
</table>

2. If a company can no longer be considered a going concern, on what basis will their financial statements be prepared? Break-up basis.

3. Why do auditors undertake going concern reviews? To obtain assurance that the business they are auditing is a going concern, therefore using the going concern basis for financial statements preparation is appropriate.

4 Which of the following is true?

<table>
<thead>
<tr>
<th>(a) Auditors are responsible for deciding whether a business is a going concern.</th>
<th>False – it is the directors’ responsibility to decide, but the auditor have to consider the issue in forming their opinion.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(b) Auditors are correct to assume that a business is a going concern if it was in the previous year.</td>
<td>False – circumstances may have changed.</td>
</tr>
<tr>
<td>(c) It is the directors’ responsibility to assess the company’s ability to continue as a going concern when they are preparing the financial statements.</td>
<td>True.</td>
</tr>
<tr>
<td>(d) Directors do not need to disclose material uncertainties regarding going concern if they arise after the balance sheet date.</td>
<td>False.</td>
</tr>
</tbody>
</table>

5 True or false?

<table>
<thead>
<tr>
<th>(a) When companies go out of business, it is more likely to be due to a lack of cash than a lack of profits.</th>
<th>True.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(b) Going concern procedures are likely to be extensive in a company where profits are high and cash flows are positive.</td>
<td>False – likely to be minimal procedures carried out.</td>
</tr>
</tbody>
</table>
(c) The auditor should rely on the directors to inform them if there is any doubt over the entity’s ability to continue as a going concern. **False – the auditor should remain alert for evidence of events or conditions which may cast significant doubt on the entity’s ability to continue as a going concern.**

<table>
<thead>
<tr>
<th>6 Give three things that you think may indicate going concern problem within a company.</th>
<th>Choose from: (not exhaustive)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• net current liabilities</td>
</tr>
<tr>
<td></td>
<td>• borrowing facilities not agreed</td>
</tr>
<tr>
<td></td>
<td>• default on loan agreements</td>
</tr>
<tr>
<td></td>
<td>• default on loan agreements</td>
</tr>
<tr>
<td></td>
<td>• unplanned sales of non-current assets</td>
</tr>
<tr>
<td></td>
<td>• behind with tax payments</td>
</tr>
<tr>
<td></td>
<td>• behind with paying staff</td>
</tr>
<tr>
<td></td>
<td>• major cash outflows</td>
</tr>
<tr>
<td></td>
<td>• unable to obtain credit from suppliers</td>
</tr>
<tr>
<td></td>
<td>• major technology changes in the industry</td>
</tr>
<tr>
<td></td>
<td>• legal claims against the company</td>
</tr>
<tr>
<td></td>
<td>• loss of key management or staff</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>7 What disclosures must directors make in relation to going concern?</th>
<th>Any doubts.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Inability to assess in the usual way.</td>
</tr>
<tr>
<td></td>
<td>Basis, if going concern basis inappropriate.</td>
</tr>
</tbody>
</table>
1. Give three reasons why auditors obtain management representations.

<table>
<thead>
<tr>
<th>Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>Formal confirmation by management of their responsibilities.</td>
</tr>
<tr>
<td>Perhaps the only evidence available.</td>
</tr>
<tr>
<td>Required by ISA 580 and other ISAs.</td>
</tr>
</tbody>
</table>

2. Give three methods for obtaining management representations.

<table>
<thead>
<tr>
<th>Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Letter from the client.</td>
</tr>
<tr>
<td>Letter from the auditors to the client acknowledged by the client.</td>
</tr>
<tr>
<td>Minutes of the meeting when oral representations were made, signed as</td>
</tr>
<tr>
<td>a true record by the client.</td>
</tr>
</tbody>
</table>

3. Suggest five things about which management representations may be obtained.

<table>
<thead>
<tr>
<th>Thing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Choose from:</td>
</tr>
<tr>
<td>• directors’ acknowledge responsibility for financial statements</td>
</tr>
<tr>
<td>• directors’ acknowledge responsibility for design and implementation of internal control procedures</td>
</tr>
<tr>
<td>• all books of account and relevant supporting information made available</td>
</tr>
<tr>
<td>• directors have assessed the risk of fraud and regard it as low</td>
</tr>
<tr>
<td>• no irregularities involving management or employees with significant role in preparing financial statements.</td>
</tr>
<tr>
<td>• all allegations of fraud have been disclosed</td>
</tr>
<tr>
<td>• all related parties have been identified</td>
</tr>
<tr>
<td>• there has been full compliance with contractual obligations</td>
</tr>
<tr>
<td>• there has been full compliance with laws and regulations</td>
</tr>
<tr>
<td>• financial statements are free from material misstatements including omissions</td>
</tr>
</tbody>
</table>
• uncorrected errors are immaterial
• all balances and transactions with related parties have been suitably disclosed
• any losses arising from sale or purchase commitments have been disclosed
• all agreements and options to buy back assets previously sold have been disclosed
• all assets pledged as collateral have been disclosed
• there are no plans or intentions which may affect carrying values or classification of assets and liabilities
• there are no plans to abandon product lines, or similar plans which may affect stock values
• the company has satisfactory title to all assets and there are no undisclosed charges, liens or other encumbrances
• all actual and contingent liabilities and guarantees have been disclosed
• there are no subsequent events requiring adjustment or disclosure
• there are no undisclosed claims against the company
• there are no unprovided claims against the company
• there are no rights of set off of bank balances or other issues which may affect the company’s financing arrangements.
Reporting

Chapter learning objectives

Upon completion of this chapter you will be able to:

• describe and analyse the format and content of unmodified and modified audit reports.
1 The audit opinion

A company’s auditors must report their opinions to shareholders/members on two primary matters:

(1) Whether the financial statements give a **true and fair** view (or present fairly in all material respects).

(2) Whether the financial statements have been **properly prepared** in accordance with relevant rules, e.g.
   - International Accounting Standards,
   - a particular country’s legal requirements.

These considerations are assessed on the basis of the audit work carried out and the evidence obtained from this.

In addition, certain other matters may have to be **reported by exception**. These matters, which are also referred to as **implied reporting**, are laid down by a country’s laws.

In the UK, these matters are:

- where **R**eturns are not received from all branches of the company
- where **A**ccounting records are inconsistent with the FS
- where **P**roper accounting records have not been kept
- where all **I**nformation and explanations were not received
- where **D**irector transactions with the company are missing from FS.

The above can be remembered using the mnemonic **RAPID**.
Reporting by exception is not the same as a qualification; however, as the matters dealt with are usually legal requirements, non-compliance will probably lead to a qualification anyway. For instance, if all informations and explanations have not been received, there will most likely be a limitation of scope. This term is explained later in the chapter.

2 The auditor’s report on financial statements

The auditor’s report on financial statements

ISA 700 The Auditors Report on Financial Statements, explains the basic principles of audit reporting and identifies the elements of the auditor’s report.

The unmodified report

An audit report may be either:

• unmodified often referred to as a ‘clean’ audit report, or
• modified (dealt with below).
We start by considering the unmodified report, which means that in the auditor’s opinion the financial statements:

- **do** give a true and fair view (or present fairly in all material respects)
- **do** comply with the applicable reporting framework.
- **do not** give the auditor any need to report other matters under the exception reporting rules (see above).

This example is based on the requirements of ISA 700. The exact wording in any particular country may vary, although ISA 700 requirements will always be followed.

**Exam hint**

In the examination, you might be asked to describe the type of report that would be appropriate, to draft sections from the opinion paragraph or to comment on whether a given example is appropriate in the circumstances. The following sections guide you through the process.
INDEPENDENT AUDITOR'S REPORT

(APPROPRIATE ADDRESSEE)

Report on the financial statements

We have audited the accompanying financial statements of the ABC Company, which comprise the balance sheet as of 31 December, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and explanatory notes.

Management’s responsibility for the financial statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes, designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor’s responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of 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 judgement, 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 financial statement presentation.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.
Opinion

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

Report on other Legal and Regulatory Requirements

[Form and content of this section of the auditor’s report will vary depending on the nature of the auditor’s other reporting responsibilities.]

Auditor’s signature

Date of the auditor’s report

Auditor’s address

Preparing the audit report

ISA 700 describes the elements that make up the audit report as:

Title

• The title should be ‘appropriate’. The use of ‘Independent Auditor’s Report’ distinguishes this report from any other report produced internally or by other non-statutory auditors.

Addressee

• The report should be addressed to the intended user of the report which is usually the shareholders, board of directors or other party defined in the engagement or local regulations.

• This varies from country to country, but is usually addressed to the members of the company. This is to prevent other parties relying on the report when it is not intended for their use.

Introductory paragraph

• Identifies the financial statements which have been audited (see below), by name or by the use of page numbers, and stating the period they cover. This is in order to distinguish such information from other documents that have not been subject to audit (e.g. the Directors’ Report).
Statement of responsibilities of management

- Preparation of the financial statements which show a true and fair view or present fairly in all material respects and
- In accordance with the applicable financial framework.
- Designing and implementing an effective internal control system.
- Applying appropriate accounting policies.
- Making reasonable accounting estimates.

Statement of responsibilities of the auditors

- Express opinion.
- Assess the risk of material misstatement.
- The fact that the audit was planned and performed to obtain reasonable assurance about whether the financial statements are free from material misstatement.
- Consider internal control as a basis for preparing financial statements without responsibility for implementing it.
- Obtain sufficient, appropriate audit evidence on which to base the opinion.

Scope Paragraph

- The standards under which the audit was conducted i.e. ISAs.
- A summary of audit processes and procedures in general terms e.g. examining on a test basis, evidence to support the financial statement amounts and disclosures.
- Evaluate the appropriateness of accounting policies.
- Evaluate the overall presentation of the financial statements.

Opinion

- This covers the primary statements and associated notes referred to in the introductory paragraph (even though only the first two are referred to explicitly).
- Truth and fairness (or presented fairly in all material respects).
- Preparation in accordance with the financial reporting framework – applicable legislation and accounting standards.
- If applicable, any other matters required under a country’s regulations. Such a statement would be made at the end of the opinion paragraph.
Auditor's signature

• This should include reference to the auditor's status as a Registered Auditor.
• The report may be signed by the firm, by the auditor individually or both. Normally the firm's signature is given as the firm as a whole assumes responsibility for the audit.

Date of report

• The audit report must be signed after the directors have approved the financial statements and preferably on the same day.
• It is not necessary that the final typewritten copies of financial statements are available for signature – draft copies may be signed, provided the draft documents are sufficiently clear to enable a proper overall assessment of presentation to be made.

Auditor's address

• The audit report should name a specific location, which is normally the city where the auditor maintains the office that has responsibility for the audit.

Test your understanding 1

(1) What main contents are included in an unmodified audit report?
(2) What opinion does the auditor give in an unmodified audit report?
(3) Who is an audit report addressed to?
(4) When should the audit report be signed?
(5) Who should sign the audit report and what further information about the signatory should be provided?
3 Modified audit reports

If the auditor is unable to decide whether the financial statements give a true and fair view, or disagrees with some aspect of them, the unmodified report may not be appropriate. When this is the case, the audit report as outlined above will require modification. Modification may or may not result in a qualified audit report.

We have considered the unmodified report above. We will now look at modified reports.

**Matters not affecting the audit opinion**

Not all modifications result in qualification.

Where there are particular circumstances surrounding the financial statements, e.g.

- significant uncertainties whose outcome depends on future events
- going concern problems
- material misstatements in prior period figures.

and they are fully disclosed, the auditors may wish to draw the reader’s attention to them in the audit report.

**The ‘emphasis of matter’ paragraph**

The way these kinds of issues are included in the audit report is by the use of an emphasis of matter paragraph. An example is shown below where an emphasis of matter paragraph has been deemed necessary due to a significant uncertainty, the resolution of which is dependent on future events outside the direct control of the entity.
‘Without qualifying our opinion we draw attention to Note X to the financial statements. The Company is the defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.’

There are some further things to note.

• The emphasis of matter paragraph is placed after the opinion paragraph.
• The auditor makes it clear in the paragraph that the opinion is not qualified.
• The sections of the report prior to the paragraph are unchanged.
• Where possible, the potential financial effect on the financial statements should be quantified (not possible in the example given).
• The paragraph is given a separate heading.

4 Qualified opinion

The available options

You can see from the grid above that there are two sets of circumstances under which the auditors will qualify their opinion.

• There is a limitation of scope of the auditor’s work, i.e. a lack of available evidence that would be reasonably expected to exist. This differs from the emphasis of matter paragraph above as in that situation the directors and auditor could not expect information to be available as it was dependent on events that haven’t happened yet.
In such circumstances, the auditor will **qualify** the report.

The exact effect on the opinion will depend on the severity of the problem in the eyes of the auditor.

**Material and pervasive**

- ISA 700 uses the phrase *material and pervasive* and we know that unless the matter is material, it will not cause the report to be qualified at all. (Although you should remember that materiality can be about an item’s nature as well as its value.)
- So the nature of the qualification depends on the degree of effect that the auditor considers it may have on the financial statements.
- To be considered pervasive, it must affect the view given by the financial statements as a whole. As such:
  - if the circumstance is a limitation of scope it will leave the auditor unable to form an opinion at all.
  - If it is a disagreement, it will be of such significance that the financial statements do not give a true and fair view.

**Effect on the audit report**

The result of these matters on the audit report is shown below. Note the circumstances given at the top of the example reports that will give you an indication of when each type will be appropriate.

**Limitation of scope – material but not pervasive**

**Previous paragraphs as per standard report ...**

**Auditor's responsibility**

Our responsibility is to express an opinion on these financial statements based on our audit. **Except as discussed in the following paragraph,** we conducted our audit in accordance with ...
**Opinion**

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to physical inventory quantities, the financial statements give a true and …

**Limitation of scope – pervasive therefore a disclaimer**

‘We were engaged to audit the accompanying financial statements of the ABC Company, which comprise the balance sheet as of 31 December, 20X1 and the income statement, the statement of changes in equity and the cash flow statement for the year then ended, and a summary of the significant accounting policies and other explanatory notes.

Management responsibility paragraph as per standard report (omit the sentence stating the responsibility of the auditor).

(The paragraph discussing the scope of the audit would either be omitted or amended according to the circumstances.)

(Add a paragraph discussing the scope limitation as follows.)

**We were not able to observe all physical inventories and confirm accounts receivable due to limitations placed on the scope of our work by the Company.**

Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements.’

**Disagreement – material but not pervasive**

**Previous paragraphs as per standard report ...**

**Opinion**

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with International Financial Reporting Standards. The provision for the year ended 31 December, 20X1, should be XXX based on the straight-line method of depreciation using annual rates of 5% for the building and 20% for the equipment. Accordingly, the non-current assets should be reduced by accumulated depreciation of XXX and the loss for the year and accumulated deficit should be increased by XXX and XXX, respectively.

In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and …’
Disagreement – pervasive therefore adverse opinion

Previous paragraphs as per standard report ...

Opinion paragraph

‘In our opinion, because of the effects of the matters discussed in the preceding paragraph(s), the financial statements do not give a true and fair view of (or do not “present fairly”) the financial position of the Company as of 31 December, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.’

As you can see, there is a potentially difficult decision process to go through when deciding what kind of modified audit report may be appropriate. When answering a question where you have to state which audit report is the most appropriate, consider what has been stated in the scenario. Have they told you that all of the accounting records have been destroyed or gone missing? If so, it is likely to be a pervasive limitation of scope. Is it just the records for receivables that are not being made available? If so, does the question give any indication as to how significant those receivables are to the balance sheet? If the question doesn’t imply that the balance in question is fundamental to the whole of the financial statements, it is most likely to be an ‘Except For’ limitation of scope. Use the same approach if it is a disagreement. If it is fundamental to the whole of the financial statements e.g. they have been prepared on a going concern basis when the directors intend to cease trading in the coming year, or if all of their accounting policies are questionable, the result will be an adverse opinion. If the auditor is unhappy about the disclosures made or the accounting treatment of an item that is material but not fundamental to the whole of the financial statements then an ‘Except For’ disagreement will be the most appropriate.

**Test your understanding 2**

1. **What are the four types of qualified audit report?**
2. **Give an example of when each type of report would be appropriate.**
3. **A pervasive disagreement gives rise to what form of audit qualification?**
4. **What is an ‘emphasis of matter’ paragraph?**
5 The impact of auditors’ reports

- The unqualified report is a summary of the auditor’s work and conclusions. It adds credibility to the contents of the financial statements.

- Clearly, if the audit report has any impact, the management should be reluctant to get themselves into a position where a qualification is required.

- If the subject matter of the qualification is a disagreement, then a large or public company faces possible/probable investigation. In the UK this will be by the Financial Reporting Review Panel. This can require a company to reissue its accounts with the ultimate sanction that it can take the company to court if it does not comply with its wishes.

- If the subject matter is a limitation of scope, the company may find itself in financial difficulties. Trade payables may be reluctant to supply goods on credit terms and the bank may call in any overdraft. It should be appreciated that overdrafts are technically repayable on demand.

- The severity of these potential effects helps to ensure that the auditor decides very carefully whether a qualification is required and ensures that management take the ‘threat’ of qualification seriously.
6 Chapter summary

- Audit Report
  - Title
  - Address
  - Introductory
  - Responsibilities
  - Basis
  - Opinion
  - Other requirements
  - Signature
  - Date
  - Address

  - Unmodified Report
  - Modified Report

  - Unqualified Report
  - Qualified Report

  - Emphasis of Matter
  - Material and pervasive?

  - Disagreement
  - Limitation of scope

  - Qualified ‘except for’

  - Adverse opinion
  - Disclaimer of opinion
<table>
<thead>
<tr>
<th>Test your understanding 1</th>
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<tbody>
<tr>
<td><strong>(1) What main contents</strong></td>
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<td><strong>are included in an</strong></td>
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<td><strong>unmodified audit</strong></td>
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<td><strong>(2) What opinion does</strong></td>
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<td><strong>the auditor give in</strong></td>
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<td><strong>an unqualified audit</strong></td>
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<td><strong>report?</strong></td>
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<td><strong>(3) Who is an audit</strong></td>
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<td><strong>report addressed to?</strong></td>
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<td><strong>(4) When should the</strong></td>
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<td><strong>audit report be</strong></td>
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<td><strong>signed?</strong></td>
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</table>
(5) Who should sign the audit report and what further information about the signatory should be provided?

The auditor’s signature should refer to Registered Auditor status and be signed either by the firm or the auditor individually.

Test your understanding 2

(1) What are the four types of qualified audit report?

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<thead>
<tr>
<th>Limitation of scope</th>
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<tr>
<td>• Except for.</td>
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<td>• Disclaimer.</td>
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<th>Disagreement</th>
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<td>• Except for.</td>
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<td>• Adverse.</td>
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(2) Give an example of when each type of report would be appropriate.

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<thead>
<tr>
<th>Examples of the above could be:</th>
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<tr>
<td>Limitation in scope – material</td>
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<td>No inventory count carried out at a branch.</td>
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<th>Limitation in scope – pervasive</th>
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<td>Destruction of accounting records.</td>
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<th>Disagreement – material</th>
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<tr>
<td>Difference of opinion between directors and auditor as to whether to provide for a doubtful debt.</td>
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<tr>
<th>Disagreement – pervasive</th>
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<tbody>
<tr>
<td>Inappropriate basis of preparation used e.g. if the going concern basis has been used when the break up basis should have been used.</td>
</tr>
<tr>
<td>Question</td>
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<td>-------------------------------------------------------------------------</td>
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<tr>
<td>(3) A pervasive disagreement gives rise to what form of audit qualification?</td>
</tr>
<tr>
<td>(4) What is an emphasis of matter paragraph?</td>
</tr>
</tbody>
</table>
Questions & Answers
1 What is assurance?

There are no questions for this chapter.

2 The rules and who sets them

External auditors

Question 1

International Standards on Auditing (ISAs) are produced by the International Audit and Assurance Standards Board (IAASB), which is a technical committee of the International Federation of Accountants (IFAC). In recent years, there has been a trend for more countries to implement the ISAs rather than produce their own auditing standards.

A school friend who you have not seen for a number of years is considering joining ACCA as a trainee accountant.

However, she is concerned about the extent of regulations which auditors have to follow and does not understand why ISAs have to be used in your country.

Required:

Write a letter to your friend explaining the regulatory framework which applies to auditors.

Your letter should cover the following points:

A  The due process of the IAASB involved in producing an ISA.

(4 marks)

B  The overall authority of ISAs and how they are applied in individual countries.

(8 marks)

C  The extent to which an auditor must follow ISAs.

(4 marks)
3 Corporate governance and internal audit

Becher Construction

Question 1

Becher are an independent construction company, dealing with large scale contracts throughout the UK and with some international interest in Europe, particularly in Spain. Becher have recently established an Audit Committee, the members of which are very concerned about meeting corporate governance ‘best practice’, particularly since they are currently looking at the possibility of obtaining a stock exchange listing.

You are an internal auditor with the company and have been asked to conduct a review of how well the company is meeting relevant corporate governance requirements.

You are required to prepare a report that addresses the following.

A What is meant by ‘corporate governance’ and why is it important that companies should comply with relevant corporate governance requirements?

(4 marks)

B What are the key issues for Becher to address to achieve effective corporate governance?

(5 marks)

C What is the role of internal audit in achieving corporate governance compliance?

(4 marks)

D What should the role of the Audit Committee be in relation to corporate governance?

(4 marks)
List the types of regular reporting that would be useful for Becher in the context of establishing sound corporate governance.

(3 marks)

(Total: 20 marks)

4 Responsibilities

Responsibilities of external auditors

Question 1

The responsibilities of external auditors are not always well understood, especially with regard to the detection and reporting of fraud. When external auditors provide non-audit services to their audit clients, it is essential that the auditors make a clear distinction between their audit and non-audit responsibilities.

Required:

A Explain the responsibilities of external auditors to directors and shareholders.

(5 marks)

B Describe the limitations of the external audit in relation to the detection and reporting of fraud.

(5 marks)

C Explain why it is essential for external auditors to be independent of their clients.

(5 marks)

D Explain the advantages and disadvantages of external auditors providing consulting services to their audit clients.

(5 marks)

(Total: 20 marks)
5 Ethics and acceptance of appointment

Viswa

Question 1

Viswa is a company that provides call centre services for a variety of organisations. It operates in a medium sized city in which yours is the largest audit firm. Viswa is owned and run by two entrepreneurs with experience in this sector and has been in existence for five years. It is expanding rapidly in terms of its client base, the number of staff it employs and its profits. It is now 15 June 20X4 and you have been approached to perform the audit for the year ending 30 June 20X4. Your firm has not audited this company before. Viswa has had three different firms of auditors since its incorporation.

Viswa’s directors have indicated to you informally that the reason they wish to change auditors is because of a disagreement about certain disclosures in the financial statements in the previous year. The directors consider that the disagreement is a trivial matter and have indicated that the company accountant will be able to provide you with the details once the audit has commenced. Your firm has explained that before accepting the appointment, there are various matters to be considered within the firm and other procedures to be undertaken, some of which will require the co-operation of the directors. Your firm has other clients that operate call centres. The directors have asked your firm to commence the audit immediately because audited accounts are needed by the bank by 30 July 20X4. Your firm is very busy at this time of year.

Requirement:

A Describe the matters to consider within your firm and the other procedures that must be undertaken before accepting the appointment as auditor to Viswa.

(10 marks)

B Explain why it would be inappropriate to commence the audit before consideration of the matters and the procedures referred to in (a) above have been completed.

(5 marks)
C  Explain the purpose of an engagement letter and list its contents.

(5 marks)

(Total: 20 marks)

**External auditor objectivity**

**Question 2**

The objectivity of the external auditor may be threatened or appear to be threatened where:

I  There is undue dependence on any audit client or group of clients.

II  The firm, its partners or staff have any financial interest in an audit client.

III  There are family or other close personal or business relationships between the firm, its partners or staff and the audit client.

IV  The firm provides other services to audit clients.

**Required:**

A  For each of the four examples given above, explain why the objectivity of the external auditor may be threatened, or appear to be threatened, and why the threat is important.

(12 marks)

B  Describe ACCA’s requirements that reduce the threats to auditor objectivity for each of the four examples given above.

(8 marks)

**Note:** In part (a) all parts carry equal marks.

In part (b) all parts carry equal marks.

(Total: 20 marks)
### 6 Planning

**ISA 300**

**Question 1**

Amongst matters required to be considered by the auditor when planning the audit in accordance with the requirements of ISA 300 Planning an Audit of Financial Statements are those of ‘materiality’ and the ‘direction, supervision and review’ of the audit.

Materiality is further the subject of ISA 320 Audit Materiality. Direction, supervision and review are considered in more detail within other Auditing Standards.

**Required:**

A Explain the concept of materiality and how materiality is assessed when planning the audit. Your answer should include consideration of materiality at the overall financial statement level and in relation to individual account balances.

(12 marks)

B Explain the nature and significance of direction, supervision and review both in planning the audit and subsequently during the performance of the audit on a particular engagement.

(8 marks)

(Total: 20 marks)

### 7 Risk

**Five Dock**

**Question 1**

As part of the process of planning the external audit of Five Dock, a public listed company, for the year ending 31 October 20X2, you have reviewed the minutes of meetings of the Board of Directors for the year to date. You have identified the following items likely to have a bearing on the assessment of audit risk and the design of audit procedures when drawing up an audit plan.
(1) On the recommendation of its non-executive Chairman, Five Dock has invested a substantial amount in the shares of Burwood, a private company, of which the Chairman is chief executive and major shareholder.

(2) Development project 21A is behind schedule. Unexpected problems have emerged which will substantially increase the cost of development and the production cost of the new product. $120,000 of development cost was recognised as an asset in the balance sheet last year. A further $50,000 has been spent this year. The original budget was $130,000.

(3) In order to encourage performance, a bonus scheme has been introduced for senior management. In total, 25% of the company’s reported profits before tax in excess of the previous period’s profits will be set aside to provide for bonuses. No bonus will be paid if profits do not exceed the previous year.

(4) An internal audit department has been established.

(5) In order to finance investment in new projects, Five Dock has taken out a substantial bank loan. The loan agreement states that the company’s gearing ratio (the proportion of loan capital to equity capital) must not exceed 30%. Last year’s financial statements had a gearing ratio of 20% and the latest monthly management accounts show a gearing ratio of 25%.

Required:

For each of the items (1) to (5) above:

A  Explain how it might affect the assessment of inherent or control risk.

(8 marks)

B  Consider how it might affect the design of audit procedures specific to that item.

(12 marks)

(Total: 20 marks)

Assume each item is potentially material. Consider each item separately.
Question 2

A Explain the term ‘audit risk’.

(4 marks)

B You are the audit manager for Parker, a limited liability company which sells books, CDs, DVDs and similar items via two divisions: mail order and on-line ordering on the Internet. Parker is a new audit client. You are commencing the planning of the audit for the year-ended 31 May 20X5. An initial meeting with the directors has provided the information below.

The company’s sales revenue is in excess of $85 million with net profits of $4 million. All profits are currently earned in the mail order division, although the Internet division is expected to return a small net profit next year. Sales revenue is growing at the rate of 20% p.a. net profit has remained almost the same for the last four years.

In the next year, the directors plan to expand the range of goods sold through the Internet division to include toys, garden furniture and fashion clothes. The directors believe that when one product has been sold on the Internet, then any other product can be as well.

The accounting system to record sales by the mail order division is relatively old. It relies on extensive manual input to transfer orders received in the post onto Parker’s computer systems. Recently errors have been known to occur, in the input of orders, and in the invoicing of goods following despatch. The directors maintain that the accounting system produces materially correct figures and they cannot waste time in identifying relatively minor errors. The company accountant, who is not qualified and was appointed because he is a personal friend of the directors, agrees with this view.

The directors estimate that their expansion plans will require a bank loan of approximately $30 million, partly to finance the enhanced web site but also to provide working capital to increase inventory levels. A meeting with the bank has been scheduled for three months after the year end. The directors expect an unmodified auditor’s report to be signed prior to this time.

Required:

I Identify and describe the matters that give rise to audit risks associated with Parker.

(10 marks)
II Explain the enquiries you will make, and the audit procedures you will perform to assist you in making a decision regarding the going concern status of Parker in reaching your audit opinion on the financial statements.

(6 marks)

(Total: 20 marks)

8 Systems and controls

Internal control – Cosmo

Question 1

A Internal control systems are designed, amongst other things, to prevent error and misappropriation.

Required:

Describe the errors and misappropriations that may occur if purchases and capital expenditure are not properly controlled.

(5 marks)

B Cosmo is a high-quality, private motor manufacturing company. It has recently joined a consortium for the purchase of parts. Cosmo’s purchases and capital expenditure systems are not integrated.

Purchases and capital expenditure

There are complex internal rules relating to what constitutes purchases and what constitutes capital expenditure and the budgets for both are tightly controlled. Problems associated with the internal rules result in a significant number of manual adjustments to the management accounts which take up an excessive amount of management time.

The system for authorising capital expenditure is not well controlled which results in some capital items being acquired without proper consideration, at the monthly meetings of the capital expenditure committee.
Purchase orders

Purchase orders are generated automatically by the computerised inventory system when inventory levels fall below a given level in the context of scheduled production. This system does not work well because the system uses outdated purchasing and production patterns and many manual adjustments are required. The orders are reviewed by the production controller and her junior managers and changes are made informally by junior clerical staff in the production controller’s department.

Some of the purchases are input into the buying consortium system which shows the optimum supplier for any combination of cost, delivery time and specification. This system has only been in operation for a few months. The system takes up a substantial amount of disk space on the company’s computers and is suspected of causing problems in other systems. It is difficult to use and so far, only two of the production controller’s junior managers are able to use it. As a result, the parts ordered through the system are sometimes of the incorrect specification or are delivered late. The remaining purchases are ordered directly from manufacturers, as before, through a reasonably well-controlled buying department.

Required:

Set out, in a form suitable for inclusion in a report to management, the weaknesses, potential consequences and your recommendations relating to the purchases and capital expenditure systems of Cosmo.

(15 marks)

(Total: 20 marks)

9 Audit Evidence

Confirmations

Question 1

Auditors obtain several different confirmations from various sources during the course of their audit.

Required:

Describe the audit evidence provided by each of the confirmations listed below, the practical difficulties in obtaining them and the alternative audit evidence available when they are not provided:
A Management representations.  
(5 marks)

B Direct confirmation of receivables.  
(6 marks)

C Confirmation of inventory held by third parties.  
(5 marks)

D Reports provided by auditors of third party service organizations.  
(4 marks)

(Total: 20 marks)

10 Audit procedures

Methods of obtaining audit evidence

Question 1

There are a number of different methods of obtaining audit evidence. Methods include:

I analytical procedures;
II audit sampling;
III tests of controls;
IV detailed testing of transactions and balances;
V computer assisted audit techniques (CAATs).

These methods overlap and may be used for different purposes during an audit of financial statements.

Required:

A Explain the advantages and disadvantages of each of the five methods of evidence gathering listed above.  
(15 marks)
11 Completion and review

Question 1

You are an audit manager in an audit firm with ten offices and 250 staff. Your firm is the auditor of Calva, a chain of supermarkets. Your firm has been the auditor of this client for many years.

All of the planning work and tests of control have been completed for Calva for the year ended 31 December 20X3. Staff are still working on substantive procedures. The company operates a continuous inventory checking system with good records and you have tested this system and will be relying on the records for the year-end figure.

The company is intending to invest a substantial amount in opening new stores during the next year and it has been negotiating with both banks and property companies in relation to leases.

Required:

A Describe the objectives of the following and how these objectives will be met in the audit of Calva:

1. Overall review of financial statements.

(4 marks)

2. Review of working papers.

(6 marks)

B Describe the:

1. auditor’s responsibilities with regard to subsequent events;

(6 marks)
II procedures that should be applied during the subsequent events review at Calva.

(4 marks)

(Total: 20 marks)

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**Corsco**

**Question 2**

A Describe the external auditor’s responsibilities and the work that the auditor should perform in relation to the going concern status of companies.

(5 marks)

B Describe the possible audit reports that can be issued where the going concern status of a company is called into question; your answer should describe the circumstances in which they can be issued.

(5 marks)

Corsco is a large telecommunications company that is listed on a stock exchange. It is highly geared because, like many such companies, it borrowed a large sum to pay for a licence to operate a mobile phone network with technology that has not proved popular. The company’s share price has dropped by 50% during the last three years and there have been several changes of senior management during that period. There has been considerable speculation in the press over the last six months about whether the company can survive without being taken over by a rival. There have been three approaches made to the company by other companies regarding a possible takeover but all have failed, mainly because the bidders pulled out of the deal as a result of the drop in share prices generally.

The company has net assets, but has found it necessary to severely curtail its capital investment program. Some commentators consider this to be fundamental to the future growth of the business, others consider that the existing business is fundamentally sound. It has also been necessary for the company to restructure its finances. Detailed disclosures of all of these matters have always been made in the financial statements. No reference has been made to the going concern status of the company in previous auditor’s reports on financial statements and the deterioration in circumstances in the current year is no worse than it has been in previous years.
Required:

C On the basis of the information provided above, describe the audit report that you consider is likely to be issued in the case of Corsco, giving reasons.

(4 marks)

D Explain the difficulties that would be faced by Corsco and its auditors if Corsco’s audit report made reference to going concern issues.

(6 marks)

(Total: 20 marks)

12 Reporting

Hood Enterprises

Question 1

You are the audit manager of Hood Enterprises Ltd. The company’s annual turnover is over £10 million.

Required:

A Compare the responsibilities of directors and auditors regarding the published financial statements of Hood Enterprises Ltd.

(6 marks)

B An extract from the draft audit report, produced by an audit junior, is given below.

Basis of Opinion

‘We conducted our audit in accordance with Auditing Standards. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of all the estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company’s circumstances, consistently applied and adequately disclosed.'
‘We planned and performed our audit so as to obtain as much information and explanation as possible given the time available for the audit. We confirm that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error.

The directors however are wholly responsible for the accuracy of the financial statements and no liability for errors can be accepted by the auditor. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the company’s annual report.’

**Required:**

Identify and explain the errors in the above extract.

**Note:** you are not required to redraft the report.

**(10 marks)**

C The directors of Hood Enterprises Ltd have prepared a cash flow forecast for submission to the bank. They have asked you as the auditor to provide a negative assurance report on this forecast.

**Required:**

Briefly explain the difference between positive and negative assurance, outlining the advantages to the directors of providing negative assurance on their cash flow forecast.

**(4 marks)**

**(Total: 20 marks)**
Test your understanding answers

External auditors

Answer 1

6 Flat SG1
Community Gardens
Long Road
Anytown
17 June 2006
Dear Jayne

I am pleased you are also thinking about accountancy as a career and understand your concern regarding the use of Auditing Standards. I will try and explain the need for standards in this letter.

The working procedure of the IAASB to produce an ISA

The start of the process of producing an International Standard on Auditing (ISA) is for a subcommittee of the International Audit and Assurance Standard Board (IAASB) to determine appropriate areas for an ISA, or to note where existing ISAs need amendment.

The subcommittee produces an exposure draft on that subject, initially for consideration by the IAASB. If the IAASB approve the exposure draft, then it is circulated to the member bodies of the International Federation of Accountants (IFAC) and any other organisations that have an interest in auditing standards and published on the IAASB website.

These bodies make comments on the exposure draft. Comments are sent back to the IAASB and the exposure draft is amended as necessary. Finally the exposure draft is re-issued as an ISA or an International Auditing Practice Statement (IAPS). The whole process can take between one and two years.
The overall authority of ISAs and how ISAs are applied in individual countries

ISAs are designed to be applied in the audit of financial statements and may be applied to the audit of other historical financial information. Each ISA contains the basic principles and procedures to apply to that ISA (identified by bold type in the ISA itself). Other text in the ISA provides guidance on the implementation of the principles. In other words, to apply the ISA, the whole of the text, not simply the parts in bold type, must be read and understood.

ISAs are not designed to override the requirements for the audit of entities in individual countries. So if our country did not require an audit of specific entities, then the ISAs would not overrule that requirement.

Regarding the detailed requirements of an audit, such as the nature of testing or the issuing of an engagement letter, where our country requirements meet those of the ISA, then the ISA will be used. It is therefore unlikely that our country would issue a separate auditing standard; the ISA would be sufficient.

Where our local codes on audit differ from the ISA, then the local requirements are used. However, we are encouraged to introduce changes in our country so that the requirements of the ISA are met. For example, our country may require an engagement letter to be signed every five years, but the ISA requires one every year. In this case, local change is needed to comply with the ISA.

The extent to which an auditor must follow ISAs

An auditor should follow the ISAs wherever possible. However, in some situations an auditor may consider it necessary to depart from the ISA so that the objectives of the audit can be achieved more efficiently. In this situation, the auditor can depart from the ISA, but he or she must be prepared to justify the departure. It is expected that departure from any ISA will be the exception rather than the rule.

The extent to which ISAs apply to small entities

To be clear, ISAs are meant to be applicable to the audit of any entity, no matter what its size. However, in small entities, the auditor may have to amend the audit approach to fit the circumstances of that business. For example, there will be greater reliance on substantive testing and management representations. However, the appropriate ISAs should be followed.
Conclusion

I hope that this clarifies your understanding of ISAs. Please let me know if I can be of further assistance to you in your accountancy career.

Yours sincerely,

Rajit Grey

Becher Construction

Answer 1

Report to the Audit Committee

A Corporate Governance

Corporate Governance concerns the way that a company is directed and controlled. It encompasses the following key aspects:

- The role of the Board and Audit Committee.
- Overall control and risk management framework.

Corporate Governance has become increasingly important to all organisations, particularly those with a stock exchange listing. For example, in the UK such companies are subject to the requirements of the Combined Code and the Turnbull report.

Management and control is often more difficult to achieve in larger, more complex organisations. In addition, shareholders (the owners) tend to be more remote from the directors who manage the company on their behalf.

The Turnbull report for example requires that companies have an ongoing process for identifying, evaluating and managing the company’s key risks. This process should comply with the Turnbull guidelines, and should be regularly reviewed by the Board. Failure by a company to comply with relevant corporate governance requirements could result in a qualification in the audit report and could damage the company’s image and reputation.
As Becher is looking at the possibility of a stock exchange listing, they will need to meet the requirements of good corporate governance. As a comparison, we can look at the requirements of the Combined Code which are applicable in the UK but which follow the OECD principles. The key issues that Becher will need to address in order to comply with the Combined Code are:

The roles of Chairman and Chief Executive should be held by separate people in order so that too much power is not held by one person. The Chairman should lead the non-executive directors and the board. The chief executive is the head of the executive committee.

An audit committee should be set up which is responsible for monitoring aspects such as risk management, effectiveness of internal controls to prevent fraud and error, compliance with laws and regulations, and the effectiveness of management information.

The audit committee should also establish an internal audit department if it is considered necessary which will help it achieve the tasks mentioned above such as monitoring of controls and risk management. The internal audit function should report into the audit committee so that it is independent of the management structure.

The appointment and remuneration of the executive directors should be made by a committee of non-executive directors such as a nominations committee and remuneration committee. If the company is not big enough to warrant separate committees such as these the audit committee should make these decisions. This is to ensure that the executive directors do not appoint ‘friends’ who will back them up in board decisions and to avoid paying excessively high salaries which are not linked to performance.

The Code also states that there should be transparency of communications with shareholders to ensure they are kept informed of matters affecting their company.

### C Role of Internal Audit

An independent and adequately resourced internal audit function should be in a position to provide the Board with much of the assurance it requires regarding the effectiveness of the system of internal control.

Internal Audit’s main role is normally to evaluate risk and monitor the effectiveness of the system of internal control.
The precise role of internal audit will depend on the nature and type of organisation and what other risk type functions are in existence within the company.

Key internal audit procedures will be to:

- review the company’s measures to achieve corporate governance
- ensure that the Internal Audit Department’s operation is consistent with the major risks facing the organisation
- produce analysis of and opinions on the effectiveness of the organisation’s control mechanisms, which should be communicated regularly to the Board and Audit Committee.

D Role of the Audit Committee

The role and importance of the Audit Committee has increased as the corporate governance requirements have been strengthened. The Audit Committee must have at least three non-executive directors who should be independent of the company in that they have no direct involvement in the day to day running of its affairs.

The Audit Committee should:

- assess the framework for complying with corporate governance guidelines within the company, including the risk assessment procedures
- review the major risks identified including their chances of occurring and their likely impact
- require regular reporting from internal and external auditors and any other review bodies, showing how the risks are being managed
- receive and review internal audit assignment reports and follow up information
- discuss and consider any concerns of directors and internal audit staff
- review annual financial statements and the results of the external auditors’ examination to ensure that the auditors have performed an effective, efficient and independent audit
- receive and deal with external auditors’ criticisms of management and ensure that recommendations of internal and external auditors have been implemented.
Types of Regular Reporting

Types of regular reporting that could be produced for the Audit Committee include:

- listing of current major risks and up-to-date assessment of impact and likelihood
- reports on control of risks including how they are being managed
- details of any issues / concerns that have arisen since the last report
- audit reports issued and impact on corporate governance
- information on follow up on outstanding risks and findings from reports.

Responsibilities of external auditors

Answer 1

A Responsibilities of external auditors to directors and shareholders

The external auditors are required to prepare a report to shareholders on the truth and fairness (or fair presentation) of financial statements prepared by management for the benefit of shareholders.

The auditors, if appointed by shareholders, act as agents for the shareholders in the same way as directors act as agents for the company.

Auditors have no specific duties to directors (other than the contractual relationship) although it is clearly necessary that an adequate working relationship is formed in order that the audit can be performed properly. Directors generally have a duty to provide auditors with the information and explanations they require to perform the audit.

Auditing standards require that auditors report weaknesses in systems that they discover during the course of their audit to management (ISA 260).
B Limitations of the external audit – fraud

I Auditing standards require that auditors plan and perform their audits with a reasonable expectation of detecting fraud and error if they are material to the financial statements (ISA 240).

II It is commonly believed that the purpose of the external audit is to detect, and report, fraud and error. The detection and reporting of such matters is secondary to forming an opinion on the financial statements.

III Material fraud is often very difficult to detect, however, and an auditor has not necessarily failed in his duty if he fails to detect such a fraud.

IV Most frauds are small, and immaterial to the financial statements. If auditors detect frauds, they have a duty to report such matters to the management of the company regardless of whether they are material or immaterial. Only matters that are material need to be reported in the financial statements.

C External auditor independence

I External auditors are required to provide an independent assessment of the truth and fairness of a company’s financial statements, and are therefore unable to fulfil their duties to shareholders if they are not independent of the entity on which they are reporting.

II If external auditors have an interest in the financial statements on which they are reporting, they may not be objective. For example, if, in the case of a listed company, they have prepared the financial statements on which they are reporting, their view may not be considered objective.

III If they have financial or employment connections with the company on which they are reporting they will not be objective.

IV If they provide a significant level of additional services to the entity, some argue that they cannot report objectively as auditors to shareholders.

D Advantages and disadvantages of external auditors providing consulting services

I The principal advantage of providing consulting services lies in the fact that auditors are best placed to provide such services, because they have an intimate knowledge of the operations of the company.

II Equally, if they provide consulting services, the knowledge so obtained will be useful in conducting the audit, and experience in general of consulting better enables auditors to conduct their duties as auditors, because knowledge of other industries can be brought to bear on the client.
The principal disadvantage is that, as auditors often make a lot of money from non-audit work, their objectivity in these circumstances is impaired, due to an unwillingness to challenge directors or issue a qualified audit report for fear of losing lucrative consulting work.

Another disadvantage is that if the auditors have implemented the systems that produce the financial statements, they are unlikely to give a qualified audit report on the information that those systems produce.

Viswa

Answer 1

A Internal matters and other procedures before appointment

The firm needs to consider a variety of commercial issues and ethical matters (under ACCA’s Rules of Professional Conduct).

Internal matters

Before accepting appointment the firm should ensure that:

I it has the necessary staff with appropriate competencies to complete the audit (this seems likely given that the firm has other clients in this sector);

II the staff are available at what is a busy time of year for the firm (it may be possible that all of the staff with the necessary competencies are otherwise occupied)

III the firm is independent of Viswa. It is unlikely that there will be any issues concerning shareholdings in the client (because it is owned and run by two entrepreneurs), however, there may be staff or partners who are related to the client or are otherwise connected with it

IV there are no conflicts of interest that cannot be properly managed. Conflicts of interest may exist because the firm has other clients in this sector.

Other procedures

The firm should:

V seek the directors’ permission to communicate with the company accountant about the nature of the ‘disagreement’ and the directors should authorise the accountant to co-operate with the firm
VI seek the directors’ permission to communicate with the incumbent auditors. If permission is refused, the appointment should not be accepted

VII ask the client to write to the incumbent auditors notifying them of the change and giving them permission to communicate with the firm (if Viswa refuses to give permission to the incumbent auditors the appointment should not be accepted)

VIII communicate with the incumbent auditors (preferably in writing) requesting all the information which ought to be made available to enable the firm to decide whether or not to accept the appointment (if there are no such matters, the incumbent auditors should inform the firm of this)

IX seek appropriate transfer information (such as a copy of the last set of accounts and a detailed trial balance reconciled to the accounts)

X indicate a likely fee (or the basis on which fees are calculated) to Viswa, ensure that this is acceptable and that the client is able to pay (by some form of credit check)

XI ensure that the incumbent auditor has properly resigned, been dismissed or has not sought re-appointment in accordance with legal requirements.

B Starting the audit

It is inappropriate to start the audit before the procedures referred to above have been completed because:

I without the staff with appropriate competencies the firm will be in breach of the Rules (and may be found negligent if things were to go wrong)

II without complying with the requirements relating to independence and conflicts of interest, the firm will not only be in breach of the Rules, but will lack objectivity and may find that the client (or other party) objects to the appointment to another client in the same sector

III without performing appropriate procedures the firm will be unable to form an opinion on the integrity of the client – it may find itself associated with an entity engaging in doubtful or even illegal activities (taking account of the disagreement over disclosures)

IV without agreeing a fee it is almost inevitable that misunderstandings or disagreements will arise

V without communicating with the accountant and the incumbent auditor, it is quite possible that disagreements over disclosures will arise, similar to those that have arisen in the past
The engagement letter is of benefit to both the client and auditor and helps prevent misunderstandings. It:

I confirms the auditor’s acceptance of appointment and constitutes a contract between the auditor and the client

II summarises the respective responsibilities of directors and auditors

III contains details on:
   (1) the responsibilities of the directors (for accounting records, the financial statements and the accounting policies on which they are based)
   (2) the responsibilities of auditors and the scope of the audit (their duty to conduct an audit in accordance with auditing standards, to review accounting policies and disclosures, to perform tests and to form an opinion on the financial statements)
   (3) the form of report to be issued
   (4) other services to be provided
   (5) the basis of calculation of fees
   (6) applicable legislation.

External auditor objectivity

Answer 2

A Why external auditor objectivity may be, or appear to be, threatened

I Undue dependence

If the auditor depends, or relies on a particular client or group of connected clients because the firm takes a large part of its fee income from the client, the auditor may be less likely to challenge accounting policies or disclosures proposed by the client, for fear of upsetting them. This typically happens when the firm is small, but the client is large.

Where the firm feels that an audit qualification may be necessary, it may be reluctant to issue it for fear of losing the client and the fee income. This applies regardless of whether the fee income is audit fee income or income for other work.
The issue is important because if the auditor does not issue a qualified audit report where appropriate, the firm may be sued for negligence. Where a large client is involved, the firm’s professional indemnity insurance may not cover the claim.

**Financial interest**

Where a partner or member of staff in a firm (or the firm itself) holds shares in a client, they have an interest in the client’s performance. If the client performs well, the value of the shares may rise. A qualified audit report is not usually associated with good performance and the firm may therefore be reluctant to issue one where appropriate. This is important for the reasons noted above.

Even if there is no question of a qualified audit report, there may be a temptation to help the client present the results in the best possible light, instead of presenting a balanced view.

There is also a financial interest where partners, staff or the firm make loans to, or guarantee the borrowings of the client or vice versa. Significantly overdue fees of amounts that are significant to either auditor or client are akin to loans.

**Family or other close personal or business relationships**

Where there are family or other close personal or business relationships between the client and audit firm, the individuals concerned may try to influence the firm in its dealings with the client in order to protect the family or personal relationship, or the mutual business interest.

If, for example, an audit partner is married to the finance director of a client, it is less likely that the client will receive a qualified audit report than it would be if the relationship did not exist. This is important in any case but more so where the effect of a qualified (or modified) audit report is likely to result in, say, withdrawal or non-renewal of banking facilities which might result in the business ceasing to be a going concern. If the firm does not issue a modified audit report in such circumstances, the firm may be exposed to claims of negligence by the bank.

If there are close business relationships between client and auditor, both parties have an interest in each other’s performance and there is therefore a double pressure to present the results in the best possible light and not to issue a qualified audit report.
Many audit firms provide their audit clients with services other than audit services. It is very common for auditors to provide their very small audit clients with accountancy services, for example.

Other services that can be provided include tax, management consulting, IT and human resources advice. Some firms not only provide consulting advice, but also perform IT and other functions for some of their clients.

There are two threats to objectivity where other services are provided. Firstly, the firm may find that it is reporting on a system that the firm itself has set up or advised on, or reporting on information that the firm itself has prepared. This means that it is reporting on its own work and it may be difficult to be objective in such circumstances. Secondly, the fee income from other services may well exceed the fee income from the audit and the client may pressure the firm to give an unqualified audit report by threatening to take the other services to another firm if a qualified report is given.

Most of the following are requirements of ACCA’s Rules of Professional Conduct.

### B Requirements

#### Undue dependence

1. **A firm should put in place additional safeguards where the recurring fee income from one client or group exceeds 15% of the gross practice income (10% for clients listed on a stock exchange or where the public interest is involved).** Additional safeguards include supplementary reviews and the rotation of the engagement partner and senior staff.

2. **There are exceptions where a practice is being set up or run down.** The rules are also applied to members practising part-time.

3. **A review mechanism should be triggered within the firm where the gross fee income exceeds 10% (5%) of gross practice income.**
More generally, there is a requirement for firms to carry professional indemnity insurance to cover professional negligence claims and ACCA monitors practising firms to ensure that they are complying with, amongst other things, the independence requirements. Firms are also required to keep up with changes in independence requirements as a condition of being permitted to practise.

### Financial interest

1. No partner in a firm, or any member of staff working on a particular audit, or any person closely connected with them, should hold any shares in an audit client.

2. There are exceptions where collective investments are held by third parties, where the individual concerned has no control over the composition of investments.

3. Where such shares or interests are acquired through marriage or inheritance, for example, the shares should be disposed of at the earliest possible opportunity, provided that the disposal does not involve insider trading. Where shares are held by the auditor because the company’s constitution requires it, the minimum level should be held and the votes attaching to the shares should not be exercised.

4. There are some exceptions for transactions on normal commercial terms with money lending institutions – a normal mortgage from a bank, for example.

5. Firms, their partners and staff should not make loans to, or guarantee the borrowings of, any audit client, or vice versa.

### Family or other close personal or business relationships

1. An officer (such as a director) or employee of an audit client, or a partner or employee of such a person, is prohibited from accepting appointment as auditor of that client. Problems can also arise if an officer or senior employee of an audit client is closely connected with a partner or senior staff member responsible for the conduct of the audit (or anyone closely connected with them).

2. Closely connected persons generally include minor children and spouses. In this case, adult children and their spouses, siblings, and any other relative to whom regular financial assistance is given (or who is otherwise indebted to the partner or employee) are also included.
(3) A member should not personally take part in the audit where he or she has been an officer or employee of a company within the two years prior to the commencement of the first day of the period reported on.

IV Other services

(1) A firm should not participate in the preparation of the accounting records of a company listed on a stock exchange or a public interest company except in relation to the finalization of the statutory accounts (assistance of a mechanical nature) or in an emergency situation.

(2) Where a firm does provide such assistance to a smaller firm, care should be taken not to take on management functions, to ensure that the client accepts responsibility for the accounting records, and to ensure that adequate audit tests are performed and properly recorded.

(3) A firm may advertise for and interview prospective staff for a client and produce a short list and recommendations, but the client must make the final decision.

(4) A firm should not audit a client’s financial statements which include the product of specialist valuations performed by the firm (such as the valuation of intangible assets or pension funds).

(5) Where a firm provides other services to audit clients, it is important that the audit team should be entirely independent of the team providing the other service. One method of achieving this is by setting up internal structures whereby the two teams do not communicate with one another.

ISA 300

Answer 1

A Materiality

Financial statements are materially misstated when they contain errors or irregularities whose effect, individually or in the aggregate, is important enough to prevent the statements from being fairly presented. In this context, misstatements may result from misapplication of applicable Accounting Standards, departures
from fact, or omissions of necessary information. ISA 320, Audit Materiality, requires auditors to consider materiality when determining the nature, timing and extent of audit procedures. In complying with this requirement ISA 320 recommends that auditors make preliminary judgements about materiality levels in planning the audit at the following two levels:

- The financial statement level (overall materiality), because the auditors’ opinion on fair presentation extends to the financial statements taken as a whole.
- The account balance level (testing materiality), because the auditors verify account balances in reaching an overall conclusion that the financial statements are fairly presented.

The overall level of materiality and the nature of account balances enable auditors to determine which account balances to audit and how to evaluate the effects of misstatements in financial information as a whole. Materiality at the account balance level assists auditors in determining what items in a balance (or transactions class) to audit and what audit procedures to undertake; for example, whether to use sampling or analytical procedures.

**Materiality at the overall financial statement level**

There may be more than one level of materiality relating to the financial statements. For the income statement, materiality could be related to revenue or to profit (usually before tax). For the balance sheet, materiality could be based on shareholders’ equity, assets or liability class totals.

In making a preliminary judgement about materiality auditors initially determine the aggregate level of materiality for each financial statement. For example, it may be estimated that errors totalling $100,000 for the income statement and $200,000 for the balance sheet would be material. For planning purposes, the auditors should use the smallest aggregate level of misstatement considered to be material to any one of the financial statements. This decision rule is appropriate because the financial statements are interrelated and many audit procedures pertain to more than one statement. For instance, the audit procedure to determine whether year-end credit sales are recorded in the proper period provides evidence about both accounts receivable (balance sheet) and sales (income statement).

ISA 320 offers no guidance for determining this relationship but, where an item has an effect on profit, a widely used rule of thumb states that:
Other commonly used bases, and materiality thresholds expressed as a percentage of that base, are as follows.

<table>
<thead>
<tr>
<th>Materiality threshold (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue</td>
</tr>
<tr>
<td>Gross profit</td>
</tr>
<tr>
<td>Total assets</td>
</tr>
<tr>
<td>Equity</td>
</tr>
</tbody>
</table>

Qualitative considerations

The emphasis in planning materiality is on quantitative considerations. ISA 320 acknowledges that in designing the audit plan, the auditor establishes an acceptable materiality level so as to detect quantitatively material misstatements. Since the errors are not yet known, their qualitative effect can be considered only during the testing phase of the audit, as evidence becomes available.

Qualitative considerations relate to the causes of misstatements or to misstatements that do not have a quantifiable effect. A misstatement that is quantitatively immaterial may be qualitatively material. This may occur for instance, when the misstatement is attributable to an irregularity or an illegal act by the entity. Discovery of either occurrence might cause the auditors to conclude there is a significant risk of additional similar misstatements. Although it is suggested that the auditors should be alert for misstatements that could be qualitatively material, it ordinarily is not practical to design procedures to detect them.

Materiality at the account balance or transaction class level

Account balance materiality – Tolerable error per ISA 530 - is the maximum misstatement that can exist in an account balance for it not to be considered materially misstated. In making judgements about materiality at the account balance level, the auditors must consider the relationship between it and financial statement materiality. This consideration should lead the auditors to plan the audit to detect misstatements that may be immaterial individually but that may be material to the financial statements taken as a whole when aggregated with misstatements in other account balances.
When the auditors’ preliminary judgements about financial statement materiality are quantified, a preliminary estimate of materiality for each account may be obtained by allocating financial statement materiality to the individual accounts. The allocation may be made to both balance sheet and income statement accounts. However because most income statement misstatements also affect the balance sheet and because there are fewer balance sheet accounts, many auditors make the allocation on the basis of the balance sheet accounts.

Allocating overall materiality to accounts is heavily dependent on the subjective judgement of the auditors. The auditors’ judgement may be influenced by qualitative considerations. Materiality in auditing cash balances may be set at a much lower level than materiality in auditing intangible assets. Cash is known to be capable of precise determination and is critical to the liquidity of the entity; intangible assets, on the other hand, are known to be incapable of precise valuation and users are unlikely to be misled by a relatively large misstatement in the reported amount.

**B  Direction, supervision and review**

**Direction**

An important function in planning the audit is the generation of material necessary for the direction of staff assigned to the audit. Staff need to receive adequate guidance as to the nature of the business and, in particular as to any specific matters affecting the audit determined during the planning phase, such as recent or proposed changes in the nature of the business, its management or its financial structure. Assistants assigned to an audit must receive direction as to such matters to enable them to carry out the audit work delegated to them.

A principal purpose of planning is determining the mix of tests of controls and substantive procedures and the nature, timing and extent of those procedures. The results of the plan are documented in an audit program which specifies the individual procedures to be performed in sufficient detail relative to the experience of the staff assigned to the engagement.

**Supervision**

The assignment of staff to the audit as part of the planning process should ensure that they are subject to an appropriate level of supervision. The more junior or inexperienced the staff, the more supervision they will require. On small audits supervision is usually in the form of daily contact with the staff members at the client’s
premises by a supervisor, usually the audit manager; with regular visits to the clients’ premises during the course of the audit. On larger audits there will be a hierarchy of staff at different levels each with responsibility for supervising the work of assistants assigned to them. During the course of the audit supervisory staff should regularly monitor the work of assistants to ensure that:

- they understand the requirements of each procedure in the audit programme to which they are assigned
- they have the necessary skills and competence to perform their assigned tasks
- the work performed is in accordance with the requirements of the audit programme.

In addition, supervision should ensure that any important matters discovered during the audit are promptly dealt with and the audit programme modified as necessary. The supervisor should also monitor the time spent on each phase of the audit against time budgeted during the planning phase. Significant variances could indicate problems in the performance of the audit.

**Review**

Supervision also involves review of the work performed. All work must be reviewed to ensure that:

- the work has been performed in accordance with the programme
- the evidence has been properly documented
- all outstanding matters have been satisfactorily resolved
- conclusions drawn are consistent with the evidence and support the audit opinion.

In addition to the review of evidence obtained in accordance with the audit programme, there needs to be a review at a higher level of more significant audit decisions made. These include a review of:

- the audit plan and audit programme
- the assessment of inherent and control risk and the proposed audit strategy
- reviews of the working papers undertaken by staff at an appropriate level of responsibility
- the proposed audit opinion based on the overall results of the audit process.
On smaller engagements this review may be undertaken by the manager; with oversight by the engagement partner that the review has been properly conducted. On larger audits the final review will be carried out by the partner. On certain audits it is considered desirable for a second partner, not otherwise involved in the audit, to perform an additional review before issuing the auditors’ report. This is sometimes referred to as a hot review.

**Answer 1**

**1. Investment**

**A  Effect on audit risk**

This transaction affects inherent risk at both a specific account balance level and at the entity level. At the level of the account balance ‘investments’ there is the risk that the value of the investment may be misstated. At the entity level there is the risk that transactions between Five Dock and Burwood may not be fairly presented. Moreover, there is the possibility that the Chairman is not acting wholly in the interests of Five Dock shareholders.

**B  Design of audit procedures**

Transactions between Five Dock and Burwood are now known to be between related parties. There is a possibility they may be deliberately structured to distort reported results in either or both companies. Such transactions need to be subjected to extra scrutiny to ensure that their disclosure and the valuation of resultant assets and liabilities are consistent with fair presentation.

**2. Development**

**A  Effect on audit risk**

There is an increased inherent risk at the level of the account balance of deferred development costs in that its valuation is subject to a considerable degree of uncertainty.

**B  Design of audit procedures**

The auditors will need to obtain sufficient appropriate evidence as to the valuation of any amount carried forward as deferred development cost in respect of project 21A at the year end. If the
project is not completed, the projected future costs to complete will need to be carefully reviewed to ensure the expected total project cost is reliably estimated. The forecast of revenues expected to be generated by the project will also need to be carefully reviewed as will the viability of the product. If there are significant uncertainties it may be necessary to seek the advice of an expert. If there is any doubt that future revenues will not substantially exceed the total costs of the project, including costs to complete, the valuation of deferred development costs must be written down if not written off completely.

(3) **Bonus**

A  **Effect on audit risk**

A profit related bonus puts pressure on management to achieve a high profit. This increases inherent risk at the entity level.

B  **Design of audit procedures**

All account balances involving a substantial degree of management estimation will need to be carefully reviewed. Allowances, such as for bad and doubtful debts and for inventory obsolescence, are all likely to be reduced. Although individual reductions may be unexceptional the auditor will need to consider the cumulative effect. There may even be pressure to distort cut-off such as by holding open the sales journal or delaying the issue of credit notes. The level of substantive testing in all such areas may need to be increased relative to previous years.

(4) **Internal audit**

A  **Effect on audit risk**

The introduction of an internal audit function will improve the assessment of the control environment. If control risk assessments were affected by concerns over the control environment, introduction of an internal audit function may enable control risk assessment to be reduced. Assessment of control risk over specific assertions relating to transactions or balances may be further reduced depending on the specific tasks assigned to internal audit.

B  **Design of audit procedures**

In order to confirm the reduction in control risk the audit plan will need to include procedures for assessment of the adequacy of the internal audit function.
If internal audit is satisfactorily evaluated, it may prove possible to co-ordinate internal and external audit activities so as to reduce the level of substantive procedures performed by the external auditors. The audit plan will need to identify procedures to which this might apply and to include procedures to evaluate the specific work of internal audit in those areas.

(5) **Gearing ratio**

**A  Effect on audit risk**

The requirement to maintain the gearing ratio below a certain limit puts pressure on the company which increases inherent risk at an entity level. Gearing has already risen substantially for the year to date. Poor profit performance will reduce shareholders’ equity and thus increase gearing even further.

**B  Design of audit procedures**

If the gearing ratio rises above the agreed level, the loan may have to be repaid. The auditors will need to pay special attention to the directors’ assessment of the company’s future as a going concern particularly if gearing rises and the loan has to be repaid.

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**Parker**

**Answer 2**

**A  According to ISA 200 Objective and general principles governing an audit of financial statements:**

**Audit risk**

Audit risk is the risk of giving an inappropriate opinion on the financial statements; for example failing to qualify when the financial statements contain a material error. Audit risk has three individual components in the formula:

\[
\text{Audit Risk} = \text{Inherent Risk} \times \text{Control Risk} \times \text{Detection Risk}
\]

**Inherent risk**

This is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming there are no related controls.
Control risk

This is the risk that the internal control system will fail to prevent or detect a material error. The auditor’s preliminary assessment of controls will help determine control risk.

Detection risk

This is the risk that the auditor will fail to detect a misstatement that exists in an assertion that could be material. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessment of the risk of material misstatement at the assertion level.

B.

Audit risks

Over-trading

The turnover of Parker is growing quite rapidly, although this growth is not matched in net profits. The company has been expanding into the Internet, and plans to introduce other product lines for sale in this division. There is the risk that the business will exhaust any cash reserves as it continues to expand but does not generate sufficient additional cash to pay for that expansion. In this situation suppliers may go unpaid and at the extreme the business will be forced into liquidation. Therefore the financial statements may not adequately disclose doubts about going concern.

Internet trading

The decision to expand the Internet business may cause other problems for Parker. Selling of books and CDs appear to be related as they are both forms of entertainment and the customer knows what the product is like. Selling toys may fall into a similar category, but garden furniture and clothes are different. Garden furniture is bulky and will certainly cost more to deliver while clothes are sold more on taste and a high level of returns can be expected. Specific risks with this decision therefore relate to:

– the overall ability of management to run the business given their apparent lack of knowledge of Internet trading
– the need to setup and manage systems for the sales of many new products
– the need to allow for a much larger volume of returns
the possibility of inventory obsolescence if Parker overstocks on clothes which go ‘out of fashion’.

Control environment

The whole environment in which the control systems should be operating appears weak. There are errors in the systems, the extent of which are not known, and the directors and the accountant do not appear to be inclined to attempt to remedy the situation. The skills of the accountant may also be questioned because he appears to have been appointed not on merit, but from some personal relationship with the directors. Other errors may also have occurred which have not been detected. The risk is that the financial statements may have material errors in them.

Bank loan

The directors require additional finance to expand the business. To provide this finance it is likely that the bank will require sight of the audited financial statements; the directors of Parker expect the audit to be completed prior to meeting the bank. The auditor may need to write to the bank to disclaim reliance on the audit report for the purposes of making a bank loan. There is a risk to the audit firm of being sued if the bank relies on the report and sustains financial loss. There is also a risk to Parker that the loan is not obtained and the company goes into liquidation. The financial statements may need to be prepared on a breakup basis.

First year of audit

The audit is also risky for the audit firm because it is the first year of an audit and the client has expectations about the type of auditor’s report to be produced. The accounting systems also appear to be unreliable, again increasing the risk of material error. The audit firm must ensure that sufficient time and resources are allocated to the audit to ensure that the audit opinion can be supported. Pressure from the directors to complete the audit quickly will have to be resisted.

Going concern work

Review the financial position of the company in detail. Budgets and cash flow forecasts showing income and expenditure for at least the next 12 months must be reviewed. The accuracy of these forecasts can be determined in part by checking how accurate past forecasts were. If the directors have not produced this information, then the auditor will ask them to produce it.
If not already done so, obtain a standard audit bank confirmation letter. Check the letter for overdraft and loan facilities to ensure that they have not been exceeded. Also check review dates (although it appears this will be three months after the end of the year) and confirm with directors what accounting information will be expected at these dates.

Review correspondence with the bank for signs of strain with the bank. A poor relationship implies that further loans may not be granted and alternative finance will be required. However, it is unlikely that any details of the relationship with their client will be provided by the bank.

Make enquiries with the directors regarding the availability of other finance which will be necessary for the planned expansion. Obtain supporting evidence for this finance, such as letters confirming amounts available and interest rates payable.

As close as possible to the date of the auditor’s report, review the most recent management accounts to help determine the extent of any additional finance required.

Obtain a letter of representation from the directors confirming their responsibility for preparing cash flow forecasts and for the overall going concern status of Parker.

Use all the evidence obtained to take a view on the going concern status of Parker and review the adequacy of disclosure (if any) in the accounting policy note to the financial statements.

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**Internal control – Cosmo**

**Answer 1**

A  **Errors and misappropriations**

Errors and misappropriations that may occur if purchases and capital expenditure are not properly controlled include:

I  purchases for goods and capital items the company cannot use resulting in wasted resources and operational difficulties

II  not obtaining the best prices available

III  purchases for goods and capital items for the personal use of staff (i.e. misappropriation)

IV  incorrect recording and classification of purchases and capital items
V non-payment for, or overpayment in respect of, purchases and capital items
VI payment for purchases and capital items not received due to suppliers issuing fictitious invoices
VII purchase of goods and capital items from suppliers with whom internal staff collude to pay inflated prices (segregation of duties is necessary to prevent this).

B Report to management

I Weakness and consequences: The overall structure of the system is complex, resulting in wasted management time in classifying purchases and capital items.

Recommendation: That the systems should be simplified to avoid management time being spent on what are essentially clerical duties. The budget setting process should be more realistic to avoid the need to classify capital items as purchases.

II Weakness and consequences: There is an out of date ordering system and an informal method of inputting changes. This results in wasted time in correcting orders produced automatically.

Recommendation: That the system be updated - the time spent making adjustments is almost certainly greater than the time it would take to update the system.

III Weakness and consequences: Buyers’ consortium system and changes to orders: changes to orders are made by the production controller’s junior managers and the buyers’ consortium system can only be used by them. This represents a lack of segregation of duties, those with access to the assets (those involved in production) should not also be able to execute the transaction (which should be done by the buying department). Whilst collusion with the buyers’ consortium seems unlikely, it is possible that goods the company does not need could be purchased.

Recommendation: That the buying department take over the responsibility for dealing with the buyers’ consortium and that staff operating the system are properly trained in its use.

IV Weakness and consequences: The buyers’ consortium system is taking up a large amount of system space and may be causing problems with other systems.
Recommendation: That additional space be made to accommodate the system and that the software is investigated by systems engineers to establish the optimum technical solution.

Weakness and consequences: Only part of the buying takes place using the consortium which may be inefficient.

Recommendation: That a review of the effectiveness of the use of the consortium be undertaken to establish whether to move more purchasing to the system.

Weakness and consequences: The systems for budgeting and authorising capital expenditure and purchases are structurally weak as staff appear to find it necessary to circumvent the rules in order to do their jobs; the systems are also operating inefficiently as unauthorised capital expenditure is regularly incurred. It appears on the face of it that the structural problems are giving rise to the operational difficulties, although the operational difficulties may be independent of the structural weaknesses.

Recommendation: That the structure and operation of both of the systems be reviewed in detail in the light of the operation of the business as a whole.

Note: Answers might also be presented in a columnar format.

Confirmations

Answer 1

A  Management representations

Evidence

Auditors obtain written representations from management on material matters where other sufficient appropriate audit evidence cannot reasonably be expected to exist. ISA 580 ‘Management Representations’ deals with this subject.

Such matters might include confirmation that all related party transactions have been disclosed in the financial statements and confirmation of all matters that rely principally on the exercise of judgment by directors – such as ‘soft’ provisions.
The letter also usually includes confirmation that all matters occurring since the balance sheet date that should be brought to the attention of auditors have been brought to their attention, and that all of the accounting records have been made available to the auditors.

III Management representations should not conflict with other audit evidence. If they do, the matter should be investigated and resolved.

**Practical difficulties**

IV In practice, it is not always easy to obtain a signed management representation letter. The letter should be addressed from the client to the auditor, but it can take the form of a letter from the auditor to management that is acknowledged by management, or signed minutes of a board or similar meeting.

V If management refuse to provide representations, this may be grounds for a qualification of the audit report on the basis of a limitation in the scope of the audit. However, this is an extreme step and auditors will always discuss with directors alternative wordings that will be acceptable to them before considering qualification of the audit report. There may be genuine uncertainty on the part of management as to the reasonableness of the representations that auditors request them to make.

**Alternative evidence**

VI Unfortunately, because of the content of these letters, there is very little alternative evidence; that is why the letter is requested in the first place.

VII Auditors need to think carefully about the content of the letter if management refuses to sign altogether, and consider whether there is alternative evidence, whether the matters are truly material and whether an audit qualification is needed. Auditors can exert some pressure on management to sign by making this threat, in practice.

**B Direct confirmation of receivables**

**Evidence**

I Auditors often seek direct confirmation of receivables to ensure that the amounts stated in the entity’s accounts receivable ledger are not overstated. Confirmation also provides evidence in relation to certain frauds and the quality of internal controls.
II Confirmation that an amount is owed is not confirmation that the amount will be paid and auditors need additional evidence on the recoverability of receivables.

III There are two types of confirmation, positive and negative. In the former case, the customer is requested to reply in any case, and the auditor can either insert the balance to be confirmed or the customer can be requested to do so. In the latter case, a reply is only requested if the customer disagrees. This method is only suitable where receivables are well-controlled.

Practical difficulties

IV The response rate to requests for confirmations is not always satisfactory and repeated requests may be necessary. It is not uncommon for replies to be inaccurate, especially where the amount stated is too low.

V Where the customer is requested to insert the balance, the reconciliation can sometimes be very difficult, even with the help of the client, and the customer’s assistance may be needed.

Alternative evidence

VI Where no reply is received it is important that alternative evidence is obtained on the same balance (and not to test another balance). Where there is a discrepancy between the client’s records and the customer’s records, the matter should be investigated and resolved.

VII Sometimes, the customer can provide a reconciliation, particularly if the matter only relates to timing differences. On other occasions there may be a dispute and a provision may be necessary.

VIII Alternative evidence for receivables includes payment of the amount after the period-end, a review of contracts and signed delivery notes, and analytical procedures on the ageing of receivables.

C Confirmation of inventory held by third parties

Evidence

I It is often not possible for auditors to confirm inventory held by third parties by attendance at an inventory count and therefore the only evidence available is confirmation from the third party.

II It is particularly important to ensure that the confirmation is genuine because of the possibility of fraudulent collusion between the third party and the client to inflate inventory and profit figures.
III  The reliability of service from the third party and the quality of documentation and correspondence are all taken account of as part of the auditor’s risk assessment in this area.

**Practical difficulties**

IV  Both the quality and quantity of inventory held should be confirmed. It is common for third parties to use different descriptions or units of measurement in their records to those used by the client and it is necessary to reconcile these items.

V  It may be possible for the auditor of the third party to provide some evidence in relation to the amounts held.

**Alternative evidence**

VI  If the inventory held by the third party is likely to be material, the auditor must consider the possibility of visiting the third party and attending the inventory count.

VII  The auditor may review and test the controls over the movement of inventory to and from the third party and the related records, in order to reduce the level of substantive evidence needed at the period-end.

VIII  Records that show ‘negative’ inventory (more ‘outs’ than ‘ins’) at either the client or the third party may be indicative of misclassifications, for example.

**Reports provided by auditors of service organizations**

**Evidence**

I  Where an entity has out-sourced a significant element of its accounting function to a third party, as is increasingly common, the auditor may be forced to assess control risk as high in that area unless he can perform tests of control.

II  In testing controls, it may be appropriate for auditors to obtain a letter from the auditors of the service organization. Such letters confirm either the suitability of the design of the system, or the suitability of the design of the system and its operating effectiveness.

III  Only where the latter type of report is obtained can the auditors reduce their assessment of control risk and perform reduced substantive testing. The auditors should also consider the competence and experience of the service organization’s auditors.
Practical difficulties and alternative evidence

IV The alternative is to visit the service organization in order to perform tests of controls, although this may be impracticable because it might be located on the other side of the world, for example. It may also be costly because it will be necessary for the auditors to obtain a working knowledge of the third party’s system before it can be tested. Such systems can be complex.

V Auditors have no right to visit the third party or test controls there; if it is considered absolutely essential to do this, the client may have to bring pressure on the third party to permit it.

VI In practice, a client that has out-sourced a significant element of its accounting (or other) functions to a third party may well have made arrangements in respect of auditors as part of the contractual arrangements with the third party.

Methods of obtaining audit evidence

Answer 1

A Advantages and disadvantages

Analytical procedures

Advantages

(1) The main advantage of analytical procedures is that they can be used at all stages of the audit to enquire into the absolute amounts to be included in the financial statements, and into the relationships between those amounts.

(2) Analytical procedures are a good test for the overall reasonableness of an amount. They can be used on a global basis, and they can be split down into their constituent elements.

(3) Analytical procedures enable the auditor to make comparisons on a continuous basis, taking prior years into account, and providing the auditor with a better understanding of both the business as a whole, and of individual account areas.
Disadvantages

(1) Analytical procedures often have to be performed on management accounts, or draft or incomplete accounts before the final financial statements have been prepared. This means that significant adjustments, which are often made at a late stage, are not taken into account.

(2) Without a prior and proper understanding of the business, the auditor may be tempted to accept the results of analytical procedures that show no unusual variations as evidence that there is nothing wrong, which may not be the case if there have been significant changes in the business of which the auditor is unaware (and which management may wish to hide from the auditors).

(3) Auditors may also be tempted to accept ‘plausible’ explanations for changes and variations without much further substantiation, where further investigation may actually be warranted.

Advantages

(1) Audit sampling enables the auditor to draw conclusions about a population without testing all of the transactions or balances in the population as a whole.

(2) Audit sampling also enables the auditor to concentrate on high risk or high value items, and to differentiate between elements of a population which may be subject to differing internal controls.

Disadvantages

(1) There is always a risk that the auditor's sample is not representative of the population as a whole (known as ‘sampling risk’). Auditors calculate and accept this risk, and perform other procedures to compensate for it, but it always remains a risk.

(2) Sampling relies on the use of judgement in relation to materiality, exceptions, and in drawing conclusions, for example. Judgement can be abused, or simply fail, particularly where staff are inexperienced.
III Tests of controls

Advantages

(1) Tests of controls enable the auditor to establish whether a control system in operation is effective. If properly designed controls are operating as prescribed, auditors can reduce the level of substantive testing required at the period-end.

(2) Tests of controls mean that auditors do not have to concentrate all of their efforts on substantive procedures at the period-end which would in many cases be impractical, inefficient and not cost-effective.

Disadvantages

(1) Tests of controls are often performed on a sample basis (disadvantages noted above).

(2) Tests of controls are often performed on routine transactions for which there are high quality automated controls. The very high risk areas in financial statements are often outside this area and relate to non-routine transactions and more intangible environmental or general controls which are not easy to test.

IV Detailed testing of transactions and balances

Advantages

(1) In detailed testing of transactions and balances, auditors are directly examining the figures and assertions that appear in the financial statements.

(2) Detailed testing enables the auditor to form a view as to whether the figures on which he is reporting are fairly stated and often involves third party, written confirmation which is a good source of audit evidence.

Disadvantages

(1) Detailed testing of transactions and balances is often performed on a sample basis (disadvantages noted above).
The level of testing of transactions and balances is determined by the level of comfort obtained by the auditor from tests of controls. If too much comfort has been obtained from tests of controls, it is likely that any error will be compounded by an inadequate level of testing of transactions and balances.

Computer assisted audit techniques (CAATs)

Advantages

(1) CAATs enable the auditors to test a large volume of data, or the operation of the controls in a system, accurately and quickly. They are therefore very-cost efficient when operated properly.

(2) CAATs reduce the level of human error in testing and enable a very high level of audit evidence to be derived.

(3) The use of CAATs frees up expensive human resources that would otherwise be engaged in routine, mechanical work to concentrate on judgemental areas.

Disadvantages

(1) CAATs are expensive to set up and require the cooperation of the client. It is usually necessary for a continuing audit relationship to be present before it is worth committing the audit resources.

(2) Major changes in client systems often require major changes in CAATs, which is expensive. If the audit fee is based on the assumption that the prior year's CAATs can be used, and a change is made without warning, the client may have unrealistic expectations about the level of service that can be provided for the fee.

Relationship between the methods of evidence gathering

I Analytical procedures are first used during the planning stage of the audit. Materiality levels and levels of tolerable error are often derived (at least in part) from analytical procedures. These are in turn used in audit sampling procedures.

II Analytical procedures help the auditor determine the audit approach (the levels and areas for tests of controls and detailed testing).

III The results of tests of controls determine the level of detailed testing of transactions and balances. Analytical procedures provide indirect evidence as to the effective operation of internal controls (if controls are working, analytical procedures may help prove that the population as a whole is fairly stated).
Detailed tests of transactions and balances are often performed towards the end of the audit in conjunction with analytical procedures – analytical procedures compensate to an extent for the weaknesses in sampling procedures both for tests of controls and detailed testing of transactions and balances (and vice versa).

Sampling is used for both tests of controls and detailed testing of transactions and balances. Where CAATs are used, sampling may not be necessary because CAATs can often be used to test the whole population, either for tests of controls, or for detailed testing of transactions and balances.

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**Calva**

**Answer 1**

A.

1. **Objectives and how they are met: overall review of financial statements**

   (1) **The objective of a review of financial statements is to provide the auditor with sufficient audit evidence, when taken together with the conclusions drawn from the other audit work, to form an opinion on the financial statements.** This includes determining whether the information in the financial statements is properly presented and disclosed in accordance with accounting standards, legislation and other regulatory requirements. Calva is a listed company and will therefore have to comply with stock exchange disclosure requirements. The usual means of achieving this is by the completion of a disclosure checklist.

   (2) **Auditors should consider the appropriateness of accounting policies in particular and whether they have been consistently applied, particularly where changes have been made.** There is no indication that any such changes have been made.
Auditors should also consider whether the financial statements as a whole are consistent with the auditor's knowledge of the business. This involves consideration of the aggregate effect of uncorrected misstatements, any overall bias in presentation and will involve analytical procedures on the final financial statements. This exercise involves the application of professional judgement and in the case of Calva, it is likely to be carried out by the senior manager and/or the audit engagement partner with the assistance of the audit manager.

Objectives and how they are met: review of working papers

1. The objective of a review of working papers is to ensure that all work has been properly planned, executed and recorded and that all outstanding matters have been followed up.

2. In the case of Calva, it is likely that some work will have already been reviewed. It is common for audit seniors and audit managers to review the work of audit juniors, and for senior managers and partners to review the work of managers and seniors. There will also be a final partner review of the file.

3. Where working papers are prepared manually, staff normally evidence review of working papers by means of initialling the working paper. Review comments are referred to the person preparing the working paper or to the partner where significant matters of judgement are concerned. Where papers are prepared electronically, electronic ‘signatures’ can be used.

4. It is important that a detailed review of working papers takes place in areas that are critical to the audit. In this case, critical areas are likely to include inventory (despite the fact that it is well-controlled, it is still a material item), cash and non-current assets.

5. It is also important during the final stages of the audit of Calva that all outstanding areas (i.e. the substantive areas) are completed, reviewed and any issues arising followed up. It is very easy for apparently insignificant matters to ‘slip through the net’ at this stage where both auditors and client are under pressure.
B.

Responsibilities

ISA 560 Subsequent Events deals with this issue.

(1) Auditors should perform procedures designed to obtain sufficient appropriate audit evidence that all material subsequent events up to the date of the audit report which require adjustment or disclosure in the financial statements have been properly dealt with.

(2) If matters requiring adjustment or disclosure are discovered after the date of the audit report but before the financial statements are issued, or after they have been issued but before they have been presented to members, or even after they have been presented, auditors should ascertain whether and how any necessary changes are to be made to the financial statements.

(3) The decision as to whether financial statements should be changed is that of the directors. Auditors cannot ‘change their minds’ once the audit report has been signed but if new financial statements are issued they can issue a new audit report. If auditors consider that the financial statements contain material errors, or are misleading, they can exercise their right to speak at general meetings and to make written representations to members.

(4) If matters are discovered long after the financial statements have been issued, it is common to deal with the matter as a prior period adjustment in the subsequent financial statements.

Subsequent events review procedures

(1) These include making enquiries of management as to how they have ensured that subsequent events have been identified, although it is likely that in this case the company will rely on the audit firm to help them with this.

(2) Auditors will read the minutes of management, shareholders and other meetings and review relevant accounting records. In this case, they are likely to review any budgets or cash flow forecasts. It is likely that these will have been prepared as a result of the negotiations with the bank.
In the case of Calva, the auditors are likely to enquire as to the possibility of any new share or loan issue to fund the expansion which may require disclosure. They may also enquire as to any significant changes in the property market that might (if the supermarket properties are carried at valuation) require either disclosure or adjustment in the accounts.

Auditors will also consider the need for disclosure of significant leasing transactions occurring early in the following year.

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**External auditor responsibilities – going concern**

**ISA 570 Going Concern**

A.

1. Auditors are required to consider the going concern status of companies and any disclosures regarding going concern in forming their audit opinion. Companies that are listed on stock exchanges may be required to make additional disclosures in relation to going concern issues.

2. Auditors are required to assess the adequacy of the means (the processes) by which directors have satisfied themselves that the going concern basis is appropriate and that adequate disclosures have been made. Auditors conduct an initial analysis at the planning stage of the audit as well as assessments at later stages.

3. Auditors should make enquiries of the directors and examine appropriate documentation supporting the company’s going concern status such as budgets and cash flow forecasts.

4. Auditors consider whether the period to which directors have paid particular attention is adequate. This should normally be at least 12 months from the balance sheet date. Auditors also enquire of management as to their knowledge of events or conditions beyond this period that may cast significant doubt on the entity’s ability to continue as a going concern.
V Auditors need to consider the appropriateness of assumptions which directors have made, the sensitivity of assumptions to external and internal changes, any obligations, guarantees or undertakings arranged with other entities, the existence and adequacy of borrowing facilities and the directors’ plans to deal with any going concern problems.

VI Auditors are required to document the extent of any concerns, taking account of matters that have come to their attention during the course of the audit and in particular, financial, operational, or other indicators of going concern problems that are present.

VII Indicators of going concern issues would include trading losses, impairment of assets, net liabilities, defaults on loans, liquidity problems, an inability to refinance loans where necessary, fundamental changes in the markets or technology having an adverse effect on the company, loss of management, staff, customers or suppliers, or major litigation, for example.

VIII Auditors should consider the need to obtain written management representations.

IX Auditors should consider the adequacy of any disclosures in the financial statements.

B Possible audit reports and circumstances

I Where the auditors consider that there is a significant level of concern about the entity’s ability to continue as a going concern (but do not disagree with the going concern basis), and where adequate disclosures of the situation are made, they modify (but do not qualify) their opinion by including an ‘emphasis of matter’ paragraph highlighting the existence of a material uncertainty as to the going concern status of the entity and drawing attention to the relevant note in the financial statements.

II Where the period to which directors have paid particular attention is less than 12 months from the balance sheet date, the auditors should consider the need to modify the audit report as a result of a limitation in the scope of the audit.

III Where the auditors disagree with the preparation of the financial statements on the going concern basis, they should issue an adverse opinion. This is very rare because auditors rarely have sufficient evidence to be sure.

IV If the auditors are unable to form an opinion on the going concern status of a company because of a limitation in the scope of the audit, they will issue an ‘except for’ opinion, or ‘disclaimer of opinion’ – but this is unusual.
C Report issued to Corsco

I In the case of Corsco, there are some indicators of going concern problems. However, the company may still be a going concern and the fact that the company has been approached by take-over bidders does not necessarily mean that there is a going concern problem (possibly quite the opposite).

II The audit opinion issued on Corsco in the current year is not likely to make reference to the going concern status of the company, as in previous years. The situation has not deteriorated significantly in the current year and it will be difficult for auditors to justify any change in their opinion from previous years.

D Difficulties associated with reporting on going concern

I If the auditors of Corsco were to report on a going concern problem, the mere act of reporting might of itself create a going concern problem (a ‘self-fulfilling prophecy’). This is particularly the case with large ‘blue-chip’ companies where the issue of an audit report that is modified in any way is unusual and might well cause the company’s share price to drop, thus precipitating a going concern problem.

II This means that it is very difficult for companies such as Corsco and their auditors to send out any clear signal to the markets without running the risk of creating a panic.

III However, recent events show that the consequences of companies and auditors failing to report where severe financial difficulties are encountered can be disastrous for both the company (its employees and shareholders) and auditors alike.

IV Auditors are failing in their professional duties if they do not report on going concern problems of which they are aware; however, situations involving large companies are rarely clear cut and auditors who propose to make any changes at all to the audit report are likely to encounter fierce resistance from management who may genuinely believe that to make such a report would be wrong.

V In the company’s annual financial statements, it is not the place of the auditor of Corsco to substitute his judgement for that of directors. However, where large companies involved in complex financing arrangements are concerned, auditors may have to fight hard against vested and powerful interests if they disagree with the directors’ judgements and decide to make reference to the matter in the auditor’s report. An auditor making reference to going concern issues in an audit report in many such circumstances will probably lose the audit (and any other work) and may run a significant risk of litigation.
Preparation of financial statements

The directors are normally required to prepare the financial statements of the company using the appropriate law of their country and in accordance with Statements of Standard Accounting Practice (SSAPs) and Financial Reporting Standards (FRSs). The auditors are normally required to check or audit those financial statements, again in accordance with company law and Statements of Auditing Standards.

Fraud and error

The directors are responsible for preventing and detecting fraud and error in the financial statements, no matter how immaterial this may be. Auditors are responsible for ensuring that the financial statements show a true and fair view; in other words that the financial statements are materially correct. Auditors are not required to detect immaterial fraud or error.

Disclosure

The directors must ensure that there is adequate disclosure of all matters required by statute or SSAPs or FRSs in the financial statements. The auditor will check that disclosure provisions have been complied with, and where certain disclosures have not been made (e.g. regarding related party transactions) provide this information in the audit report.

Going concern

The directors are responsible for ensuring that the company will continue in operational existence for the foreseeable future, and report to the members in the published financial statements if this is unlikely to be the case. The auditor will check the accuracy of the directors’ workings and assumptions and if these are considered incorrect or inappropriate, then the audit report may be qualified to bring the situation to the attention of the members of the company.

The basis of opinion paragraph may not be satisfactory for the following reasons:

The use of the term Auditing Standards is not clear, because the report does not state which auditing standards have been used. This provides uncertainty regarding the actual standard of work performed.
The assessment of estimates and judgements made by the directors normally relates to significant amounts only, rather than all of those estimates and judgements. The use of the word all implies that the audit was more thorough than it probably was. Replacing the word all with the word significant will show that there was some limit to the audit testing.

Stating that time was a factor in obtaining information and explanations for the audit is not correct as this implies some factor which could have been avoided and that the audit may therefore be incomplete. The auditor has to plan the audit carefully and ensure that all the information and explanations considered necessary are obtained to form an opinion, not simply stop work when time runs out.

The auditor does not confirm that the financial statements are free from material misstatement as this implies a degree of accuracy that the auditor simply cannot provide. Making the statement could also leave the auditor liable to claims from members or third parties should errors be found in the financial statements later. Rather than make such a categorical statement, the auditor provides reasonable assurance that the financial statements are free from material misstatement, which clearly implies that audit techniques are limited.

The disclaimer regarding errors appears to be useful in that it limits the auditor’s liability. However, it does not belong in the basis of opinion paragraph as it appears to severely limit the basis of the auditor’s opinion to stating that the directors are responsible for all errors. Directors’ responsibilities are also clearly outlined in another section of the report, and this statement also appears to extend those responsibilities making the audit report overall less clear. This could also imply that the auditor has done little or no work.

As the auditor is not required to audit the whole of the annual report of a company, it is inappropriate to refer to disclosure in that report when checking overall adequacy of presentation. Adequacy of presentation can only be confirmed regarding items actually audited, which is basically the financial statements.

**C** A negative assurance report means that nothing has come to the attention of the audit, which indicates the financial information being reported on has errors in it. However, the extent of the work carried out is normally less, which means that less reliance can be placed on this report.
The advantages of providing negative assurance include:

- the user of the financial information receives some comfort that the information is correct, even though that assurance is less than positive assurance
- the report adds some credibility to the financial information because it has been reviewed by a professional accountant
- for the preparer, the report will be more cost effective than obtaining a full positive assurance report.